

Question 2

1	<p>Q2.1</p>
2	<p>Pricing Policy</p> <p>Pricing water in the short-term is made inherently difficult for WW because it is not known what will be considered acceptable in the market, now that the industry is no longer strongly regulated. There is likely to be intense competition between the deregulated water companies, which will drive down prices and we already know what was considered acceptable immediately before deregulation but given the remaining uncertainties, it is useful to consider the four Cs, as follows:</p> <p>Cost</p> <p>In order to function as businesses, costs must be kept to an absolute minimum. It is unclear at this stage exactly what the costs are, exactly, but we do know the following:</p> <ul style="list-style-type: none"> - The marginal cost to a water company of supplying water to, and removing waste water from, an existing customer in its own region is insignificant; - Land for reservoirs and all other facilities is leased from the Holakia government on 10 year contracts, which makes up a significant proportion of operating costs. <p>The second point is vital - WW cannot afford to show much sensitivity to future increases in costs because fixed leasing costs and the consequent high operating gearing suggests that even small increases may squeeze profits and force higher-cost businesses out of the industry.</p> <p>Customer</p> <p>WW will be serving both water wholesalers and water retailers. We know that wholesale prices will be significantly lower than retail prices and that this market will be regulated to ensure fair prices to water retailers. This puts additional pressure on WW and the water industry in general since high operating costs may mean that there is a theoretical minimum that they can charge and still make a profit.</p> <p>If this is untenable, WW might consider selling a greater share of its water supply to water retailers to retain a healthy profit margin.</p>

Corporate Objectives

The pricing of the water should be in line with WW's corporate objectives. These are likely to be not so well defined at present, due to previous high levels of regulation, but with deregulation, it would be useful for WW to decide what these are. Does it want to be a cost leader or differentiator in this market? This will ultimately impact the price of the water it sells on to wholesalers and retailers.

Competition

A small number of water retailers in the area selling essentially fungible products suggests that levels of competition will be high (as discussed further below). This is likely to force prices down and squeeze profit margins in the industry.

Conclusion

Becoming a cost leader in this new and highly competitive environment, with little way to differentiate yourself from your rivals, seems like a sensible move. WW needs to undertake market research to find out what sort of prices would typically be considered acceptable in comparison to what customers had previously expected. It may be that charging significantly above these rates would simply fail in the market.

Effect of deregulation using Porter's Five Forces

Porter's Five Forces model provides for a business to analyse the competitiveness of a given industry with particular regards to the threats and opportunities that are present in that industry. In particular it focuses around:

1. The threat of suppliers;
2. The threat of new entrants;
3. The power of customers;
4. The power of suppliers; and
5. Competitive rivalry, which really links all of these points together.

The Power of Customers

Customers have come to expect relatively low prices over the years and are unlikely to be responsive to any significant changes in water prices. Water is a fungible product with little to differentiate one particular source of water from another. As such, a "cost leader" is likely to thrive in this kind of environment as customers demand the lowest prices possible for their water. The fact that wholesalers will be able to demand fair prices also suggests that customers demanding low costs will inevitably put a lot of pressure on businesses such as WW.

This is therefore a threat to the industry.

Competitive rivalry

3 This is likely to become an extraordinarily competitive industry, with a few key players, high operating costs and low margins. We know that it will be easy for water users to switch water companies at a moment's notice and this very low level of loyalty will likely mean that cost-driving activities will become of utmost importance. The fact that there are just 4 players in the market at present suggests that, much like with the big UK supermarkets, competition will be fierce. This is considered a threat.

Threat of New Entrants

We are told that the government will permit additional companies to enter the retail market if they wish to do so and that some new companies have shown an interest in doing so. There may be considerable appetite for entry into this market as the barriers to entry appear to be rather low. We know that marginal costs are low and although some infrastructure costs are imminent it is not entirely untenable for new businesses to spring up to enter a market which was previously not available to them.

It's possible that the few water companies that already exist in the market will be able to take advantage of their economies of scale, however, and form an oligopoly to prevent new players in the market. This seems unlikely however, given the high degree of competition, and so new entrants should be perceived as a threat.

Conclusion

Overall, the industry seems to present more opportunities and threats, the key threat being the high level of competitiveness due to the ease with which customers can switch suppliers and the high sensitivity to changes in operating costs. Hence, deregulation is likely to increase competitiveness in the water industry in Holakia.

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Q2.2

The new environmental pollution technology presents various pros & cons. A calculation has been included below.

Pros

- We are told that environmental protection and sustainability are key issues in the industry and so it seems likely that the implementation of new technology would be taken well, having a positive impact on the reputation of WW and of the industry as a whole, should it choose to take it up.
- It would only take one major event to happen with probability 6% to decimate the business. Depending on the risk appetite of WW's management, this would seem like a very high probability to simply ignore altogether;
- It is likely that over time, in reality, relevant technological costs will decrease and it will become cheaper and cheaper to become "greener" in our changing economy;
- Negative press coverage and reputational damage could be easily avoided by investing in this technology. Should a major event happen in the future, the company will be asked what steps they took to mitigate it happening in the first place and this will give them something to point to. This may salvage some of their reputational damage.

Cons

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- Based on the expectation value calculations alone, it would make more sense to avoid investing in the new technology;
- Such high costs would likely be of real significant to an industry that already likely has high operating costs and squeezed margins;
- It is a very high cost to justify each year to key stakeholders of the business.
- If the management are willing to accept the risks presented, then the investment doesn't make any financial sense;

Conclusion

Given that environmental protection and sustainability are such key issues in this industry, it seems like it makes sense to invest in the new technology. Ultimately the decision will depend on the risk appetite of WW's management, but in this case to avoid insuring against the risk completely seems nonsensical.

I might also recommend performing further analysis on the probabilities of pollution events, what the actual effects are and whether any other non-binary options are available for investment.

Note 1

WW, as a water wholesaler will experience only four environmental pollution events every 100 years i.e. one event will occur every 25 years on average. Let's compare a 25-year cycle under two different scenarios:

No investment in technology:

7 Expectation value of cost = $6\% \times \$160\text{m} + 94\% \times \$4\text{m} = \$13.36\text{m}$

Investment in technology:

Expectation value of cost = $25 \times \$1.1\text{m} + 6\% \times \$60\text{m} + 94\% \times \$0 = \$31.1\text{m}$.