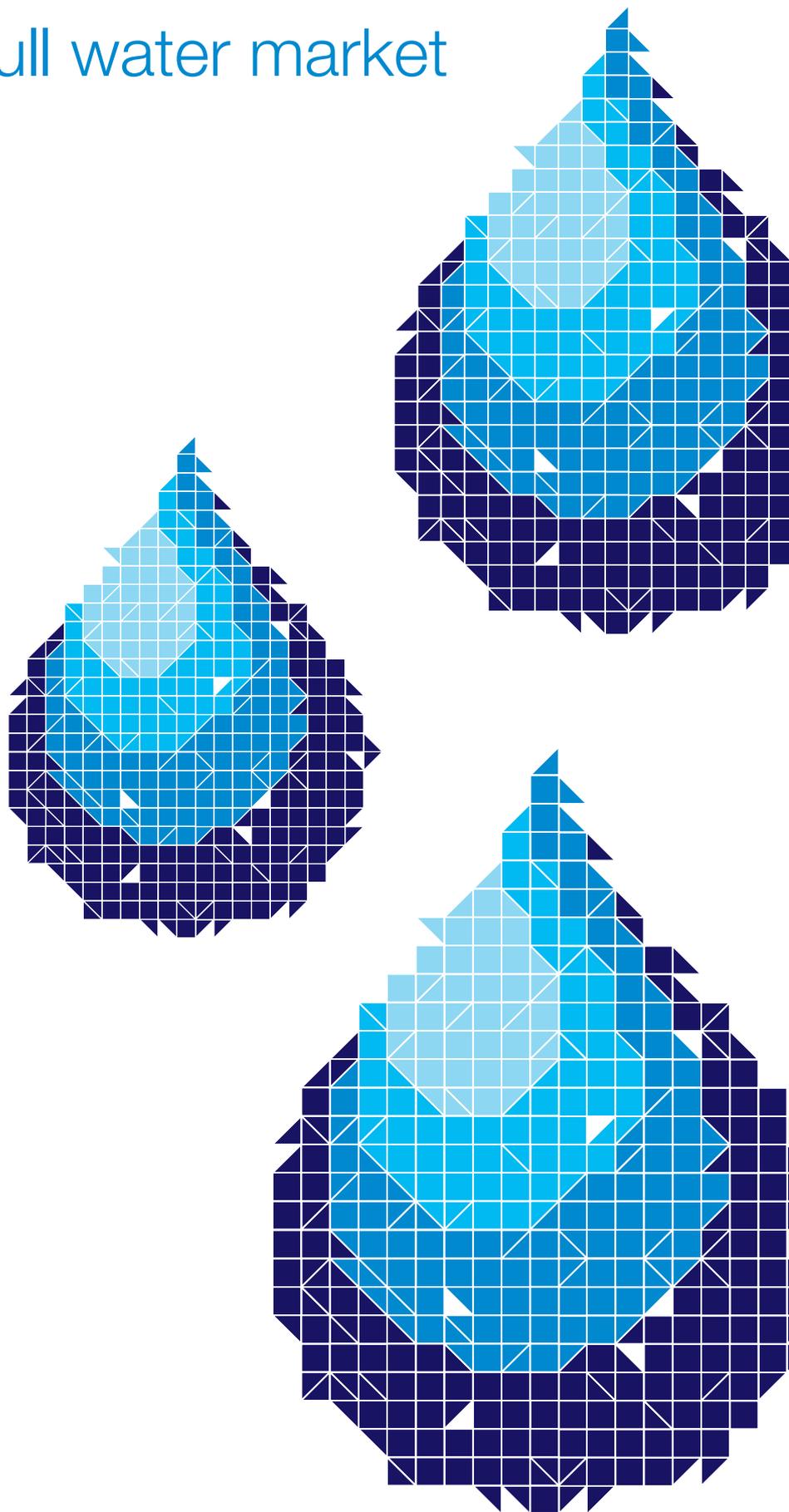


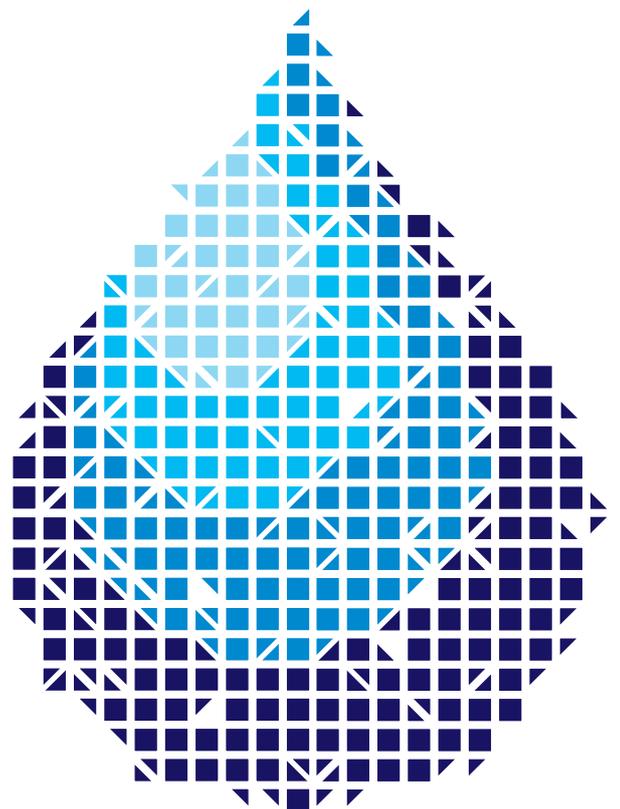
Opportunities for business customers to benefit from full water market opening





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INTRODUCTION

With full retail competition for non-domestic water and wastewater customers set to be introduced in April 2017, many businesses are looking to understand more about the potential benefits and their options.

Market opening will bring opportunities for businesses to reduce their costs, improve water efficiency and reduce administration.

This paper provides an overview on the latest developments and examines the routes for businesses customers to access the market via retailers, third party intermediaries or by directly setting up a self-supply arrangement.

- Existence of multiple wholesalers - although core processes will be defined centrally, there may be differences in bilateral operations between retailers and wholesalers.
- Planned opening of upstream markets in England, but not Scotland.
- Expectation that residential competition will be introduced in England, but not Scotland.

Market participants are now ready for the shadow opening of the non-household market in autumn 2016. Figure 1 overleaf sets out the Retail Market Opening critical path.

OVERVIEW - WHAT'S HAPPENING WHERE?

ENGLAND - SIGNIFICANT ACTIVITY AHEAD OF MARKET OPENING

The success of the opening of the Scottish water market for business customers in 2008 and the unsuccessful partial opening of the English and Welsh water markets in the early 2000's has provided valuable learning experience. The Water Act 2014 has built on this to pave the way for the full opening of the English water and waste water retail market for non-household customers in April 2017.

The UK Government has been clear that it wants a joined-up market between England and Scotland, although there is more work to be done at policy and design levels before this becomes a reality.

Whilst there are many common features between England and Scotland in terms of the architecture for the new market, there are some notable differences:

- Lack of a requirement for legal separation between retail and wholesale businesses – this means that Level Playing Field (LPF) issues may arise in England and each incumbent company may adopt a different approach to LPF compliance and functional separation.

Retail Market Opening Critical Path

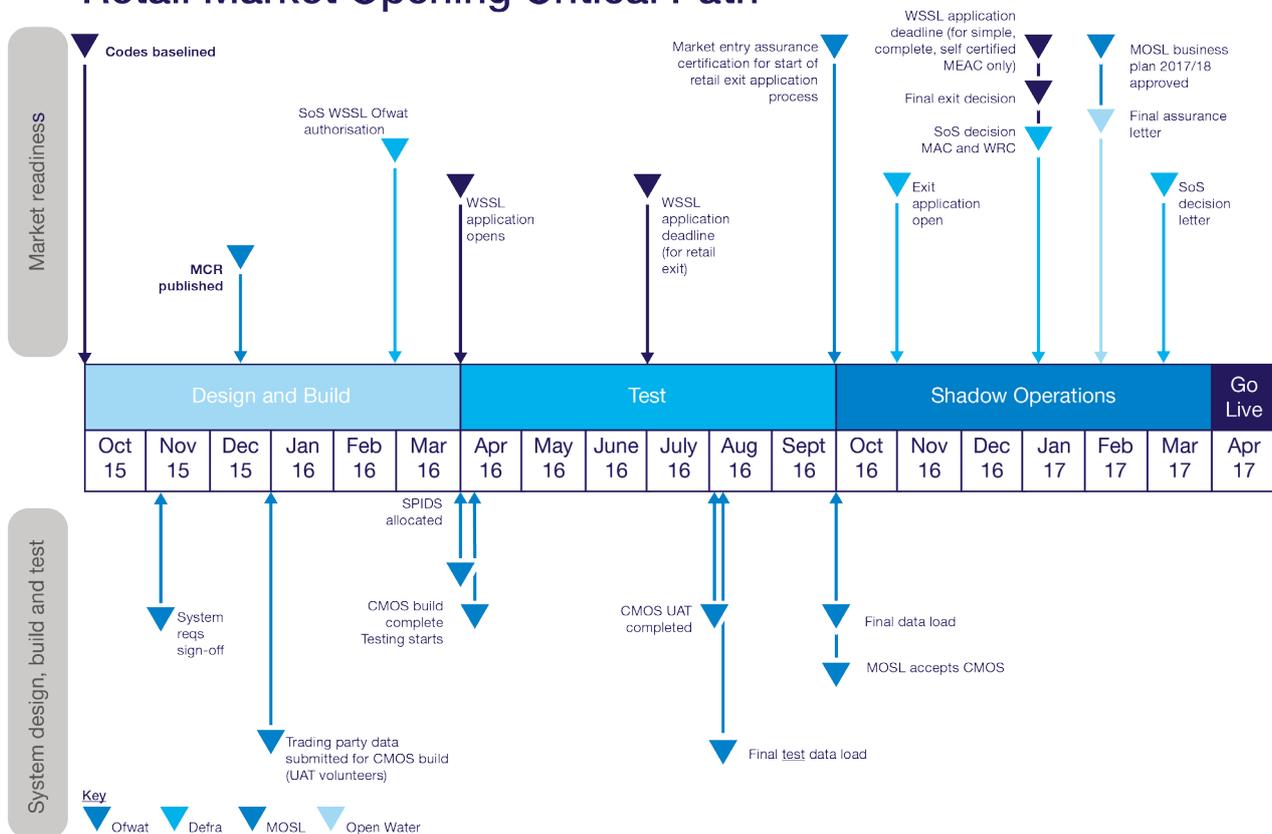


Figure 1: Retail Market Opening Critical Path

Source: Ofwat 31st May 2016

Decisions for incumbents

Incumbent water and sewerage companies (WASCs) and water-only companies (WOCs) have much to consider – remaining in the market within their own traditional geographical areas, expanding into neighbouring companies' territories and beyond, or exiting the retail market in April 2017. Similarly, those companies outside the existing English market will have been weighing up whether to enter the market and, if so, developing strategies, plans, products and services. Such companies include those in the Scottish water retail market (which opened to full competition in 2008), other new entrants (e.g. start-ups), and those operating in non-water sectors (e.g. other utility or retail players).

To date there have been a number of significant indications of intentions from incumbent companies. These include:

- Planned exit from Non Household (NHH) retail activities by Portsmouth Water, and acquisition of their NHH business customers by Castle Water, one of the Scottish market players;
- Exit from NHH retail activities by Thames Water, and acquisition of their NHH customers also by Castle Water;
- Acquisition of the NHH customers of Southern Water by Business Stream;
- Creation of a new joint venture business for NHH retail by Severn Trent and United Utilities - Water Plus - which will combine their NHH water and waste businesses; and
- Acquisition of Bournemouth Water by Pennon Group, allowing consolidation of the retail businesses of Bournemouth Water with South West Water.



Other companies have begun positioning themselves for market opening, with Affinity Water, Anglian Water, Sutton and East Surrey Water and Northumbrian Water either planning a rebrand or announcing their new brand.

Market entry process underway

Meanwhile, the entry process for the new market has started with the application to Ofwat for the new style Water and/or Sewerage Supply licences. These will replace the current Water Supply Licences and their associated obligations and processes. No company can operate without a licence, and the entry process also involves a number of qualification and assurance steps, administered by the Market Operator Services Ltd (MOSL).

Applications for new licences opened on 1st April 2016 and are now being received by Ofwat, which has recently indicated that it expects 30-40 applications in 2016/17.

It is interesting to note that as well as Business Stream, a number of the independent players in Scotland, including Castle Water, Cobalt Water and Clear Business Water have applied. It can be expected that other Scottish market participants will apply for licences. English water companies who have applied to date include Northumbrian Water Business; Pennon Water Services; South Staffordshire Water Business Limited (SSWB); Severn Trent and United Utilities; Sutton and East Surrey Water Services; Water2Business (a joint venture by Wessex Water and Bristol Water); and Kelda Retail, a retail arm of Yorkshire Water.

Further market consolidation expected

At this stage, no clear signs that companies from other utilities are planning to enter the market have emerged, but it is likely a number are considering it. The current regulated margins in NHH retail are less attractive than in Scotland which will be deterring some potential entrants, but the possibility of non-water players' market entry has been increased by the Government's recent announcement that the residential water market could be subsequently opened.

In the new market, it will also be possible for individual eligible customers to elect to become their own retailer and to self-supply with retail services. This would allow them to supply their own sites and those of persons associated with them, but

would not allow them to become a retailer for any other sites.

As well as Portsmouth Water, Thames Water and Southern Water, it has been speculated that a number of other companies may decide to exit the market, with a number of new entrants indicating they may be prepared to take over the NHH retail activities of incumbents. The window for companies applying to exit the market on Day 1 of the new market opened on 1st October 2016, with exit decisions made by the Secretary of State in January 2017. As seen in other utilities markets, further consolidation among retailers can be expected to take place in the run-up to market opening, and in the early years of the new market.

SCOTLAND - STEP-CHANGE BEING SEEN IN COMPETITION

The Scottish water and sewerage retail market has been fully opened for the 130,000 non-household customers there since April 2008. The Scottish market is regulated by the Water Industry Commission for Scotland (WICS), and has its own market framework and market arrangements. Retailers (known in Scotland as Licensed Providers) buy wholesale services, including network services and water from the monopoly wholesaler, Scottish Water. Retailers also act as the main point of contact for business customers. In order to compete in the market, retailers must be awarded a licence by WICS.

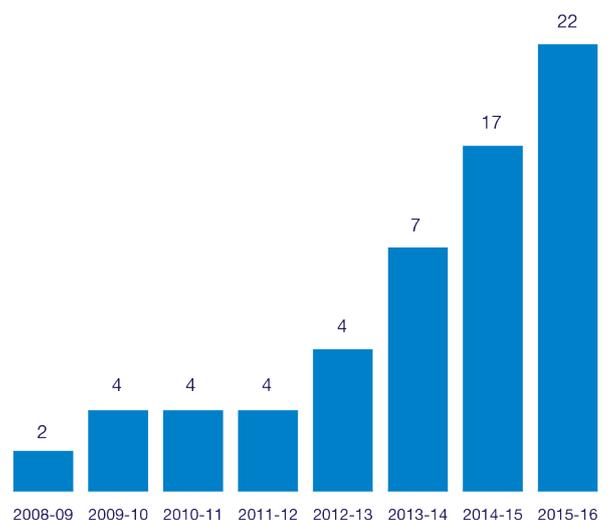


Figure 2: Cumulative numbers of new entrants in the Scottish water market

Source: WICS



Figure 2 on the previous page shows that after a relatively slow start, recent years have seen an increase in the number of retailers licensed to operate in the market. There are a total of 22 new entrants in the Scottish market, although the number of licence providers rises to 23 when you include the incumbent, Business Stream.

Figure 3 shows that the vast majority of these licences (19 out of 23) have been granted in the last four years. Eight of the new licensees are linked to English WASCs; two are linked to French water companies, with the balance being start-ups or other new entrants. Many of the English companies are believed to be using the Scottish market as a pilot to refine their retail strategies and business operations in advance of the opening of the English market.

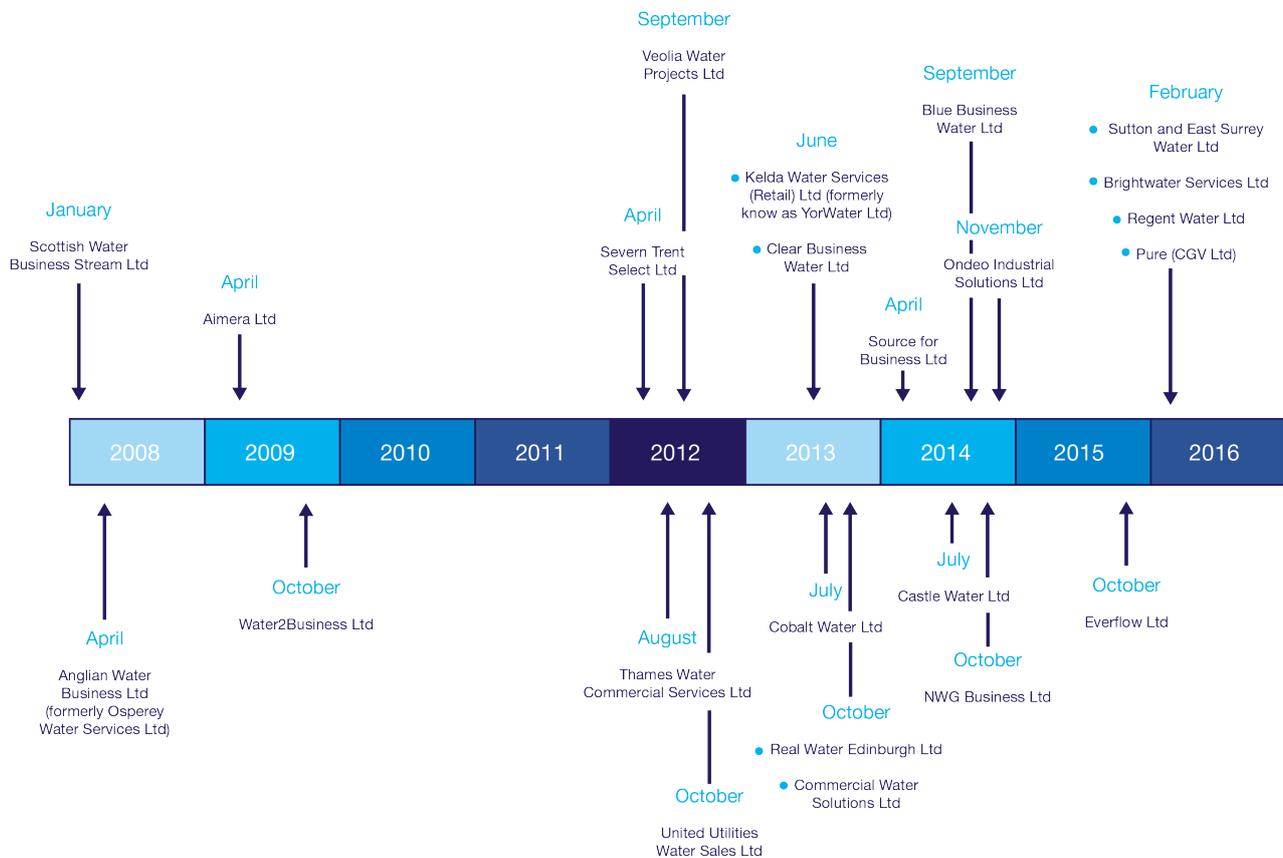


Figure 3: Licensed Providers in the Scottish water market April 2016

Source: WICS

Impact of competition

The incumbent company, Scottish Water Business Stream, was able to maintain high levels of market share in the initial years after market opening. A number of factors may explain this, including the limited number of active new entrants in the early years. However, credit is also due to Business Stream for its actions to defend its customer base. The introduction of competition saw it develop a range of contracts with related price offerings and a widening of its product range. For example, Business Stream has been proactively offering customers water efficiency and consumption reduction services tailored to the customer's needs. These include automated meter readings (AMR) loggers, allowing more targeted approaches to leak detection, as well as water and carbon saving advice and benchmarking across sites. Business Stream also offers all of its customers consolidated e-billing, a key requirement for many multi-site businesses.

However, as set out in Figure 4, after a period when market share was held around 99%, incumbents have gained significant market share in recent years.

This trend reflects a marked transformation in competition, partly stimulated by WICS' actions to improve retail margins, and partly reflecting the UK Government's decisions and the Water Act 2014 to introduce retail competition for business customers in England in 2017. This has increased the attractiveness of the market for new entrants.

The improvement in retail margins, following WICS' decision to allow the 'default' tariff to increase in line with inflation while wholesale tariffs were falling, can be seen in Figure 5.

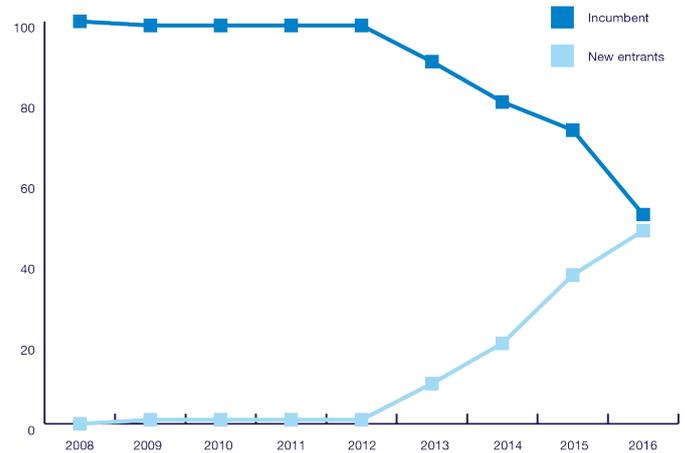


Figure 4: Incumbent - estimated loss of percentage market share volumes



Figure 5: Evolution of the Incumbent's gross retail margin

Source: WICS



Scotland - a testbed for English suppliers

As indicated earlier, at least some of the new entrants in Scotland have been using the Scottish market as a place to trial their marketing plans, and to refine their products in advance of the English market opening in April 2017. Data provided by WICS indicates that, until recently, new entrants' gains were broadly similar across both WASCs and new entrants. More recently however, new entrants such as Castle Water have claimed that switching has increasingly been in favour of new entrant companies.

Price has been a key factor in stimulating switching, and the incumbent player has been offering price deals to existing customers to stay. Business Stream has indicated that 70% of its customers have been paying less for their water than at market opening.

Despite this defensive activity, however, Business Stream has recently suffered a critical business loss with the transfer of the Scottish public sector business to Anglian Water Business; the transfer of all of the Supply Point Identification (SPID) numbers under the public sector contract in Scotland was actioned on 1 March 2016. The public sector contract loss was estimated at 21% of the market volume, and 11% of customers. Market share for Business Stream is now put by WICS as just over 50% in terms of water volumes (see Figure 6), although as a percentage of customers supplied it is still 64%.

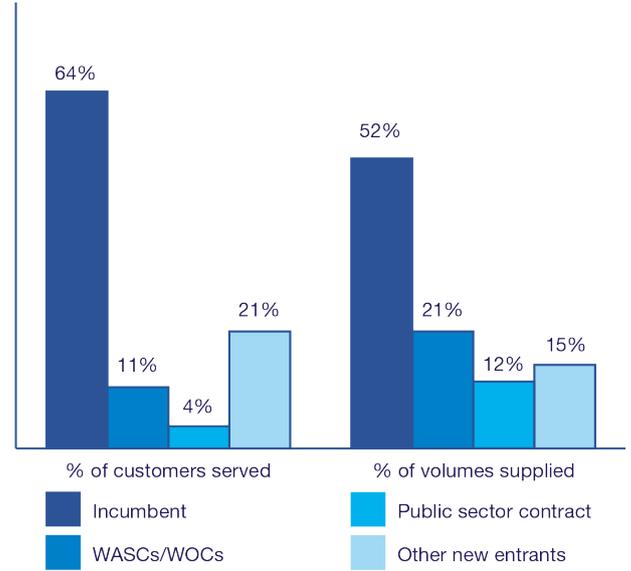
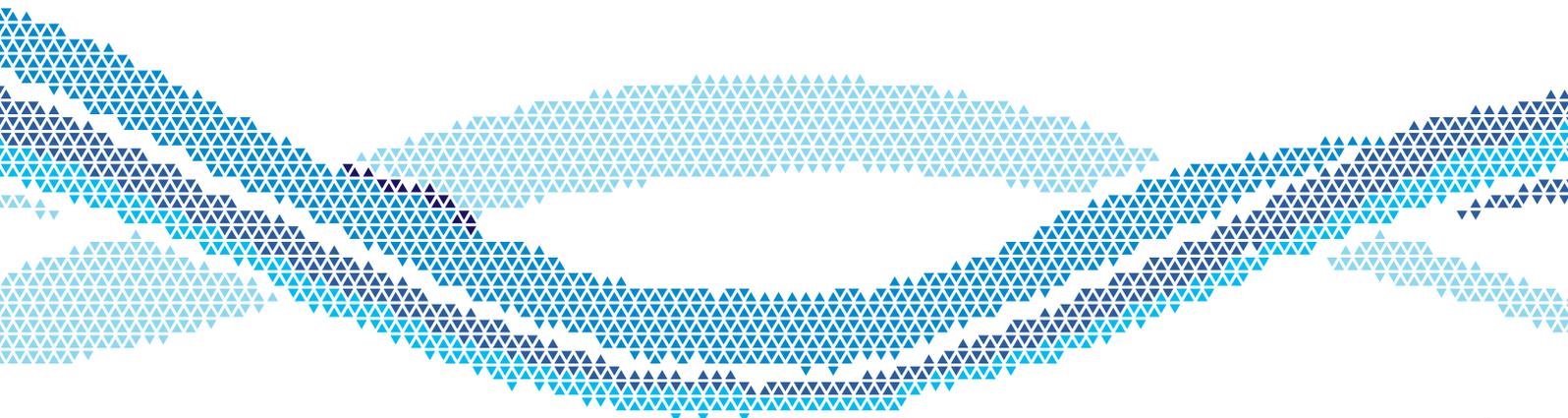


Figure 6: Business Stream's estimated market share post public sector contract loss 2016

Source: WICS





WALES – NO PLANS FOR FURTHER MARKET OPENING

While the Scottish market has been fully open for non-household customers since 2008, and the English market is due to be fully open in April 2017, the situation in Wales is very different. The market above 50ML remains open under the previous legislation, but the Welsh Government has determined not to open the market further for competition, at least not in the foreseeable future.

In its Water Strategy for Wales document issued in 2015, the Welsh Government has stated that “we will monitor the costs and benefits of market reform, which will apply to water companies operating wholly or mainly in England from April 2017.”

Cross-border issues for customers

From a customer viewpoint, an important detail to be aware of is that border issues may arise as the boundaries of water companies do not align with the administrative border of Wales and England (see Figure 7). Non household customers of companies which are wholly or mainly in Wales (Dwr Cymru / Welsh Water and Dee Valley Water), even if they are located in England, will not be able to switch supplier. The means by which the existing regime governing the Welsh market will interface with the new English market will need to be further clarified.

It should be noted that the border issue may evolve as a result of the Silk Commission recommendations that the devolution settlement should take the national borders, not water company boundaries, as a basis for differences in legal and regulatory water and sewerage governance.

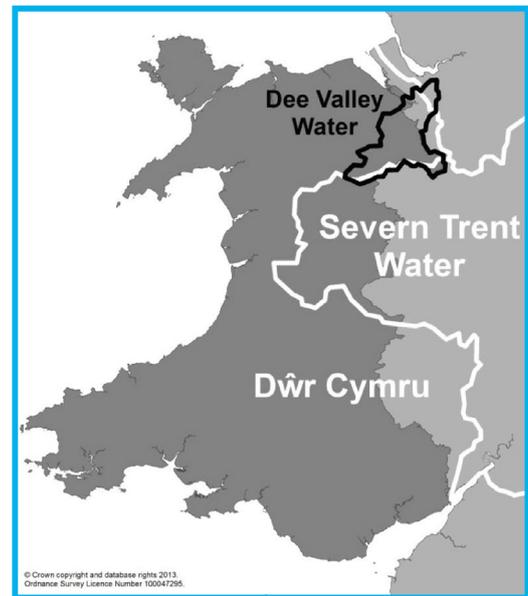


Figure 7: Welsh and English water company boundaries

Source: Welsh Government

BUSINESS CUSTOMERS' AWARENESS, NEEDS AND OPTIONS

MARKET RESEARCH AND POTENTIAL BENEFITS FROM COMPETITION

The full opening of the water market – the last of the utility markets to be opened to competition – has been long-awaited by many larger business customers in England. Market research surveys conducted for the Consumer Council for Water (CC Water) have indicated that business customers want choice. Those who have multiple sites across some of the existing (20+) water company incumbents are keen to rationalise the number of water suppliers serving their portfolio.

A study by the CC Water found that 84% of business customers supported competition in the water and sewerage industry. The same study also found that nearly two-thirds of business customers thought they were likely to switch if given a choice.

Similarly, market researcher Accent found that 69% of SME businesses thought the principle of competition in the water industry was either a 'good' or 'very good' thing.



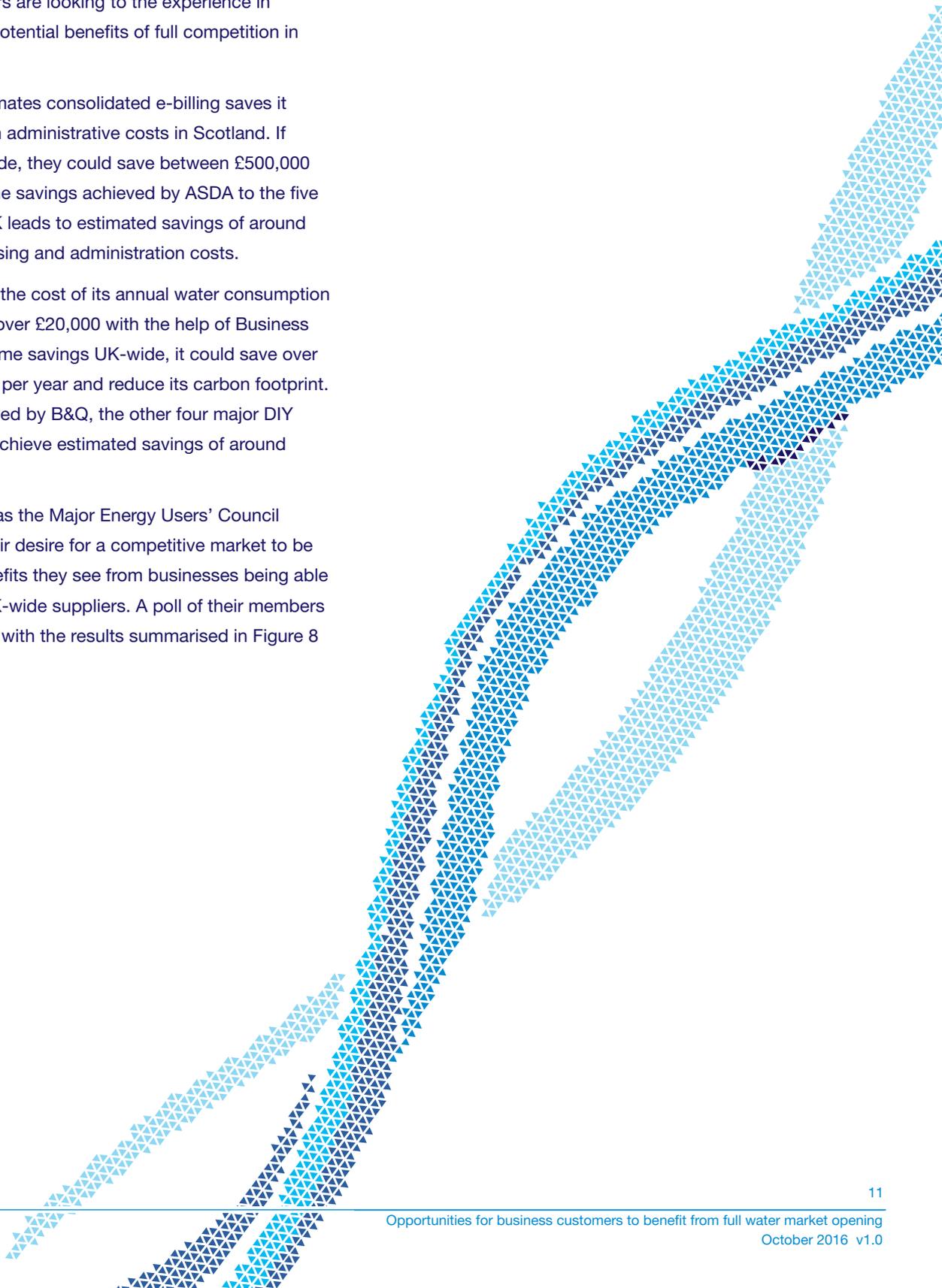
Significant savings achieved in Scotland

Many business customers are looking to the experience in Scotland to assess the potential benefits of full competition in England.

For example, ASDA estimates consolidated e-billing saves it over £80,000 per year on administrative costs in Scotland. If this was available UK-wide, they could save between £500,000 and £600,000. Scaling the savings achieved by ASDA to the five largest retailers in the UK leads to estimated savings of around £10m per year in processing and administration costs.

B&Q was able to reduce the cost of its annual water consumption at its Scottish stores by over £20,000 with the help of Business Stream. If it made the same savings UK-wide, it could save over £200,000 worth of water per year and reduce its carbon footprint. Based on savings achieved by B&Q, the other four major DIY retailers could stand to achieve estimated savings of around £700,000.

Customer groups, such as the Major Energy Users' Council (MEUC), have voiced their desire for a competitive market to be established and the benefits they see from businesses being able to choose one or two UK-wide suppliers. A poll of their members was conducted recently, with the results summarised in Figure 8 overleaf.



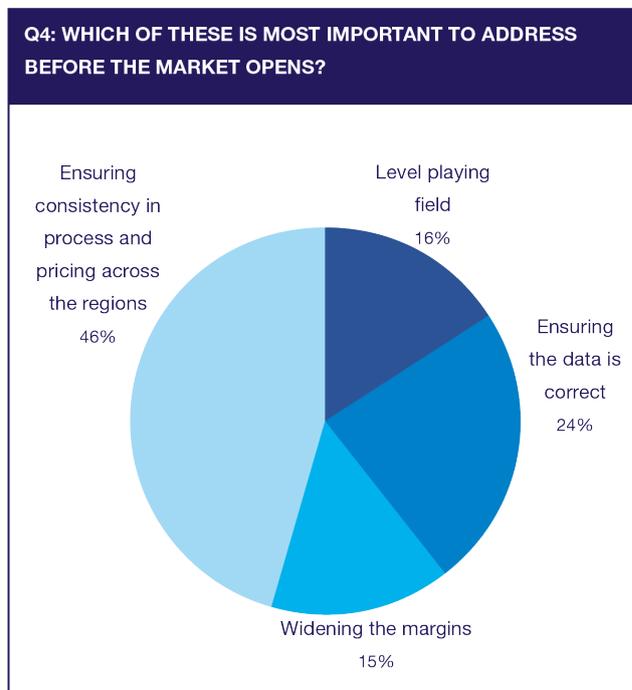
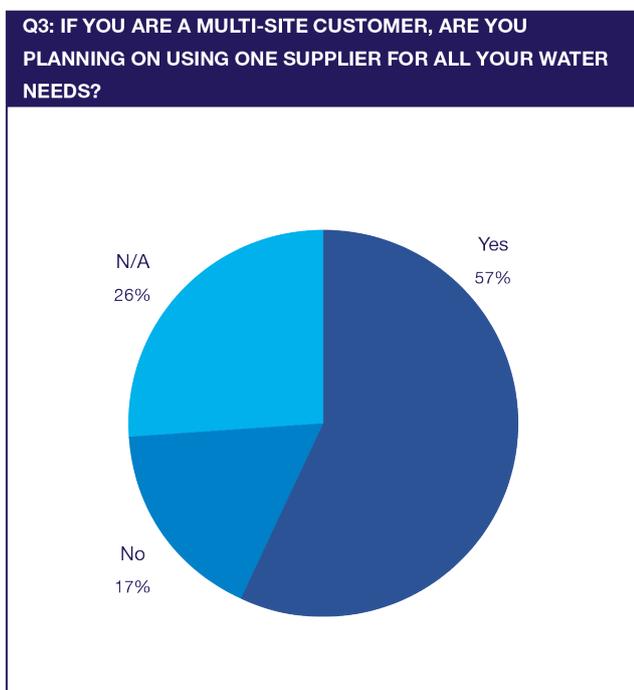
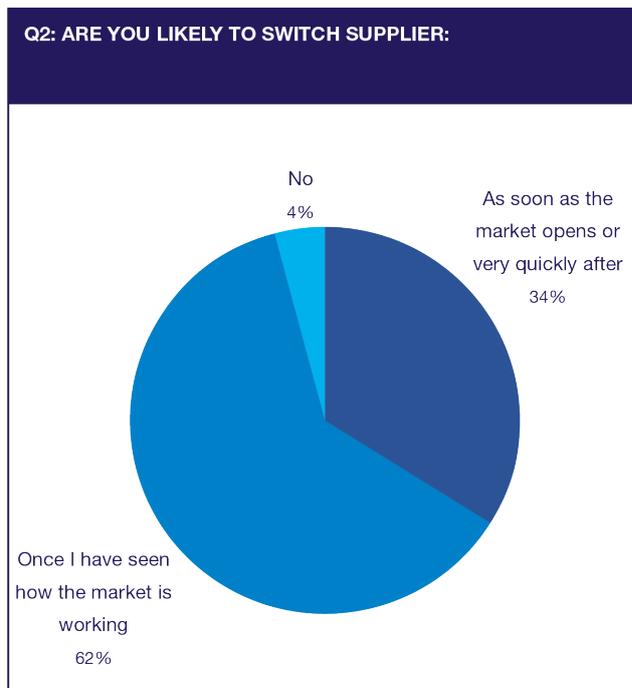
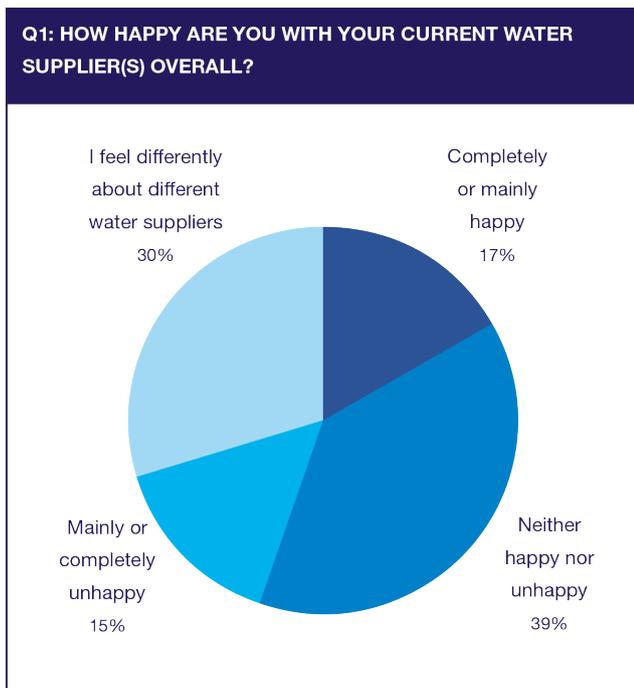


Figure 8: Results of a poll among MEUC members Spring 2016

Source: The Water Report



The poll indicated limited satisfaction with respondents' current water and sewerage suppliers, a strong likelihood of switching suppliers, a move to a single supplier for multi-site customers, and a significant desire for consistency in processes and pricing in the new market.

CC Water has made recommendations arising from its research that a high profile and structured campaign is needed to advise businesses and their representatives of the changes from April 2017. The extent and means for communications with customers is a policy issue for Defra and Ofwat which has not yet been resolved. However, it is understood that a communications plan is currently being developed in co-operation with water companies.

ESSENTIAL PRE-REQUISITES FOR A CUSTOMER LOOKING TO BENEFIT FROM THE NEW MARKET

Any NHH customer looking to benefit from the market needs to ensure they have the necessary information required, including full details of sites (address including postcode, meter types and locations, meter serial numbers) and consumption history (previous bills, meter readings). For each site the customer will ideally have the Supply Point Identification (SPID) number, which will be used by any new supplier to register the site with the Market Operator (MO). In other utilities markets, it was a requirement on the incumbent supplier to publish this number on the customer's bill; no such requirement is currently in place in water, and it is also unclear whether the NHH customer will have access to its data as located on the MO central database. These are policy issues for Ofwat.

OPTIONS FOR BUSINESS CUSTOMERS

Broadly, there are a number of potential strategies available for NHH customers interested in accessing the new market:

1. Go to the market and negotiate a deal with a retailer, including the incumbent supplier;
2. Use a third party intermediary; or
3. Utilise the self-supply option.

The suitability of each option will depend on the characteristics of the individual customer, and each has pros and cons. Customers vary widely in their characteristics from national to regional, single site to multi-site, large to smaller water users, straightforward waste to complex trade effluent features. The products and services from current and future water suppliers will similarly vary and NHH customers need to focus on what monetary, environmental and operational benefits they want from participation in the market, and choose an option and supply route which is most suitable for their needs.





1. Go to the market and negotiate a deal with a retailer, including the incumbent supplier

This option for a medium to larger NHH customer is likely to involve preparation of a tender document setting out business requirements in terms of volumes of water, timescales and any associated services required. The invitation to tender would be issued to potential suppliers, who would decide whether to bid for the contract.

The pros of this approach are:

- Allows a competitive bidding process for the NHH customer's business
- Enables engagement with a wide range of potential suppliers
- May allow a choice of lower priced commodities and services
- Provides a bid including services tailored for the NHH customer
- Bundling of utilities

However, possible cons include:

- Requires effort and resources to prepare the documentation
- Costs
- The retailer will include a profit margin in its proposed charges

2. Use a Third Party Intermediary (TPI)

In the energy market there has been substantial growth in the number of TPI. The traditional model for these companies is to act as an agent or broker on behalf of the customer, reflecting the requirements of the customer and engaging with a range of potential suppliers before making a recommended offer to the end customer. TPIs vary in the services they offer to customers but these can include price comparison websites, tailored billing, and energy efficiency activities including audits and other initiatives. It has recently been suggested that over 80% of large business customers use TPIs.

The pros of such an approach are:

- Avoids the cost and time taken to prepare tender documents
- Avoids the need for the customer to engage with the suppliers
- Uses the third party's knowledge of the market and relationships with potential suppliers
- May be able to leverage any existing relationship with an energy TPI in water
- As a result, it can be a faster route than 'Go to the market'

The cons for the option are:

- The intermediary market is not currently regulated, and may attract "cowboys"
- There could be quality differences between TPIs, so selection of the TPI needs care
- The TPI will require a commission or fee (in addition to the end retailer's margin)
- Fee structures may be opaque, and could be hidden
- Some TPIs are tied to certain suppliers, so the selection of suppliers may be restricted
- The water market is immature and there are a restricted number of intermediaries operating in it at present

3. Utilise the self-supply option

As part of the changes to support market opening, NHH customers will be apply for their own licence and self-supply their own sites. Although a less conventional route which may not suitable for all customers, it could be an attractive option for some businesses. It could be particularly useful for larger water consumers with multiple sites to be able to take full control of their supplies, or for those considering a later or wider entry into the market to gain experience of how the market operates. This option may seem complex, but consists of a number of relatively well documented and regulated steps.

The self-supply route would, at its most basic level, consist of undertaking the roles which a retailer would play:



- interacting with wholesalers, for supply and carriage of water and sewerage, at regulated Level Playing Field rates
- meter reading and billing of sites – this may require working with a third party IT supplier
- provision of data to the market operator and messages to other market participants
- operating in line with the market processes and codes as defined in the Market Architecture Plan
- Provision of SPID data to customers, and ease of access of NHH customers to their data
- Level Playing Field arrangements in each company
- Debt transfer arrangements
- Credit arrangements
- Regulation of TPIs
- Communications with customers on the new market

The pros of this route include:

- Allows supply of own and associated sites potentially at lower costs
- Cuts out the need for a third party
- Retail margin is retained as a benefit for the customer
- Allows full control of customer's data, which may help negotiate better deals with wholesalers and open up opportunities for improved water efficiency
- Can be a pilot for wider entry into the market

The cons are:

- Self-suppliers will need to acquire a licence and undertake entry qualifications
- May require a security deposit / bank or parent company guarantees
- Requires the self-supplier to undertake extra work e.g. in billing and meter reading which will require additional resources
- Wholesale contracts will be needed and interactions and tariffs / charging may be different between wholesalers

Policy issues yet to be resolved

There are a number of outstanding issues, particularly regarding customer interactions, which need to be addressed / further developed at policy level. These include:

- How the Anglo-Scottish markets will interact and work together
- Managing border issues and interfaces between Wales and England

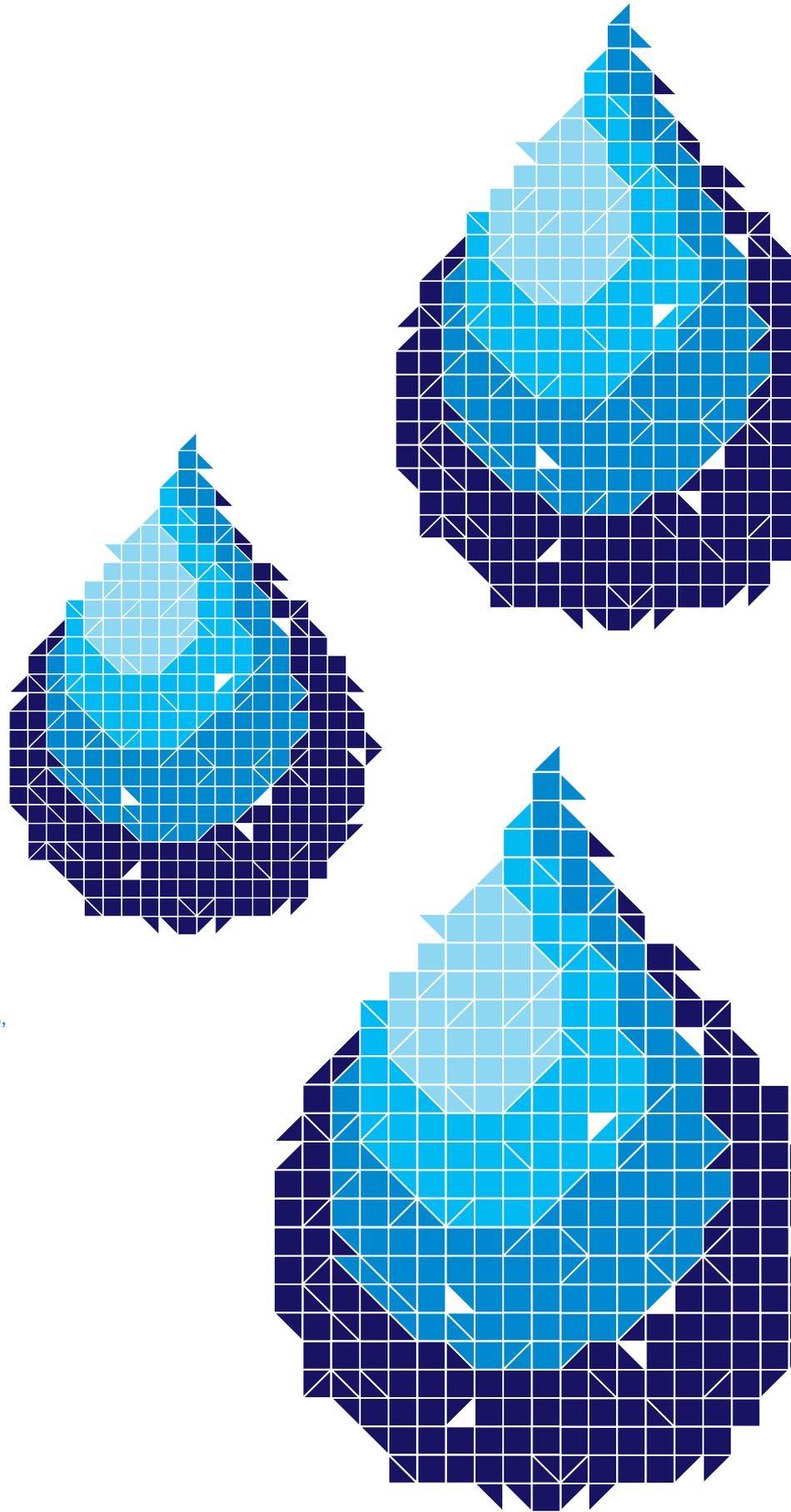
CONCLUSION: 'ENGLAND ON TAP' – NEW INITIATIVE TO HELP BUSINESS CUSTOMERS MAKE INFORMED CHOICE ON SUPPLIER

The English Water market is opening in less than six months and many business customers want to understand more about what this means to them, the benefits of competition, and what choice they have in terms of retailer.

Based on the popularity of the 'Scotland on Tap' website and demand from licensed water retailers and business customers including large procurement houses, Genserv will launch 'England on Tap' in January 2017. www.Englandontap.co.uk will provide business customers with information about the open English water and sewerage market. Customers will be able to make an informed choice of supplier based on the services available in their area, and will be able to request information direct from water retailers.

The website will provide support and advice for business customers, third party intermediaries and prospective self-supply licensees.

Genserv has many years' experience in designing and operating market entry processes in utility markets including in the GB electricity and Scottish water markets. We currently advise existing and potential water market players on English water market reform initiatives and are available for discussions and assignments for business customers, TPIs and prospective self-supply licensees. Please contact us for more information.



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