

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

# The costs and benefits of introducing competition to residential customers in England – summary of emerging findings

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# Background

Last November, the UK government published ‘A better deal’, its plan to boost competition in different markets and lower bills for firms and families. The plan said:

“Ofwat will provide an assessment by summer 2016 of the costs and benefits of extending retail competition to household water customers [in England]. Following this, the government will work with water companies to begin the transition to household retail competition before the end of this Parliament.”

This follows the work already in train to open to competition the retail market for businesses, charities and public sector organisations in England in April 2017.

At the moment, water retail services are generally provided by 17 regional monopoly companies, regulated by Ofwat for both price and quality of service.

We were not asked to reach a view on whether the government should introduce competition; or to recommend what form any competitive market should take. Those are decisions for the government. We are providing evidence and analysis to enable the government to take those decisions.

**To respond to these emerging findings or provide more evidence on the potential costs or benefits of opening the residential water market in England, please email [household.review@ofwat.gsi.gov.uk](mailto:household.review@ofwat.gsi.gov.uk).**

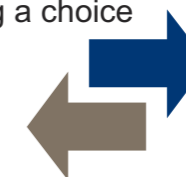
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## Emerging findings

There are **potential benefits** available from the introduction of competition. The scale of those benefits will depend on how competition is designed and implemented.



**Choice is something customers want** – our research suggests that more than half of customers would welcome having a choice as a result of competition.



Many customers say they would want **significant savings to switch**. Retail costs account for about 10% of the average bill of £386. Our analysis shows that competition could drive efficiencies in retailing that on their own would suggest a price saving for customers in the order of £6 – or 2% – off the average bill. This is in addition to the benefits that come from effective regulation.



Half of the customers we surveyed would be interested in switching and just under half would switch for the **offer of additional services**, even if there was no price saving. For example, for the convenience of a single utility bill including energy and water, or water efficiency services to help reduce consumption and lower bills, while helping to improve resilience.

Savings are more likely to be achieved if **multi-utility retailers** enter the market, as they could spread fixed costs over a larger number of customers and pass on the savings. Competition could also spur improvement in the management of bad debt.

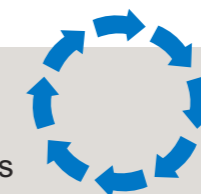
The use of **new technologies** could make switching easier for customers and cheaper for retailers, promote water efficiency and better wastewater management, and help to improve resilience.



We have also identified the **potential costs** for water companies, retailers, and those operating and overseeing the market, such as regulators. Under one scenario we have modelled, these costs could outweigh the benefits.



In modelling costs and benefits we took account of the **experience in energy markets**, as well as business learnings and technology which were not available at the time of opening the energy market. We have also been informed by the ongoing process to open to competition the business market for water and wastewater retail in England.



There are important **policy decisions** that would need to be given careful consideration ahead of introducing a competitive market. For example, whether and how to provide protection for customers who are not active in the market, how to provide assistance for vulnerable customers and social tariffs.

## Our approach

Throughout this review, we have been open and transparent. We committed to publish our emerging findings for consultation before submitting our final report.

Our work has been informed by the following.

- Customer research.
- Qualitative and quantitative analysis.
- Expertise and experience from a reference group made up of those within and outside the water sector.
- The expertise and experience within Ofwat, including our non-executive Board members.

### Customer research

We commissioned customer research to help understand customer preferences and concerns. We used the findings from this to inform our competition models and assess the costs and benefits. We also considered complementary research by the Consumer Council for Water (CCWater) which explores how much customers expect to save in a competitive market.

### Qualitative analysis

We reviewed the potential costs, benefits and models of competition in other markets to inform assumptions about the water market. We identified and tested various models of competition. We also identified a range of issues which would need to be considered in the design of any model of competition.

### Quantitative estimates

We began with an evaluation of the status quo – where there is no retail competition in the residential water sector. We took account of the fact that the market for businesses, charities and public sector organisations in England will open in April 2017 and have included spillover benefits for

residential customers that are expected from opening that market, which we would secure through regulation.

We used this as our starting point against which we could compare and estimate the impacts of retail competition.

We estimated the costs and benefits to all parties of setting up and maintaining new arrangements. We compared the costs and benefits over time to estimate the 'present' value of each, including the impact on average bills.

The potential benefits identified are in addition to benefits that could be secured through effective regulation.

### Assessing against different scenarios

To help work through possible costs and benefits, we modelled outcomes against four possible scenarios.

- Scenario 1 – lower cost, widespread innovation, strong competitive activity.
- Scenario 2 – lower cost, some innovation and good competitive activity.
- Scenario 3 – higher costs, some innovation and good competitive activity.
- Scenario 4 – higher costs, little innovation and weak competitive activity.

Our analysis aims to identify market-wide impacts and sets out the Net Present Value (NPV) over a period of 30 years. NPV figures should not be taken as bill impacts because costs and benefits would not be passed to customers only in the year they are incurred, but would be spread over time.

Even though it takes time for competition to develop, we would expect some customers to pay lower bills from day one, as new entrants and existing companies compete to offer customers a better price or product.

## Securing success

A successful competitive market could deliver benefits for customers, including lower prices, better service, greater control and convenience, and innovation in products and services. It could also deliver environmental improvements and improved resilience through water efficiency and better management of wastewater. How successful a competitive market would be depends on a number of factors which need to be addressed in the design and implementation of the market.

### Drivers for success



### Enablers of success

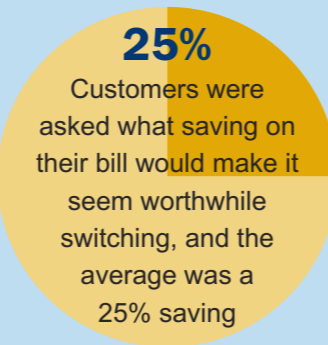
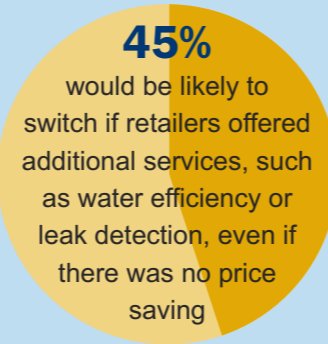
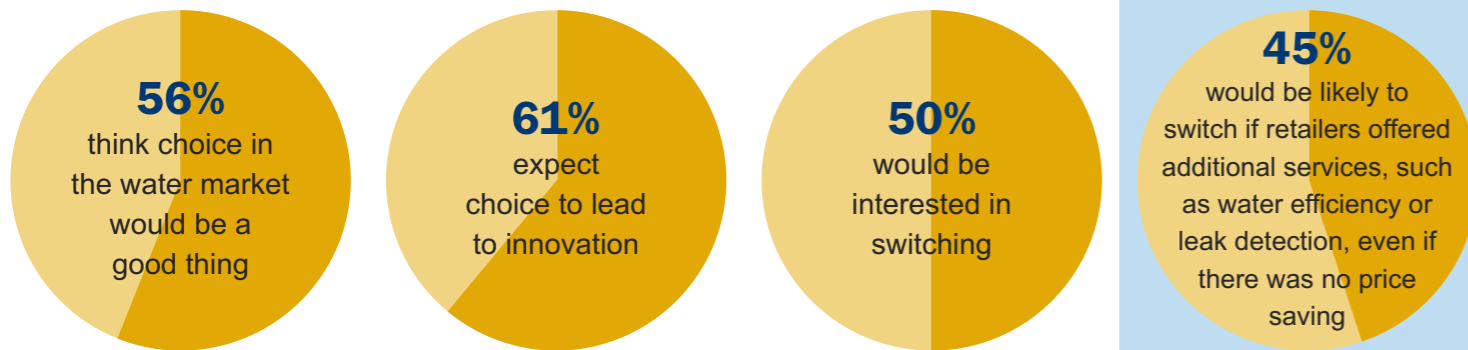




# Customers' views on retail competition

We worked with CCWater to seek customers' views and also commissioned our own research. We discussed the issues with the Institute for Customer Service and analysed the Competition and Market Authority's work on energy and banking reform. Our customer research is available in full on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk).

## Headline findings from our customer research



Older customers were least enthusiastic about switching and were concerned about the burden of choice and confusion about who to contact in an emergency

Customers struggling or in debt were more positive about the idea of choice than average

**Main reasons customers think choice is a bad idea** **X**

- Prices will go up.
- More complicated; administrative problems.
- Do not see the point.

**Main reasons customers are neutral about choice** **=**

- Happy with current service.
- Do not think choice will make a difference.
- Not sure of benefits.

**Main reasons for customers to support choice** **✓**

- Competition is a good thing.
- Cheaper bills.
- More choice, can shop around.
- Better service.

## What customers say

### Customers who support choice

“Up to 10 years ago I didn't give it a thought but having thought about this now, I do feel why don't we have a choice?”

“Anything that you have to pay for I think should be competitive, whether that's gas, electricity, chocolate bars, cigarettes.”

“I think competition is healthy and it would strengthen customer service.”

### Customers who think choice is a bad idea or there is no need for change

“All that [competition] will do is introduce another level of admin and costs will rise.”

“I'm satisfied where I am, I haven't got any problems and everything is hunky dory.”

“I would do it for car insurance where you can save £500 a year but for water, if it's £5 or £10, then no.”

“It won't be good if they are sending round people to knock on your door at 9 o'clock at night (to sell products and services).”

“I had to challenge and fight when I had a problem with my meter – if there was competition I would have switched immediately.”



# Summary and comparison

To help understand the impact of introducing competition into the residential water market, we looked at four possible scenarios.

## Scenario 1

Lower cost, widespread innovation, strong competitive activity

### What this market looks like

Implementation costs are relatively low for the companies, market operator and regulator. This is likely because market architecture and resources like switching and settlement systems are established from the opening of the business market in England, and can be easily adapted for the residential market.

Costs of operating in the market are relatively low for companies. This may be because companies have already invested in changes to their billing and account systems for the business market, which can be adapted for the residential market. It may be the case that those able to offer multi-utility products can extend their retail operations to water without incurring substantial additional costs.

Retailers can find significant cost saving efficiencies. This could be because multi-utility retailers can spread fixed costs across greater revenues. It could be a result of retailers in competitive markets having stronger incentives to manage bad debt costs, which comprise £21 of the average bill. Retailers could also put pressure on their wholesale suppliers to reduce their costs. New entrants are keen and a number of them enter the market. This could be existing water retailers in the residential market entering each other's area. It could be players in the business market entering the residential market. It could also be as a result of energy retailers and other service providers entering the market.

New entrants offer innovative products and services and drive the use of technology throughout the sector. This could result in multi-utility bundles, multi-utility efficiency services and the use of smarter water meters and sensors, promoting water efficiency services. It could be the use of technologies such as block chain switching and search engines. It could also include wastewater meters, and services to reduce the impact of residential wastewater on the drainage network, generating cost savings and improving resilience.

Retailers compete using product and service innovation, and better, more customised services. This is not purely focused on reducing the price per unit of water consumed or wastewater taken away, but reducing bills by reducing consumption. Multi-utility retailers compete not only on water efficiency, but also on energy efficiency, for example by reducing hot water consumption.

Customers find these benefits attractive and this stimulates engagement in the market. It is coupled with technology, such as search engines and block chain switching that make it possible for third parties to offer search and switching services. This could increase the proportion of customers actively engaged with the market, so that more of the benefits of competition are enjoyed by more customers.



## Scenario 2

Lower cost, some innovation and good competitive activity

### What this market looks like

Implementation costs are relatively low for the companies, market operator and regulator. This is likely because market architecture and resources like switching and settlement systems are established from the opening of the business market in England, and can be easily adapted for the residential market.

Costs of operating in the market are relatively low for companies. This may be because companies have already invested in changes to their billing and account systems for the business market, which can be adapted for the residential market. Those able to offer multi-utility products might be able to extend their retail operations to water without incurring substantial additional costs.

Retailers can find significant cost saving efficiencies. This could be because multi-utility retailers can spread fixed costs across greater revenues. It could be a result of retailers in competitive markets having stronger incentives to manage bad debt costs, which comprise £21 of the average bill. Retailers could also put pressure on their wholesaler suppliers to reduce their costs.

New entrants are keen and a number of them successfully enter the market. This

could be as a result of existing water retailers in the residential market entering each other's area. It could be players in the business market entering the residential market. It could also be as a result of energy retailers and other service providers entering the market.

Retailers find modest scope to reduce costs, for example through better management of bad debt costs. Multi-utility retailers reduce customer bills further by spreading fixed costs across a greater revenue. Retailers compete not only on price but also service. However, unlike scenario one, there is no widespread adoption of smart metering technology on the water and wastewater side.

Unlike scenario one, technology such as search engines and block chain switching, is not adopted in water, which does not help customers to engage easily in the market. Limited use of technology such as water and wastewater metering and apps means the service offer to customers is less attractive than in scenario one. As a result, there is limited customer engagement in the market. We assume a similar proportion of active customers to that we have seen to date in energy – up to half engage at the opening of the market, but that falls significantly afterwards.

**Those able to offer multi-utility products might be able to extend their retail operations to water without incurring substantial additional costs**



### Scenario 3

Higher costs, some innovation and good competitive activity



#### What this market looks like

Implementation costs are high for the companies, market operator and regulator, unlike scenarios one and two. This may be because the market architecture and resources like switching and settlement systems for the business retail market are not easily adaptable for the residential market.

Costs of operating in the market are high for retailers, unlike scenarios one and two. This may be because existing water retailers have to invest in new systems to help them compete, and because entrants from other sectors incur significant costs in adapting their systems to the water market.

New entrants include energy providers – making the offer of multi-utility bundles common, as in scenarios one and two.

Retailers find modest scope to reduce costs, for example through better management of bad debt costs. Multi-utility retailers reduce customer bills further by spreading fixed costs across a greater

revenue. Retailers compete not only on price but also service. However, unlike scenario one, there is no widespread adoption of smart metering technology on the water and wastewater side.

Overall, scope for cost savings is as in scenario two. Unlike scenario one, technology is not adopted in water which does not help customers to engage easily in the market and make service offers attractive. As a result, there is limited customer engagement in the market. We assume a similar proportion of active customers to that we have seen to date in energy – up to half engage at the opening of the market, but that falls significantly afterwards.

**Retailers find modest scope to reduce costs, for example through better management of bad debt**

### Scenario 4

Higher costs, little innovation and weak competitive activity



#### What this market looks like

Implementation costs are high for the companies, market operator and regulator, as in scenario three. This may be because resources like switching and settlement systems for the business retail market are not easily adaptable.

Costs of operating in the market are high for retailers, as in scenario three. This may be because existing water retailers have to invest in new systems to help them compete, and because new entrants from other sectors incur significant costs in adapting their systems to the water market.

There is limited entry into the market, and retailers do not compete vigorously. This may be because the high costs to operate in the market act as a deterrent to entry.

This lack of vigorous competition means retailers do not offer innovative products and services. Water efficiency and wastewater management are not promoted. Bad debt costs are not reduced.

As a result of this, and onerous search and switching costs, customers do not engage with the market. We assume that the share of active customers is lower than in the current energy market. This compounds the ineffectiveness of competition. It means customers do not experience any additional benefits, either through reduced bills or better service. The costs of competition in this scenario outweigh the benefits.

**Lack of vigorous competition means retailers do not offer innovative products and services**



# The scenarios

## Scenario 1

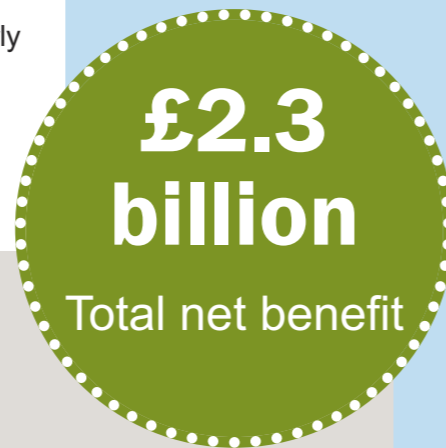
### Lower cost, widespread innovation, strong competitive activity

Innovation and technology that already exists in other sectors (including at early stages in energy) is adopted in water and taken up on a widespread basis. Costs for setting up and running the market are relatively low. There is vigorous competition, delivering greater benefits and savings for customers.



From starting the process, it takes **two** years to prepare and open the market

The market for business customers will take three years to open. Having learnt from that, this market can be opened in two years



It costs companies **£8** to get a new customer



Retailers will not spend more getting customers than they make in profit and this is based on profit margin of 1%

Within **10** years, **50%** of the residential market is actively engaging with the market

Technology and innovation encourage customers to engage actively with the market

One-off reduction of **0.75%** in wholesale costs

Anticipated benefits are 50% higher than those expected in the business customer market

Bad debt is reduced by about **2%** a year



Based on reaching the same level of bad debt as in energy and council tax

The cost of metering falls by about **1%**

New technology, such as smarter meters, is embraced and delivers cost savings



Metered customers who are active in the market could cut their water use by **20%**

This sees progress continue on current trajectory

Implementation costs companies a total of **£200 million** upfront, and **£20 million** a year thereafter

Given the scale and complexity of opening the residential market, this is about double the best estimate of the cost of opening the business market

## Scenario 2

### Lower cost, some innovation and good competitive activity

The water market follows the energy market to date. There is competition and multi-utility offers but technology, such as search engines and block chain switching, is not adopted in water which does not help customers to engage easily in the market. Costs for setting up and running the market are relatively low for the companies, market operator and regulator.



From starting the process, it takes **three** years to prepare and open the market

Based on the time it will take to open the market for business customers

Within **15** years, **30%** of the residential market is actively engaging with the market

Based on the experience in the energy market

One-off reduction of **0.50%** in wholesale costs

Based on anticipated benefits in the business customer market

Bad debt is reduced by about **1%** a year



Rivalry is lower and so retailers have less incentive to achieve cost efficiencies

No additional savings to cost of meters

Rivalry is lower and so retailers have less incentive to achieve cost efficiencies



Metered customers who are active in the market could cut their water use by **10%**

Rivalry is lower and so retailers have less incentive to promote water efficiency



It costs companies **£15** to get a new customer



Retailers will not spend more getting customers than they make in profit and this is based on a profit margin of 1%

Implementation costs companies a total of **£200 million** upfront, and **£20 million** a year thereafter

Given the scale and complexity of opening the residential market, this is about double the best estimate of the cost of opening the business market

## Scenario 3

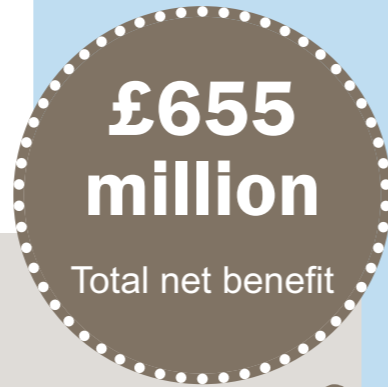
### Higher costs, some innovation and good competitive activity

There are significant costs for the companies, market operator and regulator in setting up and running the market. There is competition and multi-utility offers. Technology, such as search engines and block chain switching, is not adopted in water which does not help customers to engage easily in the market.



From starting the process, it takes **three** years to prepare and open the market

Based on the time it takes to open the market for business customers



It costs companies **£15** to get a new customer



Retailers will not spend more getting customers than they make in profit and this is based on profit margin of 1%

Within **15** years, **30%** of the residential market is actively engaging with the market

Based on the experience in the energy market

One-off reduction of **0.50%** in wholesale costs

Based on anticipated benefits in the business customer market

Bad debt is reduced by about **1%** a year



Rivalry is lower and so retailers have less incentive to achieve cost efficiencies

No additional savings to cost of meters

Rivalry is lower and so retailers have less incentive to achieve cost efficiencies



Metered customers who are active in the market could cut their water use by **10%**

Rivalry is lower and so retailers have less incentive to promote water efficiency

Implementation costs companies a total of **£400** million upfront, and **£40** million a year thereafter

Given the scale and complexity of opening the residential market, this is about double the estimate in scenario one and two

## Scenario 4

### Higher costs, little innovation and weak competitive activity

Customers show little interest in the market and there is little movement from retailers. There is little innovation or technology use in the market. There are significant costs for the companies, market operator and regulator in setting up and running the market



From starting the process, it takes **four** years to prepare and open the market

Because the market is bigger and more complex than the one for business customers, it takes a year longer to open



It costs companies **£15** to get a new customer



Retailers will not spend more getting customers than they make in profit and this is based on a profit margin of 1%

Within **20** years, **15%** of the residential market is actively engaging with the market

Engagement is significantly lower than in energy because retailers do not compete and so benefits are less attractive to customers

One-off reduction of **0.25%** in wholesale costs

Based on securing lower benefits than those anticipated in the business customer market

No additional progress in tackling bad debt



Rivalry is lower and so retailers have less incentive to achieve cost efficiencies

No additional savings to the cost of metering

Rivalry is lower and so retailers have less incentive to achieve cost efficiencies



No additional benefits on water efficiency

Rivalry is lower and so retailers have less incentive to promote water efficiency

Implementation costs companies a total of **£400** million upfront, and **£40** million a year thereafter

Given the scale and complexity of opening the residential market, this is about double the estimate in scenarios one and two



# Alternatives to competition

Our emerging findings have identified and considered the benefits and costs of competition in the residential retail water market, in addition to the benefits that can be secured through effective regulation.

However, we also considered whether similar benefits from competition could be secured through effective regulation alone.

## Benefits of competition

Lower prices for customers	
<b>Deliverable through regulation?</b>	Partially
<b>How?</b>	

Regulation seeks to mimic competition and drive down retail prices. But it is hard to encourage innovation, such as new business models and multi-utility retailers, which would potentially deliver greater benefits for customers.

Choice of supplier for customers	
<b>Deliverable through regulation?</b>	No
<b>Why?</b>	

Only competition can deliver this choice.

Innovation in products and customer service	
<b>Deliverable through regulation?</b>	No
<b>Why?</b>	

Regulation alone cannot deliver this retailer-led innovation.

Improved water efficiency and resilience	
<b>Deliverable through regulation?</b>	Partially
<b>How?</b>	

Regulation could introduce standards or incentives for water efficiency and resilience. But it would not be able to replicate the information and incentives a competitive market would provide, including incentives for the development and take up of new technology and innovative ways of engaging customers.

Tackle bad debt	
<b>Deliverable through regulation?</b>	Partially
<b>How?</b>	

Through regulation, we can and have put pressure on companies to tackle bad debt. But competitive pressures would deliver greater incentives and creativity in tackling it.

Customer convenience	
<b>Deliverable through regulation?</b>	Partially
<b>How?</b>	

Regulation could mandate changes such as online billing or the introduction of apps, but it would be difficult to regulate for the quality of these products. Regulation could not deliver the convenience of multi-utility offers.

Driving wholesalers to deliver lower prices and better performance	
<b>Deliverable through regulation?</b>	Partially
<b>How?</b>	

Regulation can help to bring pressure on wholesalers, but retailers' input would be complementary and accelerate progress.

## Lessons from the energy market

In considering the costs and benefits of competition, we reviewed what happened when other markets opened. We commissioned an independent study into the opening of the energy market and reflected on the history and recent Competition and Markets Authority report into the sector. Here we set out some significant observations and lessons from the development of the energy market.

### The differences between introducing competition in water and energy sectors

- In energy, about half of the bill is exposed to volatile global wholesale prices. This is not the case in water, where water resources are procured within the UK, and where the commodity is harder to trade (because it is bulky to move). Furthermore, we regulate wholesale prices and these make up about 90% of the cost of a water bill.
- While there are a number of energy and other service providers who could quickly compete for market share in the water sector, it could be argued that there is no one company in quite the same strong position as British Gas was at the opening of the electricity market, in terms of its ability to challenge regional incumbents.
- There are lessons that can be learned from previous market openings and how customers behave and make choices in utility markets.

### Points to consider following the experience in the energy market

- British Gas, which had a national presence, was ready to enter and challenge incumbents at the opening of the electricity market, just as the electricity incumbents had targeted gas customers in their regional areas. In the absence of this rivalry in the water sector, facilitating entry from established players in other markets, such as gas and electricity, will be important to stimulate competition.
- Consistency and clarity in regulation across different sectors is needed to encourage entry from established players in other markets, allowing for benefits from bundling of services.
- There is a need for the regulator to be active in the market and provide strong, effective regulation on behalf of customers.
- The energy markets benefited from phased opening to learn lessons as the market progressed, and water may also benefit from this approach.
- It became clear as the market developed that regulatory interventions needed to be changed to protect certain customer groups. It would be beneficial to consider the needs of potentially vulnerable customers ahead of market opening.
- As prices rose and company practices – such as doorstep selling – came under scrutiny, customer engagement stalled. As customer engagement is central to the success of a competitive market, this experience of flawed practice and companies withdrawing from customers must not be allowed to be repeated.
- As with the banking sector, those who have not engaged with the market have not benefitted as much from the potential savings. The challenge for water is to consider ways to ensure the benefits of competition reach as many customers as possible.
- One reason it has been difficult for companies to enter the energy market is that the rules governing the day-to-day running of the market are heavily influenced by incumbents. The water sector needs new entrants to be actively engaged and must ensure they are not disadvantaged in any way.

## Implementation issues to be considered

From our customer research, responses to our call for evidence and engagement with stakeholders on this review, we have identified a number of issues to be addressed in order for competition to be successful. These include the following.

- Assuring customers about water quality and continuity of supply.
- Putting in place protections for customers and offering compensation and redress when things go wrong.
- Assuring customers about their rights and choice if a retailer wants to install a meter.
- Providing support for customers in vulnerable circumstances
- Offering access to social tariffs.
- Managing bad debt and being clear with customers what actions retailers will be able to take to recover debt.
- Protecting customers who are transferred from one retailer to another, for example if their retailer exits the market.
- Protecting customers with a multi-utility bundle if there are problems with the other services on their account.

We think there are a range of potential solutions to these issues. Should the UK Government decide to introduce competition in the residential retail market in England, we would expect to carry out further work on these matters.

**We have identified a number of issues to be addressed in order for competition to be successful, including assuring customers about water quality and continuity of supply**