



Setting the agenda for water The decade ahead

Executive summary

The England and Wales water sector has undoubtedly made substantial progress over the past decade in many different areas. By now, most companies have completed the Price Review for 2015-20 and the Water Act 2014 has created the backdrop for a competitive, innovative and resilient industry with a clear focus on customer service. While much of the detail underpinning the Water Act still has to be worked out, the industry has a major role to play in filling in the gaps and shaping its own destiny.

Now is the time to look ahead and lead the debate, otherwise the industry could once again find that politics and regulation have the upper hand. In this paper, we look at some of the drivers for change, with a particular focus on areas where companies and the industry may be able to make a real impact.

The first challenge for the next ten years could be termed 'resilience'. In this context resilience encompasses the ability of clean and waste water networks to withstand ongoing changes in the climate, whether these manifest themselves in short-term weather volatility or long-term weather pattern changes. Resilience must also address other changes such as demographics, consumption patterns and house building. It is sometimes easy to forget some of the extreme weather that we have seen in recent years. The 2012 droughts, which led to hosepipe bans in southern and eastern England, were followed by devastating floods in 2012 and 2013. Furthermore, the rate of change is likely to accelerate over the next decade. While Britain is facing more extreme weather conditions, customer and political challenges are also expected to mount.

The second challenge arises from the need for the industry to continue to offer outstanding value for money. We have seen the issue of affordability rise up the political agenda in response to the squeeze on living standards. This has had a profound impact on the energy sector, and although the cost of water services is a fraction of typical energy costs, the sector has been caught in the crossfire. In addition, many believe that the 2014 Price Review (PR14) was more onerous than in previous periods. It is clear that operational efficiency will be an enormous challenge, or opportunity, for the next decade.

The evolution of the regulatory framework may also present the industry with challenges. The introduction of retail competition for non-domestic users is only two years away, and it is almost certain that further competition will be introduced, whether in some form of 'upstream' competition or, perhaps, ultimately extending retail competition to domestic users.

The industry has a choice: it can either seize the initiative to lead the debate and propose the solutions, or it can allow the regulators and politicians to take the lead. If companies and the industry were to choose the former, we believe that the opportunity to create a sustainable, resilient future is real.



Investing in resilience

The challenge of resilience comes in many shapes and sizes, and varies significantly across regions. The only feature of climate change on which all experts agree is that no predictions can be made with any degree of confidence.

In the South East in particular, individual water companies have been focused on securing clean water supplies, while using metering to help monitor and manage consumption within their boundaries. This focus has been successful to date, but more action will be needed in the future.

Currently, there is limited water trading in England and Wales. While various types of water trading exist, most notably bulk supply agreements, these are largely legacy agreements that are dependent on the availability of water from the supplying company. We see a role for an industry-wide coordinating body with responsibility for promoting effective use of water resources across boundaries, and with an obligation to suggest pricing mechanisms to promote active trade.

In addition to promoting more active cross-border water trading, there is a need to consider infrastructure solutions that would benefit more than one company. For example, a coordinating body may conclude that the often-mooted Abingdon reservoir should be completed, whereas it is undoubtedly more difficult for one company to make such a case. A coordinating body could therefore promote agreements between companies and propose funding structures via a regulatory process, whether through existing structures or following the example of the innovative structure adopted for the Thames Tideway project.

Is it time to rethink the purpose of existing bulk supply arrangements and consider using more flexible, bilateral agreements and expanding their scope beyond the current long-term arrangements? While we think that some forms of abstraction licence trading could still have a role to play, the scope for cross-border cooperation appears greater than active trading of abstraction licences.

We also see an opportunity to use the information obtained from near-universal metering in some regions to help monitor and manage leakage in an efficient manner. Leakage has long been an emotional issue in times of drought, but metering provides the advantage of much quicker identification of customer-side leakage. In addition, as the quality of data from metering improves, it should prove easier to locate leakages within the remainder of the network. Better quality data also allows effective analytics to become more embedded in company operations.

On the demand side, metering can have a significant impact on consumption, and high metering penetration in some regions has certainly helped to keep consumption in check. However, in other countries we see significant work with large consumers – typically agricultural and industrial users - on water usage patterns and water management strategies. We do not currently see the same level of activity in England and Wales.

While some corporates in England and Wales have already developed water management strategies, they are often driven by general sustainability concerns as much as a willingness to help manage water resources. We therefore see an opportunity for water companies to focus on managing commercial demand better, for example through flexible or profiled tariffs, interruptible supply or simply increased awareness.

There is also scope for the industry to facilitate water reuse for industrial applications, irrigation or household purposes. This could be further helped by the introduction and enforcement of more stringent building regulations on installing water saving devices in new developments, implementing rainwater harvesting or water recycling systems.

Operational efficiency

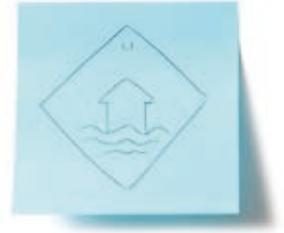
The water industry is coming under increasing pressure not only to keep customer prices affordable but also to innovate, remain resilient and continue to attract investment, all of which will depend on the sector's ability to manage costs and operate efficiently.

Views differ as to how easy it will be to continue reducing costs, either through further headcount reduction or more deep-seated structural change, while also providing ever-improving customer service. But perhaps the most exciting new opportunity over the next ten years is the effective use of data and analytics within the water companies to drive efficiency, where successes to date have been mixed.

We believe that data-driven insights will play a leading role in achieving cost savings and making operations more efficient. Utilities hold large amounts of data already, but a considerable amount of this may be of poor quality and /or not utilised effectively. Therefore, there is an opportunity for better data collection and management as well as more purposeful analysis to identify areas with the potential for increasing operational efficiency.

We believe better data analytics can result in more informed decisions in areas such as:

- field force performance monitoring, workforce scheduling and routing
- predictive asset maintenance scheduling to reduce costs of emergency repairs
- predictive power usage to enable the company to forecast the volume, timing and location of electricity needed to support flexible power contracts
- root cause analysis of customer calls, yielding insight on how to reduce the number of calls, either through addressing common issues more effectively or providing online facilities to deal with certain issues without call centre intervention
- smart meter data to monitor and address leakage in high-stress areas.



Digital advancement could transform customer service in the water sector and significantly reduce the need for costly call centres. Better customer engagement will continue to play a crucial role for many water companies and will be driven by the experience that customers have with suppliers outside the sector. Digital, a more cost-effective and efficient form of customer service, has already started to replace some of the traditional services provided by call centres. Digital advancement represents the 'holy grail' of enhanced customer service and reduced cost.

While retail competition for non-domestic users is imminent, the introduction of such competition could increase the cost for all companies without delivering benefits to the customer, either in the form of better customer services or enhanced use of billing data. We think that centralised or coordinated approaches will be needed to support industry-wide operational effectiveness.

With the era of retail competition coming, it is inevitable that some customers will switch. The industry should focus on ensuring that the customer 'journey' is as smooth as possible. It is in no-one's interest for this to fail. Perhaps the industry should consider collaborating to develop systems and functions more efficiently, either in alliances or joint ventures between water companies. Such collaboration would also enable companies to spread the cost of development and allow cost-effective competition on customer service and brand rather than IT investment.

The move towards a total expenditure approach ('totex') for more customer-focused outcomes could also present companies with the opportunity to employ more innovative and potentially cost-effective solutions. The decisions around whether to spend capital expenditure or operating expenditure to achieve certain outcomes are new, and represent a significant opportunity to forward-looking companies.

Managing the regulator

For PR14, the regulator encouraged water utilities to share and agree their plans with their customers. If this agreement was achieved, Ofwat suggested that it would limit its involvement in the Price Review process, resulting in lighter regulation. However, despite this promise, an increase in regulatory intervention was noticeable towards the end of the PR14 process. That said, the degree of customer engagement in PR14 was absolutely unprecedented.

Building on the success of customer engagement from PR14, we think that the time is right for water companies to engage with Ofwat on the nature and form of future price reviews and bring back the original intent of the PR14 review process. A genuine agreement with customers on outcomes and costs should reduce the regulatory burden significantly.

With the projected growth in population and the challenges presented by climate change, pressure on water resources will undoubtedly rise and genuine water poverty could become an increasing trend. Many companies have their own strategies for dealing with water poverty, but this is another area where coordination across companies could help tackle the problem. While it is not clear why social tariffs should vary so much by region, the sector could suggest a framework to Ofwat to address this challenge.

The industry has a critical role in ensuring that retail competition succeeds. There will be some competition for non-household customers from 2017, which could result in central system and data challenges and these may need to be addressed by the industry as a whole. And further, changes will be needed in the wholesale business to facilitate the competition.

The sector may also want to look beyond the impact of the Water Act 2014 and consider how to expand retail competition to the household market. The industry could choose to devise a defensive strategy to protect the 'sanctity' of Regulatory Capital Value (RCV) while also engaging with the regulator to create structures which promote competition but are not seen to unduly increase the risks for investors ahead of the political debate.

In addition, water utilities may also want to work with Ofwat to manage the challenges that arise from upstream competition. The Water Act 2014 could make market entry easier for new players that offer water efficient goods and services, new water resources and novel ways of dealing with wastewater. For the industry, these reforms could introduce higher levels of outsourcing and co-venturing, and increased procurement and construction contracts. At their extreme, the reforms could limit the opportunity for RCV growth in the future as large projects are procured under 'private-public-partnership' type arrangements.

The decade ahead

Future regulatory reforms will be increasingly customer, rather than asset, focused. Companies that consider customer engagement a strategic priority will be in a better position to grow in the future regulatory environment. The industry can take the lead in extending the scope of retail competition in a sustainable and managed way, as well as helping to define the scope of upstream competition.

Central planning and cooperation can have significant benefits for the sector. The water industry could consider establishing central functions and processes for upcoming retail competition and also supporting water trading at regional boundaries. This could lead to both industry-wide efficiency savings and easier customer switching. Other areas where companies and regulators could work together include efficiency initiatives, metering standards and social tariffs.

Water security or economies of scale may drive industry consolidation in both network companies and retail businesses over the next ten years. It has been a widely held view in the industry for many years that the fragmented structure in the South East makes resource planning much more difficult and that major efficiencies could be gained from merging operations in this area. But the benefit from efficiency savings would undoubtedly need to be shared between investors and customers.

Operational efficiency will be critical for the future of the water sector. Insightful analysis from good quality data can identify areas for cost savings and efficiency improvements across operations. Digital has an increasingly important role to play in customer services, while increased joint ventures and alliances, particularly for systems development and back-office functions, could deliver better value for customers.

By focusing on these areas, the water sector can take the lead in creating a resilient, innovative and efficient industry with a clear focus on customer care, where there the need for regulatory and political intervention can be reduced. By taking the lead, we believe the future of the industry can be bright.

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