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The non-household retail water market

First impressions and future developments

July 2017

About this report

This report is based on analysis of publicly available information and confidential interviews with market participants, both retailers and wholesalers.

The aim of this report is to discuss the initial experiences of a handful of retail and wholesale businesses, and to offer our views on the future of the market. While it is based on initial interviews conducted in a short timeframe, we intend to publish a further assessment after the market has been operating for over a year.

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Introduction

The largest competitive retail water market in the world has now been formed. What does the market look like currently? What are the companies' first impressions of the market and the likely future developments?

The retail market for non-household water customers in England opened on 1 April 2017. This marked the most significant development in reforming the water sector in England and Wales since privatisation in 1989.

The market opening followed years of extensive preparation and structural change in response to the Water Act 2014, which included measures to enable all non-household customers in England to switch their water and sewage supplier. Most companies have responded by separating their retail/customer facing operations from their wholesale operations, with a focus on business and non-household customers. All water companies completed the complex – and costly – exercise by 1 April 2017 and entered the market as planned. While the retail arms of most incumbent water companies remain in the market, a handful chose to exit. Along with new entrants, the shape of the new non-household retail market has started to emerge.

This report looks at the dynamic market developments over the past two years: the emergence of a number of larger retailers (through joint ventures and acquisitions) and the longer list of retail businesses of smaller incumbents, self-suppliers and niche operators. We also look at the strategic choices and decisions water companies had to make to get to the starting line.

The report then considers company experiences in the first few weeks of the new market based on discussions with a number of retailers and wholesalers. While these discussions confirmed a successful but relatively subdued start, there are numerous system, data and consistency issues still to resolve. Companies also highlighted a number of challenges from the collective readiness approaches adopted, notably a primary focus on compliance, rather than on the customer. In addition, there was limited overall customer awareness combined with perceived low margins available for retailers.

Finally, the report considers future market developments. Our view is that there will be further consolidation in the retail market in 12-to-18 months' time. A number of retailers are currently considering divestment and are likely to exit when they find the right buyer. The current low retail margin environment does not leave much room for substantial price reductions or offer attractive returns for new entrants. Therefore, companies that balance economies of scale and cost efficiencies with a focus on value-added services are more likely to succeed in the long term. Companies that are not able to build a sufficient customer base face greater challenges and may consider their long-term options for participating in the retail market.

Background

The England and Wales water industry is going through a gradual process of regulatory reforms over the next five to ten years. These reforms are removing the integrated regional monopoly model, which has barely changed since privatisation in 1989.

Essentially, water companies across England and Wales provided similar, integrated services with no or very limited opportunity for customers to switch provider. These services include providing water from source to tap and, for the majority of customers, wastewater services too.

In the years after privatisation, water utilities focused on operational efficiencies and new investments, with efficiency incentivised through economic regulation and the periodic price controls of the regulatory framework. The industry has also invested £108 billion in maintaining and improving assets, and meeting new regulations since 1989.[1]

However, the increased investment came at a cost to the customer: household charges increased 42 per cent in real terms between 1989 and 2009.[2] The industry was also facing new challenges from rising demand, increasing customer expectations, adverse effects of climate change, as well as affordability and sustainability issues.

The need to find new sources of efficiency became apparent. But questions were raised whether regulation alone was able to sufficiently incentivise companies to address efficiency concerns and enable them to tackle multiple industry challenges.

Recommendations for wider structural reforms were first put forward by the 2009 Cave review. Professor Cave argued that the limited competition that existed in the market – introduced by the Water Act 2003 for non-household customer using 50 mega litres or more water per year – offered few benefits to customers and was hindering efficiency and innovation. The Cave review therefore proposed the introduction of retail competition for all non-household customers.

The Water Act 2014 (Act) adopted the majority of the recommendations of the Cave review and set out the framework for wide-ranging industry reforms. The successful introduction of retail competition for non-household customers in Scotland in 2008 undoubtedly helped convince politicians and regulators that a similar structure could also work in England and benefit customers.

The Act allows all non-household customers – 1.2 million businesses, public sector bodies and charities – to switch their water retail supplier. Incumbent water companies are able to exit the retail market services for non-household customers (subject to an agreed approval process), while new suppliers should find it easier to enter the market.

The overarching objective of the retail market is to encourage retailers to compete for business by providing better customer service, lower prices and/or extra services that would help save water. This should not only lower customer bills, but also reduce the impact on the environment.

The next phase of water market reforms in England and Wales will likely be the introduction of upstream water competition and, at a later stage, there remains the option to extend the retail market to household customers.

1 http://www.ofwat.gov.uk/regulated-companies/ofwat-industry-overview/
2 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69462/cave-review-final-report.pdf

Getting to the starting line

Introducing the non-household retail market has led to restructuring of water and sewerage businesses in England prior to market opening. Companies were aware that the reforms were coming: the Cave report was published in 2009 and the 'Water for Life' white paper proposing a package of reforms to increase competition came two years later. But what made preparation for the retail market a great challenge was that it happened in parallel with a number of other important industry events. According to wholesale businesses, some of these events such as AMP6 and the associated price reviews, PR14 and PR16 – were resource intensive and had to take precedence over preparations for the retail market, especially in the early part of the competition programme lifecycle.

Nevertheless, all water companies got to the starting line. All incumbents have now, as a minimum, separated their non-household retail arms from their wholesale operations and have decided whether to stay in, or exit, the market.

Based on the strategic nature of the decision, water companies have gone through varying degrees of internal restructuring. Those that considered the new market an opportunity to build and expand their business initiated significant structural and cultural changes. Others decided to stay, but focused on protecting their existing 'in area' customer base. Leaving at a later stage is still a possibility for these companies, but is dependent on how the market develops and the potential offers they receive. A smaller proportion, however, decided to exit upfront. They have either already done so – as will be discussed – or are currently preparing to exit. A difficulty highlighted in our discussions with companies was the requirement that all companies demonstrate their readiness for market opening to the same standard, regardless of their intention to remain in the market or exit. To meet the 'level playing field' requirements, companies chose to separate their wholesale and retail businesses and set each up as separate operations. This allowed for the option of a potential future exit through the sale of the retail business.

However, in their preparations, some companies carefully weighed up the level of resources and investment required/committed against their corporate, longer-term objectives.

Separating the wholesale and retail businesses and then further dividing the retail businesses into household and non-household retail were complex and resource intensive activities. In particular, separating the back office functions (such as IT systems and billing) to create the necessary 'level playing field' required significant effort – either in terms of investing in new systems and/or segregating existing ones. Cleaning and preparing the data for uploading on the central system was another resource intensive area.

Retail arms of incumbents, along with the new entrants, went through a period of strategic thinking to define their target operating models and design requirements for supporting systems, data, processes and their workforce. Wholesale businesses also had to make some significant changes: building capabilities to be able to interact with a wide range of retailers – including their own retail operations, but at arm's length.

Retailers are now shifting their strategic focus to developing more innovative offerings. The next evolutionary stage will be to invest in further operational capabilities (such as additional digital, workforce and technical infrastructure) and potentially build alliances to support their customer propositions.

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Who are the new retailers?

At the time of the official market opening on 1 April 2017, a small number of businesses serving around 100,000 and above non-household customers were active in the market. Four of these were joint ventures formed by the retail arms of incumbent regional water utilities; two were experienced Scottish retailers that acquired sizeable non-household customer lists from exiting water companies in England and one was the rebranded non-household retail arm of the Kelda Group.

Table 1. The largest non-household retailers

Organisation type	Joint ventures	New entrants in the England market	Retail arms of incumbents
No. of customers			
>300,000	Water Plus (400,000)	Castle Water (330,000)	
300,000 – 200,000	Wave (250,000)	Scottish Water Business Stream (200,000)	
200,000 – 100,000	Pennon Water (180,000)		Three Sixty (130,000)
100,000 <	Water2business (90,000)		

Source: Deloitte analysis, company and news websites

Joint Ventures (JVs) – currently, nearly two-thirds of non-household customers are served by JVs of incumbent water companies:

- Water Plus – formed by United Utilities and Severn Trent. It is currently the largest non-household retail organisation with a portfolio of 400,000 business customers
- Wave – formed by Anglian Water Business and NWG Business and supports over 250,000 business customers in England and Scotland
- Pennon Water Services – formed by Pennon Group (owner of Bournemouth Water) and South Staffordshire Group (incorporating Cambridge Water). Serving some 180,000 customers, the JV accounts for approximately eight per cent of the market
- Water2business – formed by Bristol Water and Wessex Water Service and is based on a long-standing billing JV operating between the two companies since 2000.

New entrants in the England market acquiring customers from incumbents – two Scottish retailers with experience in serving business customers north of the border acquired large customer portfolios from three water companies, which decided to exit the market:

- Castle Water acquired the non-household customer lists of Portsmouth Water and Thames Water, and is currently the second largest retailer with 330,000 customers
- Business Stream acquired the portfolio of Southern Water's 200,000 non-household customers.

Retail arms of incumbent water and sewerage companies – so far, nearly half of the incumbent water only companies and water and sewerage companies have chosen to offer retail services to non-household customers in their geographical area.

- Three Sixty is currently the largest retail arm of an incumbent – Yorkshire Water (part of the Kelda Group) – serving 130,000 non-household customers in its geographical area.

Smaller retailers – in addition to the largest retailers, a longer list of smaller organisations also obtained water retail and sewerage licences leading up to the market opening. These smaller retailers include:

- water only companies which have chosen to continue providing retail services to non-household customers. Having been rebranded, these include Affinity for Business (Affinity Water), South East Water Limited and Sutton and East Surrey Water Services Ltd (Sutton and East Surrey Water customers)

- self-suppliers, such as Greene King, the pub retailer and brewer, which was the first company to apply for a licence to provide its own water supply and sewerage services

- Scottish retailers, which have been operating for a few years and spotted an attractive market in England. Those receiving licences include Cobalt Water (subsequently acquired by Castle Water) , Clear Business Water and Everflow

- new-to-water businesses, such as the Water Retail Company, Waterscan and Regent Water, the commercial gas supplier.

Market strategy: lower costs and/or value-added services

Considering the relatively modest c. 2.5 per cent net retail margin available for companies operating wholly or mainly in England, suppliers have a strategic choice of how best to provide value to customers. Prior to market opening two main strategic approaches emerged:

- lowering costs through economies of scale – gaining scale to reduce retail unit costs and offering some price reductions to customers

- focusing on value-added services – concentrating the offer on providing additional services to attract new customers, rather than targeting the cheapest tariff proposition

Some retailers have adopted one of the two approaches while others, typically the larger companies, are combining the two.

Lower unit cost

One way of attracting customers in the new market is by offering them competitive unit prices. This, however, requires a customer base of a reasonable size. A number of the larger retailers are looking to increase in scale, either by forming a JV or by directly acquiring a competitor and hence a customer 'book of business'.

Having a large enough customer base is also crucial for justifying investment in establishing or improving retail capabilities. Portsmouth Water, Thames Water and Southern Water decided that the most cost-effective solution for both their customers and wider stakeholders was to work with specialist retailers and exit the market.

Value-added services

Instead of focusing on the cheapest unit prices, the majority of retailers have chosen to offer a range of associated, value-added services. These services are designed to help customers manage their own water consumption (subsequently reducing cost and impact on the environment) and simplify the management of utility services.

While most retailers offer all customers an automated water reading, timely billing and support to increase water usage efficiency, regardless of their size, a number of products have appeared on the market that are targeting specific customer groups:

- small and medium enterprises (SMEs) – Water Plus, for example, offers a new digital service for SMEs to make it easier to manage their water bills and help them switch quickly and effortlessly

- large customers – most retailers have invested, or are considering investing, in additional IT infrastructure and more focused customer services for large non–household customers in water-intensive sectors such as the food industry, manufacturing, supermarkets or public sector. The retailers are building teams of dedicated account managers and offering flexible payment options, and tailored and consolidated billing across multiple sites, which could save customers money by reducing administrative costs. Most retailers also offer leak detection and repair, smart meters, water efficiency audits and consultancy services to manage trade effluent. These products are all aimed at helping customers lower their water usage and reduce the environmental impact

Bundled services – combining the provision of water and waste water with the supply of gas and electricity – are the next step for the retail market. These could provide one clear, itemised utility bill for multiple sites as well as offering further price reductions and more ancillary services to manage energy and water consumption better. This would be a natural progression as customers of water and wastewater companies overlap greatly with those of the gas and electricity markets

In fact, we are already starting to see the first signs of this in the market: Regent Water, a division of Regent Gas, which already supplies bundled multi-utility services in Scotland, entered the English water market in April 2017. Wave, the JV created by Northumbrian Water and Anglian Water, has also announced its intention to become a multi-utility retailer. Bundled offerings such as these could become common in the future and, with the addition of broadband services, the 'super-utility' could also emerge.

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First impressions of the non-household retail market

While it is still early days to assess the success of the non-household retail market, a number of companies – both retailers and wholesalers – have shared their initial experiences of the first couple of months with us.

First, there was wide acknowledgment and appreciation of the fact that the market opened without any major technical issues – thanks to the joint efforts of MOSL, the market operator, market participants, Ofwat, Defra and other key stakeholders.

However, our discussions with market players revealed that the start was slower than many would have expected and preferred (e.g. the level of customer engagement and switches). This is likely due in part to a number of internal issues outstanding which require immediate attention. There are also other areas to focus on and improve:

- **systems, data and consistency challenges** – a number of retailers and wholesalers noted that some of their IT and billing systems were not yet fully operational. Some companies experienced unexpected technical faults and there were also outstanding data integrity/disaggregation issues to resolve. Some argued that this should not be considered unusual as a number of data-related issues were discovered in Scotland before and after the launch of their retail market. In addition, retailers mentioned the lack of consistency across a number of areas – such as wholesaler information portals or pricing mechanisms – that make simple tasks complex and time consuming
- **focus on compliance meant a slower commercial start** – a number of companies have commented on the focus on compliance rather than the customer journey during the preparatory phase. It is inevitably more challenging and costly to add customer-related functionalities retrospectively to systems already in place and focus on operational compliance. However, companies had a good reason for such a strong focus on compliance: the principles that underpin the Wholesale and Retail Code, combined with the Open Water Assurance Framework, required companies to demonstrate market readiness on a consistent and regular basis. From the companies' perspectives, this involved working with external assurance providers and submitting three formal letters of assurance – planning, interim and final – to MOSL. Ofwat also inserted a modification clause in supply licences requiring licensees to undertake a number of market readiness activities. Non-compliance with these requirements would have risked potential penalties amounting to ten per cent of their first year revenues

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- **lack of customer switching** – despite the technically successful launch, most companies have viewed the level of switching and customer enquiries in the first few weeks of the market as low. A few large customers, who were expected to switch suppliers, have not yet done so. A number of factors could contribute to this apparently low level of initial customer interest, for example the limited savings currently on offer from retailers. Customers – perhaps those with multiple sites and numerous supply entry points – may wonder if the modest benefits will be worth the effort switching entails

- **lack of customer awareness** – some linked this to the relatively 'soft' market launch. While some retailers argued that they would have liked to see more activity from the regulator, others preferred to do their own marketing

- **low margins threatening ability to operate** – the true costs of the business will become clear over the coming months. Some of these costs have already been higher than initially thought, but there have been other unexpected expenses that are cutting into the slim margins retailers can make. While retailers understand the pressure on the regulator to keep margins low, the question arises as to whether a market with margins at this level can actually succeed.

While the focus on compliance prior to the market opening added costs and increased the level of stress on the incumbent operators, our interviews also highlighted a number of benefits the companies observed in this period. Those engaged in shadow market activities, which were open to businesses from October 2016, commented on its usefulness as it gave both retailers and wholesalers an opportunity to test their systems and processes in a safe and secure environment, making adjustments before the official opening. Wholesalers also found the ongoing support through a wholesaler focus group, where technical and operational issues can be discussed, helpful.

Future market developments

The next 12-to-18 months will likely define the longer-term shape of the market. Based on what we have seen in other de-regulated utility and cross-industry markets, during this period retailers will slowly settle in to their new roles, work their way through technical issues and identify areas for efficiency improvements. The market will test the robustness of their strategies and quality of execution, and many will make a decision on whether to stay or divest. Our view is that the modest net retail margin is unlikely to be able to support the current number of retailers, leading to further consolidation in the market.

Recipe for success in the retail market

Economies of scale are important because of the limited net retail margin available for suppliers. Initially, low unit prices and a large customer base will certainly be helpful, but experience in the gas and electricity markets suggests that scale does not always translate into higher profitability. To attract further customers, retailers need to differentiate.

- **Value-added services and superior customer care** – many SMEs [low volume, single site users] in the energy market do not engage in switching. Those that do often buy services through third parties such as brokers. Their actions as energy customers will likely indicate how they will behave as water customers. Most large users, however, actively manage suppliers and can regularly put contracts out for tender just to test the market. With limited opportunities for offering lower unit prices, water retailers will need to provide more value-added services and superior customer service

- **Bundled utility offerings** – the promise of more competitive prices and even less paperwork will be difficult to beat. Energy utilities are monitoring the market and are likely to enter quickly as soon as opportunities arise. Alliances between water and waste water retailers and energy suppliers, such as the one between Business Stream and Utilitywise in Scotland, may also become more common. Some energy utilities may even decide to undercut competitors and make a loss on water retail to attract new customers for their gas and electricity offerings

- **Effective and cost-efficient structure and governance** – with the majority of technical work to build systems and processes completed, fixed operational costs are becoming apparent. Some retailers are facing increased costs that are outside of their control. Therefore, the more retailers are able to innovate, automate and use data effectively to reduce costs under their control, the better they will be able to retain margins

- **Close and effective working relationships with wholesalers** – the market has only just opened and there are still a number of issues to be resolved. From the retailers' perspective these include data quality problems, the difficulty of dealing with multiple information portals and the thousands of combinations of differing price mechanisms across the various wholesalers and geographical regions. Ultimately, the new market will benefit from retailers working closely with the wholesaler to promote shared, consistent interfaces, simplify complex tariff structures and improve data quality where possible.

The next 12-to-18 months will likely define the longer-term shape of the market.

Reasons for re-evaluating market options

Currently, the water retail market appears to be a low margin–high resource business and could remain so until further efficiencies are found. Some incumbents may therefore decide to adjust their operating model and reallocate their workforce from non-household retail operations to focus on other parts of their business. Other retailers, which stayed just to 'test the water' without a clear focus on a viable customer segment, or are less able to invest in supporting infrastructure, may also decide to exit.

Ofwat has highlighted that having previously opposed consolidation in the sector it now envisages further consolidation as the market develops.

Lessons for the household retail market

Developments and experiences in the non-household market will prove helpful for the next phase of potential deregulation: the extension of the retail market to household customers.

In theory, establishing the household retail market should be easier because most of the 'heavy lifting' (for example separation of systems and disaggregation of customer accounts) has already been done.

Retailers also report learning a great deal about cost allocation and implementation of billing solutions, both of which turned out to be significantly more complex than previously thought. Lessons learned in these areas should make preparation for the household market more efficient and also benefit companies as they consider cost allocations before other types of competition are introduced in the sector. Some companies built their programmes with a view to scaling up in future, while others built them in isolation aiming to do the minimum to comply. Those who are furthest ahead in the non-household retail segment are likely to prosper in the household market segment.

However, given the current political and macro-economic environment, household competition, whilst still being discussed, looks less likely to happen and indeed unlikely before 2020.

Threats to the effectiveness of the non-household retail market

The modest net margin and the potential for cost escalation mean that the savings on offer will be limited and may not meet customer expectations for switching – especially if the switching is seen as a time consuming, complicated procedure.

Switching in itself, however, should not be considered the only or even the main measure of market effectiveness. The market's success should be measured by improvements in efficiency, services and lower bills over the medium and long term.

So far the actual number of customers switching has been low. But the Scottish water retail market, which is considered a success by the Scottish water industry, also had a slow start with switching levels only increasing after a number of years following the market opening in 2008. In addition, the lack of customer switching does not mean that those customers who do not switch are not seeing benefits from the market.

Significant threat to the market would be the inability of retailers to function in the tight margin environment, leading to major consolidation and ultimately a reduction in customer choice. This, coupled with potential negative news in the market in the future, could have a damaging impact on the market's reputation and the companies' confidence.

Conclusions

Whilst it is still early days for the new market, much progress has already been made. All water companies have successfully separated their retail operations from their wholesale activities and the market has opened without major problems.

Both retailers and wholesalers have learned a great deal in the process – lessons that will be helpful when preparing for the opening of further competition across the value chain.

In many respects, however, the work is only beginning. All market participants, retailers, wholesalers and MOSL are focusing on a prioritised set of continuous improvement activities – a number of which have already been discussed in this paper.

The non-household retail market will undoubtedly continue to evolve. There will be winners that quickly find their 'sweet spot' through competitive prices and value-added services, and there will be those that find market success a step too far and exit. We expect some further consolidation as the rewards currently available in the market are unlikely to be able to support the existing number of suppliers.

Both customers and Ofwat hope that the reforms will bring a renewed focus on the customer and supporting behaviours in the market: more proactive retailers who take time to listen and respond quickly to changing customer needs and who offer more cost-effective solutions, striving to bring new and innovative ways of working in a vibrant and competitive marketplace.

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