

# CEO Insight

Exclusive research from Utility Week

## What's in this report?

- △ p2 Executive summary
- △ p3 The macro-view
- △ p4 Regulation
- △ p6 Business model transformation
- △ p9 Consumer perceptions and satisfaction
- △ p10 Access to finance and investor confidence
- △ p11 Subsector focus: water
- △ p14 Conclusion

# Executive summary

As utilities grapple with the transformational change sweeping the sector, company chief executives face challenges on many fronts. In the first of a new, regular series of research reports – CEO Insight – *Utility Week* surveyed the leaders of the UK’s major utilities, to understand their views on the political and economic climate in which their organisations are operating, the regulatory and policy landscape surrounding them, and what the future holds in terms of change and challenge.

The results paint a picture of chief executives poised for sector disruption. They expect radical changes to business models, even in the short term; are dissatisfied with or lukewarm to the regulatory regimes they operate under; and express concern in relation to wider economic and political factors impacting their businesses.

While responses to some questions show significant variation in opinion between different utilities subsectors, qualitative commentary on the survey findings, provided by sector leaders, showed the findings generally resonate with chief executives across the board.

Even in areas where a single subsector stands out from the crowd – for example with regards to networks’ support for their regulatory regime – qualified comments show that there are significant and growing concerns about the direction of travel for the future, and the influence that political interventions are having on this.

In this first iteration of our CEO research, respondents from the water sector – spanning wholesale and water retail – provided especially robust responses to questions about satisfaction levels with the regulatory and market structures that envelop company operations and profitability.

To acknowledge this, as well as including observations on water responses in our general commentary, we have separated them out in a special subsector focus chapter.

The next iteration of our CEO Insight series will gather evidence over spring 2018, with a second report appearing in the summer.

## Key findings

*Utility Week’s* first CEO Insight research, conducted by *Utility Week’s* independent market research partner Insight Advantage, shows:

1. Policy and regulatory instability are the highest-rated factors impacting businesses today, receiving scores of 7.9 and 7.5 out of 10 for impact respectively. The third highest rated impact factor was change and uncertainty relating to new technologies and commercial models (7.2).
2. Brexit is currently relatively low on CEOs’ agendas, with respondents scoring its impact at just 4.5 out of a possible 10. However, this varies considerably by sector, with vertically integrated energy companies scoring it much higher than average (7 out of 10) and water retailers much lower (1.5 out of 10).
3. More than half (57 per cent) of CEOs believe the regulatory regime under which they currently operate is not fit for purpose, with water retailers and challenger energy supply brands most likely to take this view, and power and gas networks least likely to. Even with water retailers and challenger suppliers taken out of the equation however, nearly half of CEOs say their current regulatory regime is not fit for purpose.
4. Even in the next five years, CEOs expect considerable change in their business models, with respondents rating the expected scale of change at 6.7 out of 10 in the next five years. This rises to 8.7 out of 10 in the next ten years, and a transformational 9.3 out of 10 in the next 15 years.
5. Respondents expressed a strong appetite for M&A, with 81 per cent of CEOs saying their organisation would be a “buyer” in an M&A scenario. At the same time though, there was little expectation of significant M&A activity in the next 12 months, with 67 per cent of CEOs saying they expect “very little” M&A and a further 19 per cent expecting “moderate” levels of M&A.

## Methodology

We approached 48 CEOs leading organisations across the UK utilities sector, including water wholesalers and retailers, gas and power distribution networks, the big six vertically integrated energy companies and a range of challenger energy brands.

More than half – 21 – responded. Their input was anonymised and aggregated in line with market research guidelines and *Utility Week* will not be providing details of which companies have responded to the survey in order to protect the anonymity of chief executive responses in smaller subsectors.

To add meaning to the survey responses, *Utility Week* also sought out qualitative comment from a range of chief executives and other expert commentators on the sector. This input has helped to shape and inform this report’s analysis of the research findings.

This report is the first in a new series of CEO Insight research from *Utility Week*. The research will be conducted biannually, with the next iteration to appear in summer 2018.

# The macro-view

In an attempt to understand the wider context in which utilities operate, we asked our CEOs to identify the factors most heavily impacting their businesses today, as well as exploring their level of confidence in the political and economic environment the UK can offer them.

Their responses resoundingly identified change and uncertainty relating to regulatory regimes and policy frameworks as the highest impact factors for today, followed by the effects of new technologies and commercial models.

Meanwhile, the impact of international politics (excluding Brexit) was considered irrelevant to current business interests. And, perhaps surprisingly, even Brexit was rated low in term of its business impact, receiving a score of just 4.5 out of a possible 10.

Scrutinising CEO confidence levels in the government and the UK economy, responses generally exposed scepticism. Confidence in the UK economy to provide a stable environment for their businesses was rated at 4.5 out of a possible 10 and confidence in the ability of government to provide a coherent policy framework, in turn supporting effective investment planning, was rated at just 4.2 out of 10.

It should be acknowledged that confidence levels and appreciation of business impact factors varied significantly according to utilities' subsector, however.

On Brexit, for example, water retailers scored its impact much lower than the average (1.5 vs 4.5), while large vertically integrated energy companies scored it much higher (7 vs 4.5). Doubtless, this reflects the nature of the markets in which these different utilities operate: the domestic nature of water retail, where the UK is one of the only competitive water markets in the world; versus the global, and particularly European, nature of many energy generation and retail businesses, especially those with sizeable energy trading arms.

The impact of macro-economic factors, including rising

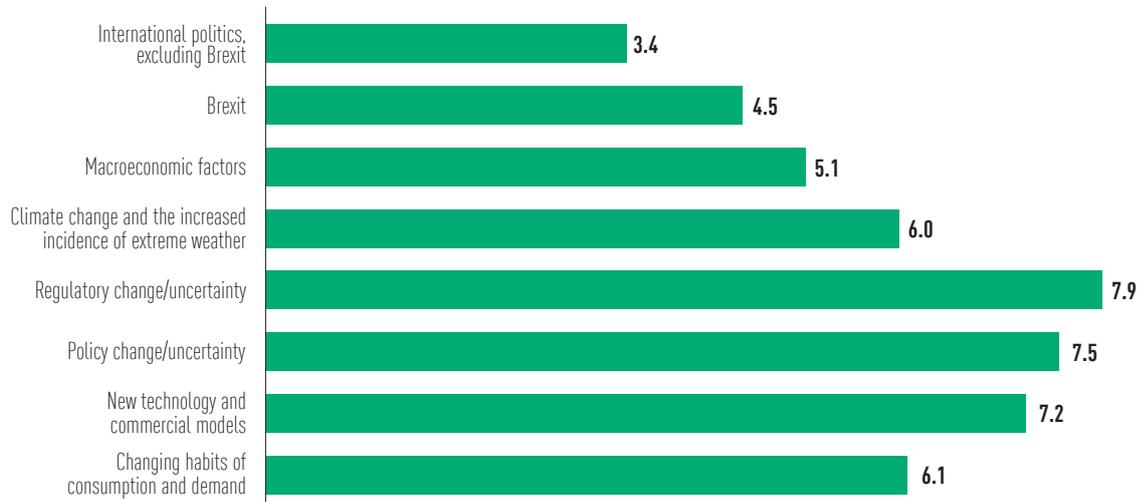
inflation and a sustained low interest rate environment, also varied widely by sector. While the overall average score of 5.3 out of a possible 10 shows CEOs consider these factors to be broadly manageable, challenger energy brands found macro-economic factors more problematic and water retailers significantly less so than the average.

This likely reflects what one commentator described as the "start-up" nature of many energy retail new entrants and their need to secure funding for expansion. This contrasts with the business models of most water retailers, which have largely spun out of larger, more established companies and have little need to raise finance.

Taking the CEO responses as a whole, however, commentators said they empathised with the overall impression of CEO sentiment. Several commentators reflected on their own experiences of the impact that policy uncertainty has on their ability to plan investment and secure financing – and therefore their ability to move for advantage in upcoming technology and commercial fields, referenced as the third largest business impact factor.

Recent efforts on the part of government to increase long-term visibility of the direction of travel for utilities policy frameworks were welcomed. The publication of the Department for Business, Energy and Industrial Strategy's (BEIS's) Clean Growth Strategy, as well as its smart systems and flexibility plan, Upgrading our Energy System, were particularly lauded for showing a clear understanding of big picture industry issues and the need to support investment to tackle these.

However, one chief executive cautioned that these positive signs of long-term thinking in policy creation are still being undermined in the immediate environment by "knee-jerk" interventions in the market, from feed-in tariff and subsidy alterations to price caps. Another warned that an apparently growing appetite for intervention in price-setting regimes is



To what extent are each of the factors above affecting your business? Indicate the impact on a scale from 1 to 10

damaging the independence of regulators, and the industry’s relationship with these bodies.

While none were under any illusions that continued industry and technological change, combined with political volatility, can be eliminated, there was a strong feeling that policy makers could work harder to avoid creating unintended market consequences in the short term.

On Brexit, commentators qualified the survey results, clarifying that Brexit is by no means considered immaterial at board level. Rather, its impacts are viewed as less immediate. Peter Emery, chief executive of power distribution company Electricity North West, observed: “I agree with what other CEOs have said here. Most of the impact we can currently understand from Brexit is what I would describe as ‘second order’ for our sector. For example, the things we think Brexit is likely to mean for us is a tightening in the availability of skilled contractors and employees at the margin and potential increases to the cost and lead time for plant and equipment.”

He also said Electricity North West is alert to the fact that Brexit could have an impact on UK economic growth, and therefore the pace of change in some strategically important

areas. “For example, if the UK economy struggles post-Brexit, the transition to electric vehicles may be slower than currently anticipated. If the economy is buoyant, the pace of change may be quicker.

“Equally, Brexit could have significant implications for the attractiveness of the UK to debt and equity providers – again due to economic buoyancy or volatility, and the changes to the valuation of the pound, which might impact the real value of their investment returns. But these are not issues for our business today, whereas some of the higher rated impact factors in the survey are more immediate.”

**“Brexit could have significant implications for the attractiveness of the UK to debt and equity providers – again due to economic buoyancy or volatility”**

## Regulation

- 🔺 Overview
- 🔺 Network regulation

Read more about CEO sentiment surrounding water wholesale and retail regulation in our subsector focus, p11.

### Overview

As the highest rated business impact factor in the survey, perceived uncertainty and change to utilities’ regulatory structures merit close attention.

It is concerning that, when asked whether they believed the regulatory regime under which their businesses operate is fit for purpose, 57 per cent of CEOs said “no”, although confidence levels did vary considerably by sector.

Least satisfied with their regulatory regimes were challenger energy retail brands and water retailers.

Verbatim comments from leaders in the latter subsector exposed particular concerns with Ofwat’s use of ex-post regulatory tools, which were deemed ineffective for a new market,

as well as the level playing field provided by regulatory rules for new entrants competing against incumbents.

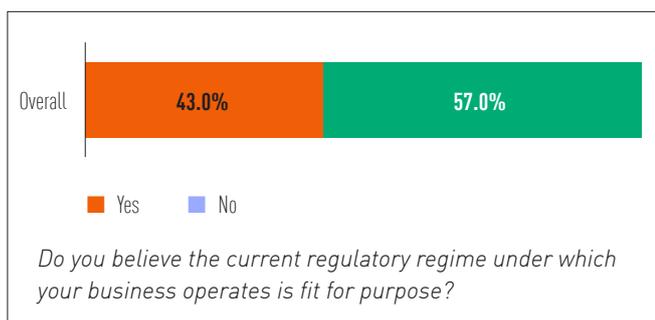
Digging down for more detail on water retailer concerns with their new market structure, *Utility Week* found significant dissatisfaction with the quality of service provided to retail businesses by wholesalers, with some 50 per cent of subsector respondents saying this is currently causing problems for their business. This finding resonates with wider market intelligence picked up by *Utility Week* and its sister title *Water Retail*, where calls have been registered for tighter rules to standardise minimum wholesaler service levels.

The dissatisfaction of challenger energy retail brands with their regulatory regime is unsurprising given the well-documented complaints of new entrants in recent years, about rules that have restricted their ability to innovate and bring new business models to market quickly, as well as market conditions that are perceived to have perpetuated the dominance of the big six retail brands.

But it seems that these historical sources of dissatisfaction for challenger brands are no longer the nub of issues with the regulatory regime. Indeed, commentary revealed that significant challenger brand dissatisfaction is now focused on the continuation of certain “special treatments” for new entrants, which are no longer deemed relevant in a market where many challenger brands have achieved mid-scale customer bases.

Commenting on the findings, Coop Energy chief executive David Bird, for example, spoke of his growing concern about the ongoing exemption of suppliers with customer numbers below 250,000 from schemes such as the Warm Home Discount.

“This is a rule that was put in place seven or eight years ago to drive competition. It has achieved its aim but now it is



actually discriminating against some of the customers which are in most need of support," he observed.

In short, dissatisfaction here, and anecdotally within larger retailers too, centres around the perceived inability of the regulator to adapt regulatory structures and mechanisms in a way that keeps pace with market conditions.

Bird suggested this is an endemic challenge for all regulators, which "are often behind the industry dynamic" and he sympathised with Ofgem's "difficult role". However, he and other energy retail representatives, large and small, urged the regulator to find ways to become more fleet of foot when considering and then implementing regulatory changes.

Ofgem's shift towards principles-based regulation and its introduction of an Innovation Link and Innovation Sandbox to support challenges to current regulatory structures were broadly welcomed as positive early signs that the regulator is taking this message on board. However, a feeling remained among commentators that Ofgem could do more to reduce friction around both the development and implementations of certain high-impact regulations.

"In core areas, Ofgem needs to be more appreciative of the business planning that is required to become ready for new regulation," said Bird. "We are now into budget year and we have no idea about the potential financial impact of some of these things. That makes it hard to plan and hard to invest."

Perhaps surprisingly, Ofgem's work to implement price regulation in the energy retail market drew little direct comment from either survey participants or qualitative commentators – although several verbatim survey responses did express concern, even anger, at Ofgem's rapidly eroding position as an apolitical regulator.

## Network regulation

CEOs from the UK's regulated power and gas networks expressed the highest levels of satisfaction with their regulatory regime – RIIO (revenue = incentives + innovation + outputs) – which was implemented in 2013 for gas and power transmission networks and gas distribution networks and 2015 for power distribution companies. It replaced the legacy DPCR regulatory model.

Survey comments commended the RIIO framework for its success in driving performance improvements while also

**“Our good framework is at risk of falling down due to political intervention and it’s our frank opinion that the regulator is losing its independence.”**

delivering cost reduction for consumers and its “balanced” approach to supporting shareholder returns while protecting service levels. Furthermore, 83 per cent of network CEOs said they agreed that the introduction of the RIIO regime has “positively changed the way we do business”. The remaining respondents were neutral in their feelings about this statement, with none opposing it (see graph, Network support for RIIO, below).

These comments reflect *Utility Week's* broader appreciation of network sentiment and the opinions of commentators. Electricity North West chief executive Peter Emery said his company – and the networks industry more broadly – support the RIIO framework.

"The RIIO concept and the ED1 framework provide incentives for continuous improvement and cost reduction and that benefits customers, shareholders and other stakeholders – including the government," he commented. "So, certainly in terms of RIIO ED1, we are very supportive of it and I would say it is fit for purpose."

This said, and acknowledging widespread network support for the RIIO concept, it is notable that both survey responses and commentary highlighted significant and rising concern among networks about the susceptibility of the regulator to political influence and the impact this could have on the financial stability of networks in the future.

Survey respondents also expressed high levels of scepticism about the idea that investors will accept lower rates of return under the next RIIO settlement, an outcome Ofgem has indicated it will push for via a reduced weighted average cost of capital. 67 per cent of respondents disagreed with this concept and none supported it (see graph, Networks doubt, below).

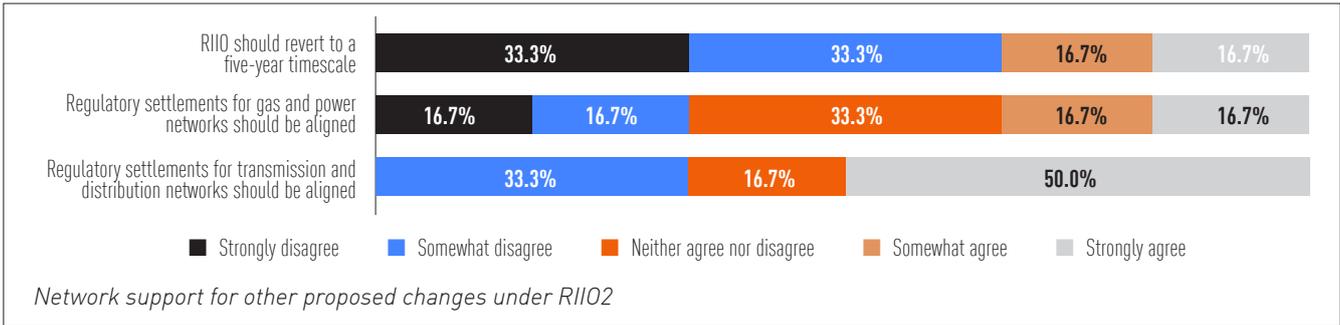
One gas network leader said: "Our good framework is at risk of falling down due to political intervention and it's our frank opinion that the regulator is losing its independ-



Network doubts about lower returns: Investors will be willing to accept a lower rate of return under the price settlement



Network support for RIIO: RIIO has positively changed the way we do business



ence.” The leader went on to clarify that this concern follows the recent exertion of political pressure on Ofgem to curb “excessive” network returns, as they have been reported in studies conducted by bodies including Citizens Advice and the Energy and Climate Intelligence Unit. The leader described such studies as “misleading and uninformed”.

Focusing on the question of future returns, the same gas network executive took a more temperate view than survey respondents, saying its investors would accept a challenging rate of return if they were confident the level at which this was set was tied to clear econometric modelling and understanding of market conditions.

Again however, they emphasised that any suggestion that the rate of the return had been set to accomplish political goals, would not be acceptable.

Electricity North West’s Peter Emery took a slightly different view on the debate around future investor returns. “Our next regulatory price regime is five years away,” he observed. “So talking about rates of return in the next period today is a bit of an academic debate.”

He did, however, urge government and Ofgem to take into account when deciding what rates of return they believe to be reasonable for the next regulatory period, that investor decisions are made in the context of global market conditions.

“Investors’ willingness to accept the rates of return available from networks in the UK will boil down to how these compare to other opportunities worldwide. And the problem with markets is that they do not gradually switch off. They are either attractive or they’re not, and there’s practically nothing a CEO can say to influence this. It’s always a risk for government or Ofgem to take to set a rate of return that they think is reasonable in a global context. And if they get that wrong, they

will have a problem – capital will move away.”

As a final observation, Emery added that debate over the rates of return for networks should consider economic factors such as currency value fluctuations. He said a continued decline in the valuation of the pound relative to the US dollar could significantly negatively impact the real value of returns from UK utilities for non-UK based investors.

The recent call from MPs including Conservative John Penrose, for Ofgem to reopen network revenue settlements as part of its RII01 midpoint review, elicited consternation among commentators, with one power network leader saying a mid-period adjustment would deliver a “massive” blow to investor confidence and trust in the integrity of the regulatory environment in the UK.

Overall, network commentators expressed hopes that the RII0 model will endure for the foreseeable future, avoiding significant damage from political intervention. However, it was also acknowledged that however fit for purpose the regulatory regime may be today, the risks associated with regulatory uncertainty will increase as networks head into the next price control period, simply as a product of big picture energy system trends such as decentralisation and decarbonisation.

Such trends are directly linked with the mooted transformation of distribution network operators (DNOs) into distribution system operators (DSOs) and to the future role of gas in the provision of domestic heating.

With significant question marks over the commercial and regulatory frameworks that would surround networks with significantly changed roles and responsibilities, network leaders agreed with the overall view that regulatory change and uncertainty is the highest impact factor for their businesses (see graph, Network support, above).

## Business model transformation

- △ Overview
- △ Workforce challenges

### Overview

It is a well-documented and widely commented on fact that the UK utilities industry is going through a significant period of disruption and transformation, which is putting pressure on companies to embrace new technologies and new ways of working.

CEO responses to our survey show transformation challenge is now being actively tackled, rather than simply planned for.

Within the next five years, CEOs expect considerable changes to manifest in their business, with respondents rating the expected scale of change at 6.7 out of 10 in this period. A complete transformation process for the industry is expected to be more drawn out, however, with increasing levels of disruption to existing business models expect over a 10- and 15-year horizon (see graph, CEO expectations, right).

As in many other areas, CEO expectations for business model change did vary by utility subsector, with challenger energy retail brands expecting the most disruption to business models in the nearer term. Water retailers expected the least change to business models in the next five years – which is unsurprising given the newness of the market and the fact that companies operating in this space have only recently established their business models.

Over a 15-year horizon, however, water retailers expected almost total business model transformation, predicting 9.5 out of 10 for the scale of change. This may reflect expectations in the market that the domestic water sector will also eventually open to competition.

Overall, gas networks and water wholesalers expected the least radical changes to their business models over the next 15 years, while challenger energy retailers, large vertically integrated energy companies and power networks all expected a 10 out of 10 total transformation of their business models over this timescale.

Commentators were unsurprised by the overall picture of CEO expectation of change. There was universal acknowledgement that trends for decentralisation, decarbonisation and digitisation have long been driving a need for change, and that these pressures are now converging and coming to a head.

Commentators from regulated utilities also expected business models to be transformed as a consequence of new commercial opportunities in markets that are currently undergoing reform or deregulation, such as bio-solids and resources for water and, potentially, the provision of flexibility services for energy networks.

Coop Energy chief executive David Bird told *Utility Week* he was “encouraged” that more and more utilities are now in the process of moving transformation plans into action via pilot schemes that put new technologies and commercial models to the test.

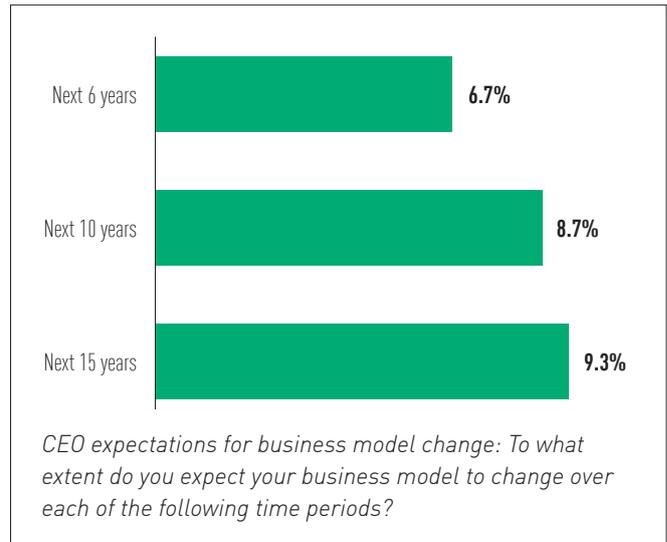
“It’s great to see different people in the sector trying different things to try and practically understand how some of the new business models that are being talked about might work in the future,” he said.

Speaking for his own organisation, he referenced a key trial in Bethesda in North Wales that is testing the workability of time-of-use tariffs linked to local sources of renewable generation. Bird said over the next ten years, such experiments could well enable traditional unit pricing of energy to be overthrown as the dominant basis for billing customers.

“Once you have the data and understand customers better, the idea of offering customers energy contracts which are based on the maintenance of a certain level of comfort in their homes between months X and Y could work.”

Bird said this was because such models would play to

**“Energy is a complex market and we should not underplay the expertise that we have in UK utilities organisations.”**



suppliers’ successful track record in managing risk for consumers. “This is often forgotten,” he said. “We buy in the wholesale energy market and spread risk so that customers experience relatively little volatility in their prices. The service-based energy supply model is, to me, simply an extension of that absorption of risk on the behalf of the customer – but we need better data and analytics to enable it.”

Tackling the suggestion commonly made by technology analysts that utility business models, especially in energy supply, could be disrupted because global tech-giants such as Google and Amazon will make them irrelevant, Bird said he was not convinced this will be the case.

“Some of these organisations may well come into the market – but I think as partners. Energy is a complex market and we should not underplay the expertise that we have in UK utilities organisations.”

Bird concluded that it is more likely existing players will find opportunities to work as “co-ordinators” for the interests of big new market entrants, “rather than being kicked out of the market altogether”.

## Workforce challenges

Although CEOs expressed high hopes for business model transformation in the near and mid-term future, it should be acknowledged that some significant barriers stand before the successful completion of this transformation journey.

According to our research, key challenges for utilities gravitate around recruiting and retaining skilled employees to support current and future operations. Commentary from sector leaders confirmed this view – although many CEOs were also confident that their approach to investing in apprenticeships and planning for changing skills needs will protect them from any risks associated with misalignment between workforce capability and organisational strategy (see graph, CEO perceptions of business challenges, below).

Observing utility company CEO attitudes toward skills challenges, Energy and Utility Skills chief executive Nick Ellins said he was encouraged to see such high-level acknowledgement that attracting and retaining appropriately skilled staff

fundamentally underpins the ability of businesses to achieve their goals.

Ellins also commended CEO commitment to supporting apprenticeships, and engagement with young people via partnerships with schools and other educational schemes designed to highlight utilities career opportunities.

However, he warned that utilities leaders must keep a close focus on resilience strategies for attracting and retaining the directly and indirectly employed skilled workers, and not underestimate the challenge they will face from other sectors and infrastructure demands. "There is currently no co-ordinated UK approach to ensuring that the common competencies and skills needed to deliver multiple major upcoming infrastructure projects are in place and sustainable. It means the sector must act for itself and work as one.

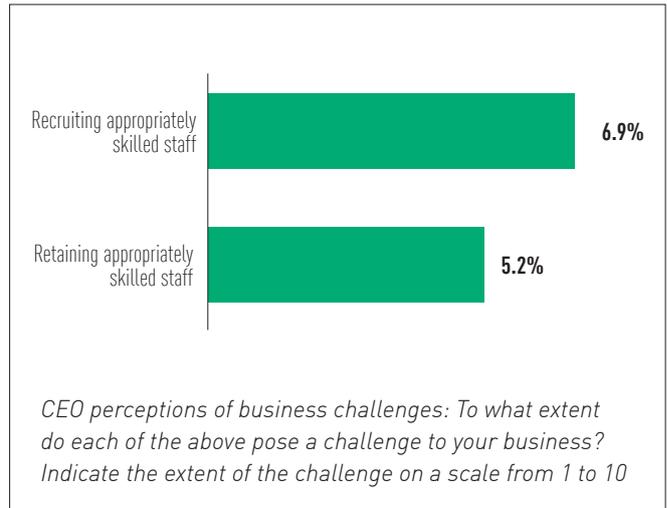
"As the Hinkley Point C project swings into full force and HS2 kicks off in parallel with a gamut of other big schemes, there is a real danger that utilities will find themselves unable to maintain their supply of skilled contractors and the internal engineering resource they need to fulfil their own business plan commitments – especially if the uncertainty of Brexit does impact the UK's ability to access European talent pools," he said.

"Companies need to be sure they have a sustainable approach to protecting their workforce resilience and doubly check they are confident they can find the volume and quality of people they need under various scenarios."

Other factors that could upset the effectiveness of utility skills strategies include fallout from the launch of the national apprenticeship levy, which Ellins said is already having an impact on the way companies invest in training across the devolved UK nations, due to opposing skills strategies in the four nations' governments and inconsistencies in the funding rules around the scheme.

With securing mass talent attraction, Ellins pointed to the Talent Source Network, which now has a database of more than 3,700 individuals with utilities-relevant skills, as a useful tool for utility-based businesses engaged in workforce resilience planning. He urged more companies to sign up to this and to the commitments of the utilities Procurement Skills Accord. Launched in late 2016, this scheme binds members to certain responsible procurement practices and asks them to cascade these to suppliers, with the aim of spreading skills resilience throughout the sector value chain.

Sector commentators recognised the need to remain alert to changing skills attraction and retention challenges. One senior leader at a gas distribution company said progress with HS2 and Hinkley Point C will "no doubt contribute to the increasing mobility of construction skills, the results of which



we have already started to feel".

Meanwhile, Electricity North West chief executive Peter Emery said that, while his organisation does not struggle to attract core STEM (science, technology, engineering and maths) skills for traditional roles, significant thought is currently going into strategies for building workforce capability in digital skills and commercial skills.

These skills areas have not historically been required to any great degree in networks companies, said Emery. But as digital technologies become pervasive, connecting consumer-grade and infrastructure assets via the internet of things, and as DNOs move to realise the opportunities tied to DSO business models, the chief executive confirmed they will be in high demand.

Coop Energy's David Bird had similar observations for the future skills needs of retailers, where he said the emphasis is shifting away from process, towards problem solving. The latter demands growth in empathetic skills, which Bird said can only be achieved by increasing the diversity of talent in the utilities sector.

**"As the Hinkley Point C project swings into full force and HS2 kicks off in parallel with a gamut of other big schemes, there is a real danger that utilities will find themselves unable to maintain their supply of skilled contractors"**

# Consumer perceptions and satisfaction

One of the most pressing issues for any CEO is the relationship of their business with its customers – and this is particularly true for utilities at the present time.

With customer trust in utilities never far from the headlines, it comes as little surprise that a significant majority (62 per cent) of CEOs said they believe customer perceptions of utilities are becoming more negative.

Water wholesalers were particularly gloomy on this count, with 100 per cent of respondents from the subsector saying customer perceptions are deteriorating. This may well be a consequence of recent high-profile political attacks on the water sector for being financially opaque and a manifesto pledge from Labour in the last general election to re-nationalise the industry. Such assaults have catapulted water companies from a position of relative anonymity into the centre of an intense public debate over the integrity and legitimacy of private utilities and would understandably contribute to a feeling that customer perceptions are worsening (see graph, CEO views on customer perceptions).

In commentary, however, one DNO chief executive cautioned against confusing political hyperbole and media coverage with the day-to-day reality of customer experience.

“There is a question to be answered by the utilities industry about legitimacy,” he commented. “But this is more to do with political philosophy than customer experience. Customers don’t ask questions about legitimacy in our everyday conversations with them, they ask questions about service.”

And on the whole, the CEO continued, Ofgem measures show that satisfaction with network service is on the increase, with most DNOs now achieving rewards for outperformance against the Broad Measure for Customer Satisfaction.

Peers at other networks agreed there is a need to differentiate between perception as it is reported in political rhetoric and mainstream media, and objective feedback captured in regulatory frameworks and independent measures such as the UK Customer Satisfaction Index, in which some utilities stand out as top performers.

For example, in the latest iteration of the UKCSI, which is overseen by the Institute of Customer Service, Wales & West Utilities outperformed brands that are commonly recognised as cross-sector exemplars for customer satisfaction, such as Amazon, John Lewis and Marks & Spencer.

Other commentators observed that declining customer confidence is not a unique challenge for utilities, but a macro-

trend that transcends sectors. “Customers across the board are getting harder to keep happy,” said one. “And while customer service scores might be going up overall, I think this is the result of laggards catching up, rather than continued improvement from service leaders.

“Generally, I think that the top performers for customer satisfaction are having to work harder and harder to stand still, but are not moving the frontier forward.”

Some chief executives were more optimistic, however, about the ability of utilities to exceed customer expectations and create positive perceptions around their brand, and the sector as a whole.

Matthew Wright, UK managing director of Orsted (formerly Dong Energy), observed that while a legitimacy issue certainly exists at the utilities-customer interface, evidenced by the move to price regulation and other market interventions, macro-trends surrounding the sector offer a great opportunity for positively transforming this relationship.

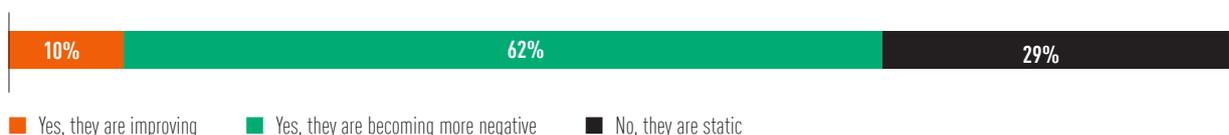
“More broadly, if you look at customer support for renewable energy – and in our case offshore wind – it’s enormously high,” he observed.

“I think it is wrong to say that customer perceptions of all aspects of utilities is poor – it depends what part of the value chain you are in. And there is a challenge, therefore, for CEOs across the sector to regain or to reinforce legitimacy by communicating a clear purpose for their organisation that customers can identify with.”

Orsted has invested an enormous amount of resources and effort into transforming its business to align with the purpose of decarbonisation and leadership in a clean energy future. The company has almost completed its divestment of fossil fuel-based business activities, in favour of a strong focus on offshore wind, other low-carbon technologies and b2b energy retail – where the emphasis is on energy efficiency.

Wright concluded that CEOs who can align their business with a clean energy future – “which holds significant positive interest for consumers” – can create a positive customer perception of their brand.

While he admitted that this challenge is arguably harder for utilities that directly bill customers, because they need to prove value for money and meet customer experience demands, he observed: “Also arguably, there is huge opportunity at the customer interface. It might be harder, but the prize is bigger.”



CEO views on customer perceptions of utilities: Do you believe that customer perceptions of utilities are changing?

# Access to finance and investor confidence

In a market experiencing significant levels of transformation, the question of access to finance and investor confidence is understandably high on the agenda – especially given the rising predilection for political intervention in regulated utilities that have long been considered secure long-term investment vehicles for those interested in sustained, above-market yields.

In survey responses, CEOs expressed mixed views about the current environment for raising debt and equity investment for their businesses. On a scale of 1 to 10, where 10 equates to “extremely easy”, CEOs overall rated debt as easier to raise, scoring it at 6.7, compared with 5.9 for equity (see graph, CEO views on ease of access to debt and equity, right).

The exceptions to this rule were contributors from challenger energy brands and water retailers, who both said it is easier to raise equity to invest in their businesses. Especially with regards to challenger energy brands, this may reflect the entrepreneurial, start-up nature of some smaller firms and their need for growth capital in the short term.

As one commentator from a big four financial services firm observed, challenger energy brands also tend to have limited access to the debt market and, of necessity, focus on “an equity play”.

Despite the current political turbulence around the UK utilities sector and the impending threat of slashed dividends on the back of the PR19 and RII0 price reviews, regulated utilities remained confident of their ability to raise debt, with power networks expressing the highest levels of confidence (9 out of 10) and water companies the lowest (7 out of 10).

Commentary confirmed that water and energy networks leaders are not currently experiencing any decline in their relationship with debt financiers. However, there was some definite nervousness about how this situation might change in the coming decade, especially among regulated water companies.

This is unsurprising given clear messaging from the financial community and credit ratings agencies that a punitively low cost of capital in the next AMP period, and downward pressure on dividends, could negatively impact the profile of the water sector for investors.

In a recently review of top trends for European regulated utilities in 2018, ratings agency S&P Global classed the UK water sector’s outlook as “at risk” due to rising political interventions and the possibility of renationalisation under a Labour government.

The concerns of water leaders also resonate with CEO sur-

**“The financial community has woken up to the fact that a sustainable business model is a lower risk business model.”**



*CEO views on ease of access to debt and equity: How easy is it for your business to raise each of the following? Indicate the level of ease on a scale from 1 to 10*

vey responses, which indicated lukewarm sentiment at best regarding the final framework for PR19. Almost half (43 per cent) express low or very low satisfaction with the regulator’s approach to calculating the cost of capital in PR19, with the remainder only “adequately” satisfied.

Likewise, in the networks space, leaders reiterated their concerns about political intervention in the regulatory regime – referenced earlier in this report – and the impact this might have on the availability and cost of debt.

One leader said a mid-period intervention would “massively” undermine the trust investors have in the ability of UK regulators to offer a secure utilities investment environment as well as jeopardise the positive way in which RII0 supports reinvestment in network businesses by incentivising investors to focus on increasing performance rewards.

Beyond the regulated utilities arena, large vertically integrated energy companies also expressed confidence in their ability to access both debt and equity, rating each at 8 and 7 out of 10 respectively for ease of access.

As a forward-looking trend, Orsted’s UK managing director Matthew Wright suggested debt markets may well become harder to access for companies without a clearly expressed sustainability agenda.

He observed that the cost of capital and insurance for low-carbon energy projects has dropped significantly in recent years, with technologies and business plans in these areas moving from a position of relatively high risk, from an investor perspective, to low risk.

“I think the financial community has woken up to the fact that a sustainable business model is a lower risk business model,” he said.

In terms of mergers and acquisitions (M&A) expectations as a reflection of investor sentiment, survey responses were more bullish, with 81 per cent of CEOs saying that in an M&A scenario, their organisation would be a buyer.

One CEO commentator observed that this sentiment seemed to contradict the rather lukewarm feelings overall

about the availability of debt and equity. But nevertheless, they agreed that significant utilities M&A activity should be expected.

This rise in M&A activity may not manifest in the immediate future, however, with 76 per cent of CEOs who classed themselves as buyers saying they expect “very little” activity in the next 12 months. Commentary suggested a three-year horizon may be more realistic in terms of seeing M&A ambitions manifest.

The focal point for utilities M&A is likely to be the energy supply market, according to commentary. Several chief executives said they believe more oil majors will look for technology and retail targets to advance their interests at the utilities-customer interface – as Shell has done recently with its acquisition of First Utility.

The possibility of more deals like the SSE-Npower retail merger was not ruled out, however, and there was a high expectation that many of the smaller suppliers currently active in the market will be consolidated over the next three years –

either joining similarly sized companies with a shared business ethos, or being subsumed into larger organisations if they have a unique technological capability to bring to the table.

Orsted’s Matthew Wright in particular said he believed the market for low-carbon technology acquisitions is ripe, and that there will be some significant activity in this space in the coming year. “The only thing that might stall that is if the market for some of these targets overheats,” he said.

A significant inflation in the valuation of battery storage firms in response to market hype, for example, may cause some buyers to hold back.

While regulated utilities tend to have a less dynamic M&A profile, the significant upcoming changes to regulatory regimes are expected to drive some exchange of ownership for these large infrastructure companies.

In addition, increasing commercial opportunities in the deregulating market mean CEOs in this space are increasingly alert to advantageous technology investments for their unregulated business arms.

## Subsector focus: Water

- △ Overview
- △ Wholesale
- △ Retail
- △ Domestic competition

### Overview

Some of the most robust CEO survey responses came from the water wholesale and retail sectors, where CEO outlook was generally gloomier than in other subsectors.

CEOs in water businesses generally expressed a lower level of confidence in the ability of the UK government and economy to provide a stable environment for their businesses. Wholesalers in particular expressed negativity around customer perceptions of the utilities sector, with all subsector responses saying perceptions are deteriorating.

This negativity may in part be attributable to the recent and sudden exposure of water companies in political debate over the legitimacy of UK utilities and the value they provide to customers. While companies in the energy sector – especially energy retail – have long been subject to such scrutiny, water companies have been used to relative anonymity in public debates over utility costs, profits and service quality.

Water chief executives also expressed the highest levels of negativity regarding their regulatory regime, with 100 per cent of retailers and 50 per cent of wholesalers saying it is not fit for purpose.

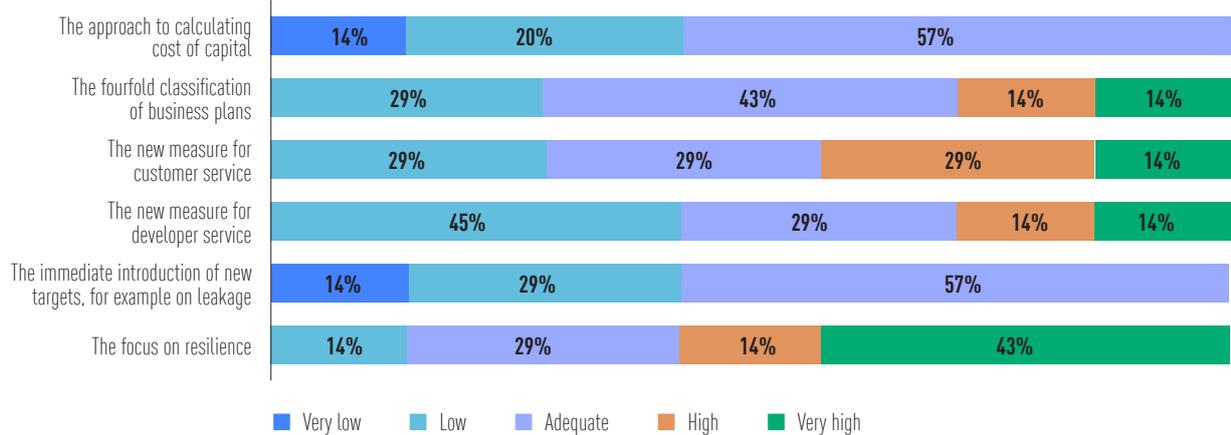
In wholesale, divided opinion on the suitability of the regulatory regime was matched with slow progress in embracing some of its newer elements, such as totex accounting. Meanwhile, water retailers were forthright in expressing dissatisfaction with the margin allowed by the regulator at market opening and the level playing field provided in the market for

### Key water findings

1. Water wholesalers and retailers expressed lower than average confidence in the UK government and economy to provide a stable environment for their business when compared to other utilities. Wholesaler CEOs were also unanimous in saying customer perceptions of the utilities sector are on the decline.
2. Wholesaler confidence in their access to debt and equity was lower than that of other regulated utilities. Wholesalers rated ease of access to debt at 7 out of 10 and ease of access to equity at 5.6 out of 10. This compares with ratings of 9 and 7.3 out of 10 for power networks.
3. Wholesalers are lagging behind their peers in gas and power networks in terms of realising the benefits of a move to totex accounting.
4. Satisfaction with the currently regulatory regime is low across the water sector, especially among water retailers, where all CEO respondents said the current regime is not fit for purpose.
5. Wholesaler sentiment around the framework for PR19 is lukewarm, with significant dissatisfaction expressed with regards to the approach to setting the cost of capital and the introduction of new performance targets.

new entrants compared to incumbents.

On a more positive note, it appears there is significant scope for M&A activity in the water retail market. An equal number of CEOs classed themselves as buyers and sellers in an M&A scenario, suggesting the market is ripe for deals to be struck.



CEO satisfaction with the PR19 framework: What is your level of satisfaction with the following elements of the methodology for PR19

## Wholesale

The most notable findings from water wholesale survey responses relate to sentiment about the current regulatory regime under which companies operate, and the direction of travel this regime is taking.

Half of water wholesale chief executives said they believe their current regulatory framework is not fit for purpose and there was clear dissatisfaction around some of the elements of the framework for the next price control – PR19.

With regards to the current environment, one commentator said they believed “considerable evolution” in the regulatory structure for water companies had led to a more “hands-on” approach from Ofwat, with the introduction of more targets and prescriptive guidance.

It’s notable too, however, that the relatively high levels of dissatisfaction with the current wholesale regulatory regime – compared with other regulated utilities – were also accompanied by an apparently laggardly approach to embracing some of its newer elements.

For example, asked to what extent their organisations had embraced benefits as a result of the move to totex accounting in PR14 – with the intention of creating longer-term thinking in asset planning and supporting the creation of smart, non-asset-centric solutions to water network challenges – CEOs responded with an uninspiring 5.1 out of 10. This compares with 8 out of 10 for gas networks and 7.7 out of 10 for power networks, which were both required to shift to totex reporting under RIIO in 2013 and 2015 respectively.

Interestingly, this finding resonates with previous research conducted by *Utility Week* in 2016, which found that less than half of water companies saw totex as being intrinsically linked to innovation in terms of finding new ways of working.

It should be acknowledged, however, that while half of wholesaler respondents said their current regulatory regime is not fit for purpose, the other half were more positive.

Taking responses in the round, Wessex Water chief executive Colin Skellett suggested the industry is not so much dissatisfied as keen to work with the regulator to find areas

where the regime can be improved.

“I don’t think we can find a different model,” he said. “It’s a question of ‘what can we do better?’ – and I think there are areas where we can.”

This said, wholesaler CEO sentiment around the final methodology for PR19 indicated little satisfaction with the direction of travel for the regulatory framework, especially around Ofwat’s approach to setting the cost of capital – a major determining factor in shareholder returns – and its immediate introduction of stretching new performance targets at the beginning of the next price control period.

With regards to the former, 43 per cent of CEOs rated their satisfaction with Ofwat’s approach as “low” or “very low”, with the remainder merely rating the approach as “adequate”.

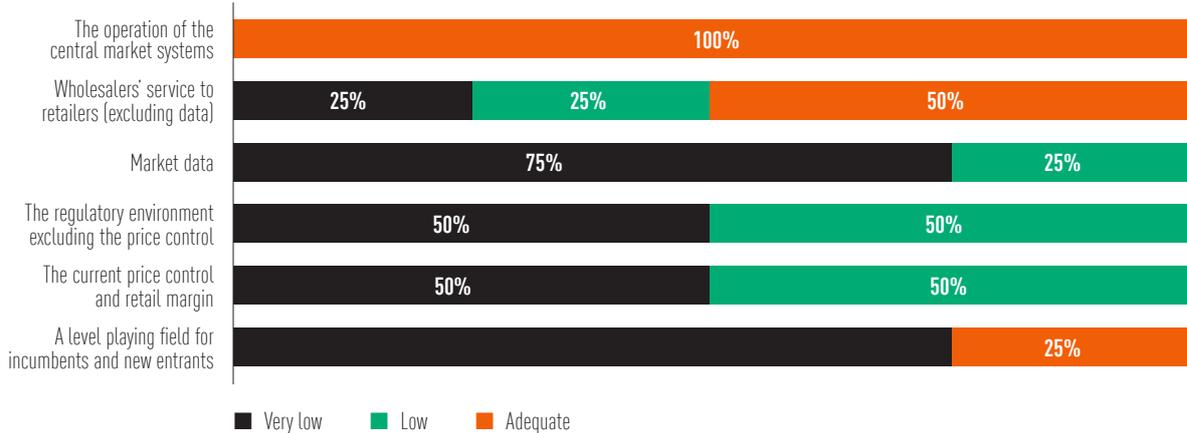
This scepticism over the regulator’s economic modelling methods is reflected in the public challenges several water companies have made to Ofwat’s plans for the weighted average cost of capital over the next regulatory period. For example, Anglian, Northumbrian and Affinity Water commissioned KPMG to review Ofwat’s methodology. The resulting publication claimed the regulator’s assumptions in calculating total market return, a key element in the cost of equity, were flawed.

The most popular element of PR19 was, unsurprisingly, the least controversial. Almost half (43 per cent) of wholesaler CEOs expressed very high satisfaction with Ofwat’s plans for an enhanced focus on resilience in the upcoming price review. A further 14 per cent expressed high satisfaction with the new importance given to this long-term issue (see graph, CEO satisfaction with the PR19 framework, above).

## Retail

Just under a year after the opening of the non-domestic water market to competition, chief executives at water retail companies are apparently less than enthusiastic about the way in which the new market is operating.

All water retail respondents to *Utility Week*’s survey said they believe the current regulatory regime for water retail is



CEO satisfaction with non-domestic water retail market opening: What is your level of satisfaction with the following elements of market opening?

not fit for purpose. Delving further into the sources of this dissatisfaction found that CEOs are only adequately satisfied at best with the structures put in place to enable non-domestic competition (see graph, CEO satisfaction with non-domestic water retail market opening, previous page).

Many of the areas of the market deemed most inadequate by respondents will come as no surprise to retailers or market commentators.

Issues around the quality of data available for non-domestic supply points, for example, have been well trailed in *Utility Week* and its sister title *Water.Retail*. Likewise, concerns over the level of the retail margin set by Ofwat have been aired since well before market opening, with many commentators saying the level is too low to incentivise real competition.

Dissatisfaction with the service levels provided by wholesalers to the retailer community is more of an emerging issue, with commentators referencing a troublesome lack of standardisation in service levels.

John Parsonage, utilities and regulatory expert at PA Consulting group, said this is a key issue that is "holding the industry back" and blocking the delivery of value to customers.

"The lack of standardisation in operational processes creates a need for bespoke interfaces for each wholesaler, increases transaction costs for retailers, tightens margins and reduces the scope for innovative solutions for customers," he observed.

"The idea that the market would sort out an optimum solution to this problem has proved to be wishful thinking. There's just no incentive for anyone to develop a solution and it's time for Ofwat to take the lead role in making this happen."

Adding to qualitative commentary on wholesale service issues, Neil Pendle, chief executive of water retail company Waterscan, observed that performance is wide ranging and "inconsistent".

While acknowledging that some wholesalers have been "very engaged" in developing their services and are "brilliant to work with", he admitted several companies are considerably less capable.

As a generalisation, he suggested wholesaler services

from water and sewerage companies are better than those provided by their water-only contemporaries, which tend to "have invested less in systems and relationships with retailers".

More broadly, however, Pendle was keen to soften the negative picture drawn by survey findings of retailer satisfaction with market structure and regulation of non-domestic competition.

He said he would generally rate the regulatory environment as "good", with Ofwat providing "clear leadership and guidance to the market on what it expects the market changes to deliver".

Pendle added that since market opening, the regulator has remained engaged with market participants, exploring their contributions to ambitious programmes for the future development of water markets, including Water 2020 and Road to Resilience.

"Where market issues have occurred, Ofwat has been able to provide assistance but allowed trading parties to resolve these together rather than intervene at every opportunity," he concluded.

Other qualitative input from water retail CEOs seemed to corroborate this view, with most saying the market's first year had been a useful, and largely positive testing ground for the regulatory framework and market mechanisms. There is now a period of opportunity, they said, to learn from the issues that have been exposed and to work collaboratively to resolve them.

Some CEO commentators were more robust in challenging Ofwat, however. Johanna Dow, chief executive of Busi-

**"The idea that the market would sort out an optimum solution to this problem has proved to be wishful thinking. It's time for Ofwat to take the lead role in making this happen."**

ness Stream – which was the incumbent retailer at market opening in Scotland in 2008, but a new entrant in the English market – reiterated previously aired opinions that the English market does not offer a level playing field for new entrants and incumbents.

She once again urged the regulator to apply similar restrictions on market incumbents in England as were applied to Business Stream as the Scottish market incumbent.

Jacob Tompkins, chief executive of The Water Retail Company, seconded this idea and called for Ofwat to rethink the licence application process for new market entrants. He described this as “laborious” and “written for the incumbents”.

## Domestic competition

Extending a competitive market to domestic water retail has been a long-cherished ambition of free market proponents, and one that was brought forward by then Chancellor George Osborne in 2015, when his autumn statement laid out plans to give water customers a choice of supplier, possibly as soon as 2020.

Brexit has kicked this issue into the political long grass, however, with the current government seeming to have no plans to act.

This seems to sit fairly comfortably with water sector leaders responding to *Utility Week's* survey. CEOs were lukewarm at best about the prospect of extended competition – some speaking of the “significant cost versus an ambiguous opportunity” involved and others simply saying it would have little impact.

Interestingly, this sentiment contrasts with anecdotal evidence that many CEOs, especially in water retail firms but also at wholesale companies, believe domestic water competition to be “inevitable”, if not imminent.

It may be that this evidence, gathered via industry events, debates and interviews over the course of 2017, has been knocked off course by the overwhelming impact of Brexit negotiations on the ability of government departments to progress non-Brexit related issues, and the surge in Labour's popularity, with an associated implication that there is little public support for extending the competitive market in utilities.

## Conclusion

*Utility Week's* first CEO Insight clearly defines the tensions being felt at board level by utilities braced for disruptive change.

While energy system transformation is well under way, some of the most radical alterations to competitive propositions and technological infrastructure are just around the corner – reflected in our CEOs' expectation of mounting business model transformation over the coming 15 years.

As this sector metamorphosis progresses, it is inevitable and right that policy and regulatory frameworks surrounding the utilities sector should also adapt.

However, our research shows significant concern among CEOs about the populist flavour of current policy decision-making and its impact on the independence of utility regulators – especially for monopoly networks.

The biggest fear in the near term for energy networks is that a threat to review revenue agreements as part of a midpoint RIIO review will cause serious immediate damage to investor confidence and company valuation. For some, even the suggestion of this possibility has proved damaging. In an interview with *Utility Week*, Robert Symons, chief executive of Western Power Distribution, claimed that Ofgem's proposal to reopen the price settlement wiped 20 per cent off the share price of its parent company PPL.

Not all utilities leaders are concerned by a propensity for snap decision-making from regulators however. On the contrary, for energy suppliers it is the cumbersome and persistently slow nature of regulatory change that is problematic.

Beyond the ramifications of either revolution or evolution

of the policy and regulation arena however, utilities must overcome other challenges if they are to successfully achieve the business model transformations CEOs anticipate.

Our research showed that long-running concerns about attracting and retaining talent for both traditional and emerging disciplines to sustain the business into the future persist and could become more pronounced as workforce mobility continues to increase and skills competition with major national infrastructure schemes like Hinkley Point C and HS2 intensifies.

Then too, business model transformation could be hampered by an increasingly problematic relationship between most utilities and the customers.

Our research showed an overwhelmingly negative CEO outlook on customer perceptions of the firms that deliver essential services in the UK, with only a handful of challenger brands or renewable energy-focused companies expressing optimism about the scope for building trust and popular interest in their businesses.

If customer perceptions of utilities continue to decline, the ability of utilities to achieve positive outcomes from business model transformation will be compromised and the scope for new entrants into the sector to usurp the customer relationship, will be increased.

While subsector views on the significance of different macroeconomic and political factors varied broadly in this research, the importance of customer perceptions and the potential for environmental factors to impact these was commonly accepted to represent a core challenge to the future

sustainability of businesses.

To some degree, this challenge may be behind the high expectations CEOs generally expressed for M&A across utilities subsectors in the near to mid-term future. As brands

seek to change the way they operate and establish new ways of serving customers, it makes sense that they will look to bring new technology and business capabilities into the fold.

## Key findings

*Utility Week's* first CEO Insight research, conducted by *Utility Week's* independent market research partner Insight Advantage, shows:

1. Policy and regulatory instability are the highest-rated factors impacting businesses today, receiving scores of 7.9 and 7.5 out of 10 for impact respectively. The third highest rated impact factor was change and uncertainty relating to new technologies and commercial models (7.2).
2. Brexit is currently relatively low on CEOs' agendas, with respondents scoring its impact at just 4.5 out of a possible 10. However, this varies considerably by sector, with vertically integrated energy companies scoring it much higher than average (7 out of 10) and water retailers much lower (1.5 out of 10).
3. More than half (57 per cent) of CEOs believe the regulatory regime under which they currently operate is not fit for purpose, with water retailers and challenger energy supply

brands most likely to take this view, and power and gas networks least likely to. Even with water retailers and challenger suppliers taken out of the equation however, nearly half of CEOs say their current regulatory regime is not fit for purpose.

4. Even in the next five years, CEOs expect considerable change in their business models, with respondents rating the expected scale of change at 6.7 out of 10 in the next five years. This rises to 8.7 out of 10 in the next ten years, and a transformational 9.3 out of 10 in the next 15 years.

5. Respondents expressed a strong appetite for M&A, with 81 per cent of CEOs saying their organisation would be a "buyer" in an M&A scenario. At the same time though, there was little expectation of significant M&A activity in the next 12 months, with 67 per cent of CEOs saying they expect "very little" M&A and a further 19 per cent expecting "moderate" levels of M&A.

## CEO Insight 2018 (H1)

We are now gathering input for the second iteration of CEO Insight. Our second report will reach out to an even wider pool of utilities leaders and build on the insights revealed in the inaugural survey.

Qualitative comment on the second survey findings

will be sought in May and the final report is set for publication in mid-June.

It will be accessible online exclusively to Utility Week members and a PDF report will also be sent to participating chief executives.