

Review of retail household markets in the water and wastewater sector: Draft terms of reference

Contents

1. Introduction	2
2. Principles and objectives	4
3. Scope	5
4. Our assessment framework	7
5. Outputs of the review	9
6. Engaging with the review	10
7. Milestones	11
8. Next steps	12

1. Introduction

On 30 November 2015 the UK Government published 'A Better Deal: boosting competition to bring down bills for families and firms', which focused on the competition aspects of the government's productivity plan and steps to boost competition and eliminate market distortions.

It noted that effective competition ensures that firms direct resources to their most productive use, and that they are incentivised to invest in technology and to innovate. But for markets to deliver these benefits they need to be open to competitive pressures.

The UK government has asked Ofwat to provide an assessment by summer 2016 of the costs and benefits of extending retail competition to household water customers. The paper stated that following Ofwat's assessment, the Government will work with water companies to begin the transition to household retail competition before the end of this parliament.

There is a wealth of evidence from other utility sectors and the broader economy that market forces can deliver a range of significant benefits to customers, including reducing costs, improving service and providing strong incentives for innovation. In line with our duty to protect the interests of consumers, wherever appropriate by promoting effective competition, we welcome the opportunity to assess the costs and benefits of household competition.

It is clear that the landscape has changed since the publication of the Cave review of competition and innovation in water markets in 2009:

- Ofwat has changed the regulatory framework for setting prices through the 2014 Price Review (PR14):
 - by encouraging a more central role for customers in the price setting process and a focus on outcomes we have seen a step change in companies' engagement with their customers and understanding of what they and wider society value;
 - by introducing household retail price controls we could set a more targeted efficiency challenge specifically for retail services, providing much stronger regulatory incentives than was previously the case;
 - by setting separate retail and wholesale price controls we have established clear wholesale charging boundaries to support non-household retail competition, providing potentially a more robust starting point for a household retail market;

- experience of the Open Water programme provides an opportunity to build on the non-household retail market framework but also provides important new information in terms of how sensitive the assessment of costs and benefits may be to:
 - the design of the new market arrangements; and
 - the approach to implementation for the water sector;
- introducing the right for retailers to exit the non-household retail market has provided a greater opportunity for mergers and acquisitions in the sector; and
- Ofwat's work on accounting separation has provided greater transparency of costs and revenues, including separate household retail charges that reflect legislative changes and strategic policy steers and guidance from Government, for example in areas such as social tariffs.

By undertaking this review now and reporting back to the UK Government later this year, we expect to be able to factor the UK Government's conclusions and decisions into our next price review in 2019.

There are eighteen times as many household customers in England who could also potentially benefit from a well-functioning market. But we are also aware of the need for careful consideration of the costs and benefits to customers and companies of implementing change and a range of policy issues for the UK Government, given the potential step change in the size of the competitive market.

This note provides all stakeholders with further information about the way that we intend to undertake the review, the areas of focus, key milestones and how we intend to engage with stakeholders during the review.

The UK Government has indicated that we should report our findings in the summer of this year. Because of the constraints of the timescale we have already begun our work on this review, but would welcome stakeholder views on any possible refinements or gaps in our proposed approach that we might take into account as the review progresses and for this purpose have issued a call for evidence.

2. Principles and objectives

When we wrote to all companies on 4 December 2015, we explained that, in undertaking this review we would follow three key principles:

- The decision on whether, in what form and on what timeline the household retail market in England will be opened to competition is a matter for the UK Government.
- Our assessment of the costs and benefits of extending retail competition to households will be evidence based.
- We will follow an open and transparent process, seeking evidence and ideas from those in the sector and beyond.

Within this context, we intend to take an approach which will help us understand:

- the views and likely behaviours of customers in respect of choice in water and wastewater retail activities;
- benefits to customers, the wider UK economy and the environment of introducing competition to the household retail activities in water and wastewater;
- issues that might inform the assessment of costs and benefits, such as design, cost and implementation of reform that are either sector specific, or that are relevant from other sectors to customers and companies; and
- potential models for implementing any reform that are possible scenarios for the range of costs and benefits.

Having considered the above, we will then set out:

- the overall potential costs and benefits for scenarios of household retail competition in England;
- specific issues for implementation that affect the scenarios; and
- the options arising for different scenarios.

3. Scope

The review will consider the opportunities for introducing competition for the provision of water and sewerage retail services to household customers and the different scenarios through which this could happen. It will include an assessment of the costs, benefits and the factors that will influence them. In doing so, it will consider the possible options for introducing competition to household customers, including the 'do nothing' option for household retail competition.

We will review the possible options for introducing competition. This could range from competition for the market to competition in the market. This could include a range of scenarios including for example an extension of the approach we are currently implementing in the non-household retail market, a separate household retail market, and auction style competition.

Competitive retail market scenarios could be expected to include:

- A “thin” retail market: where the scope of the market activities was limited to providing core retail activities, such as billing and payment handling;
- A “thick” retail market: one which includes a wider scope of activities (risk and opportunity) that retailers could undertake, including resource procurement, local distribution networks, meter provision and metering, new connections and more customer interactions;
- A “narrow” market: one in which a specific sub-set or sub-sets of household customers are contestable. This would for example allow different regions or segments of the market to be opened at different times;
- A “wide” market: one in which all household customers are contestable.

The scenarios used to support analysis will specifically consider new and existing evidence, including evidence provided by stakeholders as part of this review process, on:

- the views and priorities of different groups of customers;
- the interaction with upstream reform;
- what changes to the sector and its regulation are emerging (such as from our 2014 price review, the opening of the non-household retail market in England in April 2017, and our 'Water 2020' work to open up markets and set the framework for our price review in 2019), and what impact this has on the case for household retail competition in England;
- the findings of previous reviews in the sector (such as the Cave review) and the extent to which the findings remain relevant or have been superseded over time (for example by changes to the way we set price controls and the work underway

to open the retail market for non-households in England to competition by April 2017);

- experience from delivering a competitive retail market for non-households in England by April 2017, recognising the similarities, differences and likely interactions; and,
- experience of retail markets in other sectors, including recent market reviews of these sectors, that may provide important lessons and evidence (including but, not limited to, reviews in energy).

The diagram overleaf provides a more detailed breakdown of this.

Where we identify potential barriers to effective competition or risks to consumers from household retail competition, we will consider what forms of price control and other protection mechanisms could be used to allow effective choice to realise net benefits for customers. We will also highlight any wider potential policy issues that different scenarios could create, and identify potential solutions to those issues, with the aim of best informing the UK Government's decision making.

Our review will not consider the potential for competition in the household retail market in Wales. We recognise that, should the UK Government decide to progress competition in the household market in England, we would need to work with the Welsh Government and stakeholders in Wales to consider the implications for Wales and ensure that we continue to protect the interests of Welsh customers.

4. Our assessment framework

In delivering the review we will draw on best practice of impact assessments, including assessing costs and benefits through qualitative and quantitative research. This will involve:

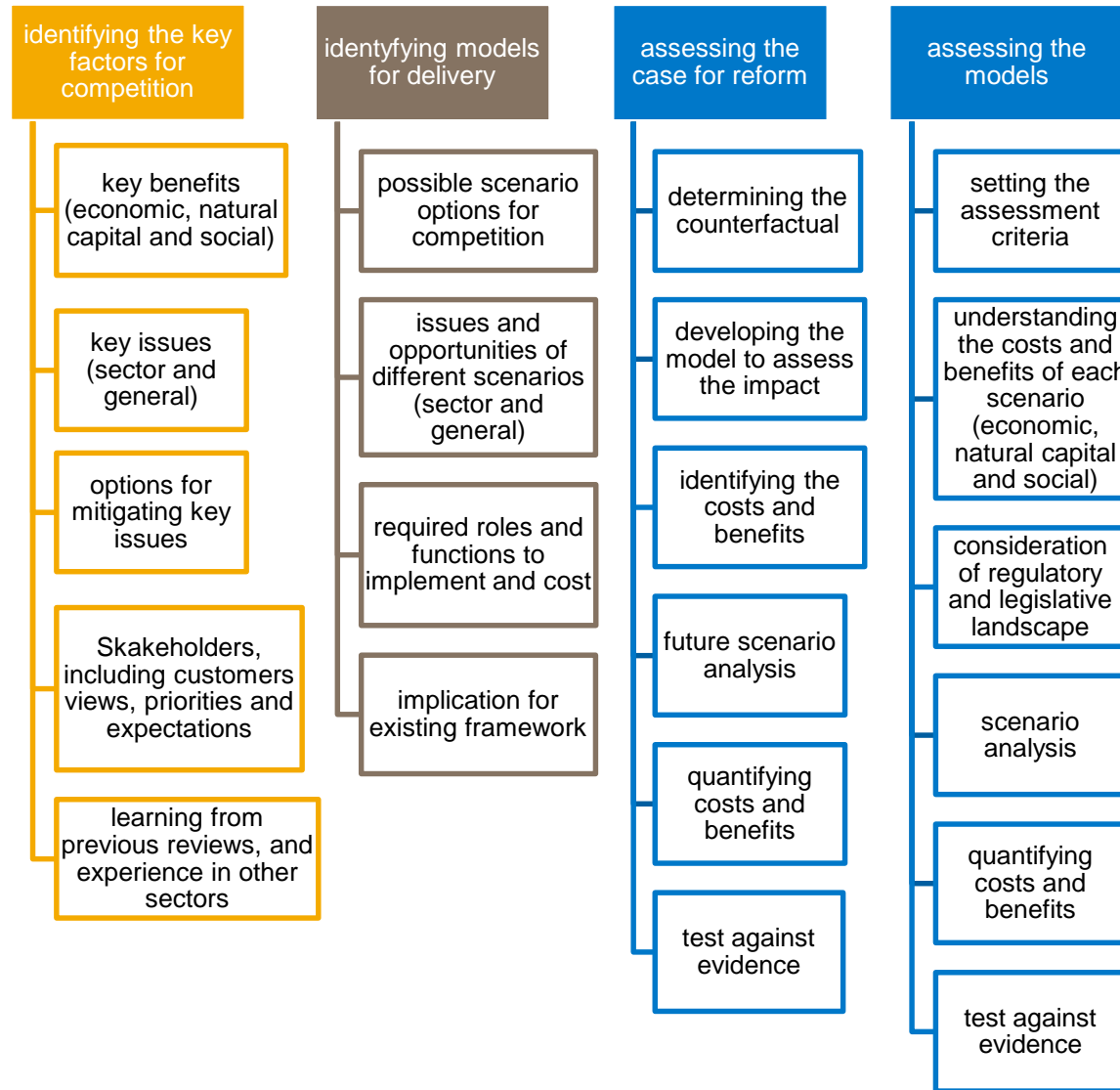
- carrying out desk research and primary research, including through a call for evidence and engagement with stakeholders to identify possible options for reform, including the 'do nothing' option; and,
- assessing those options against our objectives (below) and the base case to identify a preferred option and to undertake cost benefit analysis, quantifying the assessment where possible and consulting on our findings before issuing a final report.

Assessing the potential costs and benefits of different scenarios for competition will require different types of assessment and a range of factors and issues to be considered. Quantifying the benefits of competition, in particular the more dynamic benefits of competition such as innovation can be notoriously hard. Our assessment of costs and benefits will include assessing the sensitivity of costs and benefits to scenarios for competition and assess each scenario against our objectives:

- value for money for customers and the quality of service they receive;
- our assessment of costs and benefits will include assessing the sensitivity of costs and benefits to scenarios for competition and assess each scenario against our objectives, such as ensuring affordability and protecting vulnerable customers;
- protecting the environment and maintaining and improving resilience within the sector;
- encouraging water efficiency and sustainability of supply;
- investment in infrastructure; and
- ensuring regulation remains proportionate and targeted.

We anticipate that our scenario development work may provide useful insights for future work on:

- the impact on and need for change to the current regulatory and legislative framework;
- alignment with policy objectives of the UK government; and;
- principles of regulatory best practice.



5. Outputs of the review

We intend to publish our initial findings in July for comment. We also propose to publish specific evidence or analysis at early stages if we consider it raises important issues where it would be helpful to understand stakeholder views earlier in the process rather than wait.

We will publish our review in full by September. This will then inform decisions on policy that will be taken by the UK Government.

We recognise the importance of this review and are committed to a transparent approach.

6. Engaging with the review

In our experience, the most effective review is one where stakeholders are fully engaged and have clarity and transparency. We intend to run an open and transparent process across the sector and will welcome thoughts from across the sector. We are keen to build on the approach we have been taking in the design of Water 2020 and welcome sharing of thinking by water companies and others with an interest in, evidence on, and experience of the opening of competition. This will enable us to consider a wide evidence base and a range of scenarios for competition. Specifically, we will:

- identify key stakeholders from whom we can gain greater understanding and learning to support the review, including (not exhaustive) companies, other regulators, investors, customer representatives, and environmental groups;
- issue a call for evidence to understand issues and benefits of retail competition for households;
- recognising the tight timescales of the project we will engage with stakeholders in parallel with the call for evidence;
- work closely with water companies, customer representative groups, investors, and others to understand the costs and benefits of opening up the household retail market in England to competition; and,
- host workshops for stakeholders across the sector, working jointly with Government.

7. Milestones

We have identified the key milestones and phases of the review as:

15 January	Publish draft Terms of Reference for comment	28 January	Deadline for comments on draft Terms of Reference.
18 January	Publish Call for Evidence.	17 February	Deadline for Call for Evidence
January-April	Evidence gathering and analysis supported by stakeholder engagement and customer research.		
July	Publish draft findings.		
July – August	Stakeholder engagement to discuss draft findings.		
September	Submit final report to Government.		

8. Next steps

Please send any comments on the draft Terms of Reference by 28 January 2016.
You can do this:

- **by email:** If you would like to submit your response by email or if you would like to attach a document in response to the call for evidence, please email a copy to: household.review@ofwat.gsi.gov.uk
- **by post:** Household Retail Project, Ofwat, 21 Bloomsbury Street, London, WC1B 3HF.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

Printed on 75% minimum de-inked post-consumer waste paper.
January 2016

ISBN 978-1-910739-35-8

© Crown copyright 2016

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

