



Ofwat household market review: Lessons from the energy sector

A report prepared by KPMG

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We have indicated within this report the sources of the information provided. We have not sought to verify independently those sources unless otherwise stated within the report. This report has been prepared from publicly available documentation, such as internet sources and published accounts. All the documents which have been relied upon in preparing this report are referenced in this report.

The work and analysis for this report was performed before the publication of the final report of the CMA energy market investigation on 24 June 2016. Following the publication of the final report, we reviewed the final remedies and the aspects discussed in this report are maintained.

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1 Executive summary

Ofwat has been asked by HM Government to undertake an assessment of the potential costs and benefits for the introduction of competition into the household retail water sector for England. Ofwat must submit its assessment by September 2016. Any decision on whether, and how, to introduce competition will be a decision for Government.

Ofwat's approach is to build an evidence based assessment, considering the potential models for competition and the relevant costs and benefits for each. As part of this assessment, Ofwat wants to understand the approach taken to introduce retail competition into the gas and electricity sectors in Great Britain, and the potential lessons to be learnt from the energy sector. This includes both the introduction of retail competition starting with the introduction of the Gas Act 1986¹ and the Electricity Act 1989², the key interventions and milestones since then and through to the ongoing review of the energy market being undertaken by the Competition and Markets Authority (CMA). In that context, KPMG was engaged by Ofwat, following a competitive process, to write a report covering:

- An analysis of the market arrangements in the energy sector, setting out a narrative of the details together with KPMG's views on potential lessons learnt from competition in the energy sector; and
- A review of the CMA remedies on the energy sector and any implication for the water sector, focussing on the CMA's Provisional Decision on Remedies as part of its ongoing review of competition in the energy sector.

Together with other third party reports, Ofwat plans to provide this report to Government as part of Ofwat's assessment of the costs and benefits for retail competition for household water customers in England.

This rest of the report is structured as follows:

- Section 2 provides an introduction to the report, including the context of the report and the overview of Ofwat's responsibilities and its similarity with Ofgem.
- Section 3 sets out the background to the Ofwat assessment, including an overview of the current water sector regulatory arrangements and considerations on how the energy markets might provide useful insight and lessons for the assessment of retail competition in water in England.
- Section 4 provides an analysis of the market arrangements in energy, and the potential lessons to be learnt for both Government and Ofwat to consider in their assessment of the potential for retail competition in household water in England.
- Section 5 focusses specifically on the CMA review of energy, including the triggers for the review, the findings to date and then considers in detail the Provisional Decision on Remedies published in March 2016³, and the potential implications for the water sector.

Market liberalisation had led to a series of positive outcomes. The first of these was providing consumers with the choice to change their energy supplier. Large numbers of consumers did switch supplier, with over 5.1 million customers changing electricity supplier, and just under 4 million changing gas supplier, in 2007 alone⁴.

¹ Gas Act 1986, <http://www.legislation.gov.uk/ukpga/1986/44/contents>.

² Electricity Act 1989, 1989 Chapter 29, <http://www.legislation.gov.uk/ukpga/1989/29/data.pdf>.

³ CMA Energy market investigation, Provisional decision on remedies, 17 March 2016: <https://assets.publishing.service.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>.

⁴ <https://www.ofgem.gov.uk/ofgem-publications/76465/switching-figures-2007.pdf>

- Levels of switching in GB energy markets were high relative to international standards: Research carried out by Accent in 2005 (and referenced by Ofgem) found that 46% of all gas customers and 47% of all electricity customers had switched⁵. This figure continued to rise: BERR estimated that by March 2008, 50% of electricity customers and 53% of gas customers had switched away from their home supplier⁶. In other countries, the total number of consumers switching was much lower (32% in Sweden, 12% in the Netherlands, 6% in Germany, and 1.5% in those parts of the US market that had liberalised)⁷.
- Switching was also high relative to other industries in the UK. In telecommunications, 38% of mobile and 34% of fixed line customers had switched providers at this time. Annual switching rates were around 20%, compared to 20% for mortgages, 10% for pensions and 2% for bank accounts⁸.

Further points to note about the energy market include::

- A super complaint in 2005 by energywatch about gas and electricity billing processes did not succeed, with Ofgem's analysis not identifying significant detriment associated with the customer billing process, and finding that the competitive energy market was working well for the vast majority of customers⁹.
- Ofgem tried to keep discipline on the 'rules of the market' as covered in the Supply Licence Conditions. Indeed it carried out a major culling of rules (160 pages to 80) in 2007¹⁰.
- In addition, Ofgem's approach to market liberalisation meant that the UK avoided some of the mistakes energy regulators made in other jurisdictions. For example, Ofgem did not opt for a franchise or auction approach to market opening (i.e. blocks of customers being cast into a competitive market). While this was a popular approach in many states in the USA, one of the failings of this approach is that customers quite resented that 'choice' was being made for them and they then returned to their original supplier. In Pennsylvania this occurrence saw switching fall to less than 10% following the forced move of 30% of customers to a competitor supplier¹¹.

The potential lessons for Government and Ofwat to consider as part of the assessment for household water competition are listed in Tables 1.1 to 1.3 below, and are structured as follows: Table 1.1 summarises lessons related to the consideration of the introduction of competition, Table 1.2 focuses on lessons for the implementation process (if this is Government's decision), and finally Table 1.3 sets out those lessons that may be relevant following the opening of the market. The listings should not be regarded as indicative of priority to either KPMG or Ofwat. The tables focus on the lessons to be learnt both from the introduction of competition into the energy sector, including both the positive aspects of market liberalisation and areas where competition has worked less well, including those identified in the CMA's two year energy market review which identified a number of adverse effects on competition, and has proposed a number of remedies to address these. We set out a number of lessons that Ofwat may want to consider as part of its evidence based assessment.

⁵ Accent research quoted in <https://www.ofgem.gov.uk/ofgem-publications/76465/switching-figures-2007.pdf>

⁶ Page 13-14, , Quarterly energy prices, BERR, June 2008
<http://webarchive.nationalarchives.gov.uk/20081212160126/http://www.berr.gov.uk/files/file46669.pdf>

⁷ Page 33, 'Energy prices, fuel poverty and Ofgem', House of Commons Business and Enterprise Committee, July 2008, <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmberr/293/293i.pdf>

⁸ Page 33, 'Energy prices, fuel poverty and Ofgem', House of Commons Business and Enterprise Committee, July 2008

⁹ Page 2, 'Response to the Super-complaint on billing processes made by the Gas and Electricity Council ("energywatch")', Decision document', Ofgem, July 2005: <https://www.ofgem.gov.uk/ofgem-publications/38523/11070-16305.pdf>

¹⁰ For more details on the Supply Licence Review, see <http://webarchive.nationalarchives.gov.uk/20130402174434/http://www.ofgem.gov.uk/Markets/RetMkts/Compl/SLR/Pages/SLR.aspx>

¹¹ Alistair Buchanan presentation to BERR Select Committee, 2007

Table 1.1 Summary of lessons from considering the case for energy market competition

Summary of lessons from the energy sector				
Lessons for consideration in water	Lessons from energy	Implications and considerations for household retail water competition in England	Reference in report	
1	<p>When considering the case for competition, both clear decision making criteria and a clear strategy and approach for the future of regulation as the market is opened is required to provide clarity for market participants.</p> <ul style="list-style-type: none"> — Prior to full market opening in energy, Ofgem made use of a one year relative price cap for BGT in gas and two year price restraints for ex-PES in-area prices. Ofgem then completed a review of the market, including an assessment of key indicators including customer awareness, switching rates, market share and availability of savings¹². Following this review, Ofgem decided to introduce full competition in 2002¹³. — When deliberating whether to remove retail price controls, Ofgem was faced with a mixed set of market indicators. It chose to push ahead with market opening without all of the indicators suggesting that course of action. Unlike Ofcom or Postcomm, Ofgem did not set thresholds that had to be met, rather just strength of direction indicators. — The NAO report of 2008 stressed that regulators should aim to make use of both quantitative and qualitative data where possible, when deciding whether to remove price controls. This can help to determine success criteria for the introduction of competition¹⁴. — Ofgem initiated regulatory reporting following market opening, although it withdrew from this in 2004 (see Recommendations 10 and 11 below). 	<ul style="list-style-type: none"> — Clear decision criteria such as thresholds that need to be met provide a clear 'paper trail' around decisions taken at the time of market opening in a way that momentum indicators do not. Setting meaningful thresholds is difficult, but establishing a view of what success would look like for each option may help to provide an initial view on these thresholds. If Government decide to introduce competition, then these initial thresholds could be developed in line with ongoing monitoring of the market. — Government and/or Ofwat may want to provide clear proof that other options were considered in the run up to market opening, and indicate that they have considered the trade-offs around different options. The Ofwat assessment is the key opportunity for this. — When making decisions around market opening, it might be useful for the Government, and Ofwat in its assessment, to review its actions against what a future National Audit Office (NAO) or Industry Select Committee might regard as a robust 'go or no go' decision. 	— 4.2.1	
2	<p>The current structure of the water sector is based on regional incumbents, as was the case in energy. However, Government and/or Ofwat may need to do more to encourage household switching than was the case for energy as energy was able to draw on incumbents in gas seeking to enter the electricity market, and vice versa.</p>	<ul style="list-style-type: none"> — Energy markets had large players in the gas and electricity sectors wanting to enter each other's markets and so were pushing for competition. — Electricity incumbents had significant market power in their regions. British Gas had significant market power nationally in gas. This was used to attack incumbents in other regions. — The incumbency structure for gas and electricity provided a platform for the incumbents to build a presence in the other sector. As a result, the market shares of incumbents tumbled e.g. BG market share reduced from 84% to 67% between 1998 and 2001 and the electricity companies from 90% to 70% between 1999 and 2001¹⁵. — The CMA did not find an adverse effect on competition resulting from vertical integration in the energy market, and has not proposed any remedies focussed on the structure of the market or to specifically address market power among the former incumbents¹⁶. 	<ul style="list-style-type: none"> — The water industry will not be able to rely on the 'British Gas effect' whereby a national monopolist is able to leverage its market power to attack the market share of incumbents in another market (electricity), albeit to a lesser extent, regionally. — It would seem sensible for Government and/or Ofwat to consider the impact of the introduction of non-household competition in water, to identify potential ways in which competition may evolve if introduced for households in England. — The competitive landscape in energy supply may mean that there is potential for current energy players to enter the water market, and present a bundled offering including gas, electricity and water for customers. 	— 4.2.1
3	<p>There is potential for current energy suppliers to seek to enter the water retail market, and potentially to build on their energy market presence and retail expertise to offer a bundled product (electricity, gas and water) to customers. Consistency and clarity in regulatory requirements between Ofgem and Ofwat may assist with this, and discussions between the regulators may be useful.</p>			
4	<p>Customer experience in the energy market, as noted by Ofgem and the CMA, may have increased scepticism about the potential benefits for competition among competitors and consumers. Consideration of how to address this should be part of the assessment of the case to introduce competition for household water in England.</p>			

¹² Review of domestic gas and electricity competition and supply price regulation. Evidence and Initial Proposals, Ofgem, November 2001: <https://www.ofgem.gov.uk/sites/default/files/docs/2001/11/7101---review-of-domestic-gas-and-electricity-competition-and-supply-price-regulation-evidence-and-initial-proposals-26-11.pdf>

¹³ 'Review of domestic gas and electricity competition and supply price regulation: Conclusions and final proposals', Ofgem, February 2002

¹⁴ Page 9, 'Protecting consumers? Removing retail price controls', National Audit Office, 28 March 2008: <https://www.nao.org.uk/wp-content/uploads/2008/03/0708342.pdf>

¹⁵ Page 29, 'Protecting consumers? Removing retail price controls', National Audit Office, 28 March 2008: <https://www.nao.org.uk/wp-content/uploads/2008/03/0708342.pdf>

¹⁶ Paragraph 34, Page 8, , Energy market investigation, Provisional findings report, Competition and Markets Authority, 7 July 2015: https://assets.digital.cabinet-office.gov.uk/media/559fc933ed915d1592000050/EMI_provisional_findings_report.pdf

Summary of lessons from the energy sector			
Lessons for consideration in water	Lessons from energy	Implications and considerations for household retail water competition in England	Reference in report
<p>5 Transition to competition is preferable to sudden change, based on the energy experience in order to allow for lessons to be learnt and improvements to be made over a longer period.</p> <p>A blanket introduction of competition may require a longer lead time prior to implementation, in order to ensure that both customers and firms are ready for such a scale of change. This would depend on the model of competition introduced, if any.</p>	<ul style="list-style-type: none"> — Energy markets were opened gradually over a period of time. — Freedom to choose supplier was rolled out on a regional basis, and price controls were removed sequentially for different customer groups. This allowed systems to adapt, and also allowed consumers and firms to prepare for competition. 	<ul style="list-style-type: none"> — If Government chooses to introduce competition, then it and/or Ofwat will want to consider how to implement this. The energy market experience suggests that a phased rollout of competition may be preferable. — Ofwat will also wish to be mindful of the costs and benefits of implementing market reforms to all stakeholders. — When considering how the household water market could be opened to competition, Government may want to consider specific regional issues such as different levels of metering in different areas. 	<ul style="list-style-type: none"> — 4.2.1
<p>6 There is a need to be vigilant and remove barriers to switching across markets and sub-markets. One of the CMA's main remedies is to address barriers to switching for domestic customers and microbusinesses.</p> <p>It is worth noting that the CMA Provisional Decision on Remedies sets out the broader context of Ofgem's programme to introduce next day switching and the rollout of Smart Meters. For water, the barriers to be considered would need to encompass both information remedies and the switching process itself, as well as the potential differences for metered and non-metered customers.</p>	<ul style="list-style-type: none"> — Low levels of switching can impede competition in the market and the CMA has identified weak customer response as an adverse effect on competition¹⁷. The CMA has focused on improving switching through proposed information remedies, although the CMA notes wider key developments in this area including Ofgem's programme to introduce next day switching by 2019¹⁸, and the rollout of Smart Meters. — Competitors do not currently have an easy way of identifying consumers that have been on default tariffs with competitors for a number of years. The CMA concluded that such consumers have been missing out on potential savings from switching¹⁹. — The CMA proposed the creation of an Ofgem-controlled database to allow competing suppliers access to those customers who have been on a default tariff for more than three years. This proposed remedy has been the source for significant debate through the responses submitted to the CMA. If introduced, the aim would be for the database to allow competitors to tailor marketing specifically to these customers and seek to engage them in the market. 	<ul style="list-style-type: none"> — By improving the information provided to consumers, both about their current supplier and their potential to switch, customers may feel more engaged and consumer behaviour observed in the energy sector may not be replicated in other sectors. Regulator and companies can play a significant role in disseminating the relevant information. — If the CMA choose to introduce the database remedy, and the Government choose to introduce competition in domestic water in England, Ofwat may want to consider any potential for joint use or joint working, given that consumers using energy and water overlap significantly. — Government and/or Ofwat will need to consider the switching process itself if the decision is made to introduce competition for household water in England. The processes for energy are undergoing a programme of change to improve both the speed and accuracy of switching. There is potential for the water switching process to align with the improved process in energy which is due for delivery in 2019. 	<ul style="list-style-type: none"> — 5.2.2

¹⁷ Paragraph 28, Page 7, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.publishing.service.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

¹⁸ Moving to reliable next-day switching, Ofgem, 10 February 2015: https://www.ofgem.gov.uk/sites/default/files/docs/2015/02/fast_and_reliable_switching_decision_final.pdf.

¹⁹ See 'The Database remedy' section in the CMA's provisional decision on remedies (p. 382 onwards). Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

Summary of lessons from the energy sector				
Lessons for consideration in water	Lessons from energy	Implications and considerations for household retail water competition in England	Reference in report	
7	<p>Different segments of customers will engage in the competitive market in different ways, or not at all. A one size fits all approach to the promotion of competition may not be fit for purpose. There will be an ongoing need for Government and/or Ofwat to consider how to engage vulnerable customers, and to ensure that they are both protected and receive the benefits of competition.</p>	<p>One of the key elements of Ofgem's referral to the CMA, and an issue that the CMA have identified as an adverse effect on competition, is that those customers who are disengaged from the market are not benefiting from the savings available from switching²⁰.</p> <p>Vulnerable customers are a key constituency and the remedy on the customer database is intended to target all those who are disengaged. Ofgem's previous research has suggested that vulnerable customers are disproportionately represented among disengaged customers²¹.</p>	<p>Government and/or Ofwat must consider the extent to which it seeks to protect the interests of those customers who could choose not to engage in the market if competition is introduced. Learnings from energy will be relevant, but should be focussed on how to avoid customers becoming disengaged rather than addressing this issue once segmentation has taken place.</p> <p>Ofwat's assessment of competition models should consider the likely potential take up of competition amongst customers, and specifically among vulnerable customers.</p>	5.2.3

²⁰ Paragraph 89, Page 20, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.publishing.service.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

²¹ Page 49, Retail Energy Markets in 2015, Ofgem, 9 September 2015: https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/retail_energy_markets_in_2015_report_0.pdf.

Table 1.2 Summary of lessons from the implementation of competition

Summary of lessons from the energy sector			
Lessons for consideration in water	Lessons from energy	Implications and considerations for household retail water competition in England	Reference in report
8 Regulators and policy makers should be clear and coordinated in their approaches to promoting competition while being clear where responsibility lies.	<ul style="list-style-type: none"> — The CMA identified, as a general observation, that poor communication of impacts of policy and regulation, in combination with other factors, leads to poor trust between stakeholders²². — The Energy Act 2010 amended Ofgem’s duties, to include a requirement to consider the interests of consumers as a whole, and to consider – before deciding to carry out functions in a particular manner with a view to promoting competition – the impact on consumer protection²³. The CMA have proposed amendments to Ofgem’s duties, to avoid any real or perceived constraints on Ofgem’s ability to promote effective competition. — The CMA has identified a lack of clear division of responsibilities and formal mechanisms through which disagreements between Ofgem and DECC are managed. The CMA indicate that this, in combination with other factors, is likely to increase the risk of policies being developed in the future that are not in the customers’ interests and inhibit in the development of policies that are in their interest. The CMA has proposed to address this by calling for a more evidence-based approach to developing provisions/interventions²⁴. 	<ul style="list-style-type: none"> — The CMA is considering the introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision making can be addressed transparently. — If Government chooses to open up competition then a premium must be placed by Ofwat on high quality co-operation and communication between themselves and the various Government bodies involved (notably Defra, BIS and HMT), but also those not immediately affected (for example the Welsh Government). — If Ofgem’s duties are revised, it will likely be focused even more on competition. Ofwat’s current duties are focussed on competition and so are consistent with the CMA’s proposed amendment. If Government do decide to introduce competition for households in England, then a review of Ofwat’s duties may still be timely, to allow a clear focus on Ofwat’s role in promoting the new competitive market. 	— 5.2.4

²² Paragraph 181, Page 39, CMA Provisional decision on remedies, 17 March 2016: <https://assets.publishing.service.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EML.pdf>

²³ Page 14, Energy Act 2010, Chapter 27, Part 3 – Regulation of gas and electricity markets. http://www.legislation.gov.uk/ukpga/2010/27/pdfs/ukpga_20100027_en.pdf.

²⁴ Paragraph 169, Page 37, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

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<p>9 The regulator's role is likely to change in supporting competition and will continue to change as markets develop. Government and Ofwat need to be ready for this as part of the planning and preparation in order to get the 'Customer Promise' from market opening right. This means both ensuring that customers are aware of their ability to engage in the competitive market, and ensuring that customers have the information needed to make a confident decision that results in a better outcome for them. This outcome could be measured in terms of price and/or service.</p>	<ul style="list-style-type: none"> — Ofgem's role in promoting the energy sector has evolved over time. The national campaign undertaken at the time of market opening led to a substantial amount of customer switching. Research carried out by Accent in 2005 (and referenced by Ofgem) found that 46% of all gas customers and 47% of all electricity customers had switched²⁵. As prices inexorably rose and as company practices came under stricter scrutiny so customer engagement stalled. — By many indicators, the level of switching was much higher than in other markets that had opened (Sweden, the Netherlands, Germany, parts of the US market) and by contrast to other UK consumer sectors (such as telecoms and financial products)²⁶. — Whilst Ofgem's polling in the Probes of 2008 and 2010 indicated that the majority of consumers knew about competition and found it relatively straightforward to engage²⁷, after the first five years of open markets, the number of customers actually switching appeared to plateau at around one fifth of consumers²⁸. — Ofgem has also increasingly focussed on the quality of decision making by those customers who choose to switch, as well as the absolute number of switches made²⁹. — Ofgem was also influenced by its legal status. From 2004 it was required to be mindful of social and environmental guidance from Government and then acquired a primary duty for sustainability³⁰. 	<ul style="list-style-type: none"> — Ofwat must plan to play a positive and extensive role in any market opening as the sector regulator and to encourage consumers to understand and engage in the market. This is important both in encouraging customer engagement in the market, potentially through switching, as well as in ensuring that customers who do switch are able to make a good decision, resulting in a better outcome for them. — In energy, about half of the bill is exposed to global wholesale prices. This led to confusion over the responsibility for price increases. If household water is opened to competition, the markets should benefit from not having this unpredictable element. 	<ul style="list-style-type: none"> — 4.2.1 to 4.2.4

²⁵ Switching rate hits 5.1m in 2007, Press Release, Ofgem. April 2 2008 <https://www.ofgem.gov.uk/ofgem-publications/76465/switching-figures-2007.pdf>

²⁶ Page 33, 'Energy prices, fuel poverty and Ofgem', House of Commons Business and Enterprise Committee, July 2008, <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmberr/293/293i.pdf>

²⁷ Page 59, Energy Supply Probe- Initial findings report, Ofgem, 6 October 2008: <https://www.ofgem.gov.uk/ofgem-publications/38437/energy-supply-probe-initial-findings-report.pdf>

²⁸ Page 52, Ibid.

²⁹ Retail Energy Markets in 2015, Ofgem, 9 September 2015: https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/retail_energy_markets_in_2015_report_0.pdf.

³⁰ Page 19, Ofgem Review Final Report, DECC, July 2011, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48134/2151-ofgem-review-final-report.pdf

Summary of lessons from the energy sector			
Lessons for consideration in water	Lessons from energy	Implications and considerations for household retail water competition in England	Reference in report
<p>10 Should the reforms go through, Ofwat may need to be active in promoting markets as it may face greater, or different, challenges than Ofgem had at market opening. There will be an ongoing need for strong, effective regulation.</p> <p>11 Government may want to consider replicating the approach of Ofcom (Postcomm) and make it clear to consumers and all market participants that it will continue to monitor and watch the market on behalf of consumers. This will provide market certainty and clarity and will prevent the worst behaviours that an unmanaged free market can encourage.</p>	<ul style="list-style-type: none"> — An environment of declining wholesale prices supported the introduction of retail competition in electricity and gas, and household gas and electricity bills fell by around 10% in real terms between 1998 and 2001³¹. The politics of energy were also stable, with a strong Labour Government, and HM Treasury support for markets³² — Ofgem announced its withdrawal from regulatory reporting in 2004³³. This was overturned within two years after significant price increases³⁴ and unsettled customers. 	<ul style="list-style-type: none"> — Market and political conditions allowed competition to be introduced into the energy industry against a supportive backdrop from consumers and Government, and following the introduction of wholesale market competition and a declining price for customers. — Ofwat continues to regulate the wholesale market for water, and so the sequence of events compared to energy is different. If competition for household water in England is introduced, then Government and/or Ofwat's role would likely need to focus on consumer protection and service quality, rather than primarily on price. — Given this, and the ongoing review of the energy market by the CMA, Government and/or Ofwat will have to plan for any implementation of competition in the context of wider utility industry developments, and may have to work harder to convince consumers and other stakeholders of the benefits of competition. 	<ul style="list-style-type: none"> — 4.2.1

³¹ Price data taken from DECC, 'Annual Domestic Energy Bills' data tables published at: <https://www.gov.uk/government/statistical-data-sets/annual-domestic-energy-price-statistics>.

³² For example, Tony Blair's forward to the DTI's 2003 Energy White Paper stated: "We need competitive markets to keep down costs and keep energy affordable for our businesses, industries and households". Page 3, Energy White Paper- Our energy future- creating a low-carbon economy, DTI, 2003, <http://webarchive.nationalarchives.gov.uk/+/http://www.berr.gov.uk/files/file10719.pdf>

³³ See Page 2, Ofgem, 'Domestic Retail Market Report – March 2006' Ofgem, 2006, which states, "Our last in depth review of the domestic retail market concluded that competition was effective, and so we decided to stop undertaking regular, extensive market reviews". The previous domestic market review was published in April 2004. <https://www.ofgem.gov.uk/ofgem-publications/38493/14542-drmr-march-2006.pdf>

³⁴ Between 2004 and 2006, retail gas and electricity prices increased by 30% and 22% respectively in real terms. Source: Annual domestic energy bills, DECC: <https://www.gov.uk/government/statistical-data-sets/annual-domestic-energy-price-statistics>.

Summary of lessons from the energy sector			
Lessons for consideration in water	Lessons from energy	Implications and considerations for household retail water competition in England	Reference in report
<p>12 The Regulator will need to focus its activity on the promotion of competition in preparation for market opening. Ofwat could also make use of the current and historical price controls, to provide robust information about costs and efficiency potentials for potential market entrants.</p> <p>13 The role of the regulator in promoting competition does not stop with market opening, it is important for the regulator to design approaches that seek to maintain or further promote competition.</p>	<ul style="list-style-type: none"> — The energy market experience may have increased consumer scepticism in relation to the benefits of competition. The media have also played a significant role in both highlighting potential problems in the energy market³⁵, and in running consumer campaigns³⁶. Ofgem's decision to refer the energy market to the CMA was based upon (inter alia) the lack of trust by consumers³⁷. — In the immediate years post market opening, Ofgem focused on macro competition indicators (falls in HHI indicators, switching levels by contrast to overseas and other UK sectors), and not so much on segmented customers within the market³⁸. By 2008 Ofgem had identified segmental weaknesses in its Energy Market Probe, e.g. prepayment customers³⁹. 	<ul style="list-style-type: none"> — Given the likely importance of the water companies themselves in raising the awareness of competition, Ofwat may want to focus its efforts on those less likely to be reached by modern advertising techniques such as social media campaigns. These groups might include vulnerable consumers. — Government and/or Ofwat need to think about messaging around market opening benefits and also the potential unintended consequences more than the energy sector did. — Government and/or Ofwat will want to consider using micro reporting measures in order to pick up on segmental weaknesses as they emerge. — Ofwat may want to provide customers with assurances about how it will report and monitor progress of competition after market opening. Ofwat may be able to benefit from using a range of macro and micro indicators. 	<ul style="list-style-type: none"> — 4.2.1

³⁵ An example of this is investigation by The Sun into Age UK's recommendation of an E.ON special rate for pensioners that was more expensive than its cheapest tariffs following payments made by EON to Age UK. Source: Revealed: How Age UK protected £6m bung from E.ON and pushed expensive power deals to OAPs, The Sun, 4 February 2016: <https://www.thesun.co.uk/archives/news/34227/revealed-how-age-uk-pocketed-6m-bung-from-e-on-and-pushed-expensive-power-deals-to-oaps/>

³⁶ For a recent example see: How to switch energy providers to a cheap gas and electricity bill, Mirror, 5 May 2016: <http://www.mirror.co.uk/money/how-switch-energy-providers-cheap-5559665>

³⁷ Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain, Ofgem, 26 June 2014: https://www.ofgem.gov.uk/sites/default/files/docs/2014/06/state_of_the_market_-_decision_document_in_ofgem_template.pdf

³⁸ See Ofgem's 'Domestic Market Retail Report' series, which largely set out market metrics at an aggregate level and rather than focusing on particular market segments.

³⁹ Energy Supply Probe – Initial findings report, Ofgem, 6 October 2008: <https://www.ofgem.gov.uk/ofgem-publications/38437/energy-supply-probe-initial-findings-report.pdf>

Table 1.3 Summary of lessons from after market opening

Summary of lessons from the energy sector			
Lessons for consideration in water	Lessons from energy	Implications and considerations for household retail water competition in England	Reference in report
<p>14 Careful consideration needs to be given to the balance between regulation and allowing the development of effective competition. Any restrictions that directly or indirectly limit the ability for market players to innovate would need clear justification, given the recent CMA findings. Some of the requirements of promoting competition may result in some regulation being removed.</p> <p>15 Price comparison websites (PCWs) and other third party intermediaries should be specifically considered both at market opening and beyond, to allow them to be utilised as a way of promoting competition and engaging customers. Responsibilities and restrictions on these parties to ensure that consumers are protected, will need to be balanced with the need to allow them to play a full role in driving effective competition in the market. Ofwat's 5 year plan to increase trust and confidence in water and waste water services may provide useful parallel working to support this.</p>	<ul style="list-style-type: none"> — In its Provisional Decision on Remedies, the CMA found that the 'Simpler Choices' RMR component introduced by Ofgem had the potential to restrict competition and innovation. The CMA intends to amend this component and allow suppliers to offer as many tariffs/tariff structures as they wish including variable standing charge/unit rates. — The CMA also found that current regulations could damage the incentives for PCWs to compete in the domestic energy market. The CMA propose to remove some of these requirements to allow the potential for PCWs to promote competition to be realised. 	<ul style="list-style-type: none"> — Lifting the four-tariff rule, even if this adds to the complexity of the market, is expected to stimulate competition. This is an important lessons for Ofwat to keep in mind should Government decide to introduce competition in the retail household water sector. — Well-balanced rules and regulations for PCWs are important to allow the delivery of competition through these service providers. Lessons from energy covering both doorstep selling, and then (following the withdrawal from doorstep selling by the larger suppliers) the increasing importance of online engagement, may be useful in considering how information and opportunities can be delivered to all consumers. — The use of intermediaries is a key opportunity for customers to engage through a forum they already use for other services (energy/insurance etc.) and to potentially allow for multi-utility offerings. For example, there is potential for a triple fuel offering should a current energy supplier choose to enter the water market, if Government introduce competition. Ofwat may want to consider product bundling as part of the assessment of competition. — Ofwat may also want to consider the potential for joint working with Ofgem on the Confidence Code, to monitor and ensure consistent standards across the utility sectors for PCWs. 	<ul style="list-style-type: none"> — 5.2.5 to 5.2.6

Summary of lessons from the energy sector			
Lessons for consideration in water	Lessons from energy	Implications and considerations for household retail water competition in England	Reference in report
<p>16 Complex codes and market rules can limit competition by acting as a barrier to entry.</p> <p>The energy experience, as set out by the CMA, suggests that governance can be dominated by larger market players, particularly former incumbents. Once established, this can then provide both a barrier to change in future, and introduce potential barriers for the implementation and delivery of change driven by Government and/or the regulator.</p> <p>It is also important to consider the need to facilitate and not restrict innovative business models and market entry. Industry code governance arrangements set up to facilitate the current operation of the market may, unintentionally, restrict innovative entry in future. Ofwat and Government may want to consider how it can introduce a flexible and fair model for industry governance, ahead of any introduction of competition for household water customers in England.</p>	<ul style="list-style-type: none"> — The CMA found that the current system of industry code governance limits innovation and pro-competitive change and causes the energy markets to fail to keep pace with relevant policy objectives⁴⁰. — Ofgem did attack licence and industry code red tape in 2007 by reducing the supply licence from 180 pages of rules to 64. However, with the introduction of further regulation over the next few years, the electricity supply licence had increased to 484 pages by 2016⁴¹. — Although Ofgem introduced enhanced financial reporting in 2014, following a review by a major accounting firm⁴², the CMA still found that the current regulatory requirements do not provide for clear and relevant financial reporting of generation and retail profitability. The CMA intend to address this by improving the current regulatory framework for financial reporting for generation/retail companies. — The CMA also found that there was no adverse effect on competition arising from Ofgem's exemptions for smaller suppliers, such as on the Energy Company Obligation. The CMA noted the benefits market entry by smaller parties had brought to the sector. 	<ul style="list-style-type: none"> — Opening up the market would result in an increased need for industry bodies to govern themselves – in energy the perception is that this was set up and monopolised by the incumbents, and that this still disadvantages smaller players today. — Regulator and consumers need accurate and timely information to understand that they are getting value for money, and to avoid issues of perceptions of cartels which could reduce trust and reduce engagement. — The water industry can learn from the energy experience through ensuring that any industry governance arrangements are set up in a way that promotes and enables equal participation by all parties. This will need careful deliberation, as smaller industry players tend to have smaller resource pools from which to draw on and so a more innovative approach may be needed than just allowing all parties to participate equally. — The water industry can also consider the potential need for Ofwat (or another body) to play an ongoing role in industry governance. This includes the potential for the regulator to act as project manager and/or to drive through changes where they are required either by the regulator or by Government. 	<ul style="list-style-type: none"> — 5.2.7 — 5.2.9
<p>17 If competition is introduced, then Government and/or Ofwat may want to consider where smaller parties/new entrants should be exempt from carrying out some activities where these provide a significant regulatory burden, and may otherwise act as a barrier to entry.</p>	<ul style="list-style-type: none"> — There has been a high degree of disquiet in the energy sector following the CMA's Provisional Decision on Remedies⁴³. These fall into two categories: 1) unexpected and unintended consequences, 2) trenchant criticism of the CMA findings which have come from academics, some challenger companies and some consumer groups. The CMA has provided limited response to these concerns. It has also proposed some remedies that would reintroduce significant regulation into the energy market, including the introduction of a tariff cap for those customers with prepayment meters until 2020. — Ofgem's recent transfer of the potential competition case into PCWs to the CMA⁴⁴ is an example of concurrency between the sector regulator and the CMA. 	<ul style="list-style-type: none"> — Ofwat can learn a huge amount from the energy experiences. In particular, it needs to consider the timing of and reasons for using a CMA reference in the future and also the fact that it is not a proposition or threat that can be used lightly. Ofwat has already created a MOU with the CMA⁴⁵ and this enhanced communication will greatly assist Ofwat in understanding the CMA and providing the option for concurrency where appropriate. The CMA and Ofwat also have experience of working together as part of the Phase 1 merger process following the Water Act 2014. Ofwat will find these working arrangements to be of particular use when reviewing major strategic options. 	<ul style="list-style-type: none"> — 5.2.8
<p>18 The CMA is an important resource for Ofwat, with options for concurrency of working as set out in the recently agreed MOU, as well as the potential for Ofwat to make a reference to the CMA where it has reasonable grounds to suspect that a feature of the market prevents, restricts or distorts competition. However, the Regulator must understand the limitations of making such a reference, and the possible unintended consequences that may occur. Ofwat may want to aim for a regulatory regime which draws on concurrency with the CMA where this provides an addition to Ofwat expertise, but one where there is no need to make a formal reference to the CMA.</p>			

⁴⁰ Paragraph 187, Page 40, Energy market investigation – Provisional decision on remedies, CMA, 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b603880003b/Provisional-decision-on-remedies-EMI.pdf>

⁴¹ Electricity Act 1989, Standard conditions of electricity supply licence, Gas and Electricity Markets Authority, <https://epr.ofgem.gov.uk/Content/Documents/Electricity%20Supply%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

⁴² Rebuilding consumer confidence: Actions to improve the transparency of energy company profits, Consultation, Ofgem, 10 October 2014: https://www.ofgem.gov.uk/sites/default/files/docs/2014/10/transparency_consultation_0.pdf

⁴³ See responses to provisional decision on remedies published on the CMA website: <https://www.gov.uk/cma-cases/energy-market-investigation>

⁴⁴ Notice of final decision on transfer, Ofgem, 13 June 2016: https://www.ofgem.gov.uk/system/files/docs/2016/06/formal_notice_of_transfer_14_june_2016.pdf

⁴⁵ Memorandum of understanding between the Competition and Markets Authority and the Water Services Regulation Authority – concurrent competition powers, CMA & Ofwat, 23 February 2016: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/502668/Ofwat_MoU.pdf

2 Introduction

The context of Ofwat's assessment of the cost and benefits of competition in household retail for England comes at a time of ongoing regulatory and government change in the water sector.

Ofwat is considering a range of potential options in its assessment, which can broadly be defined as competition for different activities and/or competition for different customers (or customer groups).

Ofwat is keen to understand the potential implications and lessons from the energy sector, in building its evidence based assessment. In that context, KPMG was engaged by Ofwat to write a report covering:

- An analysis of the market arrangements in the energy sector, setting out a narrative of the details together with KPMG's views on potential lessons learnt from competition in the energy sector; and
- A review of the CMA remedies on the energy sector and any implication for the water sector, focussing on the CMA's Provisional Decision on Remedies as part of its ongoing review of competition in the energy sector.

Ofwat plans to provide this report to Government as part of Ofwat's assessment of the costs and benefits for retail competition for household water customers in England.

In support of Ofwat's evidence based assessment, this report is an independent review of the key lessons learnt in energy since market liberalisation based on the publicly available evidence.

Like energy, water is an essential service selling a homogenous product, and so the key potential competitive differentiators are price and levels of service. The structure of the market has some similarities, with incumbent network companies owning and operating on a regional basis and regulated as natural monopolies. Customers' expectations are also similar, with high standards expected of reliability of service delivery.

Ofwat and Ofgem have similar duties to promote competition, but Ofgem regulates only around 25%⁴⁶ of consumers' bills through a price control regime with the rest heavily dependent on global prices, as well as EU and Government directives and subsidies. The introduction of competition into the water market would reduce the extent to which consumers' bills for water and sewerage are regulated by Ofwat, and this ceding of control would need to be considered carefully to ensure that customers remain protected.

⁴⁶ Data portal, Ofgem: <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>.

3 Background

3.1 Water sector overview

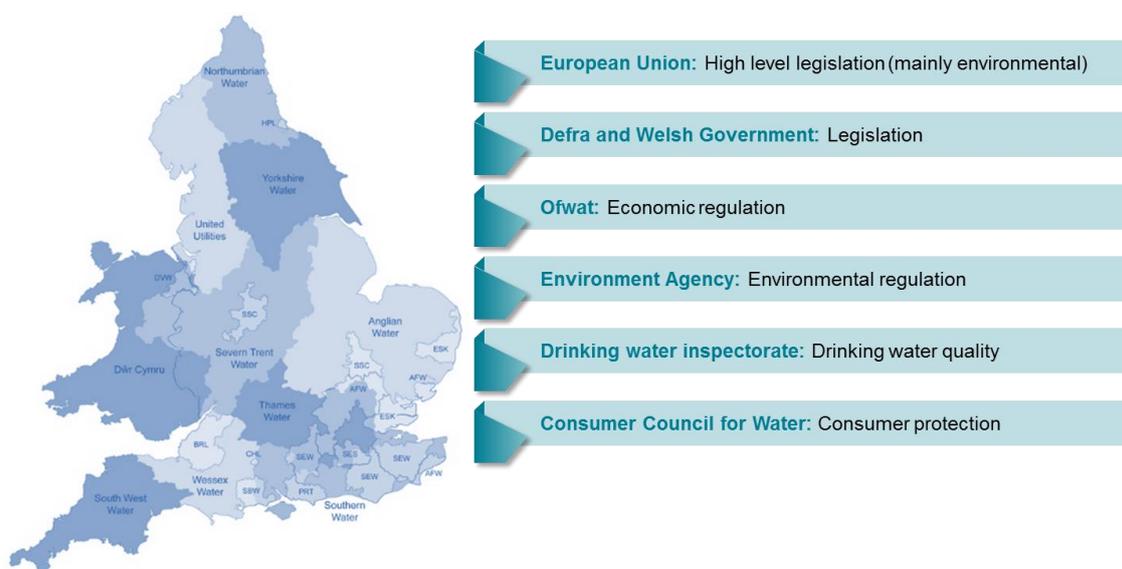
Water, sanitation and drainage services are provided to household and non-household consumers in England and Wales by 32 privately-owned companies. Water companies play an important role in delivering water supplies. Companies need to plan how they will meet the demand in the most efficient way, including meeting targets to reduce leakage and increase water efficiency⁴⁷.

Figure 3.1 below sets out the structure of the water industry in England and Wales, along with the reporting requirements for the regulated water companies.

Figure 3.1 Structure of the water industry

There are 32 regulated companies in the water and sewerage sectors. Of these, 18 are regional monopolies that provide either water services, or both water and sewerage services. Ofwat reports regularly on the performance of these water companies using the information they publish each year. Their prices are set every five years.

Each one of these companies must comply with:



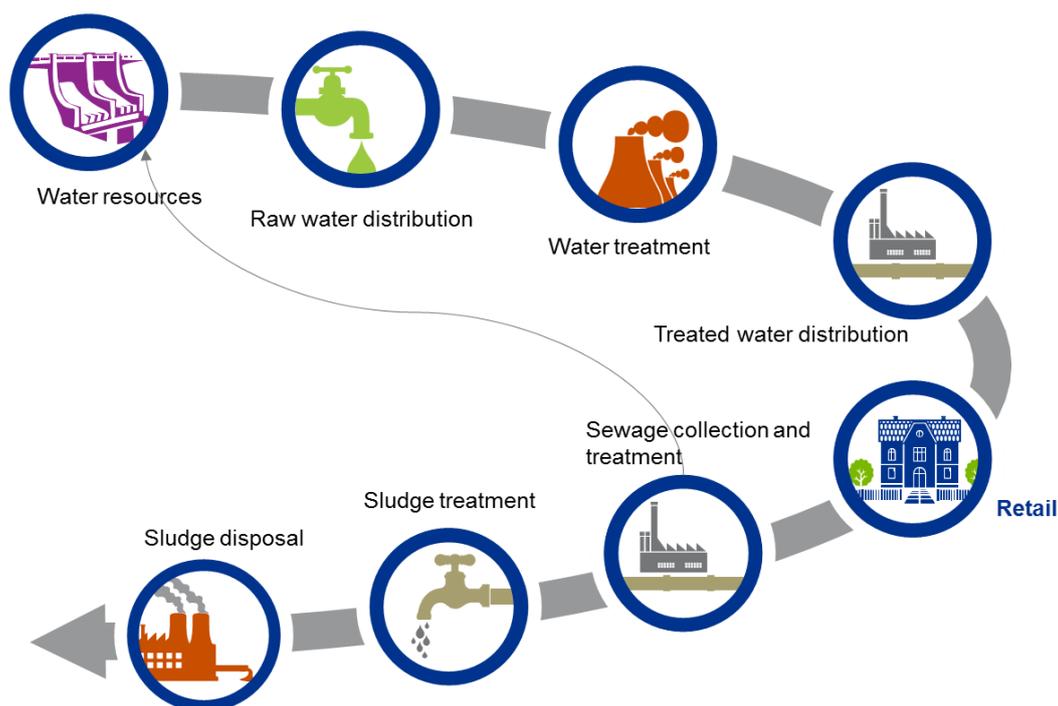
Source: Ofwat, KPMG.

The water and sewerage (wastewater) industry was privatised in 1989 and a regulatory framework has been in place since to ensure that consumers receive high standards of service at a fair price⁴⁸. The regulatory framework allows for companies to invest in maintaining and improving assets and services as well as getting an allowed rate of return. The value chain for England and Wales depicting the flow from water resources through to disposal of sludge is summarised in Figure 3.2.

⁴⁷ Conserving water, Ofwat: <http://www.ofwat.gov.uk/households/conservingwater/>

⁴⁸ Water sector overview, Ofwat: <http://www.ofwat.gov.uk/regulated-companies/ofwat-industry-overview/>

Figure 3.2 The value chain in water and sewerage in England and Wales



Source: KPMG based on Ofwat's value chain definition.

Ofwat is the economic regulator of the water and sewerage sectors. The regulator is responsible for protecting the interests of consumers, wherever appropriate by promoting competition, making sure that water companies properly carry out their functions and ensuring that they finance their functions⁴⁹.

The Department for Environment, Food and Rural Affairs (Defra) sets the overall water and sewerage policy framework in England. This includes standard setting, drafting of legislation, and creating special permits (e.g. drought orders). The Welsh Government has a similar role for Wales. Both the Welsh Government and Defra work closely together on water issues. For clarity, Scottish and Welsh water arrangements are separate and not part of Ofwat's household market review.

3.2 The introduction of competition

3.2.1 The Cave Review and non-household market opening

In 2008, Professor Martin Cave was asked by the UK and Welsh Assembly Governments to lead an independent review of competition and innovation in water markets⁵⁰. The review brought forward the Government's commitment to review the eligibility threshold for non-household customers to choose their suppliers, which was introduced as part of the Water Act 2003. At the same time, the review aimed to deliver benefits to both business and household customers and increase the efficiency and sustainability of water use. This included assessing the scope for competition and innovation throughout the water and sewerage industries.

⁴⁹ Water sector overview, Ofwat: <http://www.ofwat.gov.uk/regulated-companies/ofwat-industry-overview/>

⁵⁰ Page 3, Competition and innovation in the water markets, Professor Martin Cave – April 2009:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69462/cave-review-final-report.pdf

The Cave report was published on 22 April 2009 with recommendations for changes to the legislation and regulation of the industry in England and Wales to deliver benefits to consumers, particularly the most vulnerable. In the review, competition and innovation were considered as a means of improving services for customers and improving environmental outcomes⁵¹.

The review found that efficiency in the industry is almost totally driven by economic regulation by Ofwat. Improved performance is encouraged through rewards for outperformance relative to cost, and service quality improvements are promoted through the overall performance assessment⁵². It also found that the vast majority of network customers are supplied by their local incumbent with prices and quality standards determined by Ofwat⁵³.

However Professor Cave recommended not to extend competition to households at the time of the review⁵⁴. He recommended that Ofwat provide further assessments of the costs and benefits of these changes at an appropriate time.

3.2.2 The Walker Review: charging for household water and sewerage services

Concurrent with the Cave Review, in August 2008, UK and Welsh Assembly Governments asked Anna Walker CB to conduct a review into charging for household water and sewerage services. The aim of the review was three-fold⁵⁵:

- 1) Examine the current system of charging households for water and sewerage services and assess the effectiveness and fairness of current and alternative methods of charging including the issue of affordability;
- 2) Consider social, economic and environmental concerns; and
- 3) Make recommendations on any action that should be taken to ensure that England and Wales have a sustainable and fair system of charging in place.

The Walker report was published in December 2009 drawing out a number of conclusions in the context that while the regulatory regime in the water sector has served customers well, the industry is facing a number of new challenges. A high-level summary of the main recommendations is provided below.

The Walker Review identified that the charging system needs to incentivise the efficient use of water so as to ensure there is sustainable supplies for the future and that water also needs to be affordable for all, particularly those on low income⁵⁶. Walker's findings are similar to what is known as the 'Energy Trilemma' – affordability, security of supply and sustainability – in the energy sector.

The Walker Review also identified that for unmetered customers there is no incentive to use water wisely. People are, however, opting for meters when they think they can personally benefit from doing so. Additionally, Walker highlighted that "charging by volume of water used is the most effective way

⁵¹ Page 5, Competition and innovation in the water markets, Professor Martin Cave – April 2009: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69462/cave-review-final-report.pdf.

⁵² Page 6, Ibid.

⁵³ Page 12, Ibid.

⁵⁴ Page 84, Ibid.

⁵⁵ The Independent Review of Charging for Household Water and Sewerage Services, Final Report, Anna Walker CB, December 2009:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69459/walker-review-final-report.pdf

⁵⁶ The independent review of charging for household water and sewerage services (Walker review), 6 December 2011: <https://www.gov.uk/government/publications/the-independent-review-of-charging-for-household-water-and-sewerage-services-walker-review>

of incentivising the efficient use of water. The transition to metering needs to be led to ensure total costs are kept down”⁵⁷. Walker recommended that Ofwat provide this leadership, within an overall policy framework from government. A further recommendation is that there should be an agreed methodology for looking at the costs and benefits of metering⁵⁸. Walker’s findings are consistent with the energy sector where the view is that metering consumption can contribute to more efficient use of energy, monetary savings, a reduction in emissions and bill accuracy to name but a few⁵⁹.

Regarding vulnerable customers, the author made a number of recommendations to support low-income families. The package includes help with bills and water efficiency schemes alongside similar energy schemes with the aim of addressing the bad debt problem in the water sector. The author also recommended urgent legislative changes to allow water companies to bill named customers, thereby allowing them to pursue debts through the courts, if necessary⁶⁰.

3.2.3 ‘A Better Deal’: Government push towards boosting competition

On 30 November 2015 the UK Government published ‘A Better Deal: boosting competition to bring down bills for families and firms’⁶¹. The report focused on the competition aspects of the government’s productivity plan and steps to boost competition and eliminate market distortions. It noted that markets need to be open to competitive pressures in order to direct resources to their most productive use and to innovate⁶². As a result, the government is taking action to promote competition in the water sector in England⁶³.

Following the opening of the non-household retail market to competition, the Government wants to begin the transition to household retail competition. Ofwat has been asked to provide an assessment by summer 2016 of the costs and benefits of extending retail competition to household water customers in England⁶⁴.

3.2.4 Household market review

The Household Market Review (the Review) is Ofwat’s response to the Government’s request. In December 2015, Cathryn Ross, Ofwat Chief Executive, wrote a letter to water company Chief Executives to inform them of the upcoming review⁶⁵.

The Review considers 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. This includes a range of models comprising an extension of the non-household retail market

⁵⁷ The independent review of charging for household water and sewerage services (Walker review), 6 December 2011: <https://www.gov.uk/government/publications/the-independent-review-of-charging-for-household-water-and-sewerage-services-walker-review>

⁵⁸ Ibid.

⁵⁹ Smart meters: a guide, DECC, 22 January 2013: <https://www.gov.uk/guidance/smart-meters-how-they-work>

⁶⁰ Page 2, The Independent Review of Charging for Household Water and Sewerage Services, Final Report, Anna Walker CB, December 2009: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/69459/walker-review-final-report.pdf

⁶¹ Page 3, A better deal: boosting competition to bring down bills for families and firms, HM Treasury – November 2015:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480797/a_better_deal_for_families_and_firms_print.pdf.

⁶² Page 5, Ibid.

⁶³ Page 11, Ibid.

⁶⁴ Page 11, Ibid.

⁶⁵ Letter from Cathryn Ross to Regulatory Directors: Review of household competition, 14 December 2015: <http://www.ofwat.gov.uk/publication/letter-from-cathryn-ross-to-regulatory-directors-review-of-household-retail-competition/>

model, a separate household retail market model and an auction style competition model⁶⁶. Ofwat is also considering the width (how many customers) and depth (what services and assets) of the market. The potential impact of implementing one, or a combination, of these models will form part of Ofwat's assessment in the review. Should Ofwat identify potential barriers or risks to consumers during its review, it will also consider a range of protection mechanisms to enable effective choice and realise net benefits for customers⁶⁷.

The Review seeks to understand any wider benefits and potential policy issues of household competition in England only (the review excludes the Welsh market), with a particular focus on targeting of customers and the management of different customer groups (such as vulnerable customers and those with bad debt)⁶⁸.

On 15 January 2016, Ofwat published the draft terms of reference to provide all stakeholders with further information on the review⁶⁹. The call for evidence was then issued to gather views and supporting evidence from stakeholders⁷⁰ and set out a list of questions for stakeholders to consider when developing their evidence-based views and statements in a submission. Ofwat plans to publish the final report of the Review in September 2016⁷¹. The decision on whether, in what form, and on what timeline the household retail market in England may open to competition is a matter for the UK Government⁷².

3.3 Why might the experience from energy be useful

Ofwat's approach is to build an evidence based assessment, considering the potential models for competition and the relevant costs and benefits for each. As part of this assessment, Ofwat wants to understand the approach taken to introduce retail competition into the gas and electricity sectors in Great Britain, and the potential lessons to be learnt from the energy sector. This includes both the introduction of retail competition starting with the introduction of the Gas Act 1986⁷³ and the Electricity Act 1989⁷⁴, the key interventions and milestones since then and through to the ongoing review of the energy market being undertaken by the Competition and Markets Authority (CMA).

Like energy, water is an essential service selling a homogenous product, and so the key potential competitive differentiators are price and levels of service. There are some important differences that need to be considered:

- 1) There are technical limitations in electricity – notably in the past over storage – that define the properties of the product (the need for reactive power, etc.); and
- 2) The energy sector is tied to global fuel product markets but water is clearly a locally derived product.

⁶⁶ Page 5, Review of retail household markets in the water and wastewater sector: Terms of reference, Ofwat – March 16: http://9208a6bdb79020ec0337-99614e491dc8efff25f017339872a32a.r86.cf3.rackcdn.com/wp-content/uploads/2016/01/pap_tec20160321retailhhmarket.pdf.

⁶⁷ Page 6, Ibid.

⁶⁸ Ibid.

⁶⁹ Review of retail household markets in the water and wastewater sector: Draft terms of reference, Ofwat, January 2016: http://www.ofwat.gov.uk/wp-content/uploads/2016/01/pap_con20160115hhcompetitiontor.pdf.

⁷⁰ Review of retail household markets in the water and wastewater sector: Call for evidence, Ofwat – January 16: http://9208a6bdb79020ec0337-99614e491dc8efff25f017339872a32a.r86.cf3.rackcdn.com/wp-content/uploads/2016/01/pap_con20160118hhcompetitioncfe.pdf.

⁷¹ Page 9, Review of retail household markets in the water and wastewater sector: Terms of reference, Ofwat – March 16: http://9208a6bdb79020ec0337-99614e491dc8efff25f017339872a32a.r86.cf3.rackcdn.com/wp-content/uploads/2016/01/pap_tec20160321retailhhmarket.pdf.

⁷² Page 4, Ibid.

⁷³ Gas Act 1986, <http://www.legislation.gov.uk/ukpga/1986/44/contents>.

⁷⁴ Electricity Act 1989, 1989 Chapter 29, <http://www.legislation.gov.uk/ukpga/1989/29/data.pdf>.

Ofwat and Ofgem have similar duties to promote competition, but Ofgem regulates only around 25%⁷⁵ of consumers' bills through a price control regime with the rest heavily dependent on global prices, EU directives and Government subsidies. The introduction of competition into the water market would reduce the extent to which consumers' bills for water and sewerage are regulated by Ofwat, and this ceding of control would need to be considered carefully to ensure that customers remain protected.

The experience from energy is also useful because of the staged opening of the market with industrial and commercial customers before household customers has happened in the energy market. This is broadly similar to the phased approach that is being taken in the water industry. See Section 4.2 for more details.

Apart from similar utility characteristics, one of the major advantages from reviewing the energy sector is that prior to market liberalisation and restructuring the companies were bundled together – in the electricity sector an area board offering distribution was tied to the generators under the umbrella of the Central Electricity Generating Board (CEGB). The fact that over a period of 17 years (1986-2002) the Government forced the energy industry to brake itself up into constituent parts (or to unbundle) is of enormous value and interest to the water companies who are potentially at the threshold of moving in a similar direction.

Today, customer engagement continues to evolve, with increasing uptakes of new technology such as Hive and Nest smart thermostats, as well as the mandatory rollout of Smart Meters which will remove estimated bills and enable faster and more accurate switching. There are links between these technologies and water, with smart thermostats linked to the use of boilers for water and heating, but there is further potential for new technology in water in order to catch up with the energy sector. The potential for a multi-utility provider/utility service company, acting as a customer's supplier for water, gas and electricity would be a true innovation and a new product offering that could encourage engagement and allow competition in water to take advantage of parallel developments in energy.

As Sections 4 and 5 demonstrate, market opening in the energy sector had its own set of challenges and by addressing some issues, other arose. Lessons learnt from the energy sector are useful in the context of the water sector: it can benefit from things that did not work as foreseen, or unforeseen consequences that arose in the roll out of competition in gas and electricity markets. A summary of lessons for consideration in the water sector is provided in Section 1.

The energy and water sectors are facing similar challenges in relation to climate change over the coming years. The implications of climate change including the potential for increases in severe weather will affect both the provision of utility services and consumers' use of these services. Similarly, population growth, particularly in parts of the country already experiencing water stress and/or energy constraints, will need to be considered and managed. At the same time, customer expectations in how they engage with utility providers and the potential for ongoing innovation in technology, such as Smart Meters and smart thermostats that consumer can operate remotely will change the way that utility providers engage with their customers, both in provision of services and to win new customers.

This report is not promoting an argument that Ofwat should follow a similar path to Ofgem during the course of market opening but more an examination of the experiences that can inform Ofwat's review which will be submitted to HMT in September 2016.

⁷⁵ Data portal: <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

4 Market arrangements in the energy sector: an analysis

Section 4 deals in detail with the evolution of market arrangements in the energy sector from market opening until the Ofgem/OFT State of the Market assessment which triggered the ongoing CMA enquiry into UK energy markets (discussed in more detail in Section 5), and draws out lessons for Ofwat as it considers market opening in the domestic water sector. This section is structured around the following principal developments:

- The opening of electricity markets to full competition, starting with the establishment of competing generating companies through the Electricity Act (1989) and culminating in the removal of remaining price controls for domestic customers in 2002;
- The opening of gas markets to full competition, starting with the privatisation of the British Gas Corporation through the Gas Act (1986), and culminating in the removal of remaining price controls for domestic customers in 2002;
- Ofgem’s Energy Supply Probe (2008): This was an investigation into energy supply for households and small businesses. This uncovered concerns around the prices faced by customers off the gas grid and on prepayment meters. A package of measures was developed to improve the functioning of the market. These included: requirements for differences in Terms and Conditions offered by suppliers in respect of different payment methods to be cost reflective; prohibition of undue price discrimination; help for vulnerable/ indebted consumers prevented from switching supplier due to debt blocking; measures to improve information on bills, and to improve supplier conduct; greater transparency around the supplier reporting of supply and generation activities⁷⁶; and
- Ofgem’s Retail Market Review (2010 – 2014): this was launched in 2010 following concerns that the energy market was not working effectively for consumers. It resulted in an extensive package of measures, principally: limits on the tariff choices consumers could face; standardising tariff structures; creation of rules to simplify bundles, discounts and reward points; measures to facilitate group switching; transparency on white label suppliers; enhanced protection for consumers on both ‘evergreen’ and fixed term tariffs⁷⁷.

It is notable that over the period covered in this chapter, the role of the regulator (Ofgem) evolved significantly in relation to domestic retail markets. During market opening, Ofgem acted as a price regulator and oversaw the transition to a competitive market. Following this, it was to act as an advocate of competition, before focusing much more closely on consumer protection through the Energy Supply Probe (2008) and the Retail Market Review (launched 2010). The experience from the energy sector shows that once markets have been opened, the regulator’s behaviour is shaped to a significant degree by ‘market events’, which can in turn drive political interest.

The rest of the section is structured as follows:

- Timeline of key events and market developments during and since market opening;
- Description of four principal developments set out above; and
- Analysis of key lessons that can be drawn from energy market opening for Ofwat.

⁷⁶ Energy Supply Probe, Ofgem: <https://www.ofgem.gov.uk/gas/retail-market/market-review-and-reform/retail-market-review/energy-supply-probe>

⁷⁷ Pages 7 and 8, The Retail Market Review – Implementation of simpler tariff choices and clearer information-decision, Ofgem, 27 August 2013: https://www.ofgem.gov.uk/sites/default/files/docs/decisions/the_retail_market_review_-_implementation_of_simpler_tariff_choices_and_clearer_information.pdf

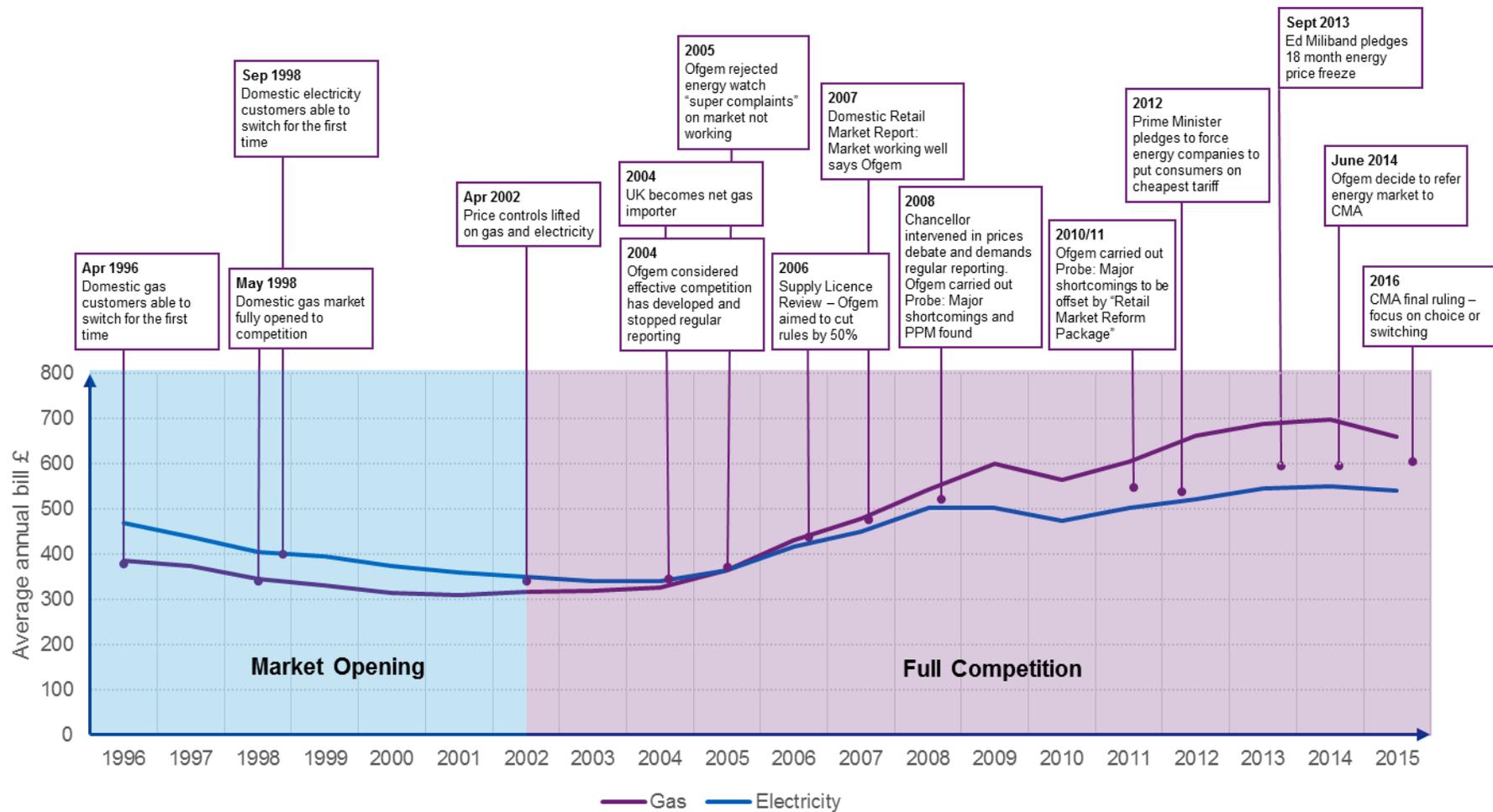
4.1 Timeline of key events

Figure 4.1 below sets out the key events leading up to the opening of the gas and electricity retail markets to competition.

We have plotted the average annual gas and electricity bills from 1996 to 2015. As prices increase, one can notice that there is more political interest and there are more interventions in the market from Government and Regulator. This demonstrates that a liberalised sector can be subject to political intervention: simply put, a significant rise in the cost of a core utility product for the average home can have political consequences. In the energy sector, this was exacerbated post-2008 by wider economic conditions as consumers were squeezed by recession. Ofgem had very little control over prices where these were largely set by global commodity prices, in particular gas price. Rising prices can also lead consumers to become disengaged from markets – they lose faith that markets deliver benefits to them.

Linked to the increase in energy prices, a number of reforms and events unfolded from 2004 onwards in retail markets, including Ofgem removing the requirement around regular supplier reporting, the Supply Licence Review, the conclusions drawn from Ofgem's Domestic Retail Market Report, the Energy Supply Probe and Retail Market Review, and finally the reference to the CMA.

Figure 4.1 Timeline of key events in the energy sector



Source: Price series taken from DECC, 'Annual Domestic Energy Bills' dataset. <https://www.gov.uk/government/statistical-data-sets/annual-domestic-energy-price-statistics>, and expressed in 2010 values.

4.2 Key market developments

4.2.1 Removal of price controls (2002)

The removal of all remaining price controls in 2002 marked the final step in the opening of gas and electricity markets, which had begun in the 1980's with the establishment of competing electricity generation companies through the Electricity Act (1989) and the privatisation of the British Gas Corporation through the Gas Act (1986). The process of domestic market opening was a gradual one, starting with the opening of former regional monopolies to competition from non-incumbents in 1998/99⁷⁸, and proceeding through the gradual removal of price controls for different customer groups from 2000 onwards. This concept of transition (as opposed to sudden change) was important as it ensured that systems and settlements processes could manage, and that both customers and companies could prepare. In water, the opening of the non-household market from 2017 may provide a similar means of learning and adaptation in the run up to any opening of the domestic retail market. Regional factors may influence how and when competition may be rolled out for households in England. For example, regional variations in the numbers of customers with water meters may suggest a need to consider phasing of roll out.

In terms of raising consumer awareness, much of the engagement around gas market opening was done by gas suppliers. An National Audit Office (NAO) survey of the 25 suppliers licenced to sell gas to domestic customers in July 1998 showed that they were using a wide range of marketing methods, with doorstep selling the most widely used⁷⁹. In addition, OFGAS carried out a publicity campaign during the period when competition was being introduced, with the slogan 'Cheaper gas in the pipeline', and produced a leaflet entitled 'All you need to know about gas competition' which was delivered to one million homes. It also published a range of factsheets on the main aspects of competition, and contracted the Consumers Association to produce regular factsheets comparing the price of different gas suppliers. In addition, OFGAS set up a free telephone enquiry service.

In the electricity market, research by the NAO⁸⁰ indicated the importance of doorstep selling in raising awareness of competition and in persuading consumers to switch supplier. However, the sales techniques used by doorstep salesmen led to significant numbers of complaints, mainly for mis-selling⁸¹. This indicated the trade-offs involved between raising consumer awareness through doorstep sales and protecting consumers. In addition, exaggerated claims by doorstep salesmen risked damaging consumer confidence when those savings did not materialise. Yet sales activities by energy companies were successful in raising consumer awareness: Ofgem's customer survey in autumn 1999 demonstrated that most consumers were now aware that they could buy electricity from suppliers other than their local electricity company⁸². Ofgem sought to alert consumers to the introduction of competition through articles and advertisements in the national and local press. They also published an information leaflet available to customers on request. To help customers identify the best deal, Ofgem published comparative price data on its website and via its free telephone helpline. Ofgem's survey in autumn 1999 i.e. prior to the removal of price controls indicated that only 3% of consumers had found out about the introduction of competition from Ofgem⁸³. This was a consequence of the limited dealings the vast majority of consumers have with the regulator.

⁷⁸ Domestic market opening began for gas in April 1996 in Devon, Cornwall and Somerset, and concluded in May 1998 with Surrey and London. For electricity, domestic market opening began in September 1998 and concluded in April 1999.

⁷⁹ Giving Customers a choice: the introduction of competition to domestic gas markets, Office of Gas Supply, National Audit Office, 12 May 1999: <https://www.nao.org.uk/wp-content/uploads/1999/05/9899403.pdf>

⁸⁰ Giving Domestic electricity customers a choice of supplier, National Audit Office, 5 January 2001: <https://www.nao.org.uk/wp-content/uploads/2001/01/000185.pdf>

⁸¹ Page 7, Doorstep Selling- A report on the market study, Office of Fair Trading, May 2004, http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/shared_offt/reports/consumer_protection/oft716.pdf

⁸² Page 27, Giving Domestic electricity customers a choice of supplier, National Audit Office, 5 January 2001: <https://www.nao.org.uk/wp-content/uploads/2001/01/000185.pdf>

⁸³ Page 30, Giving Domestic electricity customers a choice of supplier, National Audit Office, 5 January 2001: <https://www.nao.org.uk/wp-content/uploads/2001/01/000185.pdf>

A feature of market opening was increasingly strong linkages between the gas and electricity markets. In the mid-1990s, gas and electricity comprised largely separate markets, with largely separate companies, i.e. British Gas were not active in electricity, neither were the Regional Electricity Companies (RECs) active in gas. Furthermore, regulation was separate, with OFFER and OFGAS regulating electricity and gas respectively. By 2002, the situation was very different. Ofgem had been formed in 1999 as the result of the merger of OFGAS and OFFER, which was formalised in the Utilities Act (2000)⁸⁴. In the market, former gas and electricity incumbents looked to grow or protect market share in both gas and electricity, with large numbers of consumers moving on to dual fuel tariffs as a result⁸⁵. Particularly notable were the large number of electricity customers switching to British Gas. By 2008, Ofgem estimated that around half of the customers lost by regional electricity incumbents switched to British Gas.

The political environment in 2002 was supportive of increased competition, with considerable Government faith invested in markets from HM Treasury and the Department for Trade and Industry. In addition, market conditions were benign: the gas price had drifted down from 1998 to 2001 with bills falling from £346 to £309 per household⁸⁶ in real terms. Electricity bills were also enjoying a sustained period of significant price reduction (from £405 to £341 per household from 1998 to 2003)⁸⁷. As a result, the removal of price controls was completed in 2002 against an optimistic consumer response, and with support from key stakeholders.

It is unclear whether, if the decision was taken to liberalise domestic water markets, competition would be introduced to such a supportive backdrop. The energy market experience following market liberalisation (as outlined below) may have affected consumers' perception of the benefits of competition. In addition, in the years since market liberalisation, the media has become increasingly adept at picking up problems⁸⁸ and running campaigns. Ofwat may therefore seek to work more closely with consumer groups in order to secure their support for market liberalisation, thereby avoiding the confrontational stance of energywatch towards Ofgem. Neither can the water industry rely on the backdrop of falling prices that characterised the period after energy markets were liberalised.

In terms of prices, water will continue to be regulated at a wholesale level, removing the possibility of increased wholesale competition driving lower retail prices. However, the water price will not be exposed to movements in global wholesale prices as domestic energy prices are. Water markets do not have this unpredictable element. Given that water prices are likely to be more stable than energy prices following any decision to liberalise markets, Government and/or Ofwat may need to focus more on consumer protection and service quality than on price.

Following market liberalisation, outcomes appeared to be positive based on broad market metrics. Market share data indicated dynamic energy markets characterised by high levels of switching, driven at least in part by the national campaign undertaken at the time of market opening. Ofgem claimed that net switching by electricity customers had reached 40% by September 2001, with net switching by gas customers reaching 25% by April 2001⁸⁹. The market shares of incumbents tumbled, for e.g. BG market share reduced from 84% to 67% (1998-2001) and the electricity companies from 90% to 70%

⁸⁴ See <http://www.legislation.gov.uk/ukpga/2000/27/contents>.

⁸⁵ By 2008, Ofgem estimated that 38% of customers receiving gas and electricity were on a dual fuel, direct debit tariff. Page 7, Energy Supply Probe, Ofgem, October 2008. <https://www.ofgem.gov.uk/ofgem-publications/38437/energy-supply-probe-initial-findings-report.pdf>

⁸⁶ 2010 prices. Price series taken from DECC, 'Annual Domestic Energy Bills' dataset. <https://www.gov.uk/government/statistical-data-sets/annual-domestic-energy-price-statistics>.

⁸⁷ 2010 prices. DECC, *ibid*.

⁸⁸ See for example <https://www.thesun.co.uk/archives/news/34227/revealed-how-age-uk-pocketed-6m-bung-from-e-on-and-pushed-expensive-power-deals-to-oaps/>.

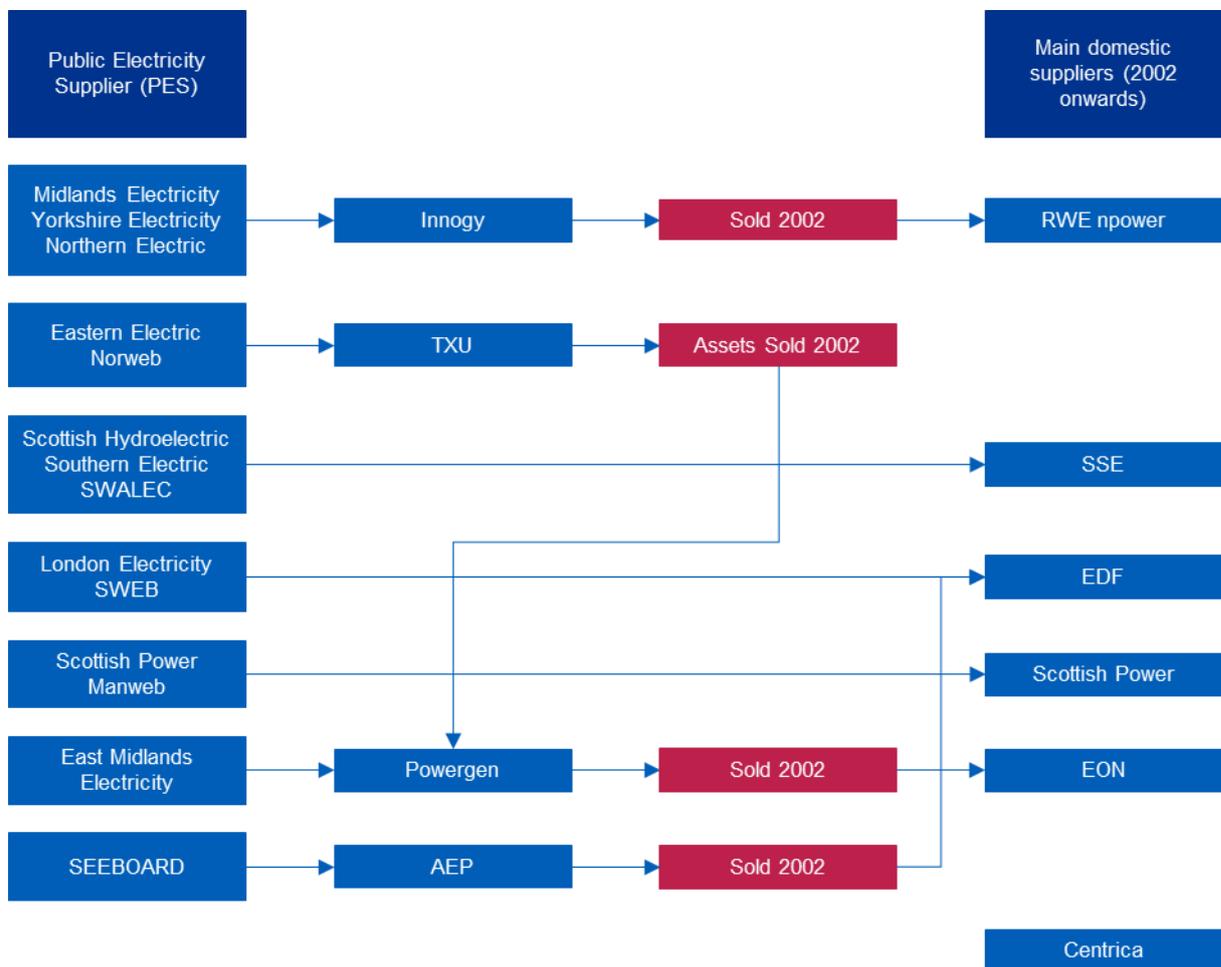
⁸⁹ Ofgem analysis, quoted at p29 of 'Protecting consumers? Removing retail price controls', National Audit Office, 2008, <https://www.nao.org.uk/wp-content/uploads/2008/03/0708342.pdf>

from 1999 to 2001⁹⁰. Particularly notable were the efforts of British Gas to gain market share in electricity: by March 2003 its share of domestic electricity customers was 23%⁹¹.

There is scope for similar dynamics to influence the development of competition in domestic water retail. Although the water industry will not face a national monopolist such as British Gas seeking to gain a foothold in a new market, there may be entry from energy suppliers seeking to exploit their bundled products for energy and water. In addition, water companies will seek to leverage their position in their former monopoly areas to drive out of area competition as energy companies did.

In electricity, there was consolidation among suppliers over the years following privatisation. Immediately after privatisation, there were a total of 14 Public Electricity Suppliers. This reduced to 5 following a spate of acquisition activity and the collapse of TXU in 2002, and together with Centrica/British Gas this group came to be known popularly as 'the Big Six'. The consolidation of the industry is summarised in the table below:

Figure 4.2 Consolidation in electricity supply, 1990-2002⁹²



⁹⁰ Page 29, 'Protecting consumers? Removing retail price controls', National Audit Office, 2008, <https://www.nao.org.uk/wp-content/uploads/2008/03/0708342.pdf>.

⁹¹ Page 43, 'Domestic gas and electricity supply competition. Recent developments', Ofgem, 2004. <https://www.ofgem.gov.uk/ofgem-publications/38550/3775-dcmr04july.pdf>

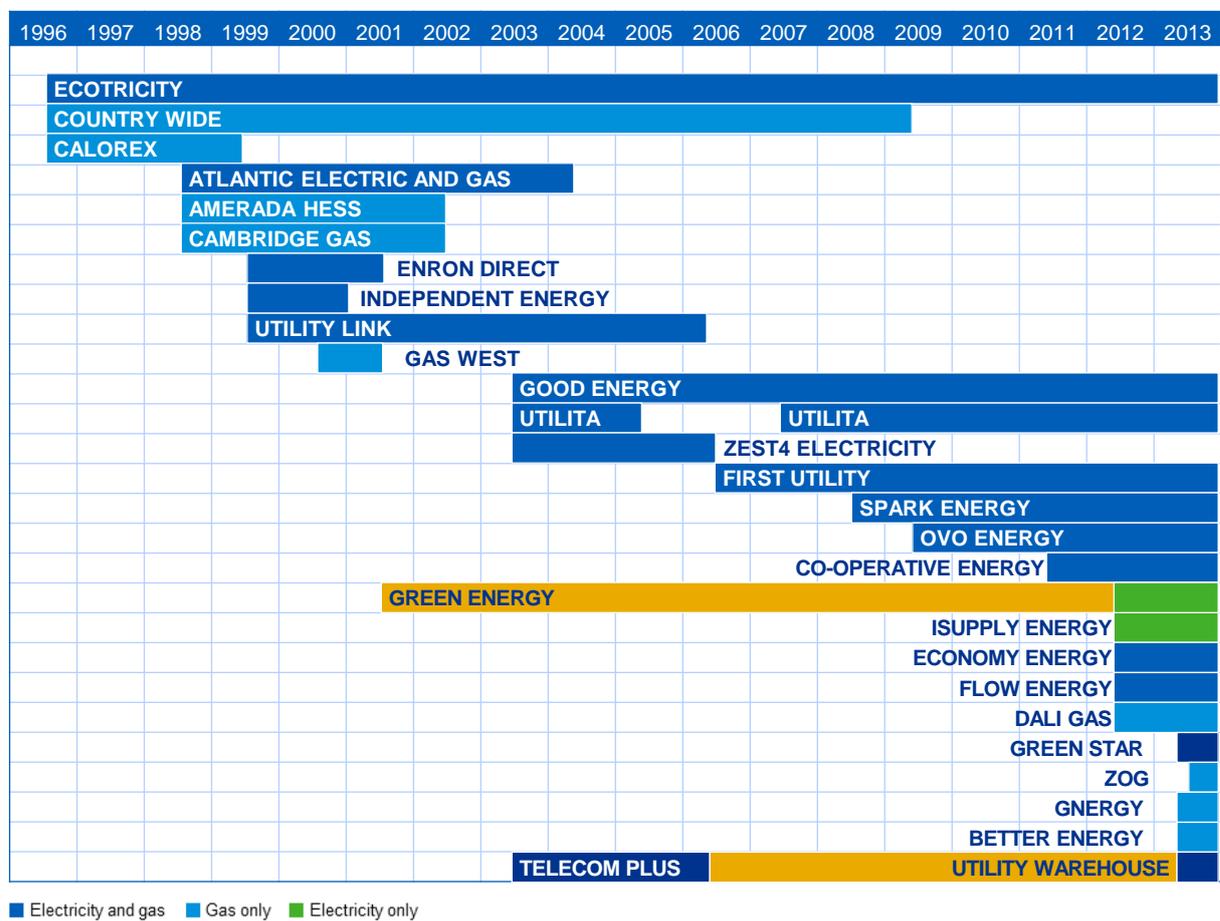
⁹² Adapted from Centre for the Study of Regulated Industries, 'Regulation of the UK Electricity Industry – 2002 edition' and added to from news articles detailing 2002 activity.

Consolidation in the UK gas retail sector took a similar pattern, with the entry of PES companies to compete for the customers of the former monopoly (British Gas) and their subsequent consolidation into the six main domestic suppliers, which all supplied both gas and electricity.

In the years following privatisation, there was a trend towards increased vertical integration between generation and supply in the electricity industry, with former PES companies purchasing generation assets, and generators purchasing supply companies. This was particularly marked in 2001 and 2002, when the collapse and insolvency of AES, Enron, Independent Energy and TXU Europe saw large amounts of merchant generating capacity taken over by vertically integrated companies⁹³. However, although the trend towards vertical integration would continue, the CMA has not taken the view that it adversely affects competition in its ongoing investigation, and has not proposed any remedies to address structural issues in the energy market.

In the early years of liberalised markets, there were numerous attempts at market entry by non-incumbent companies, most of which were short-lived. These are set out in the chart below:

Figure 4.3 Non-incumbent entry and exit in gas and electricity domestic retail markets⁹⁴



Source: Ofgem.

Prior to full market opening in energy, Ofgem made use of a one year relative price cap for BGT in gas, setting a cap on the p/kWh difference between Prepayment and LatePay customers compared to PromptPay customers, and between Prepayment and LatePay customers with Direct Debit

⁹³ Page 78, 'State of the Market Assessment', Ofgem, 2014 <https://www.ofgem.gov.uk/ofgem-publications/86804/assessmentdocumentpublished.pdf>.

⁹⁴ Ofgem, *ibid*.

customers. This was established for one year from April 2001. Ofgem also established two year price restraints for ex-PES in-area prices, capping the average price for domestic credit customers, the difference between credit and prepayment customers, standing charges and unit charges. Ofgem's price restraints did not apply to non-domestic customers, direct debit customers, other suppliers or to ex-PES suppliers' activities outside of area⁹⁵.

Ofgem then completed a review of the market, including an assessment of key indicators including customer awareness, switching rates, market share and availability of savings⁹⁶. Following this review, Ofgem decided to introduce full competition in 2002⁹⁷.

Ofgem took its decision to remove price controls against a mixed set of market indicators. While cumulative switching levels were high⁹⁸ the number of consumers who saw switching as an inconvenience was on the increase in both gas and electricity, and the number of active suppliers was falling⁹⁹. Ofgem developed a set of indicators to measure the strength of competition, but did not set criteria for the indicators at their disposal, instead relying on the direction of movement to assess whether competition was developing. Furthermore, it did not specify a threshold that would have to be met to signify that competition was sufficiently strong in all sectors of the market¹⁰⁰ – this differed from the approach of Ofcom and Postcomm. An NAO report into the removal of price controls stressed that regulators should aim to make use of both quantitative and qualitative data where possible, when deciding whether to remove price controls¹⁰¹. Indeed, this information could be used to develop a clear set of success criteria around market opening decisions.

In 2004, Ofgem announced that competition was so entrenched and successful that it was withdrawing from regulatory reporting¹⁰². This decision was overturned within two years after significant price increases¹⁰³ had led to public interest in these increases. However, there were a number of factors in the wholesale market which explained these increases, including declining North Sea gas production, and tightening capacity margins in electricity¹⁰⁴.

The other major judgement call in this first phase by Ofgem was to focus on the macro competition indicators (changes in HHI indicators, switching levels by contrast to overseas and other UK sectors), and not segmented customers within the market. There was a degree of segmental monitoring being done e.g. tracking of price differentials, levels of indebtedness, and satisfaction levels by segment

⁹⁵ Review of domestic gas and electricity competition and supply price regulation. Evidence and Initial Proposals, Ofgem, November 2001: <https://www.ofgem.gov.uk/sites/default/files/docs/2001/11/7101---review-of-domestic-gas-and-electricity-competition-and-supply-price-regulation-evidence-and-initial-proposals-26-11.pdf>

⁹⁶ Review of domestic gas and electricity competition and supply price regulation. Evidence and Initial Proposals, Ofgem, November 2001: <https://www.ofgem.gov.uk/sites/default/files/docs/2001/11/7101---review-of-domestic-gas-and-electricity-competition-and-supply-price-regulation-evidence-and-initial-proposals-26-11.pdf>

⁹⁷ Review of domestic gas and electricity competition and supply price regulation: Conclusions and final proposals, Ofgem, February 2002

⁹⁸ Ofgem analysis indicated cumulative net switching of 12m for electricity customers by September 2001 and of 6m for gas customers by April 2001. Quoted at Page 29 of National Audit Office, 'Protecting consumers? Removal of retail price controls', National Audit Office, 2008, <https://www.nao.org.uk/wp-content/uploads/2008/03/0708342.pdf>.

⁹⁹ 'Future regulation of domestic gas and electricity supply markets – final decisions', Ofgem, February 2002, https://www.ofgem.gov.uk/sites/default/files/docs/2002/02/1096-factsheet0302_15feb_0.pdf.

¹⁰⁰ Page 44, 'Protecting consumers? Removal of retail price controls', National Audit Office, 2008. <https://www.nao.org.uk/wp-content/uploads/2008/03/0708342.pdf>.

¹⁰¹ Page 9, 'Protecting consumers? Removal of retail price controls', National Audit Office, 2008. <https://www.nao.org.uk/wp-content/uploads/2008/03/0708342.pdf>.

¹⁰² See Ofgem, 'Domestic Retail Market Report – March 2006' which states, 'Our last in depth review of the domestic retail market concluded that competition was effective, and so we decided to stop undertaking regular, extensive market reviews'. The previous domestic market review was published in April 2004.

¹⁰³ Between 2004 and 2006, electricity prices rose by 22% and gas prices by 32% in real terms. Source: DECC, 'Annual domestic energy bills', <https://www.gov.uk/government/statistical-data-sets/annual-domestic-energy-price-statistics>.

¹⁰⁴ Margins in winter 2005/06 stood at less than 1%. Source: National Grid, quoted at <http://www.bbc.co.uk/news/business-29794632>

around vulnerable groups of consumers, a greater focus on which might have enabled Ofgem to pick up earlier on the segmental weaknesses (to Prepayment Meter (PPM) and Off Gas Grid (OGG) customers) identified in the 2008 Probe. In water, a segmental approach to monitoring may enable issues with particular areas of the market to be picked up sooner.

The future development of the market made Ofgem's decision and subsequent actions around reporting appear over-optimistic. By 2008, customers had endured massive price increases and also lost confidence in the behaviours of the Large Energy Firms. The latter being due to clumsy sales techniques and a confusion – either of the unaware customer or the aware company – that led to large numbers of customers who switched mistakenly buying a more expensive product. By 2011, Ofgem estimated that 40% of consumers who switched had switched to a weaker deal¹⁰⁵. The macroeconomics judgement call of laissez faire light touch regulation appeared inappropriate, especially for the vulnerable customers. Ofgem reached its turning point after writing in its 2007 Domestic Retail Report that 'suppliers put self-regulation in place to protect a small number of unhappy customers'. The hard line of 'trust in markets and leave alone' had probably reached its furthest extent. The NAO put it another way in its 2008 report– 'regulators have focused more on understanding and reforming the industry than on building an understanding of consumers'¹⁰⁶.

4.2.2 Positive outcomes from energy market opening

Despite Ofgem's shift of emphasis from 2007 onwards, market liberalisation had led to a series of positive outcomes. The first of these was providing consumers with the choice to change their energy supplier. Large numbers of consumers did switch supplier, with over 5.1 million customers changing electricity supplier, and just under 4 million changing gas supplier, in 2007 alone¹⁰⁷. Apart from providing consumers with the freedom to switch, there are other, objective ways of measuring success, including:

- Levels of switching in GB energy markets were high relative to international standards: Research carried out by Accent in 2005 (and referenced by Ofgem) found that 46% of all gas customers and 47% of all electricity customers had switched¹⁰⁸. This figure continued to rise: BERR estimated that by March 2008, 50% of electricity customers and 53% of gas customers had switched away from their home supplier¹⁰⁹. In other countries, the total number of consumers switching was much lower (32% in Sweden, 12% in the Netherlands, 6% in Germany, and 1.5% in those parts of the US market that had liberalised)¹¹⁰.
- Switching was also high relative to other industries in the UK. In telecommunications, 38% of mobile and 34% of fixed line customers had switched providers at this time. Annual switching rates were around 20%, compared to 20% for mortgages, 10% for pensions and 2% for bank accounts¹¹¹.
- A super complaint in 2005 by energywatch about gas and electricity billing processes had not succeeded, with Ofgem's analysis not identifying significant detriment associated with the

¹⁰⁵ Paragraph 18, House of Commons Energy and Climate Change Select Committee, Ofgem's Retail Market Review, 25 July 2011, <http://www.publications.parliament.uk/pa/cm201012/cmselect/cmenergy/1046/104603.htm#a4>

¹⁰⁶ Page 7, 'Protecting consumers? Removing retail price controls', National Audit Office, 2008, <https://www.nao.org.uk/wp-content/uploads/2008/03/0708342.pdf>

¹⁰⁷ <https://www.ofgem.gov.uk/ofgem-publications/76465/switching-figures-2007.pdf>

¹⁰⁸ Accent research quoted in <https://www.ofgem.gov.uk/ofgem-publications/76465/switching-figures-2007.pdf>

¹⁰⁹ Page 13-14, , Quarterly energy prices, BERR, June 2008

<http://webarchive.nationalarchives.gov.uk/20081212160126/http://www.berr.gov.uk/files/file46669.pdf>

¹¹⁰ Page 33, 'Energy prices, fuel poverty and Ofgem', House of Commons Business and Enterprise Committee, July 2008, <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmberr/293/293i.pdf>

¹¹¹ House of Commons Business and Enterprise Committee, *ibid*.

customer billing process, and finding that the competitive energy market was working well for the vast majority of customers¹¹².

- Ofgem tried to keep discipline on the ‘rules of the market’ as covered in the Supply Licence Conditions. Indeed it carried out a major culling of rules (160 pages to 80) in 2007¹¹³.
- In addition, Ofgem’s approach to market liberalisation meant that the UK avoided some of the mistakes energy regulators made in other jurisdictions. For example, Ofgem did not opt for a franchise or auction approach to market opening (i.e. blocks of customers being cast into a competitive market). This was a popular approach in many states in the USA, but one of the failings of this approach is that customers quite resented that ‘choice’ was being made for them and they returned to their original supplier. In Pennsylvania this occurrence saw switching fall to less than 10% following the forced move of 30% of customers to a competitor supplier¹¹⁴.

4.2.3 Energy Supply Probe (2008)

By 2008, electricity prices had risen by a further 21% (in real terms) from 2006 levels, and gas prices by 26%¹¹⁵ creating a political awareness that had been absent – almost since 1990. The interest was fuelled by the creation of a department of Government with a sole focus on energy and climate change (DECC) and was being made by third parties as accountable to Parliament¹¹⁶. Further, the 2005 interventions on climate change targets by Tony Blair’s Government signalled a political interest in how green charges were to be paid for. Bills would now rise further in the following years as the costs of environmental schemes rose: green charges came to comprise 9% of the typical household energy bill by 2012¹¹⁷. Ofgem’s statutory role also changed, reflecting increased concerns around sustainability. As part of the Utilities Act (2000) Ofgem was required to ‘have regard to’ Government-issued guidance on social and environmental policies. The Energy Act (2004) introduced the duty to contribute to sustainable development as a secondary duty, and this was promoted to a primary duty in the Energy Act (2008)¹¹⁸.

At that stage the main lesson for all participants in the industry was the extent to which the energy markets sat within a broader sustainability parameter, and that actions had to take this into account. Meanwhile, the multiple voices on climate change, rising prices, and poor customer service issues combined to decrease trust in competitive energy markets¹¹⁹.

Ofgem’s Energy Supply Probe was launched against the backdrop of steep increases in world fuel prices¹²⁰, and consequent large increases in wholesale and retail electricity and gas prices, as well as

¹¹² Page 2, ‘Response to the Super-complaint on billing processes made by the Gas and Electricity Council (“energywatch”), Decision document’, Ofgem, July 2005: <https://www.ofgem.gov.uk/ofgem-publications/38523/11070-16305.pdf>

¹¹³

<http://webarchive.nationalarchives.gov.uk/20130402174434/http://www.ofgem.gov.uk/Markets/RetMkts/Compl/SLR/Pages/SLR.aspx>

¹¹⁴ Alistair Buchanan presentation to BERR Select Committee, 2007

¹¹⁵ DECC, ‘Annual Domestic Energy Bills’. <https://www.gov.uk/government/statistical-data-sets/annual-domestic-energy-price-statistics>

¹¹⁶ For example, the UK’s commitment to reduce greenhouse gas emissions to 80% 1990 levels is enshrined in the Climate Change Act (2008). <http://www.legislation.gov.uk/ukpga/2008/27/contents>

¹¹⁷ ‘Estimated impact of energy and climate change policies on energy prices and bills 2012’, DECC, 2013. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/172923/130326_-_Price_and_Bill_Impacts_Report_Final.pdf

¹¹⁸ ‘Ofgem Review- final report’, DECC, 2011, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/48134/2151-ofgem-review-final-report.pdf

¹¹⁹ In the Energy Supply Probe, Ofgem stated that ‘In virtually all groups we found a degree of cynicism, disillusionment and mistrust (though very little genuine anger) towards energy companies’. Page 161, Energy Supply Probe, Ofgem, 2008, <https://www.ofgem.gov.uk/sites/default/files/docs/2008/10/energy-supply-probe---initial-findings-report.pdf>

¹²⁰ Crude oil prices had risen by 60% from 2004 levels by 2008. Source: DECC, ‘Monthly and annual prices of road fuel and petroleum products’ <https://www.gov.uk/government/statistical-data-sets/oil-and-petroleum-products-monthly-statistics>

a deteriorating overall economic outlook. As a result, Ofgem was increasingly mindful of difficulties consumers faced in paying their energy bills¹²¹. In addition, Ofgem's polling found that while that consumers knew about competition and found it relatively straightforward to engage, after the first five years of open markets, the number of customers actually switching appeared to plateau at around one fifth of consumers. The Probe focused on domestic and small business consumers, and looked at parameters such as consumer experience, switching, pricing in different market segments, relationship between wholesale and retail processes, market share, liquidity and market entry.

Table 4.1 summarises the key Probe findings and the remedies Ofgem implemented to address them.

Table 4.1 Issues raised by Energy Supply Probe and remedies

Issue	Ofgem findings	Remedies
Market structure	<ul style="list-style-type: none"> — No significant competitive fringe. 	<ul style="list-style-type: none"> — Vertically integrated suppliers subject to additional reporting requirements to improve the transparency of their supply and generation activities via segmental reporting and increased transparency on transfer pricing.
Supplier behaviour	<ul style="list-style-type: none"> — No coordination. — Poor selling, resulting in poor outcomes from switching. 	<ul style="list-style-type: none"> — Better information provided to customers through bills and Annual Statement. — Suppliers required to help vulnerable and indebted customers blocked from changing suppliers due to outstanding debts ('debt blocking'). — Overarching voluntary five-point code of conduct for suppliers. — Better information for small business customers regarding terms and conditions, and restricting suppliers' ability to move them on to fixed term contract.
Price differentials	<ul style="list-style-type: none"> — Higher prices charged to some groups of customers, including prepayment meter customers, and between regions and fuels. — Some of these pricing differentials could not be explained by differences in costs. 	<ul style="list-style-type: none"> — New licence condition for domestic suppliers (introduced September 2009) requiring any difference in cost between different payment methods to be cost reflective. — Second new licence condition prohibited undue discrimination in any terms and conditions offered to consumers.

Source: KPMG based on Ofgem decision document

It is hard to assess the impact of the remedies aimed at improving supplier behaviour and improving information for consumers since the Retail Market Review also addressed this market feature. Switching began to decline from 2008 onwards¹²². The reasons for this are not established or clear but are probably a combination of:

- Consumer apathy and mistrust;
- Critical sales techniques being curtailed, notably withdrawal of the major energy suppliers from doorstep selling. Once this had been removed, switching had to be customer initiated, with the internet now the main means by which suppliers could reach out to consumers. This also had distributional impacts, since vulnerable consumers are generally less likely to have internet access; and

¹²¹ See Ofgem, 'Domestic suppliers' social obligations: 2008 annual report' which stated 'We recognise that, in the current economic climate, many customers will be struggling to pay their energy bills', <https://www.ofgem.gov.uk/sites/default/files/docs/2009/08/2008-supplier-social-obligations-annual-report.pdf>

¹²² Page 9, 'State of the Market Assessment', Ofgem, 2014. <https://www.ofgem.gov.uk/ofgem-publications/86804/assessmentdocumentpublished.pdf>

- Possibly the non-discrimination measures of the 2008 Probe, which may have had the effect of stifling innovation and increasing prices for some groups of consumers¹²³.

4.2.4 Retail Market Review (2010-2014)

The need for a second industry probe in 2010, so soon after the 2008 Probe, was driven by concerns that behaviours in the market were still not in the best interests of consumers. The conclusion drawn was that a more radical and comprehensive package (or intervention) was required. Ofgem’s Retail Market Review concluded that further action was needed to make energy retail markets in Great Britain work more effectively in the interests of consumers. On 21 March 2011, Ofgem published its findings and initial proposals¹²⁴.

In March 2013, Ofgem published its final domestic and non-domestic proposals for the Retail Market Review¹²⁵ and initiated a consultation on policy effect and draft licence conditions. Following the publication of Ofgem’s statutory consultation on 20 June 2013, Ofgem published its decision to proceed with licence modifications to give effect to Ofgem’s Retail Market Review (RMR) proposals on Simpler Tariff Choices and Clearer Information on 27 August 2013. These proposals were then implemented between August 2013 and July 2014.

The key matters of concern raised by Ofgem in relation to domestic retail markets:

Table 4.2 Retail Market Review-key issues and remedies

Issue	Ofgem findings	Remedies
Complex pricing information	<ul style="list-style-type: none"> — Difficult for customers to make well-informed choice of supplier. 	<ul style="list-style-type: none"> — Maximum number of tariffs that suppliers can offer at any one time. — Simplified tariff rate structures so that all models have a simple standing charge plus a unit rate structure. — Simplification of how discounts, bundles and reward points are offered and presented.
Sticky customers	<ul style="list-style-type: none"> — Many customers on standard or ‘evergreen’ tariffs lacked obvious trigger points for interaction with market. — Segmentation of customers allowing suppliers to earn higher margins from sticky customers. 	<ul style="list-style-type: none"> — Improving existing and introducing new customer protection safeguards for both evergreen and fixed term offers. — Facilitating collective switching. — Migrating customers from dead tariffs (ones no longer open to new customers). — More information in bills and annual statements, plus notices around price increases, end of fixed term and dead tariffs. — Terms and Conditions (‘T&Cs’) to provide greater consumer protections.

At a high level, the RMR package, even though more interventionist than the Probe, was not seen to placate customers’ concerns. In 2014, following a joint assessment of the energy market by Ofgem, the Office of Fair Trading (OFT) and the CMA¹²⁶ Ofgem referred the GB energy market to the CMA for

¹²³ For example, Richard Green noted ‘a large increase in the level of the average bill at almost exactly the same time that companies started to reduce their cross-regional differences’. Quoted in ‘Promoting or restricting competition? Regulation of the UK retail residential energy market since 2008’, S Littlechild, 2014. <http://www.eprg.group.cam.ac.uk/wp-content/uploads/2014/09/1415-PDF.pdf>

¹²⁴ ‘The Retail Market Review- findings and initial proposals’, Ofgem, 2011, https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/rmr_final.pdf

¹²⁵ ‘The Retail Market Review- Final domestic proposals’, Ofgem, 2013. <https://www.ofgem.gov.uk/ofgem-publications/39350/retail-market-review-final-domestic-proposals.pdf> and ‘The Retail Market Review- Final non-domestic proposals’ <https://www.ofgem.gov.uk/ofgem-publications/39355/retail-market-review-final-non-domestic-proposals22-marchfinal.pdf>

¹²⁶ ‘State of the market assessment’, Ofgem, 2014, <https://www.ofgem.gov.uk/publications-and-updates/state-market-assessment>

investigation. In its main press release, Ofgem expressed the hope that the enquiry would 'help rebuild consumer trust and confidence in the energy market'¹²⁷. The CMA's Terms of Reference implicitly rejected four of the five theories of harm which had been put forward by Ofgem. The reference should also be seen in the context of wider political developments, particularly the pressure on the Government to be seen as actively addressing issues in the energy market following the Labour Party's pledge to freeze energy prices by 18 months (made in September 2013)¹²⁸.

The CMA's analysis around the introduction of RMR found that some of the RMR measures restricted the behaviour of suppliers and constrained consumer choice, with the potential for adverse impacts on competition and consumer welfare. The CMA noted that RMR had not been in place long enough for it to evaluate full overall impact on consumer engagement and competition, but even allowing for this caveat, it observed that the available evidence was not encouraging, in particular:

- There were few, if any, signs of material improvement in consumer engagement, either in terms of direct consumer activity (e.g. switching, shopping around) or their experience and perception (e.g. views on tariff complexity). Those who were disengaged before the RMR appeared to remain so.
- The four-tariff rule impacted on the 'active' side of the market as a result of the Six Large Energy Firms withdrawing a number of tariffs and discounts, and changing tariff structure which may have made some customers worse off. In particular, some genuinely innovative tariffs were withdrawn.

The CMA were less conclusive on the impact of the RMR on the intensity of price competition between suppliers, saying that while discounted variable-rate tariffs had been removed, price competition now took place in over fixed-term fixed-rate tariffs. CMA did find that RMR had been harmful to price competition in relation to price comparison websites, since these could no longer attract customers by sacrificing commission, either directly by way of cashback, or indirectly by securing exclusive tariffs from suppliers because of the four-tariff rule.

Since the review began, Ofgem has increasingly focussed on the quality of decision making by those customers who choose to switch, as well as the absolute number of switches made¹²⁹. Indeed, Ofgem's website now features a prominent section entitled 'Be an energy shopper' encouraging customers to learn how to shop around to get the best deal¹³⁰. In order to ensure quality switching by consumers, Ofwat may want to make this a key part of its planning and preparation in order to get the "Customer Promise" from market opening right. This means both ensuring that customers are aware of their ability to engage in the competitive market, and ensuring that customers have the information needed to make a confident decision that results in a better outcome for them.

¹²⁷ <https://www.ofgem.gov.uk/press-releases/ofgem-refers-energy-market-full-competition-investigation>

¹²⁸ <http://www.bbc.co.uk/news/uk-politics-24213366>

¹²⁹ See for example page 26 of Retail Energy Markets in 2015, Ofgem, 2015, which states 'we hope that these positive developments [related to the RMR clearer information measures] are reflected in the quality of consumers' switching decisions'.

https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/retail_energy_markets_in_2015_report_0.pdf

¹³⁰ This is currently displayed on the main ofgem.gov.uk page

5 CMA provisional remedies on the energy sector: a review

Section 5 focusses on the CMA energy market investigation, including the triggers for the review, the findings to date and considers in detail the Provisional Decision on Remedies published in March 2016. Each sub-section presents the potential implications and lessons for the water sector.

This section covers:

- What triggered the CMA energy market investigation;
- The lessons from the CMA review and their implications for household retail water competition in England; and
- A case study of the CMA investigation into retail banking.

5.1 What triggered the CMA energy market investigation?

In November 2013, the UK Government asked Ofgem to undertake a joint review with the Office of Fair Trading (OFT) and the Competition and Markets Authority (CMA) to produce an assessment of the State of the Market by March 2014¹³¹. It was published in December 2013 and established the basis for assessing the energy market. The Joint Assessment Framework outlined the three-stage assessment framework that would be used in Ofgem's first annual State of the Market Report (2014)¹³²:

- 1 A description of a well-functioning market, and how competition should work to deliver desired outcomes;
- 2 An explanation of the broad categories of reasons why the competitive process may not be working as it should (potential 'sources of harm'); and
- 3 An explanation of how Ofgem would use data and information ('indicators') to identify features of the market and analyse, investigate and conclude on how these features affect the process of competition and outcomes for consumers, including vulnerable consumers.

Ofgem used the concept of a hypothetical well-functioning market to act as a counterfactual against the current state of the market. According to Ofgem, in the short term, a well-functioning energy market would be characterised by consumers being engaged and empowered to secure good outcomes when they participate in the market. In the longer term, it would be characterised by dynamic competition making the most of new opportunities arising from new technological, market or regulatory developments¹³³. The concept of a 'well-functioning market' was criticised by some academics – for example, Littlechild described it as being a 'vision' of a successful energy market rather than a benchmark itself, because the 'vision' is not anchored in any concept of what levels of

¹³¹ State of the Market Assessment, <https://www.ofgem.gov.uk/publications-and-updates/state-market-assessment>

¹³² Page 22, State of the market report – Assessment framework, Ofgem, 19 December 2013: <https://www.ofgem.gov.uk/ofgem-publications/85260/assessmentframework18decfinal.pdf>

¹³³ Pages 23-24, *Ibid.*

new entry, innovation, customer service and switching it is realistic to expect a competitive market to provide^{134 135}.

The Joint Assessment Framework also looked at the following key aspects¹³⁶:

- **Unilateral effects/market power:** Are incumbent suppliers able to exploit a 'sticky' customer base?
- **Weak competition/tacit coordination:** Do the six largest suppliers compete vigorously with each other and with other market players?
- **Barriers to entry and expansion:** Why are there low levels of penetration by new entrants in the domestic market?
- **Vertical integration:** Does common ownership of electricity and generation create barriers to entry in retail and/or wholesale markets?
- **Weak customer response/engagement:** Is the market complex and confusing for customers?

On 27 March 2014, Ofgem published the Joint Assessment, and its provisional decision to refer the energy market to the CMA. It identified that¹³⁷:

- Prices and profits were increasing (from 2009 to 2012);
- There was weak competition between incumbent suppliers which arose from market segmentation and possible tacit co-ordination;
- Smaller suppliers' market share was around 5% of the domestic market;
- Switching rates had fallen since 2008 – although there was a peak both in switching levels overall, and in switching to smaller suppliers, at the end of 2013;
- Customer trust and confidence were low; and
- There were persistent differences in prices between groups of domestic customers that did not appear to be justified by cost differences.

Ofgem confirmed its decision to refer the energy market to the CMA on 26 June 2014, citing the findings of the Joint Assessment, the persistence of the problems and, the general support from stakeholders to make the reference. Ofgem confirmed that wholesale gas, transmission and distribution networks, gas storage, interconnectors and settlement were working well, and should not be within scope of the CMA review as they had not found evidence that they were having a detrimental impact on competition¹³⁸.

¹³⁴ It was also noted that economic theory does not imply that operating costs of suppliers in a competitive market will converge over time. The lack of evidence regarding systematic operating costs convergence in other sectors seems to suggest that the absence of any convergence over time does not imply that the market is uncompetitive or not well-functioning. Page 3, Operating cost variations in a competitive market, Stephen Littlechild. Submission to the CMA, 20 February 2015:
https://assets.publishing.service.gov.uk/media/5511630bed915d1427000012/Stephen_Littlechild_submission_20_February_2015.pdf

¹³⁵ Page 34, Stephen Littlechild, Response to the CMA's Statement of Issues, 15 August 2014:
https://assets.publishing.service.gov.uk/media/53f1bcf2e5274a48c1000011/Stephen_Littlechild_-_Promoting_or_restricting_competition_-_response_to_IS_with_cover_note.pdf

¹³⁶ Page 5, State of the market report – Assessment framework, Ofgem, 19 December 2013:
<https://www.ofgem.gov.uk/ofgem-publications/85260/assessmentframework18decfinal.pdf>

¹³⁷ State of the Market Assessment, Ofgem, 27 March 2014:
https://www.ofgem.gov.uk/sites/default/files/docs/2014/03/assessment_document_published_1.pdf

¹³⁸ Page 5, Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain, Ofgem, 26 June 2014:
https://www.ofgem.gov.uk/sites/default/files/docs/2014/06/state_of_the_market_-_decision_document_in_ofgem_template.pdf

On 26 June 2014, the CMA announced it would carry out an investigation into the GB energy market¹³⁹. The CMA's scope of work included carrying out their own comprehensive, independent investigation to see if there were any features of the energy market which prevented, restricted or distorted competition and, if so, what action might be taken to remedy them.

The CMA's initial statement of issues was published on 24 July 2014 followed by an updated statement of issues on 18 February 2015. On 10 July 2015, the CMA published its provisional findings and identified the relevant markets as being¹⁴⁰:

- The wholesale electricity and gas market in GB (including trading);
- The retail supply of electricity and gas to domestic customers in GB; and
- The retail supply of electricity and gas to SMEs in GB, comprising, at least, a microbusinesses segment.

Section 5.2 focuses on the lessons from the CMA energy market investigation. It presents lessons for Government and/or Ofwat in relation to the CMA's findings and provisional remedies and recommendations as well as their implications and considerations for household retail water competition in England.

5.2 Lessons from the CMA energy market investigation and their implications for the household retail water competition in England

5.2.1 CMA Provisional Decision on Remedies

The CMA energy market investigation involved extensive research, analysis and stakeholder engagement during the past two years. This has included written consultation documents, including working papers, hearings with key stakeholders and use of external advisers for consumer research. The CMA Statement of Issues presented five Theories of Harm of which four were subsequently rejected¹⁴¹. CMA has not proposed any structural remedies to break up the vertically integrated companies and have not identified any areas where individual action against a specific company is required¹⁴².

The CMA's extensive research culminated in the Provisional Decision on Remedies published on 17 March 2016¹⁴³ where the CMA proposed a range of remedies in five areas:

- 1 Wholesale electricity market;
- 2 Updated assessment of AECs and detriment affecting domestic customers;
- 3 Domestic retail;
- 4 Microbusiness retail; and
- 5 Governance of the regulatory framework.

For the purpose of this report, we focus on the retail market (domestic and microbusiness) and the regulatory framework as these are the most relevant aspects for the retail household water sector. The CMA's wholesale remedies are less relevant to water, as they focus on locational charging for

¹³⁹ Energy market referred to CMA, 26 June 2014: <https://www.gov.uk/government/news/energy-market-referred-to-cma>

¹⁴⁰ Paragraph 27, Page 8, Summary of provisional findings report. Energy market investigation, CMA: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/442500/EMI_PFs_Summary.pdf

¹⁴¹ See Updates Issues Statement, 18 February 2016: https://assets.publishing.service.gov.uk/media/54e378a3ed915d0cf7000001/Updated_Issues_Statement.pdf

¹⁴² See Section 5.2.9 for more details.

¹⁴³ The CMA energy market investigation final report was published on 24 June 2016: <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

losses on the electricity system and on arrangements for DECC's contracts for difference. Neither has a direct read across to the household retail water sector in water.

The CMA's remedy proposals on the retail market are intended to encourage a greater number of consumers and microbusinesses to switch to more competitively priced deals. CMA proposed five broad categories of remedy, including¹⁴⁴:

- The establishment of an Ofgem programme to promote customer engagement directly or through their own suppliers;
- Ofgem making greater use of principles rather than prescriptive rules in addressing potential adverse supplier behaviour concerning the comparability of their tariffs;
- Enhancing the incentives and ability of Price Comparison Websites (PCWs)/Third Party Intermediaries (TPIs) to engage with customers;
- Creating an Ofgem-controlled database of 'disengaged customers', to allow rival suppliers to use these data for the purpose of postal marketing; and
- Requiring all suppliers to make all their single-rate tariffs available to domestic customers on restricted meter.

Following our review of the CMA PDRs, we have identified eight key lessons for Ofwat to consider:

- 1 There is a need to be vigilant and remove barriers to switching across markets and sub-markets.
- 2 Different segments of customers will engage in the competitive market in different ways, or not at all.
- 3 Regulators and policy makers should be clear about their approaches to promoting competition and coordinated in their approach while being clear where responsibility lies.
- 4 Careful consideration needs to be given to the balance between regulation and allowing the development of effective competition.
- 5 Price comparison websites (PCWs) and other third party intermediaries should be specifically considered both at market opening and beyond, to allow them to be utilised as a way of promoting competition and engaging customers.
- 6 Complex codes and market rules can limit competition by acting as a barrier to entry.
- 7 If competition is introduced, then Government and/or Ofwat may want to consider where smaller parties/new entrants should be exempt from carrying out some activities where these provide a significant regulatory burden, and may otherwise act as a barrier to entry.
- 8 The CMA is an important resource for Ofwat, however it must understand the limitations of making such a reference, and the possible unintended consequences that may occur.

Sections 5.2.2 to 5.2.8 cover the key lessons presented in section 5.2.1 above. Section 5.2.9 present a number of approaches used by Ofgem in the retail market where the CMA has not proposed any actions is also included. Our lessons learnt are based on evidence drawn from CMA analysis and findings as well as stakeholder responses to the CMA. These are in turn linked to the potential implications and considerations for household retail water competition in England.

5.2.2 Barriers to switching

There is a need to be vigilant and remove barriers to switching across markets and sub-markets.

A number of rules and regulations have restricted switching and the removal of those barriers across markets and sub-markets is expected to have a positive impact on switching levels and retail competition.

¹⁴⁴ Paragraph 6.7, Page 326, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

In both the energy and retail banking sectors, CMA found that a large number of customers in the energy and retail banking markets were disengaged¹⁴⁵. In the energy sector this included a large number of customers being on a relatively expensive default tariff (part of the Domestic Weak Customer Response AEC). This was a combination of customers not fully aware of the available options for them, unable to access information related to switching and unable to switch to a different supplier¹⁴⁶. Some academics have criticised the CMA's characterisation of a well-functioning competitive market as one where it is a prerequisite to have engaged consumers to have effective competition. For example, Littlechild believes that competition should be seen as including the process for getting consumers engaged in the market¹⁴⁷.

One of the CMA's main remedies is to address barriers to switching for domestic customers and microbusinesses. It is worth noting that the CMA Provisional Decision on Remedies sets out the broader context of Ofgem's programme to introduce next day switching and the rollout of Smart Meters. For water, the barriers to be considered would need to encompass both information remedies and the switching process itself, as well as the potential differences for metered and non-metered customers.

Barriers to switching

Initial analysis conducted by the CMA found that domestic customers exhibited weak customer response, where a number of those had never considered switching while others were on default tariffs¹⁴⁸. Further analysis demonstrated that there were material and persistent savings available to customers from switching, the potential savings available to customers on standard variable tariffs were, on average, larger than savings available to non-standard tariff customers and that standard credit customers enjoyed higher savings than customers on other payment methods. CMA also found that the annual potential savings for dual fuel customers had risen substantially from 2013 to 2015¹⁴⁹.

The CMA has focused on improving switching through proposed information remedies, although the CMA note wider key developments in this area including Ofgem's programme to introduce next day switching by 2019, and the rollout of Smart Meters. The proposed remedy is a recommendation to Ofgem to establish an ongoing programme to identify, test and implement measures to provide domestic customers with different or additional information with the aim of promoting engagement in the domestic retail energy markets^{150 151}.

Competitors do not currently have an easy way of identifying consumers that have been on default tariffs with competitors for a number of years¹⁵². The CMA concluded that such consumers have been

¹⁴⁵ A Case Study on the CMA investigation into retail banking is included at the end of this section.

¹⁴⁶ Paragraph 4.29, Page 189, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

¹⁴⁷ Page 35, Stephen Littlechild, Response to the CMA's Statement of Issues, 15 August 2014: https://assets.publishing.service.gov.uk/media/53f1bcf2e5274a48c1000011/Stephen_Littlechild_-_Promoting_or_restricting_competition_-_response_to_IS_with_cover_note.pdf

¹⁴⁸ Paragraph 28, Page 7, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.publishing.service.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

¹⁴⁹ Paragraph 33, Page 8, Ibid.

¹⁵⁰ Paragraph 6.12, Page 327, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

¹⁵¹ While the CCP believes the "CMA's proposed interventions are likely to raise consumer engagement, [it] expects the cumulative effect to be *at the margin* rather than transformative. Page 5: <https://assets.publishing.service.gov.uk/media/5717441c40f0b64314000000/centre-for-competition-policy-response-to-pdr.pdf>

¹⁵² See 'The Database remedy' section in the CMA's provisional decision on remedies (p. 382 onwards). Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

missing out on potential savings from switching¹⁵³. The creation of an Ofgem-controlled database of ‘disengaged customers’ who have been on a default tariff for over three years is expected to allow rival suppliers to prompt these customers to engage in the retail energy markets. This proposed remedy has been the source for significant debate through the responses submitted to the CMA – namely the CCP who states potential downside risks and negative outcomes¹⁵⁴. If introduced, the aim would be for the database to allow competitors to tailor marketing specifically to these customers and seek to engage them in the market.

Switching has been the source for significant debate throughout the energy market and retail banking investigations. The Ofgem-led database remedy has been subject to criticism. For example both the CCP and EDF Energy noted that there are potentially serious unintended consequences from such a remedy being applied to domestic and microbusiness customers¹⁵⁵. If Government choose to introduce competition in domestic water in England, Ofwat may want to consider in the future any potential for joint use or joint working, given that customers using energy and water overlap significantly.

In the retail banking investigation, some stakeholders and academics believe that the onus should fall on banks to better serve loyal customers who stay with their lenders for years, typically on lower rates than new customers and that the CMA should not “be putting all their weight on consumer switching” as there are some benefits of a longstanding relationships between customers and their banks¹⁵⁶. Additionally, CMA found that innovation happened even with low switching, with the benefits rolled out to all customers. This is a relevant point for water where projections for switching rates are not high.

In the energy sector, possible synergies may already exist between existing PCWs and online platforms such as the ECOES and SCOGES and other regulated utilities may be able to benefit from existing platforms through ‘product bundling’. A consultation response from the Centre for Competition Policy (CCP) on Ofwat’s call for evidence on the review of retail household markets in the water and wastewater sector provides evidence on that point:

While CCP’s evidence suggests that an expected saving of £40 is unlikely to be sufficient to generate substantial engagement or switching by water consumers, there is one scenario where opening the household water sector to competition may have greater importance. This is if, rather than there being separate markets for water, energy and telecoms etc., a combined market for ‘home services’ emerges in the future. Here potential savings from household water competition may be important if, when combined with

¹⁵³ There are some dissident views on the levels of savings available to final consumers. For example, Paul Hunt believes that “the savings which the CMA estimates final consumers would make if they were all to shop around and to choose the cheaper offer available are totally illusionary” as suppliers will “compete to gouge as much revenue as they can from final consumers”. Page 2, Response to CMA Energy Market Proposed Remedies, Paul Hunt, 31 July 2015:

https://assets.publishing.service.gov.uk/media/55e6bdcbe5274a55800001c/Paul_Hunt_resp_to_PFs.pdf

¹⁵⁴ For example, consumers receiving multiple and uncoordinated offers may feel confused or overwhelmed, or it may be interpreted by consumers as ‘being hassled’ and result in consumer ignoring the suppliers efforts to engage with them through switching. Page 13, Competition and Markets Authority: Energy market investigation – Provisional decision on remedies, Consultation response from the Centre for Competition Policy, 8 April 2016: <https://assets.publishing.service.gov.uk/media/5717441c40f0b64314000000/centre-for-competition-policy-response-to-pdr.pdf>

¹⁵⁵ EDF stated its concern in relation to protecting customers from the misuse of information, the risks of further disengaging customers and the need to provide means by which the success of the proposed remedy could be measured. Paragraph 0.13, Page 4, Competition and Markets Authority Energy Market Investigation, EDF Response to the Provisional Decision on Remedies, 7 April 2016:

<https://assets.publishing.service.gov.uk/media/57176a8140f0b6431400000c/edf-energy-response-to-pdr.pdf>

¹⁵⁶ CMA told to drop efforts to make customers switch banks, Financial Times, 7 June 2016:

<http://www.ft.com/cms/s/0/70741fc6-2ca8-11e6-bf8d-26294ad519fc.html#axzz4BCA0Ehue>

*savings from other markets, the expected gain to a consumer is sufficient to induce a switch between home service providers*¹⁵⁷.

CMA has recommended that the prescribed timetable for smart meter roll-out is adhered to (end of 2020 or earlier) as smart meters will help improve customer engagement by making the relationship between prices and consumption more visible and improving the accuracy of bills. The CMA also expect that smart meters will address specific barrier to engagement experienced by customers on restricted meters. Yet, the CMA acknowledges that there is limited evidence available at both national and international levels on the impacts of smart meters on engagement in domestic retail energy markets¹⁵⁸. This was also highlighted by a number of academics. For example, the CCP claims that “smart meters introduce considerable uncertainty regarding the future development of the energy market, rather than necessarily offering a clear solution to CMA’s identified problem of consumer disengagement”¹⁵⁹ and competition.

The key difference between the energy and water sector is that water domestic consumption is not always metered. As such, the benefits that may be observed in the energy sector may not be fully applicable to the retail metered household water sector. In the water sector, unmetered customers have a set monthly/yearly tariff and hence know exactly how much they need to pay on a monthly/yearly basis. In contrast to this, metered customers are subject to volumetric charges (fixed and/or variable) and the price they pay is based on their water consumption. As highlighted in the Walker Review, the absence of a water meter can impact the drive for consumers to monitor their own consumption. This could result in lower savings available from a competitive market and may lead to market segmentation if competition is introduced.

The CCP note that “the absence of metering does not necessarily preclude retail competition [...], however it would make the retail competition being proposed ‘non standard’¹⁶⁰. The authors go further by saying that to “consider retail competition in the absence of metering has two clear consequences for the Ofwat review: i) Ofwat will have to be particularly detailed in specifying what competition without metering looks like, and ii) much of the existing theoretical and empirical results regarding the benefits of competition may not be directly applicable to this scenario”¹⁶¹. Ofwat is considering whether the competitive scope would be restricted to customers with a water meter or to all consumers, regardless of their metering type. As such, this aspect of the water market needs to be treated carefully. Lessons learned from the energy sector may not be directly applicable and more research might be required to further explore the impacts of competition in a non-metered market.

Understanding consumer behaviour

Understanding consumer behaviour is pivotal in increasing switching levels. Market participants will have to do more to attract and retain customers. The regulator’s understanding of consumer

¹⁵⁷ Page 9, Ofwat Review of retail household markets in the water and wastewater sector – Call for Evidence, Centre for Competition Policy, 16 February 2016:
http://competitionpolicy.ac.uk/documents/8158338/11690925/CCP+Consultation+Response+to+Household+Wate+r+Competition+Call+for+Evidence_Feb+2016.pdf/1d8e5672-ebf7-4154-a761-1c9d83aa5317

¹⁵⁸ Paragraph 4.75, Page 200, Energy market investigation: Provisional decision on remedies, 17 March 2016:
<https://assets.publishing.service.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

¹⁵⁹ Page 9, Competition and Markets Authority: Energy market investigation – Provisional decision on remedies, Consultation response from the Centre for Competition Policy, 8 April 2016:
<https://assets.publishing.service.gov.uk/media/5717441c40f0b64314000000/centre-for-competition-policy-response-to-pdr.pdf>

¹⁶⁰ Page 3, Ofwat Review of retail household markets in the water and wastewater sector – Call for Evidence, Centre for Competition Policy, 16 February 2016:
http://competitionpolicy.ac.uk/documents/8158338/11690925/CCP+Consultation+Response+to+Household+Wate+r+Competition+Call+for+Evidence_Feb+2016.pdf/1d8e5672-ebf7-4154-a761-1c9d83aa5317

¹⁶¹ Page 3, Ofwat Review of retail household markets in the water and wastewater sector – Call for Evidence, Centre for Competition Policy, 16 February 2016:
http://competitionpolicy.ac.uk/documents/8158338/11690925/CCP+Consultation+Response+to+Household+Wate+r+Competition+Call+for+Evidence_Feb+2016.pdf/1d8e5672-ebf7-4154-a761-1c9d83aa5317

behaviour will also be important as it designs consumer engagement programmes. This is closely linked to lesson 9 (get the 'Customer Promise' from market opening right).

As previously mentioned, some research suggests that consumers do not want to be switching banks every now and then as they believe there are some benefits in a longstanding relationships with their banks, for e.g. lower rates for loyal customers¹⁶². A member of the financial services consumer panel suggests that consumers do not switch for very rational reasons and that competition should be working in line with current consumer behaviour rather than trying to change the behaviour of millions of consumers¹⁶³. Consumer behaviour is intricate and sometimes even irrational¹⁶⁴. The CCP's response to Ofwat's call for evidence on the review of retail household markets in the water and wastewater sector alluded to this. The authors' state that¹⁶⁵:

- 1 The size of monetary savings is consistently a core driver of consumer switching, although, the presence of substantial monetary savings does not guarantee consumers will switch;
- 2 The level of switching varies systematically across different types of consumers; and
- 3 Consumers may make 'mistakes' regarding the tariff they choose so they pay more than they have to, although, through learning, these mistakes tend to diminish through time.

This may suggest that despite improving the information provided to consumers, switching levels may remain low regardless. The CCP paper goes even further by saying that "for a rational consumer to consider switching, and therefore be a driver of competition, the expected gains from switching must exceed the expected costs^{166 167}". Should monetary savings be perceived by customers as being low, they will not have an incentive to switch. The CCP's response to the CMA provisional decision on remedies (energy market investigation) strengthens this point by stating that "if all consumers were 'engaged' it is not automatic that all firms would charge prices equivalent to the 'competitive benchmark price' [... and the latter] could adjust upwards [...]"¹⁶⁸

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By improving the information provided to consumers, both about their current supplier and their potential to switch, customers may feel more engaged and consumer behaviour observed in the energy sector may not be replicated in other sectors. Regulator and companies can play a significant role in disseminating the relevant information. It is also important for Government and/or the Regulator to understand what consumers value the most. For example, business models in energy are moving away from 'supply' and moving more into the 'home', covering data management, thermostats, security, etc. There are important questions about how regulation can ensure that it remains focussed on those services that consumers value the most, and how consumer behaviour and expectations may continue to change over the coming years.

¹⁶² CMA told to drop efforts to make customers switch banks. Financial Times, 7 June 2016: <http://www.ft.com/cms/s/0/70741fc6-2ca8-11e6-bf8d-26294ad519fc.html#axzz4BCA0Ehue>

¹⁶³ Ibid.

¹⁶⁴ Page 10, Ofwat: Review of retail household markets in the water and wastewater sector – Call for evidence, Centre for Competition Policy, 16 February 2016, http://competitionpolicy.ac.uk/documents/8158338/11690925/CCP+Consultation+Response+to+Household+Wate+r+Competition+Call+for+Evidence_Feb+2016.pdf/1d8e5672-ebf7-4154-a761-1c9d83aa5317

¹⁶⁵ Page 7, Ofwat: Review of retail household markets in the water and wastewater sector – Call for evidence, Centre for Competition Policy, 16 February 2016, http://competitionpolicy.ac.uk/documents/8158338/11690925/CCP+Consultation+Response+to+Household+Wate+r+Competition+Call+for+Evidence_Feb+2016.pdf/1d8e5672-ebf7-4154-a761-1c9d83aa5317

¹⁶⁶ Page 8, Ibid.

¹⁶⁷ Costs include: 1) the opportunity cost of time spent searching for cheaper tariffs and completing the switch, 2) contractual terms, such as exit fees, that impose costs, and 3) uncertainty regarding the quality of the new supplier.

¹⁶⁸ Page 3: Energy market investigation (a response by Catherine Waddams Price). European Policy Forum, 20 October 2014: https://assets.publishing.service.gov.uk/media/5450f87440f0b613120000d/Submission_from_Catherine_Waddams_for_the_European_Policy_Forum.pdf

If Government choose to introduce competition in domestic water in England, Ofwat may want to consider in the future any potential for joint use or joint working, given that customers using energy and water overlap significantly.

Government and/or Ofwat will need to consider the switching process itself if the decision is made to introduce competition for household water in England. The processes for energy are undergoing a programme of change to improve both the speed and accuracy of switching. There is potential for the water switching process to align with the improved process in energy which are due for delivery in 2019.

5.2.3 Approach to the promotion of competition

Different segments of customers will engage in the competitive market in different ways, or not at all.

A one size fits all approach to the promotion of competition may not be fit for purpose. Academic research has concluded that the responsiveness of consumers to particular factors varies systematically across customer segments¹⁶⁹. A conclusion drawn by the CCP based on extensive research and surveys reveal that the introduction of competition for household water consumers will affect consumers in different, and potentially complex, ways¹⁷⁰. This conclusion also stands for other regulated markets as one would expect similar consumer behaviour. Government/Ofwat may want to bear this in mind should retail household water markets open to competition and there is a need to develop a consumer engagement approach to stimulate the market.

There will be an ongoing need for Government and/or Ofwat to consider how to engage vulnerable customers, and to ensure that they are both protected and receive the benefits of competition. Consumer trust should be maintained and enhanced during the design and implementation of an approach to the promotion of competition – communication will be key. One of the key elements of Ofgem's referral to the CMA, and an issue that the CMA has identified as an adverse effect on competition, is that those customers who are disengaged from the market are not benefiting from the savings available from switching¹⁷¹.

In Ofgem's Proposals to improve outcomes for PPM customers (December 2015), it had found that PPM customers can suffer detriment due to the charges they face, the service they receive from their energy suppliers and/or a lack of competitive tariffs which resulted in poor consumer outcomes and barriers to engagement, particularly for consumers in vulnerable situations¹⁷². As part of the CMA's energy market investigation, the CMA found that PPM customers have been able to access much lower gains from switching than other customers despite the fact they pay higher prices on average¹⁷³. The CMA proposed a price cap remedy to protect customers on prepayments meters¹⁷⁴ to address the Prepayment AEC directly in the transitional period (2017 to the end of 2020) while the other proposed remedies are implemented. The PPM Price Cap Remedy aims to ensure that the annual bills paid by prepayment customers do not exceed a specified benchmark reference level, for a period until the end

¹⁶⁹ Flores and Waddams Price, Consumer behaviour in the British retail electricity market. Centre for Competition Policy working paper, 2013: <http://competitionpolicy.ac.uk/publications/working-papers-2013>

¹⁷⁰ Page 10, Ofwat: Review of retail household markets in the water and wastewater sector – Call for evidence, Centre for Competition Policy, 16 February 2016, http://competitionpolicy.ac.uk/documents/8158338/11690925/CCP+Consultation+Response+to+Household+Wate+r+Competition+Call+for+Evidence_Feb+2016.pdf/1d8e5672-ebf7-4154-a761-1c9d83aa5317

¹⁷¹ Paragraph 89, Page 20, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.publishing.service.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

¹⁷² Page. 6 Proposals to improve outcomes for prepayment customers, Ofgem, 17 December 2015: https://www.ofgem.gov.uk/sites/default/files/docs/final_consultation_ppm_0.pdf

¹⁷³ Paragraph 4.119, Page 210, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

¹⁷⁴ Paragraph 7.6, Page 436, Ibid.

of 2020. The intended outcome of the PPM Price Cap is to limit how much suppliers can charge but still preserve suppliers' incentives to compete¹⁷⁵. The CMA decided not to propose a regulated tariff on other domestic customers¹⁷⁶. The PPM price cap remedy has come under intense scrutiny with a number of parties providing detailed responses to the CMA opposing its introduction¹⁷⁷. This includes Professor Martin Cave who "felt that the provisional retail remedy package was unlikely to succeed in reducing, in a timely way, the significant level of detriment identified [...] and that a short-term price cap, covering a substantially larger number of customers, is required to reset the market"¹⁷⁸.

The role of the Regulator in protecting customers in vulnerable situations

Vulnerable customers are a key constituency and the remedy on the customer database is intended to target all those who are disengaged. We note that not all vulnerable customers are disengaged but previous research conducted by Ofgem has suggested that vulnerable customers are disproportionately represented among disengaged customers¹⁷⁹. In the water sector there is a more general view of customers in 'vulnerable circumstances', with the implication being that such a state may be transitory.

Protecting customers who are less able to engage is expected to remain a priority for Ofgem, despite its increased focus on competition. Ofgem extended its stakeholder engagement incentive programme to include consumer vulnerability – now called Stakeholder Engagement and Consumer Vulnerability (SECV) Incentive¹⁸⁰.

Given the CMA's direction of travel in relation to protecting customers, especially the ones who are potentially in circumstances that make them vulnerable, more emphasis will be put on offering effective and inclusive support. This will be especially important in the water sector where bad debt adds £21 to every bill¹⁸¹, and there is no option for customers to be disconnected from supply.

The establishment by Ofgem of a programme to provide customers – directly or through their own suppliers – with information to prompt them to engage is aimed at addressing some aspects of the features contributing to the Domestic Weak Customer Response AEC¹⁸². It may be useful for Ofwat and Government to consider the regulatory role in the future and, if competition is introduced for household water customers, whether the offering of a multi-utility product may suggest that regulators should either ensure consistency and cooperation, or if a central cross-sectoral body may be more effective in engaging customers.

The implementation of a programme to promote engagement at the outset of market opening may contribute to customer engagement and the Regulator and companies can play a significant role in disseminating the relevant information. Special attention must be given to consumer engagement in markets where products are less/not tangible as some group of consumers may need more visual marketing materials to feel engaged – this responsibility may lie with both the Regulator and

¹⁷⁵ Paragraph 7.21, Page 441, Ibid.

¹⁷⁶ Page 440, Ibid.

¹⁷⁷ See responses to provisional decision on remedies published on the CMA website: <https://www.gov.uk/cma-cases/energy-market-investigation>

¹⁷⁸ Paragraph 196, Page 43, Energy market investigation: Summary of provisional decision on remedies', Competition and Markets Authority, 10 March 2016: https://assets.publishing.service.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

¹⁷⁹ Retail Energy Markets in 2015, 9 September 2015: https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/retail_energy_markets_in_2015_report_0.pdf.

¹⁸⁰ RIIO-ED1 Stakeholder Engagement and Consumer Vulnerability (SECV) incentive consultation, 16 December 2014: https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/ed1_secv_consultation.pdf

¹⁸¹ PN 03/16 Many water customers in situations of vulnerability don't get the help they need – new report finds, Ofwat, March 2016: <http://www.ofwat.gov.uk/pn-0316-many-water-customers-situations-vulnerability-dont-get-help-need-new-report-finds/>

¹⁸² Paragraph 13.7, page 799, Energy market investigation, Final report, 24 June 2016: <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

companies. Yet, it is worth noting that consumer engagement is likely to impose costs on both consumers and firms¹⁸³.

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Government and/or Ofwat must consider the extent to which it seeks to protect the interests of those customers who could choose not to engage in the market if competition is introduced. Learnings from energy will be relevant, but should be focussed on how to avoid customers becoming disengaged rather than addressing this issue once segmentation has taken place.

Ofwat's assessment of competition models should consider the likely potential take up of competition amongst customers, and specifically among vulnerable customers. A key message from the CMA energy market investigation is that if a market is opened to competition, then any restrictions on pricing or innovation should be removed, as seen in the remedy to remove the 'Simpler Tariffs' element of RMR. When considering vulnerable customers, Ofwat and/or the Government may want to consider an 'opt in' approach to competition or excluding a defined segment of vulnerable customers from the competitive market and continuing to provide other forms of regulatory protection to this segment.

5.2.4 Approaches to competition and Regulator and Government responsibilities

Regulators and policy makers should be clear and coordinated in their approaches to promoting competition while being clear where responsibility lies.

Duties and responsibilities

The CMA provisionally found that Ofgem's statutory objectives and duties may constrain its ability to promote effective competition¹⁸⁴, in particular the 2010 Energy Act amendments. The CMA also identified that the lack of effective communication of impacts of policy and regulation, in combination with other factors, leads to poor trust from stakeholders¹⁸⁵. Consumer trust in the market may have an impact of the level of switching. As such, consumer trust should be maintained and enhanced during the design and implementation of an approach to the promotion of competition – communication will be key.

The Energy Act 2010 amended Ofgem's duties, to include a requirement to consider the interests of consumers as a whole, and to consider – before deciding to carry out functions in a particular manner with a view to promoting competition – the impact on consumer protection. The CMA have proposed amendments to Ofgem's duties, to avoid any real or perceived constraints on Ofgem's ability to promote effective competition. These amendments are expected to have a positive impact on Ofgem's ability to promote competition. Ofwat and Ofgem have similar main duties and objectives¹⁸⁶: they have

¹⁸³ Page 4, Competition and Markets Authority: Energy market investigation – Provisional decision on remedies, Consultation response from the Centre for Competition Policy, 8 April 2016: <https://assets.publishing.service.gov.uk/media/5717441c40f0b64314000000/centre-for-competition-policy-response-to-pdr.pdf>

¹⁸⁴ Paragraph 169, Page 37, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.publishing.service.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

¹⁸⁵ Paragraph 181, Page 39, CMA Provisional decision on remedies, 17 March 2016: <https://assets.publishing.service.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

¹⁸⁶ Note that the powers and duties of GEMA also include powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation (Council Regulation (EC) 1/2003) and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission. This is not the case for Ofwat.

a principal objective to protect the interest of existing and future consumers by promoting effective competition, wherever appropriate.

Ofgem informed the CMA that it considered that its duty to pursue its principal objective by 'wherever appropriate promoting effective competition' had been progressively downrated relative to other duties over the last ten years. The proposed remedy is a recommendation to DECC to amend primary legislation in order to clarify Ofgem's statutory objectives and duties and thereby remove any constraint (actual or perceived) on Ofgem's ability to pursue its principal objective (protecting the interests of existing and future customers) by promoting effective competition where it considers this appropriate¹⁸⁷.

Division of responsibilities and conflict resolution

The CMA also identified a lack of clear division of responsibilities and formal mechanisms through which disagreements between Ofgem and DECC are managed¹⁸⁸. The CMA indicated that this, in combination with other factors, is likely to increase the risk of policies being developed in the future that are not in the customers' interests and inhibit in the development of policies that are in their interest. The CMA is therefore considering the introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision making can be addressed transparently. The CMA has proposed to address this by calling for a more evidence-based approach to developing provisions/interventions. The remedies on the responsibilities of Ofgem and DECC set out to improve the policy and regulatory framework by providing a clear division of responsibilities¹⁸⁹. This involves a recommendation to establish a clear process (through legislation) requiring Ofgem to publish opinions on all draft legislation and policy proposals that are relevant to its statutory objectives and that are likely to have a material impact on the GB energy markets. Furthermore, the CMA proposes to recommend to DECC and Ofgem that they publish detailed joint assessments setting out action plans for the implementation of proposed DECC policy objectives that are likely to necessitate Ofgem interventions, with clear responsibilities and timetables¹⁹⁰.

Evidence-based approach and principles-based regulation

Finally, the CMA found that a number of provisions implemented in the past had not been tested prior to their introduction. A CMA remedy will address that by calling for a more evidence-based approach to developing provisions/interventions in the future, through the use of rigorous testing and trailing – this point was also endorsed by a number of stakeholders, notably the CCP¹⁹¹ and Ecotricity. The latter state of the early closure of the RO to onshore wind and solar and the removal of the exemption for electricity generated by renewables from the Climate Change Levy as two examples of non-evidence-based decisions¹⁹².

¹⁸⁷ Paragraph 177, Page 39, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

¹⁸⁸ Paragraph 169, Page 37, Ibid.

¹⁸⁹ Page 641, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

¹⁹⁰ Paragraph 180, Page 40, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

¹⁹¹ Page 11, Competition and Markets Authority: Energy market investigation – Provisional decision on remedies, Consultation response from the Centre for Competition Policy, 8 April 2016: <https://assets.publishing.service.gov.uk/media/5717441c40f0b64314000000/centre-for-competition-policy-response-to-pdr.pdf>

¹⁹² Page 3, Ecotricity Response to the CMA Provisional Decision on Energy Market Investigation, 14 April 2016: <https://assets.publishing.service.gov.uk/media/5718b2cb40f0b641e5000004/ecotricity-response-to-pdr.pdf>

Principles-based regulation is an approach to regulation where the regulator does not dictate prescriptive rules and supervisory actions for how firms should operate their business¹⁹³. By making greater use of principles based regulation, Ofgem will allow market players to decide how best to align their business objectives and processes with the regulatory outcomes specified. This is very much in line with Ofgem's outputs focused regulation for RIIO and Ofwat's PR14 outcomes based regulation. With this remedy, the CMA would expect companies' behaviour to change to adjust to this shift in emphasis. The CMA remedies highlight the fact that prescriptive rules based regulation can never be fully exhaustive and increase the risk of supplier gaming behaviour. CMA therefore places a greater emphasis on the use of principles based regulation¹⁹⁴ as described above.

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The CMA investigation has demonstrated that clear division of responsibilities is key in decision-making. If Government chooses to open up competition then a premium must be placed by Ofwat on high quality co-operation and communication between themselves and the various Government bodies involved (notably Defra, BIS and HMT), but also those not immediately affected (Welsh Government etc.).

If Ofgem's duties are revised, it will be focused even more on competition. Ofwat's current duties are focussed on competition and so are consistent with the CMA's proposed amendment. If Government do decide to introduce competition for households in England, then a review of Ofwat's duties may still be timely, to allow a clear focus on Ofwat's role in promoting the new competitive market.

The CMA is calling for a more evidence-based approach to developing provisions/interventions in the future. Ofwat is already using evidence-based approaches. An example of this is in Cathryn Ross's letter to Chief Executives informing them of the Government's consideration of opening household retail markets. One of the overarching principles that govern Ofwat's approach is its evidence based assessment of the costs and benefits of extending retail competition to households¹⁹⁵ to inform their analysis.

5.2.5 Balance between regulation and effective competition

Careful consideration needs to be given to the balance between regulation and allowing the development of effective competition.

Any restrictions that directly or indirectly limit the ability for market players to innovate would need clear justification, given the recent CMA findings. Some of the requirements of promoting competition may result in some regulation being removed.

In its PDR, the CMA found three Adverse Effect on Competition (AECs) concerning domestic retail energy markets¹⁹⁶: 1) Domestic Weak Customer Response: relates to weak customer response; and 2) Two AECs relating to aspects of the regulatory framework i. elements of the 'simpler choices' component of the Retail Market Reform (RMR) rules (RMR AEC), ii. the electricity and gas settlement systems (including the Prepayment AEC)).

¹⁹³ Page 4, Principles-based regulation, Focusing on the outcomes that matter, The Financial Service Authority, April 2007: <http://www.fsa.gov.uk/pubs/other/principles.pdf>

¹⁹⁴ Paragraph 98, Page 23, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

¹⁹⁵ Letter from Cathryn Ross to Regulatory Directors: Review of household retail competition, Ofwat – 4 December 2015: http://9208a6bdb79020ec0337-99614e491dc8eff25f017339872a32a.r86.cf3.rackcdn.com/wp-content/uploads/2015/12/ltr_stk201512householdcompetitionreview.pdf

¹⁹⁶ Paragraph 25, Page 5, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

The CMA noted that a regulatory framework that allowed suppliers to compete effectively would be vital for the retail energy markets to service customers' interests¹⁹⁷. The CMA identified a number of aspects of the regulatory framework that undermined effective and efficient competition and proposed a number of remedies including the withdrawal of the simpler choices component of the RMR¹⁹⁸. This aims to promote competition and innovation between retail energy suppliers in the retention and acquisition of domestic customer by allowing them to offer a wider range of tariffs, including tailored tariffs designed to appeal to certain customer groups and to facilitate competition between PCWs by allowing them to negotiate exclusive tariffs with domestic energy suppliers and to offer discounts funded by the commissions they receive from suppliers¹⁹⁹.

In their Provisional Decision on Remedies, the CMA found that the 'Simpler choices' RMR component introduced by Ofgem had the potential to restrict competition and innovation^{200 201}. The CMA intends to amend this component and allow suppliers to offer as many tariffs/tariff structures as they wish including variable standing charge/unit rates. Some academics have expressed the view that new issues may emerge if there is a complete removal of restriction on tariff complexity, namely the CCP on supply-side response and non-discrimination clauses²⁰².

Implications and considerations for household retail water competition in England

The energy market investigation allowed to identify that technical and regulatory constraints can restrict retail suppliers' ability to innovate in designing tariff structures²⁰³. The promotion of competition implies the removal of some regulation. Ofwat may wish to consider this point if Government decides to open the retail household market to competition.

Lifting the four-tariff rule, even if this adds to the complexity of the market, is expected to stimulate competition. This is an important lessons for Ofwat to keep in mind should Government decide to introduce competition in the retail household water sector.

¹⁹⁷ Paragraph 4.8, Page 184, Ibid.

¹⁹⁸ This remedy is not covered in this report.

¹⁹⁹ Paragraph 73, Page 17, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

²⁰⁰ This conclusion was also drawn by a number of academics, namely Professor George Yarrow which stated that is also restricted pricing freedoms and tariff differentiation. Paragraph 26, Page 6, Summary of hearing with Professor George Yarrow, Chairman of the Regulatory Policy Institute on 11 December 2014. CMA energy market investigation: https://assets.publishing.service.gov.uk/media/559cebe740f0b61567000029/Summary_of_hearing_with_Professor_George_Yarrow_11_Dec_2014.pdf

²⁰¹ We note that Professor Catherine Waddams highlighted the fact that simplification of tariffs was an attractive policy response to complaints that companies were deliberately imposing complex tariffs to confuse consumers. Yet, complex tariffs were a direct response to the non-discrimination clauses, which forbade differentiation between region in the standard tariffs, and so companies were allowed by the regulator to offer special deals. Page 7, Energy market investigation (a response by Catherine Waddams Price). European Policy Forum, 20 October 2014: https://assets.publishing.service.gov.uk/media/5450f87440f0b6131200000d/Submission_from_Catherine_Waddams_for_the_European_Policy_Forum.pdf

²⁰² Page 11, Competition and Markets Authority: Energy market investigation – Provisional decision on remedies, Consultation response from the Centre for Competition Policy, 8 April 2016: <https://assets.publishing.service.gov.uk/media/5717441c40f0b64314000000/centre-for-competition-policy-response-to-pdr.pdf>

²⁰³ Paragraph 4.9, Page 185, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EML.pdf>

5.2.6 Role of PCWs/TPIs at market opening

Price comparison websites (PCWs) and other third party intermediaries (TPIs) should be specifically considered both at market opening and beyond, to allow them to be utilised as a way of promoting competition and engaging customers.

The CMA found that current regulations could damage the incentives for PCWs to compete in the domestic energy market. The CMA propose to remove some of these requirements to allow the potential for PCWs to promote competition. The CMA remedy aims to promote competition and innovation between retail energy suppliers and PCWs by allowing the latter to negotiate exclusive tariffs with suppliers and to offer discounts funded by the commissions they receive from suppliers²⁰⁴. With regards to harnessing the incentives of rival suppliers and third party intermediaries (TPIs) to engage customers, the proposed CMA remedies seek to lift certain regulatory restrictions that dull price comparison websites' incentives to compete to engage customers and to liberalise access to data by giving PCWs access to the Electricity Central Online Enquiry Service (ECOES) and the Single Centralised On-Line Gas Enquiry Service (SCOGES).

Following an initial investigation, Ofgem transferred a potential breach of competition law to the CMA for investigation on 14 June 2016²⁰⁵. The suspected breach relates to paid online advertising by some PCWs²⁰⁶. The CMA's current aim is to reach a decision on whether to proceed with or close the investigation in August. The transfer was done following GEMA becoming aware of communications between some of its staff and the staff at the TPIs prior to the investigation being opened²⁰⁷.

Ofgem do not directly regulate TPIs or PCWs through licences. Regulation focusses on the voluntary Confidence Code for domestic customers²⁰⁸. TPIs and PCWs tend to operate across a number of markets, such as energy, banking and insurance. Given this gap, Ofwat and Government may want to consider if there is a cross sectoral approach to ensuring that any water customers engaging through TPIs and PCWs are protected, if competition is introduced.

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Responsibilities and restrictions on these parties to ensure that consumers are protected, will need to be balanced with the need to allow them to play a full role in driving effective competition in the market.

Well-balanced rules and regulations for PCWs are important to allow the delivery of competition through these service providers. Lessons from energy covering both doorstep selling, and then (following the withdrawal from doorstep selling by the larger suppliers) the increasing importance of online engagement, may be useful in considering how information and opportunities can be delivered to all consumers.

The use of intermediaries is a key opportunity for customers to engage through a forum they already use for other services (energy/insurance etc.) and to potentially allow for multi-utility offerings. For example, there is potential for a triple fuel offering should a current energy supplier choose to enter

²⁰⁴ Paragraph 73, Page 17, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

²⁰⁵ Notice of final decision on transfer, Ofgem, 13 June 2016: https://www.ofgem.gov.uk/system/files/docs/2016/06/formal_notice_of_transfer_14_june_2016.pdf

²⁰⁶ Energy price comparison websites: suspected anti-competitive agreements, 14 June 2016: <https://www.gov.uk/cma-cases/energy-price-comparison-websites-suspected-anti-competitive-agreements>

²⁰⁷ Notice of final decision on transfer, Ofgem, 13 June 2016: https://www.ofgem.gov.uk/system/files/docs/2016/06/formal_notice_of_transfer_14_june_2016.pdf

²⁰⁸ Confidence Code Decision, January 2015: https://www.ofgem.gov.uk/sites/default/files/docs/2015/01/confidence_code_review_-_january_2015_policy_decision_0.pdf

the water market, if Government introduce competition. Ofwat may want to consider product bundling as part of the assessment of competition.

Should the household retail water market open to competition and water is bundled with other utilities into a single 'utilities offering package', Ofwat may also want to consider the potential for joint working with Ofgem on the Confidence Code, to monitor and ensure consistent standards across the utility sectors for PCWs.

The CMA's investigation into the potential breach of competition law by some PCWs, and the transfer from GEMA to the CMA arising from previous communications between Ofgem staff and the TPIs²⁰⁹, suggests that the regulation of PCWs is an important and ongoing issue that Ofwat would need to manage carefully, should competition be introduced for household water in England.

5.2.7 Code governance and market rules acting as a barrier to entry

Complex codes and market rules can limit competition by acting as a barrier to entry.

The energy experience, as set out by the CMA, suggests that governance can be dominated by larger market players, particularly former incumbents. Once established, this can then provide both a barrier to change in future, and introduce potential barriers for the implementation and delivery of change driven by Government and/or the regulator. This argument was strengthened by a number of academics, namely Professor George Yarrow, who believes that the current set-up gives too much influence to the companies participating in the market and not enough to independent assessors²¹⁰.

Impact assessment, promotion of transparency and code governance

The CMA investigation culminated with the following provisionally findings:

- Ofgem has insufficient ability to influence the code modification process²¹¹;
- Parties have conflicting interests and/or limited incentives to promote and deliver policy changes²¹²; and
- There is a lack of a regulatory requirement for clear and relevant financial report concerning generation and retail profitability²¹³.

The CMA believe that the current system of industry code governance limits innovation and pro-competitive change and causes the energy markets to fail to keep pace with relevant policy objectives²¹⁴. We note that Ofgem did attack licence and industry code red tape in 2007 by reducing the supply licence from 180 pages of rules to 64. However, with the introduction of further regulation over the subsequent few years, the electricity supply licence had increased to 465 pages by 2016.

The CMA noted that government policies would help to shape the nature of competition in the energy markets²¹⁵. The CMA's findings conclude that the current industry code governance arrangements

²⁰⁹ Notice of final decision on transfer, Ofgem, 13 June 2016:

https://www.ofgem.gov.uk/system/files/docs/2016/06/formal_notice_of_transfer_14_june_2016.pdf.

²¹⁰ Paragraph 4, Page 1, Summary of hearing with Professor George Yarrow, Chairman of the Regulatory Policy Institute on 11 December 2014. CMA energy market investigation:

https://assets.publishing.service.gov.uk/media/559cebe740f0b61567000029/Summary_of_hearing_with_Professor_George_Yarrow_11_Dec_2014.pdf

²¹¹ Paragraph 187, Page 41, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

²¹² Paragraph 187, Page 41, Ibid.

²¹³ Paragraph 169, Page 37, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf.

²¹⁴ Paragraph 187, Page 40, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

²¹⁵ Paragraphs 10.1-10.4, Page 622, Ibid.

are having an adverse effect on competition. The CMA found that the overall governance of the GB energy markets were lacking robustness and transparency in regulatory decision-making, leading to inefficiencies in the energy markets²¹⁶. CMA aimed to provide a package of proposed remedies to ensure that policy decisions were robust, efficient and timely, and driven by the concern and interests of consumers²¹⁷.

The proposed remedies are based on a simple set of principles which recognise the importance of robust analysis underpinning decision-making and improving transparency and an independent and authoritative regulator²¹⁸. CMA remedies relating to the governance of the regulatory framework intend to promote transparency in relation to policy creation. CMA found that there is a lack of effective communication concerning the forecast and actual impact of government and regulatory policies on energy prices and bills²¹⁹. As such, transparent analysis will help deliver robust policies and regulation and CMA has proposed strengthening Ofgem's independence, reporting powers and ability to drive forward changes, including industry codes and governance²²⁰ and that DECC make code administration and/or implementation of code changes a licensable activity and to appoint an independent code adjudicator to determine which code changes should be adopted in case of dispute.

Financial regulatory reporting

Although Ofgem introduced enhanced financial reporting in 2014, following a review by a major accounting firm, the CMA still found that the current regulatory requirements do not provide for clear and relevant financial reporting of generation and retail profitability. CMA found that a lack of regulatory requirements for clear and relevant financial reporting concerning generation and retail profitability was a feature of the GB gas and electricity markets that, in combination with the other features, gave rise to the Governance AEC²²¹. The CMA intend to address this by improving the current regulatory framework for financial reporting for generation/retail companies.

The proposed remedy aims to address the weaknesses in the current reporting regime in such a way that relevant information (such as revenues, costs and profitability) used for decision making is robust and available for annual publications such as a state of the market assessment by Ofgem.

The introduction of robust financial reporting regime from the outset can contribute to transparent reporting and the generation valuable data/information that can be used to inform decision making, policy design and annual publications should as the state of the market review.

Implications and considerations for household retail water competition in England

Opening up the water market would result in an increased need for industry bodies to govern themselves, but in energy the perception is that this was set up and monopolised by the incumbents, and that this still disadvantages smaller players today. An important learning experience in relation to the energy industry code arrangements is that, for water, efforts should be made to avoid these difficulties from the very start. The CMA recognise the difficulties in addressing this issue in energy once these arrangements are established, and have proposed both licensing code bodies and increasing Ofgem's role to try to address them.

²¹⁶ Paragraph 10.7, Page 623, Ibid.

²¹⁷ Paragraph 10.3, Page 622, Ibid.

²¹⁸ Paragraph 175, Page 39, Energy market investigation – Summary of provisional decision on remedies, CMA – 10 March 2016: https://assets.digital.cabinet-office.gov.uk/media/56e1974ae5274a036b000018/Energy_PDR_Summary_March_2016.pdf

²¹⁹ Paragraph 10.157, Page 659, Energy market investigation – Provisional decision on remedies, CMA – 17 March 2016: <https://assets.digital.cabinet-office.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf>

²²⁰ Paragraphs 10.51-10.54, Page 635, Ibid.

²²¹ Paragraph 10.215, Page 674, Ibid.

Regulator and consumers need accurate and timely information to understand that they are getting value for money, and to avoid issues of perceptions of cartels/tacit coordination which could reduce trust and reduce engagement.

The water industry can learn from the energy experience through ensuring that any industry governance arrangements are set up in a way that promotes and enables equal participation by all parties. This will need careful deliberation, as smaller industry players tend to have smaller resource pools from which to draw on and so a more innovative approach may be needed than just allowing all parties to participate equally. It is also important to consider the need to facilitate and not restrict innovative business models and market entry. Industry code governance arrangements set up to facilitate the current operation of the market may, unintentionally, restrict innovative entry in future. Ofwat and Government may want to consider how it can introduce a flexible and fair model for industry governance, ahead of any introduction of competition for household water customers in England.

The water industry can also consider the potential need for Ofwat (or another body) to play an ongoing role in industry governance. This includes the potential for the regulator to act as project manager and/or to drive through changes where they are required either by the regulator or by Government.

5.2.8 Limitations of the CMA energy market investigation for the water sector

The CMA is an important resource for Ofwat. Ofwat must understand the limitations of making such a reference, and the possible unintended consequences that may occur.

There has been a high degree of disquiet in the energy sector following the CMA's Provisional Decision on Remedies²²². These fall into two categories: 1) unexpected and unintended consequences, 2) criticism of the CMA findings which have come from academics, some challenger companies and some consumer groups. The CMA has provided limited response to these concerns. The CMA has also proposed some remedies that would reintroduce significant regulation into the energy market, including the introduction of a tariff cap for those customers with prepayment meters until 2020.

The CMA is an important resource for Ofwat, with options for concurrency of working as set out in the MOU, as well as the potential for Ofwat to make a reference to the CMA where it has reasonable grounds to suspect that a feature of the market prevents, restricts or distorts competition. However, the Regulator must understand the limitations of making such a reference, and the possible unintended consequences that may occur. Ofwat may want to aim for a regulatory regime which draws on concurrency with the CMA where this provides an addition to Ofwat expertise, but one where there is no need to make a formal reference to the CMA. Ofgem's recent transfer of the potential competition case into PCWs to the CMA²²³ is an example of concurrency between the sector regulator and the CMA.

Ofwat can learn a huge amount from the energy experiences. In particular, it needs to consider the timing of, and reasons for using a CMA reference in the future and also the fact that it is not a proposition or threat that can be used lightly. The timing of, and reasons for referring a market to the CMA is important and this could be used as a 'tool' to review the aspects of the market that are not working well. Put differently, the CMA can be considered a 'tool' that a regulator can 'use' when appropriate to launch a market investigation. Ultimately, it is a regulator's decision when to refer the market to the CMA. Professor George Yarrow alluded to this in his hearing with the CMA in December 2014. He explained that

“[...] while at Ofgem he had proposed on two occasions, in 2008 and 2009, that the energy market should be referred to the Competition Commission. He had made these proposals for two main reasons, one, that prices had been

²²² See responses to provisional decision on remedies published on the CMA website: <https://www.gov.uk/cma-cases/energy-market-investigation>.

²²³ https://www.ofgem.gov.uk/system/files/docs/2016/06/formal_notice_of_transfer_14_june_2016.pdf

deregulated for five years, so it seemed like an opportune time to review how deregulation had worked, and two, from 2008 onwards there was increasing political concern about the market, which a Competition Commission investigation would have helped to address²²⁴”.

Yet, a CMA reference can unfold in various ways. For example, at the outset, the CMA’s research and analysis may find there are no problems in the market and exclude from the investigation the market segments where no AECs were identified.

Ofwat has already created a MOU with the CMA and this enhanced communication will greatly assist Ofwat in understanding the CMA and providing the option for concurrency where appropriate. The CMA and Ofwat also have experience of working together as part of the Phase 1 merger process following the Water Act 2014. Ofwat will find these working arrangements to be of particular use when reviewing major strategic options.

5.2.9 Areas where the CMA found no features that lead to AECs

In its Statement of Issues, the CMA provided the findings of its initial analysis on the energy market and provided a rationale for the issues/parts of the market that it was not minded to investigate. This included wholesale gas markets, gas interconnection and storage and regulation of revenues from transmission and distribution²²⁵. We note that this approach was criticised by some academics – it is thought that an investigation is a process of discovery and it is not possible to forecast *ex ante* where it will lead and that excluding some areas from the investigation at the outset might be premature²²⁶.

The CMA provided a number of additional conclusions on the wholesale energy markets along with other areas where it concluded there were no features that lead to AECs in its Provisional findings. A summary of the areas where the CMA found no features that leave to AECs is provided in the paragraphs below.

5.2.9.2 Smaller supplier exemptions

The CMA also found that there was no adverse effect on competition arising from Ofgem’s exemptions for smaller suppliers, such as on the Energy Company Obligation. The CMA noted the benefits market entry by smaller parties had brought to the sector. CMA believes that there is a legitimate rationale for providing some degree of exemption – the cost of delivering any scheme would fall disproportionately on small suppliers due to the fixed costs of compliance and therefore make entry into the market more difficult²²⁷. Should the retail water household market open to competition, Government/Ofwat may want to consider whether smaller suppliers should be exempt from carrying out a range of activities that may cause undue burden to them given their size.

The CMA also noted the benefits that entry has brought to the sector in terms of increased competition. The CMA noted that firms above the exemption thresholds have relative strength compared with new entrants – mainly due to the existence of an established customer base and

²²⁴ Paragraph 1, Page 1, Summary of hearing with Professor George Yarrow, Chairman of the Regulatory Policy Institute on 11 December 2014. CMA energy market investigation:
https://assets.publishing.service.gov.uk/media/559cebe740f0b61567000029/Summary_of_hearing_with_Professor_George_Yarrow_11_Dec_2014.pdf

²²⁵ Paragraph 60, Page 17, Energy market investigation, Statement of issues, 24 July 2014:
https://assets.publishing.service.gov.uk/media/53cfc72640f0b60b9f000003/Energy_Issues_Statement.pdf

²²⁶ Paragraph 8, Page 2, Energy market investigation, Response to the CMA’s Statement of Issues, Georgy Yarrow:
https://assets.publishing.service.gov.uk/media/53f1c32fe5274a48c400000f/George_Yarrow_response_to_IS.pdf

²²⁷ Paragraph 168, Page 36, Energy market investigation, Provisional findings report, 7 July 2015:
https://assets.digital.cabinet-office.gov.uk/media/559fc933ed915d1592000050/EMI_provisional_findings_report.pdf

experience in dealing with regulatory requirements. As such, the CMA believes that the impact of the current exemptions is not likely to be market distorting²²⁸.

If competition is introduced, then Government and/or Ofwat may want to consider where smaller parties/new entrants should be exempt from carrying out some activities where these provide a significant regulatory burden, and may otherwise act as a barrier to entry.

5.2.9.3 Wholesale gas markets

In its Statement of Issues, CMA stated that it had not found evidence suggesting that the GB wholesale gas market does not possess the potentially harmful features that have been identified in wholesale electricity²²⁹. The wholesale gas market still remained important to the investigation and the CMA provided an update on its position in its Provisional findings. The CMA did not believe that the harm that can sometimes arise from vertical integration is a significant risk in the wholesale gas market. Additionally, the CMA did not believe that the lack of price transparency is likely to constitute a barrier to entry in the GB gas market²³⁰.

The CMA's findings on vertical integration is very relevant to the water sector as a whole. It suggests that the CMA does not see vertically integrated companies as a barrier to competition. It is worth noting that when the energy market opened to competition, the regulatory framework in place at the time left it to the market to decide whether vertical integration was more economic than non-vertically integrated companies. This precedent, along with the CMA's recent findings, suggest a rather clear direction of travel coming from Government. Nothing seems to indicate that the potential market opening in water would be treated differently.

5.2.9.4 Wholesale electricity markets

With regards to competition in the wholesale electricity markets, CMA found no evidence that overall, the Six Large Energy Firms earned excessive profits from their generation business over the period studied. CMA neither found that wholesale market prices were above competitive levels, which is consistent with the CMA's provisional conclusion that generators do not have unilateral market power²³¹. On market rules and regulation, CMA found no evidence that the self-dispatch system in Great Britain, when compared with alternative dispatch systems, reduces price transparency or increases transaction costs²³².

This finding suggests that industry wholesale pricing trends do not necessarily imply that companies operating in both the wholesale and retail market have unilateral market power. This is relevant to the water sector as a whole as it suggests the CMA found no evidence of tacit coordination and excessive profits in the energy sector which implies no precedent is set.

²²⁸ Paragraph 168, Page 36, Ibid.

²²⁹ Paragraph 60, Page 17, Energy market investigation, Statement of issues, 24 July 2014: https://assets.publishing.service.gov.uk/media/53cfc72640f0b60b9f000003/Energy_Issues_Statement.pdf

²³⁰ Paragraph 34, Page 8, Energy market investigation, Provisional findings report, 7 July 2015: https://assets.digital.cabinet-office.gov.uk/media/559fc933ed915d1592000050/EMI_provisional_findings_report.pdf

²³¹ Paragraph 38, Page 9, Ibid.

²³² Paragraph 42, Page 10, Ibid.

Case study

CMA investigation into retail banking

The CMA is investigating the supply of personal current accounts (PCAs) and of banking services to small and medium-sized enterprises (SMEs). On 7 May 2016 it published its provisional decision on remedies²³³.

The investigation into retail banking is relevant to water as the customers affected overlap significantly. Banking is a commercial activity in GB and customers do not have a default provider – they must therefore, at least once, make an active choice of provider. In the banking sector, there is scope for innovation and variation in the way the product is sold, packaged with other related products and priced.

CMA findings of relevance to water

- 1 Switching levels in banking are very low, even lower than energy, telecoms and other financial products. CMA found that engaged consumers were more likely to search, but only marginally more likely to switch. The key drivers for switching were both push and pull – better deals, account conditions and poor customer service for example.
- 2 CMA found that there was some competition between banks, but this was in specific segments of the market. CMA also found that given the average length of banking relationships, banks were able to price discriminate and effectively charge more to sticky customers.
- 3 Alike in the energy sector, CMA found that there was weak customer engagement leading to an adverse effect on competition (AEC), but for slightly different reasons, namely because there are no trigger points for customers to engage with the market, customers perceive the offerings of suppliers to be relatively generic and the complexity of comparing charges across providers made it difficult for customers to estimate potential gains from switching.

Understanding customer behaviour in retail banking could help water and sewerage providers in designing and offering product offerings and flexible account conditions that appeal to consumers. Combined with good customer service, these measures could have a positive effect on switching rates. Tailoring product and service offerings to different customer groups could also stimulate competition between providers. Should product bundling with other utilities be considered, water companies may be more successful in attracting customers if their charges are transparent and straightforward to understand in such a way that customers can compare charges across providers. It will be important to strike a balance between oversimplification of tariff structures, for e.g. Ofgem's four-tariff rule, and innovative and appealing offers.

- 4 CMA found that there was quite a high degree of innovation in the PCA market and that, in many cases, these innovations (and improvements in customer service) benefitted all customers even if they were developed to attract new customers.

A regulatory framework that stimulate innovation and provide rewards for outstanding customer service may help attract new customers as well retain current ones. If Government introduce competition in the household retail water sector, Ofwat may want to consider programmes such as Ofgem's Network Innovation Competition (NIC) for electricity and Network Innovation Allowance (NIA) for gas. A programme similar to Ofgem's Stakeholder Engagement and Consumer Vulnerability incentive may encourage water and sewerage providers in improving customer service and developing enduring relationships with their customers.

CMA provisional remedies of relevance to water

In its retail banking PDRs, the CMA proposed a series of remedies that will help improve competition, innovation and trust in retail banking. Similar to the CMA's energy PDRs and relevant to the water sector, the CMA proposed a remedy that will make banks provide their customers with the right information so that they can easily find out which provider and type of account offers best value for money. Additionally, the CMA proposed to push the development of new online comparison tools and improve the current account switch service (CASS) to make switching banks more straightforward and give customers more awareness, of and confidence in, the process. Another relevant remedy is the Open API (application programming interface) banking standard, where customers will be able to compare offers tailored to their particular circumstances and directing them to the bank account which offers them the best deal²³⁴.

²³³ Retail banking market investigation, Provisional decision on remedies, CMA, 17 May 2016: https://assets.digital.cabinet-office.gov.uk/media/573a377240f0b6155900000c/retail_banking_market_pdr.pdf

²³⁴ <https://www.gov.uk/government/news/cma-wants-banks-to-work-harder-for-their-customers>

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