



## Household Retail Project

Ofwat

21 Bloomsbury Street

London

WC1B 3HF

## Strategy & Regulation

Name Nick Fincham  
Phone 0203 577 4989  
E-Mail [nick.fincham@thameswater.co.uk](mailto:nick.fincham@thameswater.co.uk)

17 February 2016

Dear Sir

### **REVIEW OF RETAIL HOUSEHOLD MARKETS IN THE WATER AND WASTEWATER SECTOR: CALL FOR EVIDENCE**

Thank you for inviting contributions for Ofwat's assessment of the costs and benefits of extending retail competition to household water and wastewater customers. We welcome the opportunity to support Ofwat's review and look forward to a balanced and objective assessment of the incremental costs and benefits of extending competition to households. We were grateful for the opportunity to meet with Iain McGuffog and Margaret Pyne on 3 February 2016 and welcome Ofwat's commitment to continued engagement.

Reviewing the costs and benefits of extending competition to households is a significant undertaking. Our work in collating this response has emphasised this. This underlines the importance of keeping closely to the remit outlined by the Government if you are to deliver the review on time.

We look forward to continuing to work closely with Ofwat on this project. Please do not hesitate to contact me if you wish to discuss these points in more detail.

Yours faithfully

A handwritten signature in black ink that reads "Nick Fincham".

**Nick Fincham**  
**Director of Strategy & Regulation**

Thames Water Utilities Limited

Clearwater Court, 2<sup>nd</sup> East  
Vastern Road  
READING  
RG1 8DB

T 0203 577 4989  
I [www.thameswater.co.uk](http://www.thameswater.co.uk)

Registered in England and Wales  
No. 2366661 Registered office  
Clearwater Court, Vastern Road,  
Reading, Berkshire, RG1 8DB

## **Thames Water response to Ofwat's call for evidence on its assessment of the costs and benefits of extending retail competition to households**

### **1. Selecting the correct counterfactual case**

The cost benefit analysis for the non-household market assumed that between 60% and 70% of the overall benefits of introducing non-household competition were derived from “spillover effects” for household customers.<sup>1,2</sup> Ofwat expects its Water2020 proposals to bring further benefits to customers from wider sludge and water resources markets, irrespective of the decision on retail household competition. It is important, therefore, that the correct counterfactual is used by Ofwat as the basis against which the incremental costs and benefits of extending retail competition to household customers can be assessed. We encourage Ofwat to set out its assumptions for the “do nothing” option as clearly as possible.

### **2. Customer engagement**

As Ofwat has identified in assessing the costs and benefits of extending retail competition is its importance to consider the views and opinions of customers themselves. We asked Britain Thinks to conduct a survey as a follow up to the deliberative events that Thames Water held in December as part of our customer engagement for PR19. It should be noted that this is a small sample which isn't necessarily representative of our customer base and that due to their participation in these deliberative events that these customers are more informed than is typical for our customer base. We attach the survey for Ofwat's review.

We would also encourage Ofwat to consider evidence from the market in the run up to non-household retail competition as to customers' appetite to switch. Evidence from customers and potential entrants suggests retail profit margins may need to increase to make entry attractive enough to encourage participation from customers.<sup>3</sup>

### **3. Priorities**

Thames Water's core services are the delivery of water and removal of waste water. We have to be careful that management time is not distracted from delivering these core services. Thames Water is already working with the rest of the sector to prepare for the opening of the non-household retail market in April 2017. We are also working with Ofwat on developing its Water 2020 proposals, which Ofwat has highlighted as bringing further benefits to household and non-household customers. Both of these projects add complexity to the water and wastewater sector, particularly up to 2020. In our view this risk – and the extent to

---

<sup>1</sup> Competition and Innovation in Water Markets, Martin Cave, April 2009.

<sup>2</sup> Introducing retail competition in the Water Sector, Impact Assessment, Defra, December 2011, accessed at: <http://www.legislation.gov.uk/ukia/2011/304>.

<sup>3</sup> For example, see 31 March 2015 article by Scottish Water Business Stream, accessed at <http://www.business-stream.co.uk/ensuring-competition-success-uk-water-act>.

which it can be mitigated through the appropriate pacing and sequencing of reform – should be taken into account in Ofwat’s assessment.

#### **4. Scenarios for retail competition**

Ofwat is considering the scope of competition to households (and refers to “thin” and “thick” markets, “narrow” and “wide” customer segmentation<sup>4</sup> as well as a wider scope of ancillary services such as resource procurement, local distribution networks and meter provision<sup>5</sup>). The brief to Ofwat from UK Government is to analyse the costs and benefits of “extending retail competition” and to work with companies to begin the “transition”<sup>6</sup>. We interpret this brief as asking Ofwat to examine retail choice (i.e. a “thin” and “wide” market).

With little time to complete its analysis, Ofwat may find it helpful to target its efforts on the thin and wide options, instead of a broader scope that encompasses activities ancillary services. This will also help Ofwat to guard against the risk of scope creep.

There could be benefits for opting for a thin – rather than thick – model for household competition. For example:

- it will maximise the extent to which synergies and sunk costs from non-household competition could be exploited for the benefit of customers;
- from a pragmatic perspective it makes sense to only de-regulate one section of the supply chain at a time; and
- a thin retail market could be ‘thickened’ in a controlled way once it is working effectively.

In terms of a “wide” or “narrow” market, arguments can be made to support both options. For example a “wide” market:

- avoids the complexity of administering separate markets at the same time; and
- where competition is available to all customers, it is likely to be less confusing and perceived to be ‘fairer’ than one where customers are segmented.

For a “narrow” market:

- there are precedents from the deregulation of the electricity and gas markets for the progressive opening (i.e. area by area) of competition; and

---

<sup>4</sup> Review of the retail household markets in the water and waste water sector: call for evidence.

<sup>5</sup> Review of the retail household markets in the water and waste water sector: terms of reference.

<sup>6</sup> “The government is driving water market competition. Business and other non-household customers will be able to switch suppliers from 2017. Ofwat will provide an assessment by summer 2016 of the costs and benefits of extending retail competition to household water customers. Following this, the government will work with water companies to begin the transition to household retail competition before the end of this Parliament.” A Better Deal, December 2015.

- it could be argued that competition should be made available to at first to customers with metered supplies or those without debt.

One potential aspect of household competition that could be explored further is whether greater consolidation among both wholesale and retail companies would be more efficient, to maximise economies of scale and to mitigate any loss of economies of scope from vertical disaggregation.

We would be interested in exploring the scope for an incentive mechanism for getting monopoly companies ready for competition (e.g. milestones, incentives for reaching milestones sooner, performance commitments, extra benefits for companies that choose greater degrees of separation).

## **5. Assessing the costs and benefits**

Ofwat has said it will assess costs and benefits under three headings: economic, natural capital and social. We have the following comments on each of these areas.

### **5.1 Economic**

Ofwat appears to be contemplating a wide range of potential costs and benefits in its analysis. As discussed at our meeting on 3 February, we would encourage Ofwat to be clear about the scope and scale of set-up and ongoing costs of competition to wholesale companies. We also offer the following comments on four specific issues, noting that Ofwat has suggested counter-party risk is part of its 'social' group of costs and benefits.

- **Counter-party risk**  
Counter-party credit risk is a material issue for credit-rating agencies. To the extent that licensed retailers are unrated, this can materially increase the credit risk for wholesale companies. To reduce the risk, customers could pay in advance or there could be a mechanism in the network plus price control to allow for the recovery of bad debts from retailers that are bankrupt. This type of mechanism is used in electricity distribution price controls. We attach the terms of reference for the paper on counter-party credit risk which we are commissioning.<sup>7</sup>
- **The impact on bad debt**  
Currently bad debt costs are shared across our customer base. Individual customers are not charged more because they are a bad debt risk compared with charges to customers who are low risk. In the absence of a suitable mitigation mechanism, retailers would have an incentive to target good payers leaving a decreasing number of customers still with

---

<sup>7</sup> The effects on counterparty credit risk of potential household competition in the English water sector: issues and mitigation mechanisms - terms of reference, Thames Water, February 2016.

the incumbent retailer to pick up a larger share of bad debt costs (which could also exacerbate the counter-party credit risk problem). A suitable mitigation mechanism should be designed to deal with customers that cannot or will not pay. There is an important difference between the water and energy sectors when dealing with bad debt. Unlike for energy supply, there is a prohibition on the use of pre-payment meters for water supply. Therefore, water customers are unable to use such devices to help them manage their budgets and can more easily fall into debt. It follows that Ofwat's assessment should examine closely the impact of retail competition on vulnerable customers, taking into account the differences between the legal frameworks that apply in water and energy.

- **Fixed and variable costs**

Ofwat should be clear in its assessment about how it apportions retail costs between those that are fixed and those that vary by volume. The Cave Review assumed a ratio of 75% fixed costs and 25% by variable costs.<sup>8</sup> A recent review by Moody's assumed the ratio was 50:50.<sup>9</sup> We recognise that one of the dynamic benefits of competition is to put downwards pressure on fixed costs. However, until that happens, if a company were to lose 10% of its customers (and therefore 10% of its revenue) it would only save between 2.5% and 5% of its costs. It is also important to note that if acquiring licensees of incumbent companies are obliged to opt in to interim supply arrangements they will be required to retain capacity to serve all customers, even if customers chose to switch to an alternative supplier. In such cases a large proportion of costs will be fixed. It is important that these arrangements are taken into account when an assumption is made on the ratio of fixed and variable costs.

- **The cost of preparing for competition**

Thames Water supports the greater use of market forces and believes efficient competition can bring benefits for companies, customers, the natural environment and society as a whole. We also agree with Ofwat's comment that quantifying the benefits of competition is difficult and often imprecise.<sup>10</sup> Preparing for competition is however, undeniably costly. It is important, therefore, that the benefits that will be received can be articulated.

- **Loss of economies of scope**

Vertical disaggregation will lead to loss of economies of scope. We would therefore suggest that Ofwat gives consideration to the one off and ongoing costs of such disaggregation.

---

<sup>8</sup> Competition and Innovation in Water Markets, Martin Cave, April 2009.

<sup>9</sup> "Is it really worth it" The Water Report, December 2015.

<sup>10</sup> Review of retail household markets in the water and wastewater sector: Draft terms of reference, Ofwat, January 2016.

## **5.2 Natural capital**

Ofwat suggests competition could lead to an improvement or reduction in water quality and the environment. Water quality is central to our business and neither we nor our customers would condone any change which could impact that quality. We therefore believe that quality should be a primary filter to judge whether options or scenarios should be considered or dropped. That said, we do not believe that retail has any impact on water quality. We are therefore confident that our customers' water quality will not be impacted by competition.

## **5.3 Social**

As stated earlier, we are concerned the competition could impact vulnerable customers adversely. Competition will place pressure on retailers to identify the risk profiles of their customers and to charge them accordingly. We are concerned that this could place upward pressure on the bills of customers who are, by definition, least able to pay.