

**Reforming the UK water industry:  
A discussion paper on introducing competition to the retail market**

Over two years after the release of the Government-commissioned Cave review of the UK water and sewerage industry<sup>1</sup>, the Ofwat-endorsed proposal to introduce retail competition for non-household customers<sup>2</sup> remains at the forefront of industry debate.

Significantly, Moody's recently stated that Ofwat's proposals could threaten water companies' creditworthiness<sup>3</sup>, substantiating concerns that reform could deter investors from financing the industry's significant capital investment needs. (The forthcoming transfer of private sewers has again brought to the fore the funding constraints on water companies).

How investors react to industry change will undoubtedly have an impact on pension schemes from a financial perspective. Trustees must consider not only the implications for pension scheme affordability, but also independently evaluate the increase in the medium- to long-term business risk. This will shape future discussions on recovery plans, and could lead to further divergence between the view of pension deficit reduction taken by the economic regulator, Ofwat, and the Pensions Regulator ("TPR").

*Could retail competition jeopardise investor confidence in the sector?*

Currently, customer prices, and hence investor returns, are limited to a return on a water company's Regulated Capital Value ("RCV") i.e. its capital invested. Retail accounts for only a small proportion of total RCV, and therefore acts predominantly as a cost centre (with operating expenditure recovered through the current regulatory pricing arrangements).

*The prospect of reduced returns for incumbents*

A key industry concern is that extracting a retail profit without increasing customer prices would reduce returns for incumbent operators, at least in the short-term. By way of example, Evolution Securities estimates that an indicative 1.5% retail margin would reduce the rate of return for existing operators from 5.1% to 4.75%<sup>4</sup>.

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<sup>1</sup> Referred to simply as the water industry in this report.

<sup>2</sup> Initially with a consumption threshold of 5 megalitres (representing 2% of non-household consumers) before being applicable to all non-household customers.

<sup>3</sup> Financial Times, 17 May 2011.

<sup>4</sup> Evolution Securities, May 2011 – based on WASC average revenues and costs for 2009/10, with revenue scaled back to be in line with allowed return over the 2011-15 period. This assumes no additional cost efficiencies from the reforms.

It should be recognised that water companies have continued to raise large amounts of capital in the challenging economic environment of recent years<sup>5</sup>. Nevertheless, commentators fear that investors, already feeling “squeezed” by a challenging regulatory environment, could reduce their exposure to an industry that needs to attract capital of £100bn over the next 20 years. Indeed, the prospect of lower returns has resulted in some leading investors recently reducing their investments in quoted water companies.

### *Upstream reform*

Yet it is future upstream market reform that will ultimately determine the full operational and financial impact of retail competition on incumbent operators. These future ‘wholesale’ water suppliers will rely increasingly on maximising the resources they have available to them, and delivering on commitments to third party retailers, in order to remain competitive.

It is widely accepted in the industry that more efficient use and allocation of water resources is key to addressing supply shortages and lowering costs for customers. It is not clear, however, to what extent future regulation will drive market reform, including redistribution and re-pricing of abstraction rights, and cross-network water supply. Companies will look to Ofwat to provide sufficient financial incentives to compensate for regulatory-driven changes to operational and capital projects, and to sustain sufficient profit margins to maintain investor confidence in the sector.

At present, the indications are that upstream market reform will be gradual. This is designed to minimise market disruption, but a ‘two-step’ approach to market reform may, in the meantime, favour retailer margins, at the expense of upstream operators.

### *Reducing the retail cost base: the Scottish example*

Ofwat is looking for competition to reduce the retail cost base, and thereby minimise the impact on incumbent operators.

There is indeed evidence to suggest that the introduction of retail competition in Scotland, in April 2008, has reduced prices and improved services<sup>6</sup>. Notably, this is being driven by retailers consolidating online metering and billing services, and developing water efficiency measures for customers. Retail competition in Scotland is also driving upstream efficiency by pressurising Scottish Water (the upstream monopoly) to improve its wholesale service.

Maximising the benefits of retail competition will require some relaxation of Ofwat’s restrictive special merger regime. However, the large number of operators in England & Wales adds significant complexity to the process in comparison to Scotland, where horizontal consolidation took place prior to vertical separation. This presents further financial and execution risks, making market reform, and cost savings, all the more challenging.

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<sup>5</sup> Water UK, Meeting future challenges, pp.6.

<sup>6</sup> Water UK, Meeting future challenges, pp.8.

## *The implications for pension scheme trustees*

Introducing retail competition is seen as the first stage of widespread industry reform that may directly affect investor returns, and also potentially increase business risk from a change in the wider competitive environment. This, in turn, could lead to investors demanding a higher cost of capital, and further increase company financing constraints (and cash available to service pension scheme deficits).

From a pension scheme perspective, trustees have historically taken comfort from the monopolistic characteristics of current water companies; these provide a strong, stable revenue stream, with high gearing capacity.

For many, the long-term certainty provided by regulated assets also substantiates Ofwat's policy of spreading 'efficient' pension deficit costs over a 15-year period, compared to the Pensions Regulator's ("TPR") ten-year guideline for recovery plans. Reconciling the two regulatory perspectives is indeed a key challenge in recovery plan negotiations between companies and trustees, with capital investment and customer pricing pressures constraining pension scheme affordability for companies.

Going forward, trustees will need to carefully consider the impact of market changes on the company's financial and business risk profile, both from a short-term financial perspective, and from a longer-term market view. To this extent, industry reform may add further complexity to recovery plan discussions.

## *Conclusion*

It is clear that many investors and other key stakeholders remain sceptical towards Ofwat's current proposals. Introducing retail competition should be considered in the context of future market reform for the entire value chain, and further details will be needed before a more 'holistic' view can be taken on the implications for incumbent companies, and their ability to finance the industry's future investment needs.

For now, the industry awaits the release of the Government Water White Paper on industry reform, the publication of which has been delayed until this autumn.

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