



**Supplementary response to Ofwat's call for
evidence – Literature review**

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1. Executive Summary

This note reviews a number of research papers published by the Centre for Competition Policy at the University of East Anglia to examine customer switching patterns and the possible implications for anticipated engagement, savings and market structure in a potential household retail market. This draws upon the experience of other competitive markets.

Across several studies there is evidence that the main driver for customer switching across all social groups is the expected monetary net gain from switching retailer. Different customer groups are found to respond differently both to the anticipated gain of switching and other factors such as anticipated switching time. There is evidence that customers in vulnerable circumstances are less likely to be engaged in a markets and switching than other customers. Positive switching experiences in other retail markets are also a prerequisite for engagement in new markets.

Based on the experience in markets such as banking and energy, we note that the retail element of household water and wastewater bills is small relative to the level of savings required to encourage significant customer switching. This suggests a potentially smaller pool of customers would be likely to switch retailer for water and wastewater relative to the sectors.

Finally, the evidence suggests that the following factors need to be taken into account to ensure fairness in a future retail market:

- The most appropriate structure for the metered and unmetered markets
- The impacts of competition on those who are not engaged in the market
- Any differential impact of competition on customers in vulnerable circumstances who may be less engaged in the market
- The potential ramifications that policy decisions to protect disengaged customers could have on the market as a whole

The evidence from this literature review suggests that when evaluating the potential household retail market for water and sewerage, there are several critical factors that require further consideration.

2. Purpose

In response to Ofwat's call for evidence for introducing competition to household Water and Wastewater Services, this paper provides a summary of recent research undertaken by the Centre for Competition Policy in relation to customer switching and vulnerability in competitive markets beyond the water sector. The purpose of this note is provide an evidence-base from the academic research conducted in other retail markets to feed into Ofwat's call for evidence. The remainder of the note is structured around three broad themes:

- Engagement in markets and impact of competition on vulnerable groups;
- Expected savings in the household Water and Wastewater sector;
- Market structure considerations and implications.

3. Engagement in markets and impact of competition on vulnerable Groups

Key messages

The main driver for switching in competitive markets is the assurance that the level of gain sufficiently exceeds the cost of switching.

Some customer groups are less likely to engage in the market than others for a given level of net gain (such as those with limited internet access). Whilst price is the primary driver, other factors - such as anticipated switching time- alter a consumer's likelihood of switching. Any policies aimed at engaging certain groups in a competitive market would need to take influences on switching into account.

Evidence from the energy sector suggests that regional price discrimination could offer a good deal on price for those engaged in the market, but leave those who are not engaged subject to higher prices. Interventions to remedy this should take into account the implications for customers across the market.

A number of studies have reviewed the determinants of customers' level of engagement in retail markets. The main driver for switching across all customer groups in the energy market is the confidence that savings are available and that the level of gain sufficiently exceeds the costs of switching¹. Another significant driver is the anticipated switching time, though this is only significant amongst some groups.

¹ Flores & Waddams Price (2013)

Within the evidence the likelihood of switching increasing with anticipated gains and lower expected switching times, however there are variations in both in terms of the likelihood of various groups engagement in a market and also which drivers have the greatest influence on specific groups to engage.

For example in the energy sector², low levels of switching are observed both for households who rent (which may be due to bills being included in rental price, the need for an agreement between householders and lack of incentive due to the short time a tenant is likely to live in a property) and those without internet access (likely a result of information about different firms and tariffs being less accessible). Both of these categories are more likely to contain 'vulnerable' customers, so potential remedies for these groups would need to be considered. This could for example include providing assistance with searching for and switching to a customer's best tariff via phone or face-to-face.

However, the picture for customers in vulnerable circumstances is more complex. For example, there is evidence³ to suggest that older people (another social group with a higher proportion of 'vulnerable' customers) are more likely to switch than those who are middle aged; and once other factors have been taken into account those on lower incomes are more likely to switch, are less responsive to anticipated gains and are more deterred from switching by the anticipated switching time. This suggests that specific policies to engage those on lower incomes may be required.

To attract customers away from the regional incumbent in the energy sector, it was common for firms to charge less to customers outside of their incumbency region (i.e. a region where that firm is a new entrant), counteracting status quo bias and increase the net gain from switching (the most important driver of customer switching, as discussed earlier). The Non-Discriminatory Clause (NDC) was introduced in 2008-09 which prevented firms from using this pricing structure as price changes now had to be replicated in all the regions in which it was operating.

It was anticipated that this would provide some protection for those customers who were not active in the market and had not switched from their regional incumbent. Figures of the profitability of the 'big 6' firms suggest that prices rose overall after this, and switching rate predictably fell⁴ given the reduced price differential on offer between regional incumbents and new entrants, thus leaving nearly all customers worse off as a result.

Thus, policy interventions intending to protect those customers who do not engage in the market from higher pricing would need to consider the impact on the

² Waddams, Hviid & Deller 2015 (2015)

³ Waddams Price, Webster & Zhu (2013)

⁴ Waddams Price & Zhu (2013)

competitiveness of the market overall. This is particularly important given the clear role of price in customer switching and the small net gains expected from switching in the household retail market for water and wastewater as we discuss below.

4. Expected savings in the Household Water and Wastewater sector

Key messages

Evidence from customer switching in the banking and energy sectors suggest the anticipated level of savings that could be made by switching in the household water and wastewater market would be unlikely to prompt the vast majority of customers to switch retailer.

This has significant implications in the likely market evolution over time due to the smaller pool of customers who are likely to switch and the reduced scope for segmentation of customers by consumption volume.

Retail costs currently account for circa 10%, or £40 of the average household water and sewerage bill. On the basis that any price benefit from switching will be constrained within this envelope, there is evidence from other markets that this scale of potential savings is unlikely to promote a high level of switching⁵. For example, this is lower than the estimated £100 per annum saving required to incentivise switching in the banking sector.

The level of potential switching rates is major consideration within the framework for assessing the costs and benefits of any future household retail arrangements. Deller et al. (2014) conducted a collective switching study in the energy market which observed peak switching rate of 43% at savings levels of over £300 per annum. In this study, switching rates at the level where savings were of the magnitude of the current retail cost level in water (e.g. £40/yr or less) reached a maximum switch rate of 12.3%. At an individual level, a large proportion of customers not engaging in the market mean that individuals miss out on the best deal. At the market level, if there is such a lack of switching by a large proportion of consumer base then there is a secondary impact of the competitive pressure on firms also being limited.

⁵ This is currently being researched through the on-going CC Water research, however this finding is supported through verbatim comments from focus groups held in the Anglian region prior to the time of writing.

There is also evidence from the energy market⁶ of new entrants aligning their fixed and marginal pricing policy with incumbents shortly after market liberalisation. This price co-ordination reduced over time suggesting segmentation of the market by customer volume. This gives some indication of the possible evolution of the competitive household retail water market, however the smaller anticipated potential saving compared to energy would suggest both a reduced scope for the volume of customers who are likely to switch (given the evidence outlined earlier of this being the principle driver of switching) and a reduced scope for segmentation of customers and thus reduced scope for consumer choice.

5. Market structure considerations

Key messages

The structure of a household retail water and wastewater market would need to take into account the treatment of metered and unmetered customers and the associated current cross-subsidies.

It is likely to be simpler from a customer perspective to treat water and wastewater services as a single market.

Two major considerations for the structure of the future household retail market relate to the treatment of water and wastewater services and metered and unmetered customers.

Deller & Hviid (2016) suggest it is likely that in a competitive household market, treating water and wastewater as a single package would be beneficial for the consumer in terms of simplicity and coordination of water and wastewater services.

Splitting the market into these two services would also have the effect of reducing the potential savings to be made from switching if these products are freely switched separately. Evidence from the Scottish non-household retail market supports the view that these services are generally switched together.

With regards to the treatment of metered and unmetered markets, in absence of full meter penetration consideration needs to be given to how the appropriate incentives exist for unmeasured customers to participate in the market. Deller & Hviid (2016) also note that the absence of full meter penetration:

- Risks firms who incorrectly estimate unmetered demand recovering losses from the unmetered market;

⁶ Davies, Waddams Price & Wilson (2012)

- Could mean that firms may only focus on the unmetered or metered markets separately and;
- There may be charges of unfairness if there are lower prices in the unmetered market, trapping metered customers on higher prices

Deller & Hviid (2016) conclude by suggesting that remedies for supporting competition for unmetered customers could work through a collective switching approach for all customers in a geographical area or a riskier option of charging prices based on correlation according to a customer's observable characteristics, noting the potential complexities of co-ordinating such arrangements.

6. List of references

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