Make or break

Smash and grab: water companies need to shatter the amorphous organisations they once were, identifying elements of the business that can exist as stand-alone entities with their own definable

Utilities have changed beyond recognition in the last ten years as vertically integrated single product companies have redesigned themselves to adapt to the new competitive environment.

In the world of gas and electricity, the players have all effectively disaggregated the value chain elements that make up their businesses and re-aggregated them into different forms suited to the marketplaces they feel most equipped to compete in.

For example, Centrica has re-defined itself as a 'home and road services business' and Sweb has become an electricity and water distribution business (including a water supply business) after its acquisition of Hyder.

United Utilities has become a holding company for a water retail business, a distribution networks business (electricity and water), an asset management service company (running other people's assets) and a managed services operation (Vertex).

TXU/Eastern has chosen to focus on trading as its core competence, contracting in non-core back-office processing and joint venturing its asset management activity with London Electricity (EdF) through 24seven.

As another major reconstruction takes place – BG plc splitting again, this time into Lattice and BG – it is worth reflecting on the value generation potential of business re-invention.

The value of British Gas has been transformed through its split into BG and Centrica in 1997. Prior to demerger, the business was worth just under £11 billion. Today it is worth more than £24 billion. More than £13 billion of shareholder value has been created – more than ten times that created by the rest of the utility sector in the UK over the same period. Clearly, BG is looking to repeat this success.

But what does all this mean for the water industry?

Water companies have found themselves with market capitalisations well below the value of their regulated asset bases, with competition looming, and with competitors beginning to move down the business re-invention route to create competitive advantage.

Mutualisation has been dismissed by the regulator as a means of getting shareholders back at least to asset base values.

The main glimmer of hope for shareholders has been the potential arrival of 'white knights', which in the case of Thames Water shareholders turned out to be RWE. The German company was willing to pay 20 per cent more than the worth of the regulated asset base for the business, which up to then had been languishing at a 20 per cent discount to asset values. This of course raises the question of how RWE will now extract value for its shareholders having paid such a high premium.

The answer lies in business re-invention. Disaggregating and then re-aggregating the value chain elements that make up the enterprise into a more remunerating form is the key to unlocking shareholder value.

If we take a major water company we can identify a whole raft of value chain elements. Examples of these are water treatment plants, water sources, water distribution, maintenance services, pipe-laying, asset management, licence management, network control, water supply, supply managed services (such as billing) and call centres.

Within each element one could identify potential stand-alone activities such as engineering design, call centres and IT processing.

Value chain elements trapped in the body of the integrated enterprise do not have the wherewithal to configure themselves to suit the market – they have become part of the amorphous whole which makes up the traditional utility.

The skills and competencies required to make a success of each value chain element are different – and a common culture and mind-set cannot reflect these varied requirements, leading to sub-optimisation across the totality of the enterprise.

The water industry is on the threshold of self-transformation

Each value chain element needs to be thought of in its 'liberated' context. For example, British Gas' supply business needs to be thought of as a 'customer relationship' business rather than a part of a gas utility. Defining the business in this way puts the focus on 'churn' and 'revenue per relationship' and has led to the creation of a completely new skill set compared to the integrated days.

Making Centrica fit for purpose has allowed the product and service scope of the business to expand dramatically, thus accessing a much greater spread of value potential.

Another example is asset management service provision, as exemplified by United Utilities and Severn Trent which were recently locked in battle to establish their respective rights to offer these stand-alone services to Hyder. Again, accessing broader geographical scope adds to the potential long-term profits of the value chain element, thus increasing shareholder value.

Another example within United Utilities is the provision of back- and front-office transaction processing by Vertex, which has clearly defined itself as a generic provider rather than one focused on the utility scene. Through expanding the scope of this value chain element, value is enhanced as the market expands.

However, the new stand-alone entity needs to be best in breed in a much broader marketplace if it is to succeed – a significant challenge for entities that are used to being operating divisions or cost centres within an integrated utility.

The first step for a water company considering going down this value chain separation route is to decide the appropriate level of disaggregation – the appropriate level being the number of business units that can stand alone as businesses, as opposed to activities which must be outsourced – that comes later.

After disaggregating, water companies need to be re-formed by piecing together those parts with a demonstrable synergy such that the new whole is worth more than the sum of the parts.

The water industry is on the threshold of self-transformation – those that do it well will serve their shareholders well and recover the ground lost over the last years.

So, how can value be maximised? What is the optimum configuration?

There is no single recipe for success, indeed history has shown that companies can and will choose alternative models dependent on their own particular strengths and weaknesses, distinctive competencies and capabilities.

However, one feature of successful design is clear. That is to make each business entity a suitable fit for the marketplace it serves, as opposed to a part of the amorphous utility of the past.

Again the British Gas example is a case in point with the 1997 demerger creating a customer relationship business (Centrica) and a networked asset business (BG). The skill sets and cultures necessary for success are completely different for these two businesses and adapting each to the needs of its marketplace is what has arguably added the shareholder value.

The current demerger creating Lattice (the networked gas and telecoms business) and (new) BG plc recognises the different needs of these two businesses and it is to be expected that this will too will release significant value as each part is tailor-made for its market.

Whenever there is the possibility of creating an entity that can enjoy economies of scale by serving more than one player in the industry, or can to enjoy economies of scope by deploying its competencies in other sectors, the potential for shareholder value creation exists.

Whenever greater focus on the market to be addressed can enhance the entity's competitive position (eg Centrica's focus on leveraging the customer relationship), there is scope for generating additional value through superior market performance.

The challenge is to identify the opportunities for establishing existing value chain elements of the business as stand-alone entities with greater scale or scope, or opportunities for better market performance through greater focus.

Once these opportunities have been identified the business should be disaggregated and re-aggregated in a way that allows these opportunities to be translated into reality. n

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