



## Water Market Reform

In April 2017 the water market in England is going to open to full retail competition for non-household (NHH) properties. This is the first step in widening competition in the water sector to allow customers freedom of choice. The government hopes that allowing greater exposure to competitive forces in the highly-regulated water market will drive increased efficiencies by companies and benefits such as lower costs for consumers.

This is, however, a relatively modest step and will not be on a par with the full competition available in the energy sector; at least, not for the time being. Only businesses, charities and public sector organisations will be able to choose their provider for now, and that will only be for “retail” services such as billing.

### Background

Currently, the water industry in England and Wales is heavily controlled by the regulator Ofwat. 10 regional water and sewerage companies (WASCs) perform all sewerage activities in their supply areas, and provide water supply for a large majority of the population in these areas. However, there are also 12 water-only companies (WOCs) that each occupy sub-areas within the regions of the WASCs. These provide all water services to the customers in their catchment areas, but rely on the local WASCs to provide sewerage activities (see image to the right).

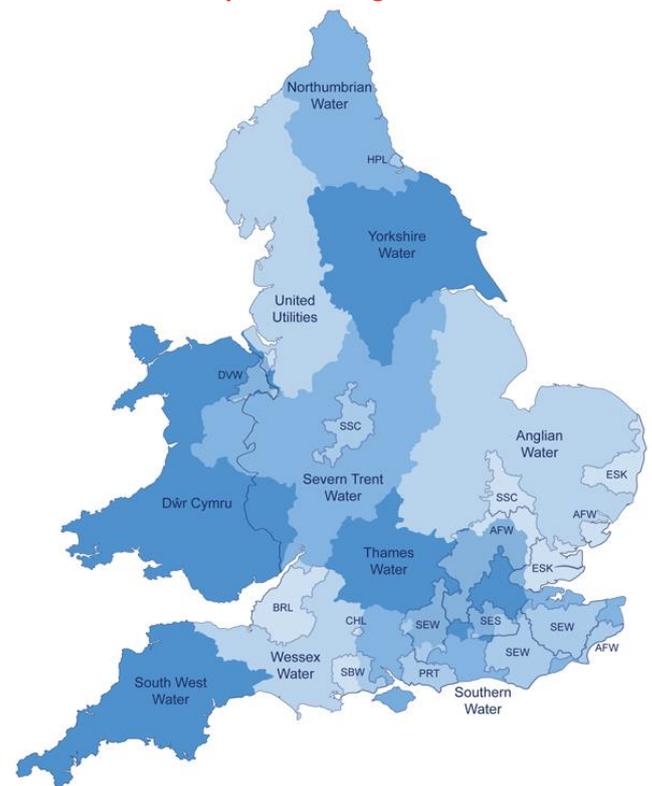
Activities by water companies are classified as either wholesale or retail. The wholesale side can best be thought of as “hard” aspects of the industry, encompassing the whole physical delivery chain. This includes abstraction (the offtake of water from sources such as reservoirs and rivers), treatment of that water to make it drinkable, the pumping of water to premises, the removal of wastewater from premises, and its treatment to allow it to be safely returned to the natural environment.

Retail activities are the “soft”, customer-facing components that support the delivery of water and wastewater services. The most prominent of these is the billing process (including meter readings, payments and debt), but there is also customer enquiry services, water efficiency advice, and help with dealing with leaks in the customer’s piping.

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**Water companies in England and Wales**



Source: Ofwat



## What's changing?

At the moment, all households in England and Wales receive their water and sewerage services from their regional suppliers. However, NHH customers in England that use at least 5mn litres a year are allowed to choose their retail supplier. The actual water they receive and where their wastewater is treated does not change, as these are wholesale activities. Competition only extends to the retail elements, like billing, which only represent about 10% of the average bill.

Come next April, all the non-household organisations in England (numbering around 1.2mn) will be able to choose who they want to provide their retail services. This has been the case in the Scottish market since 2008, though Wales has decided against extending competition, so NHH customers there may only switch if they use at least 50mn litres. All the incumbent companies in England will need to separate their businesses into wholesale and retail divisions with arms-length provisions between them so as not to give them unfair advantages over new entrants.

## The Welsh situation

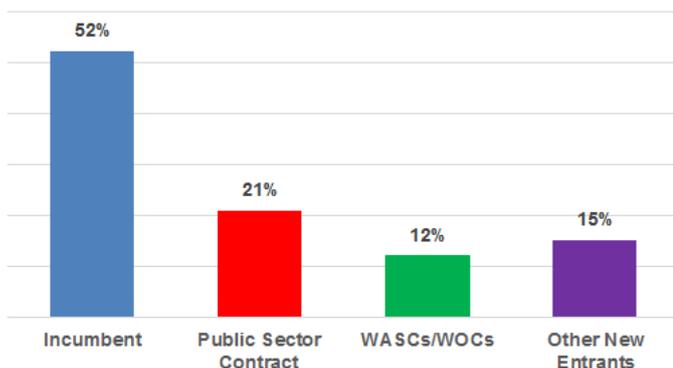
The Welsh government has consistently opted against pursuing competition in the water sector. When England decided to reduce the switching threshold for NHHs from 50mn litres to 5mn, Wales did not follow suit, and has chosen not to participate in the further expansion of competition that will occur in 2017. Dŵr Cymru (Welsh Water) is the WASC for most of Wales and is unique among WASCs in following a non-profit model. The Welsh government is therefore keen to protect this setup from the risks of competition.

The WASC for a large portion of eastern Wales is Severn Trent Water, and Dee Valley Water provides water in the northeast of Wales. Furthermore, part of Dee Valley Water's supply area intrudes into that of United Utilities. This complicates the position that companies in these supply areas will face post-April 2017. For example, a company that gets its water from Dee Valley Water and its wastewater services from United Utilities would be able to switch sewerage retail services freely (as its wastewater provider, Affinity Water is located "wholly or mainly in England"). However, it could not choose a water retailer unless it uses over 50mn litres a year (as its water supplier, Dee Valley Water, is located "wholly or mainly in Wales").

## Progress in Scotland

Scotland opened its NHH water market to full retail competition in 2008, and the process England is following is extremely similar. However, it is not exactly the same as England has nine WASC companies, whereas Scottish Water effectively fulfils that role for the entirety of Scotland. Unfortunately, this means that nationwide companies will have to deal with different regimes for England, Wales and Scotland.

Scottish market share by supply volume (Jan 16)



Source: Water Industry Commission for Scotland

After a slow start, retail competition has proved very successful in Scotland. Since 2008, the Scottish Water NHH spin-off Business Stream has had its market share steadily depleted from 100% down to around 50% in 2016 as a result of competition. A large number of English water companies operate subsidiaries in Scotland in order to gain experience of market competition. Notably, in late 2015 Anglian Water Business won a contract from the Scottish government to provide retail services for most public buildings north of the border, taking away a significant chunk of Business Stream's customers.

There are also 12 other licensed providers in Scotland who are not affiliated with English water companies.



## **What does it really mean?**

The opening of the market will see a fundamental shift in the water sector for businesses in England. Both WASCs and WOCs will still continue to provide all wholesale services in their regions, but they may choose to opt out of providing retail services in a process known as retail exit. Those companies that plan to exit will hand their customers over to other retailers at market opening for continuity of billing and other services, but will continue to be their wholesale provider. Companies that exit after the new market has begun operating will either make arrangements for their customers, or they will be allocated to another supplier.

For example, Affinity Water is a WOC that operates in a subset of Thames Water's supply area. If both companies were to exit the market, a business in that joint area would continue to receive water from Affinity's sources and have its waste treated by Thames. However, they would be billed by whatever third supplier took on those companies' customers.

## **Who will compete?**

All the English WASCs have confirmed their plans for the new market. Yorkshire, Wessex, South West, Northumbrian, and Anglian Water will all continue to operate their NHH subsidiaries and compete for customers. Severn Trent and United Utilities will set up a joint venture called Water Plus to compete.

Southern Water, however, confirmed in June that it would exit and sell its customers, while Thames Water made the shock announcement in July that it would follow suit. Serving around 20% of all businesses in the country, this has been seen by some as a damning vote of no confidence in water competition. The truth though is more pragmatic: most water companies are owned by major infrastructure investors, who are much more interested in the asset-intensive wholesale side of the water industry and would prefer to concentrate on that. At the same time, bad debt is a pervasive issue in the water sector and is held on the retail side, so it also makes sense for investors to try to distance themselves from it.

English NHH customers will be met with new faces too. So far, there have been no licence applications from new companies to set up to compete in the English market, or other utility companies seeking to branch out. However, Scottish companies are already making their move. Business Stream, the NHH-supply arm of Scottish Water and the incumbent when the market opened north of the border in 2008, has already arranged to take over Southern Water's customers in April. New startup Castle Water has also obtained Portsmouth Water's customers and recently agreed to take on Thames Water's, which will increase its customer base dramatically (Thames Water's base of NHH customers is almost as big as that for the entire Scottish market).

Two other companies, Cobalt Water and Clear Business Water (which claims to be the second biggest retailer in Scotland), have also applied for licences in England. It is likely others will follow suit.

## **Household competition**

In November 2015 the government officially declared its intention to begin extending retail water competition to household premises by 2020, and directed Ofwat to provide a review of the likely costs and benefits of doing so. Ofwat published its [final report](#) in September 2016, which presented a rather mixed picture. It estimated that under the best case scenario, the market would cost around £326mn to set up and deliver a Net Present Value of over £2.9bn to the industry over 30 years. However, this involved some generous assumptions about the level of customer engagement.

In contrast, the worst-case scenario would see setup costs of around £653mn and an overall net loss to the industry of £1.4bn over 30 years. Ofwat did not make any judgement on these findings, merely reporting



them. However, government statements strongly indicate that it intends to drive through household competition regardless.

The chief problem facing household competition is going to be the very low profit margins available. Because wholesale services will remain regulated for the immediate future, it is only the c. 10% retail aspect of the average bill that will be contestable. Estimates by Ofwat and the Consumer Council for Water indicate that customers who switch would generally see a £4-£8 saving off their annual bill of £350-400, so it is questionable if Ofwat’s optimistic switching rates will be realised.

While margins will be similar on the NHH side, the much larger value of bills and potential economies of scale between multi-site organisations will allow more substantial savings for customers and profits for retailers. While it is one of

the most extreme cases of economies of scale, Anglian Water Business was able to offer the Scottish government savings of around £10mn per year with its contract to serve public buildings.

### Looking forwards

The development of a fully competitive water market is going to be a long one with several stages, as was the case with energy in the 1990s. NHH retail competition will be the first step and will take several years to get bedded-in, with the main opportunities being for companies both within the sector and out that can deliver combined bills for multiple sites, or make multi-utility offerings as has been successful for the likes of Utility Warehouse. Another example would be a company like SSE, which operates its SSE Water business which is a “New Appointee” in England, meaning that it does not possess a supply area but supplies new property developments.

Household retail is the much bigger gamble and it should be borne in mind that the government has only committed to beginning the process: it cannot be assumed that household retail will be ready to launch in April 2020. Companies biding their time in the hope of cracking the much larger household market may have a long wait. Furthermore, based on the low margins available and probably low switching rates, they may be disappointed when it does open.

This situation may change however. The government hopes that increased competition will drive efficiencies, which may allow greater differentiation in cost between suppliers. Additionally, Ofwat is working to open up trading of water between supply zones and the market for sewage sludge processing, which may offer new sources of revenue and improved efficiency for companies. It would also be relatively simple for regulatory changes to shift the balance between retail and wholesale activities. The line between them is arguably quite arbitrary and reclassifying certain wholesale activities as retail would make a much larger portion of the industry contestable.

### Scenarios for household retail

Scenario	Net present value
1. Low cost, widespread innovation, strong competition among retailers	£2,917 million
2. Low cost, less innovation, competition among retailers	£1,214 million
3. High cost, less innovation, competition among retailers	£185 million
4. High cost, little innovation and weaker competition among retailers	£-1,445 million

Source: Ofwat