

FAO: Mr Iain McGuffog

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Direct line: 01392 443467
Email: ivosper@southwestwater.co.uk
Our ref:

By email: Iain.McGuffog@ofwat.gsi.gov.uk

17 February 2016

Dear Iain

HOUSEHOLD RETAIL CALL FOR EVIDENCE

South West Water and Bournemouth Water welcome the opportunity to respond to the call for evidence to inform Ofwat's assessment of the costs and benefits of extending retail competition to households.

Following the government proposal on 30 November to introduce household retail competition before the end of this Parliament, this is a useful and necessary first step in understanding this potential change.

Like all changes, we are supportive of any proposal that is in the longer term in the best interests of customers. We believe this proposal has the potential to have a range of benefits including greater choice for customers and improved service.

Indeed, South West Water has undertaken some initial high level customer research to understand what household customer views are on choice of supplier (copy enclosed) and we will continue to engage with our customers more fully as the proposals in this area are developed.

On the assumption that water customers want competition and would engage in the market (we note that the recent Competition and Markets Authority energy market investigation found in its provisional findings material evidence of domestic customers' lack of understanding of, and engagement in retail markets), there are a number of complex areas that require consideration before a household retail market is introduced. These areas include but are not limited to the existing customer protections afforded to vulnerable customers and social tariffs. The issues surrounding these areas and others will need to be accommodated in the design of the household market to ensure a good outcome for

customers. We will continue to engage with Ofwat and other stakeholders to explore these and other issues over the coming months.

Finally, in conclusion, we should note that there already has been a significant amount of work undertaken by the industry in preparing for retail non-household competition and there will no doubt be lessons learned from this experience that will benefit any extension of this market into household customers. Adequate time should be given to reflect on the learning in this area before finalising any decision for household customers.

We have attached detailed responses to the consultation questions in the appendix to this letter, and have provided our most recent customer research and engagement on household competition.

We are supportive of the approach Ofwat has taken to date, and are pleased that a transparent and open approach to the assessment is underway. We look forward to continuing ongoing engagement on this issue throughout the course of the assessment.

Yours sincerely



Iain Vosper
Regulatory Director

Q.1 What are the advantages and disadvantages of extending competition to retail services in the water and sewerage sector to household customers? How could this best be achieved?

As set out in the table below, we consider there are a number of advantages and disadvantages to extending retail competition to households, which in turn may lead to implementation issues;

ADVANTAGES	DISADVANTAGES
<p>BAD DEBT:</p> <ul style="list-style-type: none"> • With the introduction of a competitive market for retail services, there is the potential for new and existing providers to innovate to seek out further opportunities in reducing the instances and longevity of bad debt. • While every company will pursue its own approach to recovering debt from water customers, in general, currently the most cost effective approach across the industry results from processing bad debt instances in bulk. However, in the advent of a market, where it is assumed that the retailer will carry the risk of default payments from customers on both the retail and wholesale charges, this will constitute a much larger incentive for retailers to actively manage bad debt. 	<p>BAD DEBT:</p> <ul style="list-style-type: none"> • However, while we consider that a focus on bad debt is likely to result in a positive outcome for the industry as a whole, we are cautious that, without having developed any detail around how this may work in practice, there are likely to be risks also associated with the approach. For example, if retailers are liable for carrying the full bad debt risk for both wholesale and retail charges, this may result in a situations where retailers are reluctant to take on customers from regions where the bill is relatively larger than in other areas (as the bad debt risk will be larger). • Similarly, without appropriate regulatory architecture supporting the market, it may be that retailers will be reluctant to take on customers who are perceived to be of a higher bad debt risk than other customers (for example, customers who have defaulted on utility bills previously, customers in the rental market, customers in high deprivation areas etc).

IMPLEMENTATION CONSIDERATIONS: BAD DEBT

- How will historic bad debt be treated? A clear line between debt incurred prior to market opening and that afterwards needs to be drawn to ensure a level playing field for all retailers. If an incumbent retailer has to carry the totality of bad debt incurred before market opening, it is unlikely the retail function will be financially viable or sustainable.
- Similarly, if retailers are allowed to 'cherry pick' customers with the lowest level of bad debt risk (i.e. those in affluent areas where the wholesale services price is relatively low), there is the potential for incumbent retailers to be left with a much high proportion of customer with doubtful debt, which in turn will have an impact of the cost of retail services for those indebted customers (i.e. if the incumbent retailer costs either go up or remain static compared to a new entrant with lower cost to serve customers). This would disproportionately affect customers least able to pay.

COST SAVINGS:

- By introducing competition into the retail element of the value chain, there is the potential for cost savings to be achieved and passed on to customers. For example, through economies of scale in the size of the customer base, or from introducing new technology such as fully automated contact systems or web-only retail functions for those customers wishing to only pay for a 'minimal' service.

COST SAVINGS:

- Customer research consistently suggests that customers would only be willing to switch if there are 'significant' cost savings. While there may be potential in some retail activities to reduce costs, the level of cost savings may not drive customers to switch. Given the experience in the energy market, and relatively less water bills in comparison, there may be small engagement in a household market. In a recent study, Ofgem have asked customers what the minimum saving would need to be to induce them to switch, the median of which was £94. Ofwat would need to undertake a similar exercise with household customers to determine whether the savings which would induce a customer to switch water supplier are likely to be realised through introducing competition to the retail element of costs only
- Similarly, the costs of implementing the market architecture and the associated systems required for both

	<p>retailers and wholesalers to operate in a multi-interactive environment have the potential to outweigh any costs savings that follow from a competitive market in the retail element of the value chain.</p>
<p>IMPLEMENTATION CONSIDERATIONS: COST SAVINGS</p> <ul style="list-style-type: none"> • The design of the market, and the extent of customer eligibility for switching retail providers, will have a large impact on the likely cost of the market architecture and systems required to facilitate the market. If a similar framework to that being rolled out in the non-household market is used, then set up costs could be managed, and the impact on the customer minimised. • However, the likely organisational impacts and costs for incumbent wholesalers should not be underestimated. The complexity of introducing a household retail system is likely to be much higher than that of the non-household market, which will have consequences for the scale of resource, time and expenditure required. 	
<p>BUNDLING OF SERVICES:</p> <ul style="list-style-type: none"> • From a customer perspective, one of the prime benefits of access to a competitive retail market could come from being able to 'bundle' utility services, such as happens in communications (i.e. broadband, TV, phone packages) and energy (gas and electricity dual services). Being able to manage separate utility services through a single retail provider has been consistently identified through customer research as desirable as it reduces the time and hassle associated with managing household bills. 	<p>BUNDLING OF SERVICES:</p> <ul style="list-style-type: none"> • While bundling utility services would provide a distinct service benefit for customers, it introduces the need for consistency in market operation and codes between utility industries. • For example, in the energy and gas market, customers will contact retail providers for customer service and billing related issues, but will contact the wholesale provider directly for any supply issues. It is not clear how such an approach would combine with a water market, particularly if the retailer is established as the only point of contact as in the non-household water retail market.
<p>IMPLEMENTATION CONSIDERATIONS: BUNDLING OF SERVICES</p> <ul style="list-style-type: none"> • If providing customers with the opportunity to jointly manage utility bills is recognised as a beneficial objective for the water household retail market, then there is the 	

potential to consider how regulation for these retail services across the wider utility industry is operated. It is not unreasonable to assume that a utility retail regulator, operating across a number of different utility sectors, may be better placed to oversee a combined retail market, rather than duplicating efforts between existing regulators.

DELIVERING CUSTOMER OUTCOMES:

- If the extension of household competition results in a 'thick' market, where the majority of household customers are able to switch retail supplier, and it mimics the operation of the non-household market, then previous studies have identified the potential for retailers to exert significant pressure on wholesaler suppliers in achieving customer outcomes. By acting as a consumer champion, the retailer could be in a powerful negotiating position to influence the price and services offered by the wholesaler.
- As a retail business will be incentivised to retain customers, this is likely to drive up the level of service offered.
- Customer expectations around the level of service provided may increase with the expectation of the benefits a market can deliver.

DELIVERING CUSTOMER OUTCOMES:

- There is the potential for the consumer voice to become fragmented if there is a large increase in the number of retailers operating across the industry. Retailers will be expected to interact with c20+ water and wholesale service providers and may only be representing a small number of customers from each regional area. This could reduce the influence of the customer on the wholesale service provider. Equally, in the current system, where there are integrated retail and wholesale functions within a company, the customer will be interacting with a retailer who has good local knowledge of region and often direct experience of the customer's community and region. There is the potential for this unquantifiable aspect of customer service to be lost in a market where retailers will be geographically distinct from customers.
- In terms of customer protection, if a retail business is heavily focussed on profit maximisation, how will vulnerable customers be protected against mis-selling?

IMPLEMENTATION CONSIDERATIONS: DELIVERING CUSTOMER OUTCOMES

- Alongside 'outcome orientated' regulation, where customers views and priorities are an integral part of shaping business plans, there is a potential for a retail market to act as an extra barrier, or layer of interaction, between customers and wholesale

providers. As recently proposed in Ofwat's Water2020 consultation (December '15), there is a great opportunity for companies to make use of existing information collected as part of the day-to-day interactions with customers. However, it is unclear how this approach might function where a retail market is in existence.

- During a drought, water companies are reliant on customers changing their behaviour to conserve supplies. In a competitive environment, the customer expectations of service reliability may change with the choice of retail supplier if it is framed as providing better service. During the study, it would be pertinent to explore customer behavioural change on service reliability as a result of competition to understand if there is any inadvertent detrimental impact to supply security.
- Customer protection mechanisms will need to be carefully designed to ensure any form of market does not cause detriment to customers, particularly those who may not be willing or able to participate in a market. In particular, issues around data protection and mis-selling will need to be addressed.
- Latest information from Ofgem shows that the big 6 still have around 88% market share and over 60% of customers don't recall ever changing supplier. In its 2014 State of the Market Assessment Ofgem noted that 37% of electricity customers and 40% of gas customers were still being supplied by their regional incumbent (electricity) or Centrica (gas), household customers have been in a position to switch supplier since 1996-98 for gas and 1998-99 for electricity. Recent South West Water customer research suggests that a significant proportion of customers are satisfied with their current retail service and would not be looking to switch suppliers. It will be important for any assessment of costs and benefits of a competitive household retail market to ensure that a realistic forecast of the likely number of customers to benefit directly from switching suppliers is considered.

CHANGE IN RISK PROFILE:

- The introduction of retail competition could potentially affect the risk profile of all businesses within the industry. New retail businesses could grow, and incumbents could choose to specialise in retail or wholesale, or both.

CHANGE IN RISK PROFILE:

- It is unclear how the finance markets may view the change in business risk from the new market, and if this could increase financing costs as a result of the uncertainty.

Q. 2&3 What scenarios for retail competition could be considered in Ofwat’s analysis? What are the advantages and disadvantages of each for water and wastewater services for customers, the environment, wider society and investors?

With respect to potential competition scenarios used to support the analysis, what additional risks or opportunities should be captured in Ofwat’s analysis? How should these be assessed?

Building on the scenarios presented by Ofwat during the company 1-1 telephone calls, we have provided comments on the outlined scenarios:

Scenario	Advantages	Disadvantages
‘Narrow Market’	<ul style="list-style-type: none"> • Builds on existing arrangements in the industry • Offers a gradually phased approach to implementing a market, which could reduce complexity and risk in the long run • Potentially enables competitive forces to be introduced on areas of retail/wholesale operations which have the most bearing for customers (leak detection, water efficiency etc). • By basing the narrow market on a ‘change or event’, this is likely to reduce the set up costs associated with identifying eligible customers to the market. 	<ul style="list-style-type: none"> • It’s not clear if the existing ‘no discrimination’ licence obligation would allow a market place for only sections of the customer base to have access to a retail market. • By adopting a ‘phased approach’ to retail household market opening, there is the potential for increasing set up costs due to a longer programme timeframe • Restricting market participation to a narrow subset of customers, or on an event, it is likely to be very confusing for the customer base in understanding what the market is and how it operates. Customer research consistently suggests that customers have a very low awareness about the potential for competition in both the household and non-household markets, so effectively communicating a restricted market opening is likely to be challenging and potentially confusing for customers.

<p>'Extension of Non-household retail'</p>	<ul style="list-style-type: none"> • Removal of eligibility criteria will reduce complexity between the two retail markets (household and non-household), allowing greater economies of scale to be realised from retail businesses. • Similarly, the use of same central mechanisms and codes across household and non-household retail markets would reduce the household market start up costs. • Retail exit options will allow for the most efficient market structure to develop, and remove perverse situations where incumbents maybe left with riskiest customers. • Removing the eligibility criteria would make communicating with customers about who could participate in the market clearer, increasing the potential of a well functioning market. • Removing the eligibility criteria for household customers may potentially allow multi utility bundling of service to be offered as a retail package. • For investors, extending the non-household retail market would send a clear signal of the extent of retail activity at risk from competitive forces (i.e. the full retail business) 	<ul style="list-style-type: none"> • There are differences in the service requirements between household and non household customers, which would affect the treatment in the market and influence the extension of central codes and mechanisms to households. In the case of non-households, a much higher proportion of the customer base is metered compared to households, which is likely to have a considerable impact on how financial settlement is operated between the customer bases. • When household bills are estimated, and only issued at the end of the financial year, there is the potential for these customers to be treated as a much higher financial risk than measured customers. • Similarly, as disconnections are available in the non-household customer base to help manage non-payment, these would not be applicable in the household segment. • In terms of extending the 'retail exit' clause for household retailers, in principle this would enable efficient functioning of the market, however it is likely that additional customer protections would be needed for household customers. It is not clear how the issue of bad debt could be managed in the circumstances of a retail exit, or if interim supply arrangements were required in the event of a retailer failing
---	--	---

		financially. Would the bad debt transfer with the customers?
'Specific Household Retail Market'	<ul style="list-style-type: none"> • Specific household wholesale codes and mechanisms would ensure that where there are differences between the household and non-household customer bases, these would be appropriately addressed (such as disconnections, leak allowances etc). • Restricting the scope of competition in household retail to a defined or specific set of customers will limit the perceived risk exposure by investors. 	<ul style="list-style-type: none"> • Separate regulatory approaches, market systems, codes and mechanisms between household and non household retail customers would essentially duplicate much of the cost and effort between the two segments and may not be the most efficient approach. • Separate regulatory models for household and non-household could potentially cause difficulties for the groups of customers who may regularly switch between classifications (i.e. properties which move between household and non-household classifications).
'Auctions and Extensions'	<ul style="list-style-type: none"> • Extending the approach used in the energy market would provide opportunities to understand the potential costs, risks and benefits associated with the approach. 	<ul style="list-style-type: none"> • It is currently not clear how an auction mechanism might operate, and would system infrastructure would be required to enable such an approach.

Q4. What would be necessary for each of the scenarios to be implemented successfully? Over what time period could implementation take place?

In reference to the list of costs and benefits outlined in the slide pack provided for the 1-2-1 telephone calls, we consider that a comprehensive range of potential factors have been identified.

However, we are keen to highlight that it will also be important to consider some of the potential public health risks that may result from a change in the current model of water provision, even in scenarios where substantial customer protection mechanisms are envisaged. Despite the lack of disconnection option in the household segment, it is not infeasible to envisage situations arising in a retail household market where the most vulnerable and difficult to reach customers adapt their water consumption behaviour in response to more focussed debt management practices. In terms of assessing the potential costs, benefits and risks associated with the introduction of retail household competition, it

will be important not to overlook these 'low probability', 'high consequence' situations, not only for the social and environmental impacts, but also the overall affect on 'trust and confidence' in the water sector as a whole.

As outlined in South West Water and Bournemouth Water's response to the Terms of Reference for the assessment, understanding how the costs and benefits of the different scenarios vary depending on the timing of implementation, will provide a solid platform for informing decisions on opening up the market for household retail competition. Recognising that the UK Government has already outlined that it will work with water companies to begin the transition to household retail competition before the end of this Parliament, it is likely that there will be much higher risks and costs associated with trying to implement a household retail market in a compressed timescale.

It is clear that the timescale over which the potential benefits for household customers may emerge from retail competition will also vary. It could take considerable time for a retail market to operate at an optimal level, in terms of the number, size and scale of retailers, and so many of the efficiencies that could be realised by a market approach will not be immediately available. The consolidation of the retail energy market structure happened over the course of several years, so it would not be unreasonable to assume a similar trajectory for water retailers.

What are the interactions between household water retail and other markets in the water sector and beyond?

As outlined above, there are potentially considerable benefits from aligning the retail markets between different utilities, allowing customers to 'bundle' their services and reduce the time and cost associated with managing household bills. However, in order for this to be successful, there are a number of differences between the two markets that would need to be addressed:

- Energy retailers are currently not responsible for dealing with contacts from customers about wholesale service issues. If the household water market operates in the same way as the non-household retail market is being set up, then customers will not have any direct contact with the wholesaler. If a joint retail service between energy and water is envisaged, a consistent approach to retail and wholesale responsibilities will need to be implemented.
- The requirements for the provision of social tariffs would need to be aligned between different utilities; otherwise there is the potential for individual customers with a single retailer for both water and other utilities to be subject to different eligibility criteria's.