

March 2016

Trust in water

# **Review of retail household markets in the water and wastewater sector: Terms of reference**

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## 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	<b>Error! Bookmark not defined.</b>

## 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. We will continue to engage with stakeholders throughout the review.

## 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 that will help us understand:

- the views and likely behaviours of customers in respect of choice in water and wastewater retail activities;
- costs and benefits to customers, the water sector, the wider UK economy and the environment of introducing competition to the household retail activities in water and wastewater including those associated with implementation and operation of a competitive market;
- issues that might inform the assessment of costs and benefits, such as the design of the competitive market and the approach that is taken to the implementation of reform; these issues could be specific to the water sector, or there may be relevant lessons that we can learn from other industries; and
- potential models of competition that could be used to support market reform; this will inform the scenarios that we develop with respect to the range of costs and benefits associated with the implementation of household retail competition.

Having considered the above, we will then set out:

- the overall potential costs and benefits that may be incurred as a result of any potential implementation of a set of defined competition models using a range of scenarios of how the future market for household retail competition in England could evolve;
- specific issues that could affect the feasibility of implementing certain competition models, for example, time available for implementation; and
- the options that are evident under various different scenarios of the way that the future water sector in England may evolve.

### 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 and benefits as well as 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; ranging from competition for the market to competition in the market. We intend to consider a range of models including, for example: an extension of the approach we are currently implementing in the non-household retail market; a separate household retail market; and an auction style competition. We also intend to assess possible combinations of these models, including the impact that their implementation could have in aggregate and at customer segment level.

Competitive retail market scenarios could be expected to include:

- A "thin" retail market: where the scope of activities is limited to providing core retail services, such as billing and payment handling;
- A "thick" retail market: where the scope of activities that retailers could undertake is broader, including resource procurement, local distribution networks, meter provision and metering, new connections and more customer interactions.
- A "narrow" market: where a specific sub-set or sub-sets of household customers are contestable. This could enable different regions of the market or customer segments to be opened at different times;
- A "wide" market: where all household customers are contestable.

The competition models that we use to support analysis will specifically consider new and existing evidence, including the information that is provided by stakeholders as part of this review process. We anticipate that this evidence could provide insights on:

- the views and priorities of different groups of customers;
- the interactions that the implementation of competition in the household sector could have with upstream reform;
- the changes to the sector and its regulation that are likely to emerge, and the impact that this could have on the case for household retail competition in England (e.g. from the Ofwat 2014 price review and the opening of the non-household retail market in England in April 2017 as well as and the 'Water 2020' work that Ofwat is progressing to open up markets and set the framework for the price review that will take effect from 2019);

- the findings of previous reviews in the sector (such as the Cave review) and the extent to which these 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 and behaviours 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 on page 10 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 enable effective choice and realise net benefits for customers. Our review will not cover proposals beyond retail competition but will seek to understand any wider benefits of household competition on the sector. 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 impact assessments, including analyses of costs and benefits that have previously been taken forward via qualitative and quantitative research. This will involve:

- carrying out desk and primary research through a call for evidence and engagement with stakeholders to identify possible options for reform, including the 'do nothing' option;
- understanding customers views through direct customer research; and,
- assessing the possible options for reform against our objectives and the base case to identify solutions, that will ultimately inform the cost benefit analysis we undertake; with the intent of quantifying the assessment where possible. We intend to consult on our findings before issuing a final report.

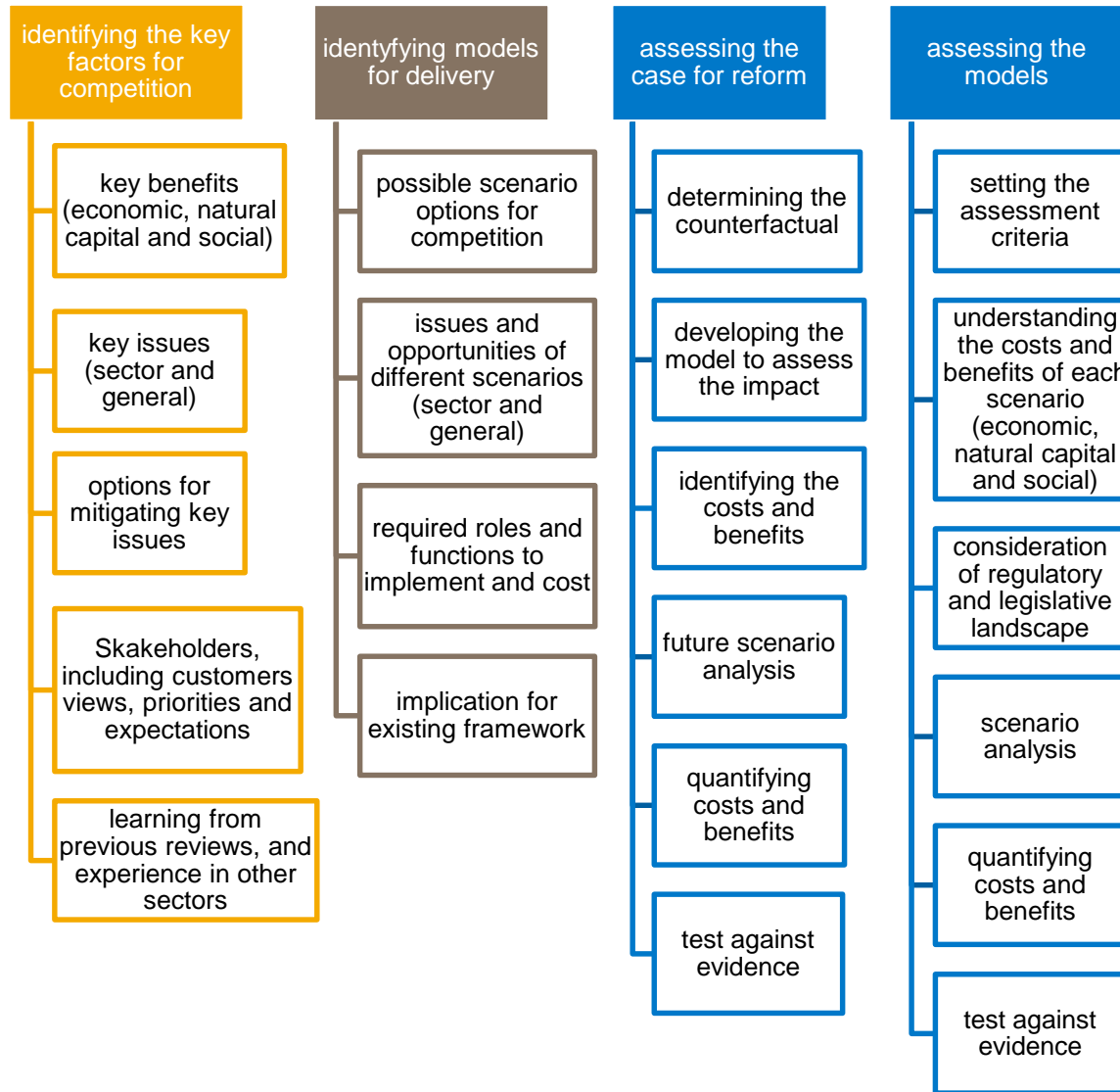
Assessing the potential costs and benefits of different models for the implementation of competition will require varied types of assessment, and a range of factors and issues to be considered. Quantifying the benefits of competition, particularly the more dynamic benefits of competition such as innovation, is notoriously hard. Our assessment will include analyses of the sensitivity of costs and benefits to different models of competition and assess each of the corresponding outcomes against the Ofwat objectives:

- value for money for customers and the quality of service they receive;
- ensuring affordability and protecting vulnerable customers;
- understanding the costs of potential complexities associated with new protections for customers in the new market;
- protecting the environment and maintaining and improving resilience;
- encouraging water efficiency and sustainability of supply;
- investment in infrastructure; and
- ensuring regulation remains proportionate and targeted.

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

- the impact that the introduction of household competition could have on the sector and the corresponding need for change to the current regulatory and legislative framework;
- alignment between the potential implementation of household competition in water and the overall policy objectives of the UK government; and;
- the continued suitability and applicability of the commonly-agreed 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 an earlier stage if it raises important issues and 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 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 on both the process that Ofwat is following and the options that are being considered. We intend to run an open and transparent process across the sector and welcome insights from a range of stakeholders. 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 possible models that could be used to support the development of competition. Specifically, we will:

- identify key stakeholders from whom we can obtain understanding and learning to support the review including, amongst others, companies, other regulators, investors, customer representatives, and environmental groups;
- consider responses to our call for evidence to understand issues and benefits of retail competition for households;
- engage with stakeholders in parallel with the call for evidence, recognising the tight timescales associated with the project;
- 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 and outside 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.		

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.

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