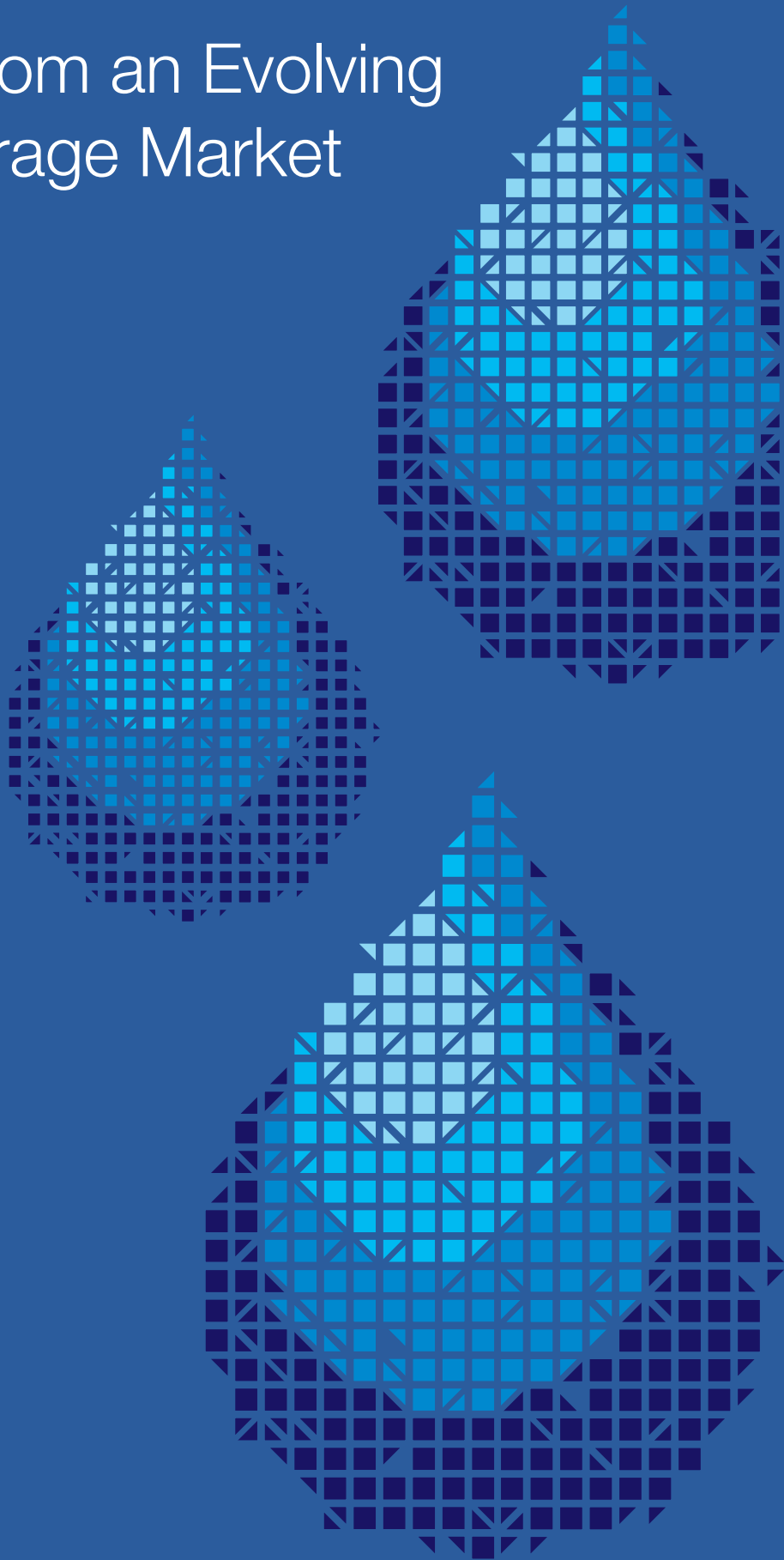


Tapping into New Opportunities: How to Benefit from an Evolving Water and Sewerage Market





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1. Introduction - A seismic change for the sector

With less than 12 months to go until the non-household market opens to full retail competition, the English water sector is preparing for a transformation that will change it beyond recognition.

The experience of the energy sector, which has been fully open for competition since 1998, highlights the potential scale of change involved. The fact that last year saw the highest switching rate among UK households in four years underlines how that market continues to evolve almost two decades on.

Where there is change, there is also opportunity and the introduction of a market for water means up to 1.2 million business customers will potentially be looking to switch to a new supplier.

This paper examines the background to the current UK water market and the challenges and opportunities for new entrants. It also looks at the benefits of different business models and market approaches and highlights the steps which need to be taken.



2. Market context

THE ENERGY SECTOR AS A REFERENCE

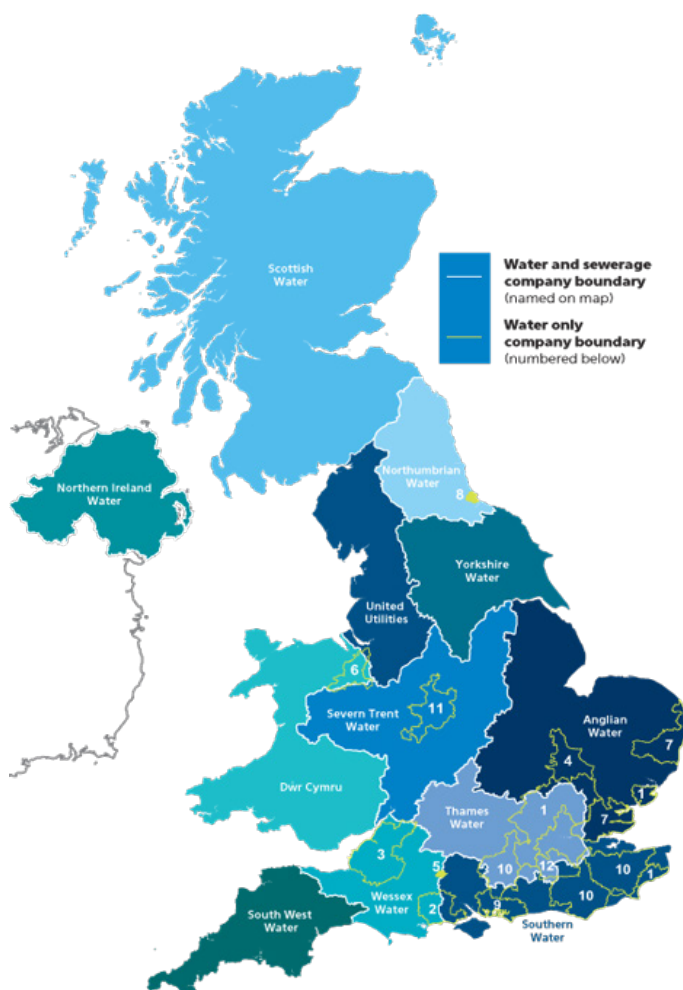
The gas and electricity sector is today a multi-billion pound market, with customers switching at a rate of over 500,000 per month. However, the introduction of competition into the UK gas and electricity markets in the 1990s had both supporters and opponents, and the process was a gradual one. Both industries changed significantly over that period with many businesses entering and others separating or restructuring.

Within the first ten years of market opening, at least 75% of customers (20 million households) had switched energy supplier at least once. From 2004 to 2015, the number of energy suppliers operating in the market had nearly trebled.

NEW ENTRANTS CONTINUING TO EMERGE

New entrants are continuing to emerge and taking ever larger slices of a market which has long been dominated by the ‘Big Six’ largest suppliers. The evolution in water to date has been more sedate, although the future may see the same pace of change.

As in the early days in electricity, new entrants in the English water market will face an initial position of strong regional incumbent monopolies, with over 20 Water and Sewerage Companies (WASCs), and Water Only Companies (WOCs) serving the vast majority of non-household customers within their geographical boundaries (see Figure 1 below).



Water only companies

1. Affinity Water
2. Bournemouth Water
3. Bristol Water
4. Cambridge Water (South Staffs)
5. Cholderton and District Water
6. Dee Valley Water
7. Essex & Suffolk Water (Northumbrian)
8. Hartlepool Water (Anglian)
9. Portsmouth Water
10. South East Water
11. South Staffs Water
12. Sutton and East Surrey Water

Water and wastewater companies

1. Anglian Water (Hartlepool Water)
2. Dwr Cymru - Welsh Water
3. Northern Ireland Water
4. Northumbrian Water
5. Scottish Water
6. Severn Trent Water
7. South West Water
8. Southern Water
9. Thames Water
10. United Utilities
11. Wessex Water
12. Yorkshire Water

Local water and wastewater companies

1. Albion Water
2. Independent Water Networks
3. Peel Water Networks
4. SSE Water
5. Thames Water Commercial Services
6. Veolia Water Projects

Figure 1: Current Water Market Structure



THE CURRENT WATER AND SEWERAGE MARKET

The Water Act 2014 has paved the way for full opening of the English water and sewerage retail market for non-household customers in April 2017. Market participants, including new entrants, now have less than six months to ensure they are ready for the shadow opening of the market in the autumn of 2016. Incumbent water and sewerage companies (WASCs) and water only companies (WOCs) have to consider whether they want to remain in the market within their own traditional geographical areas; expand into neighbouring territories and beyond; or exit the retail market altogether.

Companies outside the existing English market, such as those in the Scottish water retail market, other new entrants (start-ups) and companies operating in non-water sectors (other utility or retail players) will have been weighing up the benefits of entering the market and are developing their strategies, plans, products and services accordingly. A number of players in the Scottish market have already applied for licences in England.

Figure 2 below shows the key stakeholders and statistics in the current English water market.

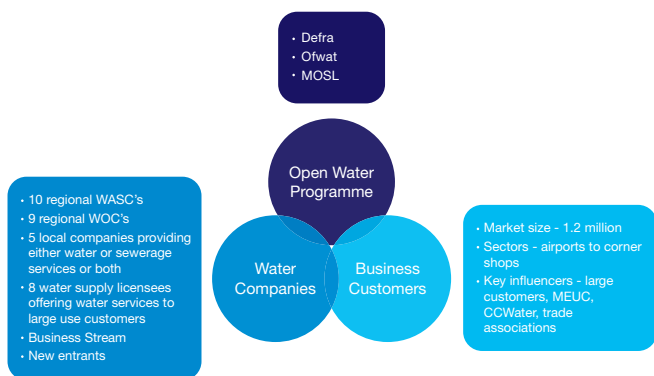


Figure 2: Key Players in the English Water Market

The current market is a complex mix of customer types ranging from airports to corner shops, large industrial sites to government offices and the charity sector. Different customers have different priorities from price, customer service and aggregated bills to value added services such as water efficiency measures (e.g. leak detection and reuse of water), and more complex services (e.g. trade effluent).

Their characteristics could be defined in a combination of the following segments:

- large commercial and industrial sites;
- single and multi-site customers;
- small medium size enterprises; and
- micro size customers.

The annual spend of these customers ranges from £100 to over £1 million, equating to 45m³ per annum for the lowest users to over 50,000m³ per annum for the highest. Given this range, as in all potential new business entry activities, it is essential to carefully consider customer needs, which will vary significantly among customer segments and appropriate marketing strategies.

Figure 3 overleaf shows the evolution of the UK Water market since 2005.

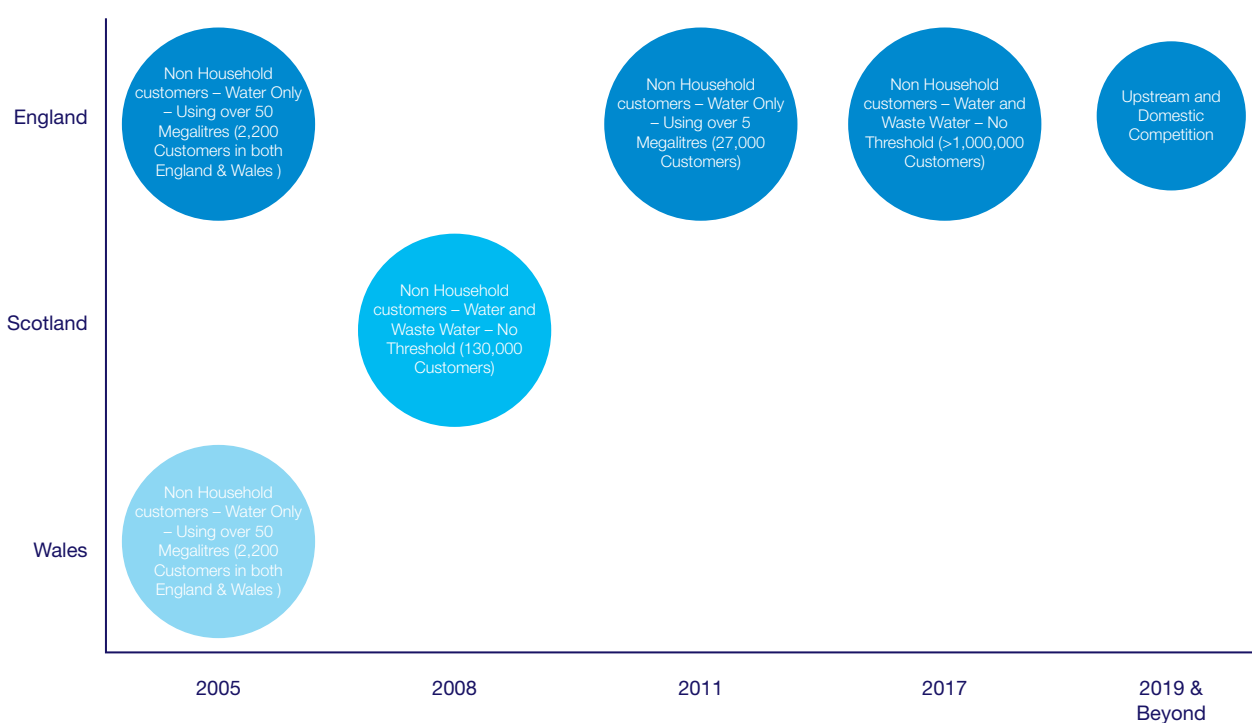


Figure 3: Evolution of retail competition for UK non-household customers

Currently, water competition in England only applies to the 27,000 larger water customers at individual sites, consuming over 5MI p.a. To date, only a limited number of switches have taken place and it is expected that, once the market fully opens in 2017, this will increase significantly. This partly reflects the increase in size as the full business market (circa 1.2 million customers) is eligible for competition. Also of importance is the move to more transparent charging arrangements, a consistent national set of market processes and the opportunity to tender for more sites within a group (i.e. including Scotland and England).

The new market arrangements will mirror many features of the Scottish water market and GB energy markets allowing competition in England to cover all eligible non-household customers and for competition to be extended into sewerage. In addition, the introduction of new licences, wholesale charging arrangements, market codes and rules, processes and procedures, data standards, and data exchange protocols will provide a foundation set of market arrangements for water which draws upon the experience gained in GB energy and Scottish water markets.

The new market rules will only apply in England, as the Welsh Government has decided not to extend retail competition in Wales beyond water customers using over 50MI p.a.



SCALE OF THE OPPORTUNITY

The opportunity for new entrants in water will be transformed by market opening, as the non-household market in England is estimated to be around ten times the size of the Scottish water market. The vast majority of customers take both water and waste water services from the same monopoly provider in a WASC area, or from two separate providers: water from a WOC and waste water from a WASC.

The market design draws upon the market arrangements in Scotland, with a central market agent managing the switching and settlement processes, and holding a central database of all eligible customers.

New entrants considering their marketing strategies will find important regional differences in the incumbent supply of water and sewerage. Figure 4 shows the distribution of non-households billed by the incumbent WASCs and WOCs. It is sorted by total number of customers and excludes Scotland and companies operating wholly or mainly in Wales. The table indicates the number of Non Household (NHH) customers billed for both water and sewerage. There are significantly different mixes of water and sewerage billing of NHHs by the WASCs dependent upon which WOC borders the WASC's territory and requires sewerage services to be billed. This situation also leads to geographical complexity and variations in tariffs and services, which new entrants will need to consider in their tariff and product strategies.

COMPANY	NHHs BILLED 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	-

Figure 4: Non Households billed by company 31 March 2014

Source: Water UK

FEATURE – SCOTLAND

- Until the English and Welsh water markets partially opened to competition, Scotland was the only country in the UK to have a competitive retail water market, opening in 2008.
- The Scottish market has seen a significant increase in new entrants and switching activity in recent years with the number of active players increasing from 6 to over 20.
- A key factor is that margins in Scotland are significantly greater than those in England, allowing more flexibility in terms of pricing offers.



- A number of English water companies are also using Scotland as an ideal market to set up and test their retail businesses; in effect to understand the switching process and other challenges prior to the opening of the English market in 2017.
- This market had been dominated by one player, Business Stream, the retail offshoot of Scottish Water but, in the past few years, its market share has dropped from over 90% to just over 50%.
- A number of Scottish (pure) new entrants have already indicated their intention to compete in England. These include Castle Water which has announced its takeover of Portsmouth Water's non household customer base; others have also applied for new licences in England.

GOVERNMENT AND REGULATORY ENVIRONMENT DEVELOPMENTS

A key objective of the UK Government for the market design is to deliver a seamless customer experience across the UK. The Open Water Programme, which has been overseen by a variety of stakeholder representatives, is delivering the market arrangements and has developed the Market Architecture Plan, which includes the various codes, processes and rules for the market's operation.

As well as providing the foundation for retail competition, the Water Act also presages the introduction of upstream water competition, which is not expected to be introduced before 2019. The UK Government has recently announced that it is keen to examine the case for the introduction of household competition, as part of a wider productivity initiative. Ofwat has been asked to provide an assessment by summer 2016 of the costs and benefits. A decision to open up the household market would expand the number of customers potentially able to participate in competition by eighteen fold.

In addition, Ofwat has recently indicated that it intends to open up the market for sludge services, aiming to stimulate innovative approaches, and open up markets for biogas.

Figure 5 shows the potential development of competition across the water and waste water value chains. This structural evolution is similar to that which has occurred in other utilities markets; competition has been introduced wherever possible in the value chain, leaving the network activities as core monopolies.

NEXT PRICE CONTROL CRITICAL

Taking all of this into consideration, there is considerable scope for new entrants to the sector to offer innovative approaches and new business models. However, there is much to consider and many aspects of the emerging business environment are not yet clear.

One aspect relates to the margins that will be available in the various parts of the value chain as competition opens. The current price control period brought regulatory reform in the shape of a split price control between retail (HH and NHH separately) and wholesale activities for incumbent water companies, with separate controls for water and sewerage activities. These controls set a 2.5% margin for NHH retail. However, this has been challenged by entrant companies and business customer groups as insufficient to make the market attractive and Ofwat has been consulting recently on this issue.

The next price control will see further reform as the wholesale controls are expected to be split further into network and other activities. The shape and details of these controls will be critical factors for new entrant companies and proactive entrants will be keen to engage in the debates and influence the outcomes.

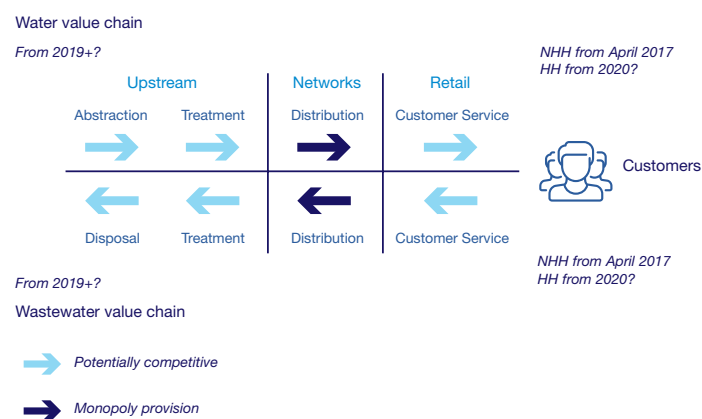


Figure 5: Potential development of competition across the value chain

There has been extensive debate over the eligibility definitions of customers for the new market and Ofwat has recently issued guidance on this. Water companies are cleaning up their data to ensure that it is fit for purpose, with particular challenges relating to mixed sites and ensuring that these have been appropriately allocated between HH and NHH markets using the Ofwat guidance. This is of importance for new entrants, as it would be a licence breach to supply ineligible customers.

DATA ISSUES WILL REQUIRE CARE

Data has proved to be a major issue in other utilities market deregulations and the Scottish water market continues to refine its data almost eight years after it first opened. New entrants will therefore be wise to take particular care over data issues.

In energy, data mismatches, errors and missing data all proved to be important challenges to overcome in the gas and electricity market's early periods. In the electricity sector, the Electricity Central Online Enquiry Service (ECOES), a central database, was set up to align and co-ordinate data between the market players; it has over 30 million supply points, with data updated daily.

In water and wastewater, a central database will also be used to manage the new market movements. Data will be uploaded to this database by the market incumbents in 2016 and managed

by a central agent, Market Operator Services Ltd (MOSL), owned by the market players and expected to become the Market Operator. The rules for access to this database are not yet fully defined and this will be an important detail for new entrants.

MERGERS, ACQUISITIONS AND VENTURES

Given the rapidly changing business and regulatory environment, the composition of the market players will potentially change radically over the coming years as players make strategic decisions on the direction of their businesses. Inevitably, the expectation is that there will be more mergers, acquisitions and ventures between players in the English and Scottish markets, new start-ups in England and entry by energy players seeking to create pan-utility offers for customers. Some existing retailers will take the retail exit option currently being developed by Defra.

Recent M&A (merger and acquisition) activity has included:

- The acquisition of Bournemouth Water by Penmon resulting in a rebrand of their business retail arm;
- The acquisition of Portsmouth Water's NHH business by Castle Water, one of the most prominent new entrants in the Scottish Water market; and
- The merging of United Utilities and Severn Trent Water's retail arms to form joint venture Water Plus which is estimated to have 25% of the market in England and Scotland.

Feature – Water takeover rationale

- Water companies may decide to exit the retail market for a number of reasons. These may include the relatively low retail margins but, for some, there is a desire to focus on the core functionality of the business, i.e. the engineering infrastructure to provide secure and reliable production of safe drinking water, and efficient transportation and disposal of waste. Size may also play a part in the decision to exit, as separation would have resulted in the creation of new positions, systems and challenges. There will be added complexity, cost and distraction from the core functionality



of the business - to produce water and transport waste, focussing on assets and networks.

- A small customer base can make certain companies a prime acquisition target for companies (such as Castle Water) who can use the acquisition as a springboard into the English Water market.
- This scenario is exactly what was seen in the early days of the electricity market in terms of consolidation and separation with companies such as National Power and EDF moving to acquire retail businesses from incumbent, integrated businesses and build larger scale retail operations.

MARKET ENTRY STRATEGY – BUILDING A BUSINESS CASE

The questions a number of new entrants will ask themselves are: “Why would I want to enter this market?”; “What are the benefits?”; “What are the risks and how sustainable is this market?” and “What do I need to do to enter this market?”

Answers to these questions form the basis of the business case to enter and depend upon careful analysis of the business environment, market risks and opportunities, taking into account the core competencies of the potential market entrant.

We know that this market is an industrial and commercial market with similar characteristics to those which exist in other utility markets and niche industrial and commercial players exist in these other markets. The question is: why would the water market be any different and, if so, what is different about it?

QUESTION OVER MARGINS

There is a question regarding the margins available in the English retail market at present and the regulator Ofwat is confident that these margins are sufficient to stimulate a competitive market. However, this may put off new entrants who are used to margins of up to 15% in Scotland and up to 7% in the energy markets. Currently the market is open to competition from a retail perspective only, with wholesale and domestic due to follow on after 2020.

Taking into account the above, why would a new entrant want to enter the water market? The following may be important elements in developing a business case:

- Builds economies of scale by extension of the customer base;
- Potential strategic move as a springboard for the future, either organically or by acquisition;
- Builds capability and knowledge for future wider market entry into residential and other markets;
- Builds revenue and profitability, exploiting existing customer relationships e.g. by cross selling and multi-utility positions;
- Allows extended service offerings to build profitability and meet customer needs (e.g. added value products and services in addition to existing energy services);
- Protects existing customer base - defensive strategy;
- Builds upon Scottish experience and capability; and
- Exploits synergies with existing business e.g. customer service infrastructure and systems.

BUSINESS MODELS AND DEVELOPING A LONGER TERM VISION

Market entrants will need to consider their Unique Selling Propositions (USP) and develop a long term vision for their business. The business models of the smaller players in the energy market highlight the variety of different approaches and models, which those thinking of entering the water market could replicate.

These include a bundled commodity (gas and electricity) and added value services approach; a focus on key market segments; added value services using green and environmental positions; becoming smart and digitally focussed players; and a recent trend towards community energy positioning. In energy, there has also been a significant increase in the use of third party intermediaries and switching sites.



Studying these different approaches could be beneficial to water companies in terms of refining their business visions and models, taking into account not just the imminent non-household opportunities, but also the variety of likely further opportunities as competition is progressively introduced into household and upstream parts of the value chain.

MARKET ENTRY ROUTES

Entry options vary from acquisition, joint venture or new start-up. This means either growing a new business organically; building upon an existing business (whether an existing water supplier or not); or potentially a combination of these two routes.

Choosing the right option requires market research and careful analysis of the business opportunities, costs and benefits; in developing these, it is essential for potential new entrants to carefully consider customer needs, which will vary significantly among different market segments.

New entrants also need to assess existing business capabilities and, where necessary, to carry out negotiations over establishing new ventures. For some players, such as those entering from the Scottish or the energy market, it may be possible to utilise existing business operations, systems and people to keep costs lean, and operate on a marginal cost basis. Some investment in new processes and IT facilities may be necessary, as this will be an important driver in the business case evaluations, especially where scale operations are envisaged.

Having evaluated and selected the right option, it is necessary to develop a full business plan to support the case for entry. This plan needs to include the capability to operate in the new market from a regulatory and technical viewpoint, and these aspects are discussed in section 3.

3. Market entry - How to get into the water market: regulatory and market readiness planning

New entrants wishing to participate early in the new market will be watching the progress of the market reform programme closely to gain confidence that the market will open on time so customers will be able to switch, without difficulty, between retailers. As a new entrant, there needs to be a level of reassurance that there is an effective market design in place with appropriate governance, process, procedures and assurance.

The assurance processes being operated by the central market body, MOSL, need to ensure that they, along with their central systems and all participants, will be ready for opening in April 2017, with sufficient quality in their data, processes and people to make the market work successfully. MOSL has recently stated its confidence that, from its perspective, there is no technical reason why the market cannot open on time.

NEED FOR LEVEL PLAYING FIELD

New entrants will also want to gain reassurance that the new market will operate a Level Playing Field (LPF) between incumbent water companies and new entrants. The Water Act 2014 removed some of the barriers to new entrants, most particularly the planned replacement of the so-called “cost principle” by a set of regulated wholesale charges. Now incumbent and new entrant retailers can operate on the same cost basis. Currently, there is a lack of any requirement for legal separation of incumbent retail businesses from wholesale operations, but incumbent water companies will face licence obligations to operate in a non-discriminatory manner towards retailers. In the early period of market opening, new entrants will want to be sure that they are receiving a fair service equalling that provided to an incumbent retailer and will be focussed upon monitoring water companies’ LPF compliance. The incumbent water companies need to separate their businesses between wholesale and retail entities, but Ofwat has not been specific on what it expects in terms of the model for separation. Figure 6 sets out the choices and key separation decisions for incumbent companies. A number of new entrants are known to be concerned with progress on these issues and Ofwat has indicated further work on LPF issues will be undertaken in the summer 2016.

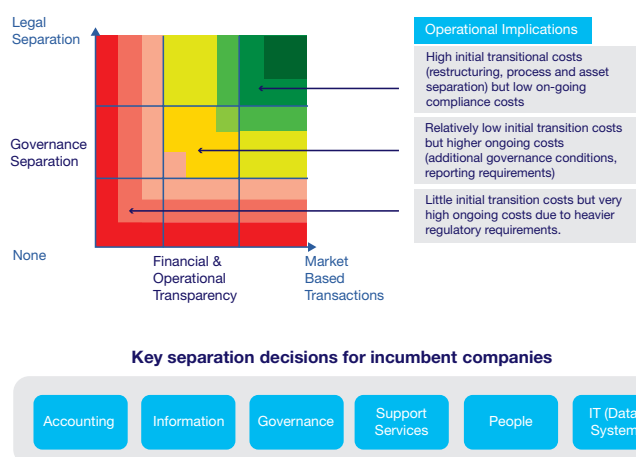


Figure 6: Choices for water companies

New entrants also have a key part to play in being ready and able to inter-operate in the new market and Figure 7 provides an illustrative roadmap for some of the key steps.

The new market will be underpinned by a new Water Supply and Sewerage Licensing (WSSL) regime, whereby new entrants and existing incumbents can apply for separate retail water supply and sewerage licenses for the new market from April 2016. Companies holding current water supply licenses to operate outside their appointed areas (WSLs) will need to apply for a new licence.

The first requirement from a regulatory perspective for a new entrant is to apply and be granted a licence from Ofwat to operate. Separate licences will be needed for entry into the water and sewerage markets in England. If the new entrant also wishes to operate in Scotland, separate licences will need to be granted by WICS.



STEPS REQUIRED TO OBTAIN LICENCE

In terms of gaining a licence from Ofwat, a new entrant must complete an application and provide a business plan together with a certificate of adequacy that it has all the management, financial, technical and, operational and other resources needed to meet the licence obligations. Ofwat will undertake an assessment on the basis of the information supplied that the company has the managerial, financial and technical competencies required to operate.

Before granting a licence, Ofwat will require that the entrant gains certification from MOSL that it has completed the market entry assurance process. This requires that the company can demonstrate it can comply with the market rules, which are set out in the Market Architecture Plan (MAP) suite of documents. This will require that the company completes a series of assurance steps, culminating in Market Entry assurance Testing. In order to participate in the new retail market, new entrants will have to become trading parties by fulfilling the trading conditions defined within Code Subsidiary Document (CSD) 0001, Market Entry Assurance and Reassurance.

In addition to holding a Water Supply Licence and/or a Sewerage Licence, the Market Entry Assurance Process needs to be completed to become a member of the market operator (expected to be MOSL), and enter into an accession agreement to be admitted as a party to the Market Arrangements Code.

New entrants will also need to sign wholesale agreements in the areas in which they intend to operate with incumbent wholesale companies. These will give effect to the requirement for the new entrant to conform with the Retail-Wholesale Code. A potential concern for new entrants remains that there is a lack of clarity on how bilateral operations between retailers and wholesalers will work in practice. New entrants can be expected to press for further consistency and improvements in this respect.



Figure 7 Road map to 2017

Although some initial teething problems may be experienced by new entrants when the market opens, customers will expect prompt resolution of issues and corrections of any errors.

SUPPORT AND ADVICE FOR NEW ENTRANTS

Gemserv has many years of experience in designing and operating market entry processes in other utility markets, including the GB electricity and Scottish water markets. We currently advise existing and potential water market players on the English water market reform initiatives and are available for discussions and assignments for new market entrants. Please contact us for more information.

This is the latest in a series of papers ahead of the opening up of the non-household market. Previous papers have examined lessons learnt from other markets; governance arrangements at market level; market entry requirements; and the requirements for a Level Playing Field between incumbent water companies and new entrants.

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