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Trust in water

The costs and benefits of introducing competition to residential customers in England: report on stakeholder views and issues

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About this document

In our [terms of reference](#) for the review of the costs and benefits of competition for residential retail markets in the water and wastewater sector (“the review”), we outlined our principles and objectives. In addition to analysing the overall potential costs and benefits, we undertook to consider specific issues that could affect the feasibility of retail competition.

In this document, we set out the key policy issues, which stakeholders raised with us through our [call for evidence](#) and through other forums. Our qualitative analysis shows how these issues could impact on the costs and benefits of introducing competition. We also provide an overview of how we have engaged stakeholders throughout our review process, and summarise the responses to our call for evidence. We have published these responses separately as part of this consultation exercise. This report is published alongside our analysis, “[The costs and benefits of introducing competition to residential customers in England – emerging findings](#)” (“emerging findings”).

In the review we have assessed a wide range of relevant evidence. Stakeholders have provided much of this evidence, and this has informed our initial findings. In some cases we have identified and discussed specific policy issues, or made policy assumptions. In line with our terms of reference, we have done so only for the purposes of illustrating the analysis in our emerging findings, so that our final assessment can best inform the government. Our analysis assumes no changes to current government water policy. The government has not asked us to assess any specific policy changes. Our analysis should not be taken as proposing any changes to government policy.

Contents

1. Issues raised by stakeholders	3
2. Stakeholder engagement process	20
3. Evidence submitted by stakeholders	26

1. Issues raised by stakeholders

In this report we outline some key issues that stakeholders have raised which could impact on the introduction of retail competition in the residential sector. We consider whether any of these issues could materially impact our assessment of the costs and benefits of introducing competition. For each issue we consider whether there is relevant evidence from the water sector or other sectors to assess how material it could be. Where there are relevant examples of how similar issues have been resolved in other sectors (such as the business retail market or the domestic energy market) we note how lessons may be drawn on in the residential retail market. The key issues we consider are:

- customer debt;
- customer support schemes;
- making the market work for all customers;
- retail exits and separation;
- counterparty and credit risk;
- customer engagement;

We discuss our analysis of each of these issues below. For each issue we:

- set out stakeholders' views; and
- provide our analysis and note any assumptions we have made on the issue in our emerging findings.

We also consider, at a high level, some additional issues which stakeholders have raised with us. These include customer contact and emergencies, disruptive technologies, customer data management, intermediaries, water resale, regional differences and legislation to introduce competition.

We have considered responses from stakeholders to our Call for Evidence, including discussions with stakeholders (including a number with experience in other sectors) in meetings. We have also taken account of our work with the sector on the arrangements for the business customer retail market opening in April 2017, as well as the Water 2020 work towards future water resource and bioresources markets. There are important parallels with this review and wherever relevant we have considered following the same approach, as synergies are likely to lower the total cost of implementation and potentially result in greater benefits. We have also recognised where there are differences in the regulatory and policy framework between residential retail and business retail as well as wholesale markets.

1.1 Customer debt

1.1.1 Stakeholder views

Respondents to our call for evidence identified risks to the successful implementation of competition in the residential retail market. In particular, they highlighted the significant and rising costs in the water sector associated with customer bad debt, and the limited mechanisms available to companies to tackle debt.

The two distinct points that stakeholders suggested that might deter new entrants are that:

- unlike in other markets where goods and services may be withdrawn as a result of non-payment, this is not the case in water and as such it would make the risks for new entrants higher than for other markets; and
- any arrangements which saw a customer's existing debts transfer on change of supplier would exacerbate this risk.

1.1.2 Analysis

Given the amount of debt currently outstanding in the water sector,¹ we understand that stakeholders consider this to be a major issue. We draw some observations below, based on a consideration with parallels with other sectors.

Firstly, as set out in the quantitative analysis, we expect that opening the market to competition will reduce bad debts as companies have better information on the identity of their customers and are incentivised to find better ways of mitigating bad debt risk.

Having discussed this issue with experts with knowledge of other sectors we consider that there are a number of potential mitigations for current debt which could be explored in any further analysis undertaken.

¹ In [Affordability and Debt 2014-15](#) we noted that there was £2.2bn of revenue outstanding in 2014.

These include distinguishing between customer debt that exists prior to the market being opened to competition and customer debt incurred after the opening of the market. If legacy debt is treated in a different fashion such that liabilities did not sit with retailers, then the market would open as a level playing field for incumbent retailers and new entrants. We understand the advantages of this approach, provided that any perverse incentives or other unintended consequences can be mitigated.

Alternatively, if debt is transferred to new suppliers, experience from the energy market suggests that it has been possible for losing and gaining suppliers to agree a financial adjustment to make the transfer acceptable to the latter. While the context in energy is different, this is also an approach which could be explored more fully.

From our analysis, we consider that evidence suggests that bad debt need not be a barrier to the introduction of retail competition. However, the government will need to consider this issue further if it decides in principle to proceed with introducing competition.

1.2 Customer support schemes

1.2.1 Stakeholder views

The majority of stakeholders who responded to our Call for Evidence noted that particular attention should be paid to how a competitive market would impact on customers in vulnerable circumstances. Stakeholders questioned whether existing support schemes, such as WaterSure and permitted social tariffs, could continue in a competitive market. Some stakeholders questioned whether new entrants to the market would be bound by the legislation that underpins the schemes. Stakeholders also asked how customers that currently benefit from these schemes might engage with the competitive market.

1.2.2 Analysis

We note that there are a variety of social support schemes that exist in the competitive energy market. Therefore on the broad question of whether social support schemes are compatible with a competitive market, there is evidence to suggest that this is possible. We consider that any assessment of the compatibility of existing support schemes is beyond the scope of this review.

For the purposes of our assessment of costs and benefits we have assumed that some form of social protection would be in place for customers in vulnerable circumstances. We have not taken any view on whether this protection would take the form of existing support schemes or some other form.

1.3 Making the market work for all customers

1.3.1 Stakeholder views

Stakeholders suggested to us that in a competitive market retailers would seek to mitigate risks by only targeting customers that they considered to be the most profitable (a practice known as “cherry picking”). In a competitive market, there is a risk that suppliers would actively avoid customers that they considered to be unprofitable such as customers with a poor payment history.

Stakeholders raised the potential for retailers to segment the market or differentiate between customers based on whether they are metered or unmetered, or differentiate by means of payment method. They suggested that this could create a barrier to customer switching, because less attractive offers would be available to some customers as a result. Stakeholders have also suggested that the absence of compulsory metering may inhibit the emergence of more innovative service offerings.

Some stakeholders argued that the practice of cherry picking would leave incumbents at a competitive disadvantage. They would have a customer base with a higher than average cost to serve than their competitors, and a disproportionately high number of indebted customers. It was also suggested that this practice would benefit customers who are typically cheaper to serve (such as those that pay by direct debit). Such customers tend to be more affluent. Respondents suggested that new entrants would seek to attract them with discounted offers. Less affluent customers, who are typically more expensive to serve, could lose out. It was suggested that less affluent customers are more likely to be in vulnerable circumstances. Not only would such customers not benefit from discounted offers, they might risk higher charges as their retailer would need to raise charges to cover the shortfall from the loss of profitable customers.

We have noted research from Water UK which illustrates cross subsidies that exist between different categories of customers and services. It suggested that certain customer groups, such as those with meters and paying by direct debit, were cheaper than average to serve even though (in cases where there is no direct debit discount) they pay equivalent charges to more expensive to serve customers. Such

customers tend to be more affluent and have a lower propensity to accumulate bad debt.

1.3.2 Analysis

On the basis of our qualitative analysis, we do not think that arguments relating to cherry picking have merit on balance. As noted in our emerging findings, we see value in a quantitative analysis of distributional impacts. For the purposes of our assessment of costs and benefits we assume that metering policy is unchanged, i.e. metering is not mandatory but customers can continue to request a meter installation. We have considered the evidence on the impact that the competitive process would have on reducing retail costs, including metering and bad debt, which arises from the sharper incentives on retailers to lower costs as part of their business model compared to combined wholesale and retail incumbents. These incentives also support other benefits associated with metering that lower the costs of wholesale activities.

Some stakeholders suggested that suppliers could profile customers by targeting tariff discounts (such as for example a discount for metered customers paying via direct debit). We think that this is an over-simplification of likely outcomes in a competitive market. In practice provided appropriate mitigations are incorporated into the market design to limit or neutralise exposure to debt (which we think plausible) then the incentive to aggressively cherry pick through such means would be considerably reduced as exposure to debt is the most significant factor in the cost to serve of different groups of customers.

With regards to the evidence of profiling around metering, in our view the evidence is mixed. Evidence submitted by some water companies demonstrates that metered customers are more likely to use cheaper to serve payment methods than some groups of unmetered customers. However, the correlation may arise in part as a result of greater customer interaction with metered customers (such as requesting the meter or submitting meter readings), allowing customers to select metered budget plans (an estimated amount paid by direct debit which gets reset periodically when meter readings are taken). Unmeasured customers would by default pay annually or six monthly in advance, unless they have proactively sought to pay by direct debit. Unmeasured customers who do pay by direct debit or in advance are actually cheaper to serve and therefore also attractive to target. Profiling customers purely on the basis of metering or paying by direct debit would therefore not be an optimal strategy.

We do not consider that the absence of uniform metering would hinder the introduction of competition. We also do not consider that metering is a pre-requisite for customers having choice in a competitive residential retail market. This is based on the conclusions of the Cave Review, and evidence on the introduction of competition into the business retail market. Although 90% of business customers are metered, the business retail market has been developed to accommodate unmetered customers. We anticipate that a competitive residential retail market may have some impact on metering but this will largely be determined by the market design.

Customers who prefer to pay using payment books (for instance in cash at the post office), are costlier to serve. These customer groups may also have less digital access to retailers' online offerings. In the energy sector, regulatory tools have been employed to mandate that certain methods of payment remain available. In our view this is a plausible approach for water if the government sees fit.

We have observed that customers in other markets are active rather than passive, and seek out new suppliers. Suppliers therefore have far less control over the customers they acquire than the theory of cherry-picking would suggest. Our assessment is that impacts only occur if retailers can target certain customer groups and if it is not profitable (rather than just relatively less profitable) for retailers to serve them. Distributional and commercial impacts on incumbent suppliers only emerge if there is an active market with engage customers switching to different service and price offerings. This point was recognised within the analysis for Water UK by ICS Consulting. We also take the view that in a competitive context, retailers have a clear incentive to develop strategies that minimise the cost of serving customers, which should benefit all customers. Customers making a choice of retailer will result in retailers understanding their customers need more than current suppliers do in the absence of a market. This is one of the main impacts expected from the introduction of the water business retail market and the same dynamic would apply to residential customers.

1.4 Retail exits and separation

1.4.1 Stakeholder views

Some stakeholders noted that for a competitive residential retail market to work effectively, arrangements would need to be in place to allow for water companies to separate their retail and wholesale activities, and then to exit the retail market. Stakeholders have suggested that arrangements being established for the business

market may offer lessons for the opening of the residential market. Some stakeholders have noted that incumbent retailers need to be able to exit the market, or merge or form joint ventures to achieve economies of scale or to facilitate market entry. Without this ability, the full benefits of competition may not be realised. These stakeholders see exit arrangements would be a prerequisite for competition. Links were also drawn to the issue of whether companies should be required to separate their retail functions from the rest of their business to ensure a level playing field between incumbents and new entrants.

Stakeholders also noted that if companies were allowed to exit the market, measures would be needed to safeguard customers in vulnerable situations. It was suggested to us that provisions such as those introduced to facilitate exit in the business retail market would be required as a minimum for residential customers. However some felt that these safeguards, on their own, would not be sufficient to address the needs of residential customers if their supplier were to exit the retail market. It was suggested that the provisions would need to work hand-in-hand with market and regulatory design to ensure consumers received adequate protection.

1.4.2 Analysis

We have considered what lessons might be drawn from the opening of the business retail market in April 2017. The introduction of the competitive market allows incumbent retailers to decide whether to continue to provide retail services to the business customers in their area of appointment. Currently water companies operate as integrated companies. They must provide both wholesale and retail services to all customers in their area of appointment. The legislation within the Water Act 2014 allows for retailers to exit the market, affording incumbents to opportunity to exit from the business market and sell their customer base on to an unrelated licensee. We have already seen in the business market evidence of companies recognising the benefit of retail exit and choosing to do so.² Alternatively, they may choose to outsource the entirety of their retail function to a retail service provider, or to obtain a new licence to compete outside of their area of appointment.

The Water Act 2014 introduced provisions for exit and separation. These allow water companies greater flexibility about their structure and commercial strategies to compete effectively in the business retail market. Some companies may choose to

² For example [Portsmouth Water's announcement of a partnership with Castle Water](#).

exit the retail market, while others may merge or form joint ventures. We have seen examples of both in the preparations for business retail market opening. Retail exit can help to reduce market opening costs (with exiting companies not obliged to fund start-up activity). Retail exit provisions open up other opportunities, such as allowing for new entrants to gain a market foothold through acquisition, and facilitating the achievement of efficiencies through economies of scope and scale.

In relation to company structure, a decision to allow, but not to require, business separation would align with the approach taken in relation to the business retail market. Without similar provision in the residential market, competition is likely to be less attractive to entrants, unless other mechanisms were introduced to ensure a level playing field between retail entrants and incumbents' retail activities.

The government has sought to ensure that business customers have access to the same standards of protection whether or not their undertaker chooses to exit the market. We are currently considering the required regulations to ensure this. To protect business customers in the event their supplier chooses to exit the retail market, proposed retail exit Regulations will establish a fair price for affected customers, a supplier of last resort regime, a supplier of first resort regime, and effective customer communication provisions. Our customer research for this review also identifies that residential customers would expect this type of process and communication. Companies must also comply with a customer protection code of practice which seeks to provide targeted protection to micro-businesses that some consider have similar characteristics to residential customers.

For the purposes of our assessment of costs and benefits we have assumed that some form of exit and separation arrangements would be implemented for the residential retail market in the event that competition was allowed.

Customers of an incumbent provider planning to exit the residential retail market (or any other change in its retail arrangements) would need appropriate protections. Similar provisions in place to facilitate exit in the business retail market provide an example of how this might be achieved. We also note from the business market that a particular focus on customer communication and protection would be necessary. This was a concern identified in our Customer Research and research undertaken by CCWater.

1.5 Counterparty and credit risk

1.5.1 Stakeholder views

A number of stakeholders have raised the issue of counterparty risk with us through our call for evidence and in meetings. Some stakeholders have suggested that counterparty risk is a normal part of business and arises from a combination of the credit terms and the collateral risk in a market. Thames Water submitted a report in response to our Call for Evidence which suggests that counterparty credit risk could either increase or decrease as a result of the implementation of residential retail competition. The report also suggests that, in the event of an increase in risk, changing credit ratings could ultimately affect the cost at which wholesalers can raise debt. The report also outlined that:

- many British utility markets require retailers to have strong credit ratings or provide collateral; and
- without mitigation, the failure of a retailer could be material to the market given the resulting impacts on customers, other market participants and levels of market confidence.

1.5.2 Analysis

For the purposes of our assessment of cost and benefits we have assumed that counterparty and credit risk involves a transfer of risk between different parties, but not an increase in overall risk. We assume therefore that suitable risk mitigation arrangements would be in place within a competitive market.

As part of the business retail market opening programme we have been working with KPMG to better understand how different credit and payment terms could impact the business retail water market sector from April 2017. The initial conclusion is that payment and credit terms have the potential to impact significantly on the effectiveness of the new retail market.

If the working capital arrangements for retailers are too onerous, this could inhibit their appetite to enter the market. This could impact the choice customers have and the quality of market outcomes. Similarly, allowing entrants into the sector without sufficient collateral increases the risk of those retailers going out of business, with detrimental impacts on wholesalers, customers and other market participants.

The consultation on the credit and collateral risk arrangements for the business retail market starts from the principle that the arrangements must represent a fair and efficient allocation of risk. In an effective competitive market where multiple buyers and sellers exist we would expect some risk sharing to be agreed between the two parties. For the business customer retail market we are proposing to mimic this competitive market arrangement and provide an efficient allocation of risk.

Supplies to customers are already protected in the current arrangements through special administration measures and, if competition were introduced in the residential market, provisions would continue to apply to wholesale services, which will protect retailers operating in the market. It may be that market protections from retailer failure may also be needed to protect customers who have paid retailers in advance.

1.6 Customer engagement

1.6.1 Stakeholder views

A number of stakeholders drew our attention to the ongoing energy market investigation and suggested that customer engagement might be an issue in a competitive water market.

1.6.2 Analysis

The CMA noted in its Energy market investigation – Final report document that domestic customer activity can be measured along several dimensions:

- Choice of tariff – notably whether the customer is on a standard variable tariff or a non-standard tariff.
- Choice of payment method – standard credit, direct debit or prepayment.
- Choice of supplier, for one or both of electricity and gas.

CMA noted that there is a “material percentage of customers who are disengaged in domestic retail energy markets” despite the substantial levels of savings available and, as such, it has developed a wide range of remedies that attempt to improve customer engagement. The remedies package consists of five broad categories of remedy, which focus on the role of different participants in the retail markets (Ofgem, the customer’s own supplier, third party intermediaries, and rival suppliers) in strengthening domestic customer engagement.

The report we commissioned from KPMG points to a number of lessons around customer engagement from energy markets. The report highlighted the need to stimulate customer engagement, particularly at the outset of retail market opening, and to account for the differing needs of different customer groups.

Our Customer Research and research carried out by Systra for CCWater explored how customers might engage in a residential water retail market. The CCWater research identified that whilst the majority of customers supported the principle of a competitive water market, potential bill savings of £4-£8 (representing 10% - 20% of the c£40 retail cost element of customer bills) that were presented in the research were far below what most customers expected, in the context of the total water bill. The research also suggested price was the major factor from market choice that was of interest to customers, as they were generally satisfied with current services.

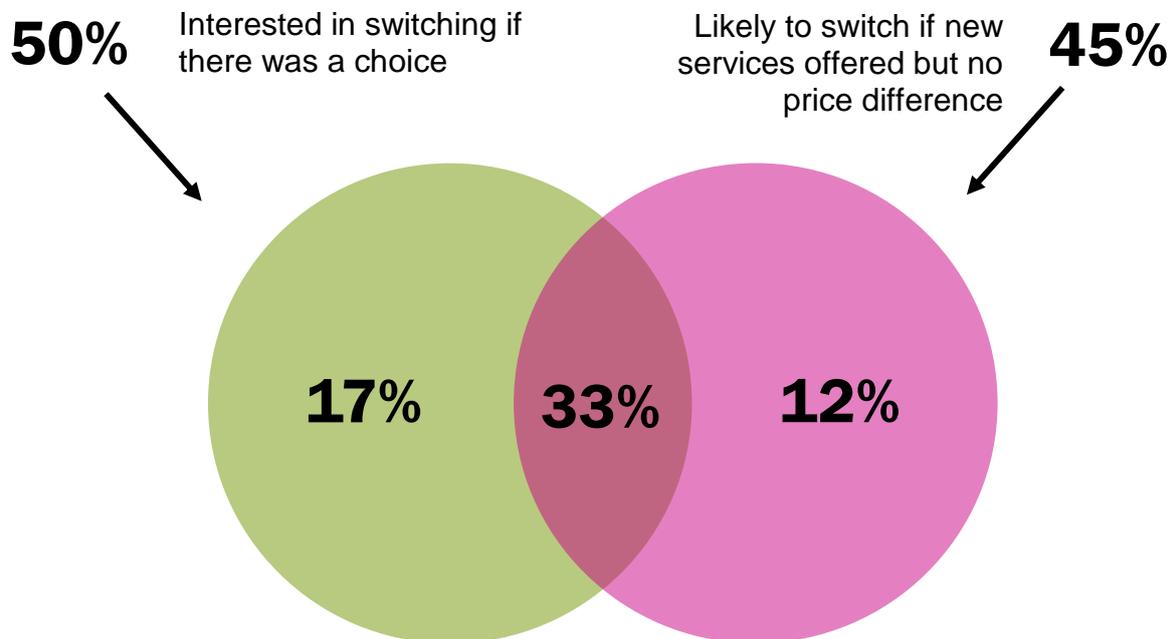
Our research confirmed that customers supported a market that was open to all residential customers as choice was important to the majority. Bill saving expectations in this market for the 50% likely to switch were on average 25% of their total bill. However, the likelihood to switch only reduced marginally from 50% to 45% when retailers offered new services (such as water efficiency) rather than a price reduction.

In our research just over a quarter of customers (27%) expressed loyalty to existing suppliers. They did not see the benefit of choice in the market, despite the large price savings that appeared to be on offer in the energy market. This group had a higher proportion of elderly people in it than other customer groups. Customers that indicated that they are less likely to switch were typically less engaged with technology, more likely to reside in social housing, and were more likely to be in situations of vulnerability or over 65 years of age. These demographic characteristics are consistent with those the CMA found were associated with low levels of engagement in the energy retail market.

The risks of loyalty to existing suppliers and disengagement from the market, particularly for elderly customers, may be lower in a water market than the energy market. Customer water demand is less sensitive to weather than energy used for heating. Water wholesale prices will remain subject to price controls, rather than fluctuating with production and generation costs. Lower price risks should help with market engagement, as it makes price comparisons easier.

Our research identified that whilst 50% of customers were interested in the market because of price, 45% were likely to switch because of new service offerings from retailers such as water efficiency.

Figure 1: Relationship between interest in switching and likelihood of switching if new services offered but no price difference



This evidence suggests that retailers will need to consider both price savings and service offerings and the existence of a diverse set of demands from customers may result in a some diversity in the approaches that new entrants take, with a range of retail models with scale price and ease of service offerings against those innovating with metering and other aspects of service.

We explored with customers emerging technology in the energy market. New intermediaries are introducing technology that has the potential to allow third parties to use customer data to minimise market deal search and switching costs.³ If combined with water efficiency services such approaches in the water market would create the potential for the market to attract customers with hassle free switching and a mixture of price and service offerings.

Third party intermediaries (TPIs), such as price comparison websites, can be a key element of the competitive market. However, we note evidence from the CMA banking and energy investigations that customers with internet access and

³ See for example [Flipper](#).

confidence to engage on-line were more likely than average to switch⁴ and that a broad range of approaches would be needed to ensure appropriate coverage across all customer groups. In our research of water customers 4% of customers were excluded from switching due to lack of digital access.

For the purposes of our analysis of costs and benefits we have made a range of assumptions around levels of engagement. These assumptions are reflected in our different scenarios, with our “lower cost, widespread innovation, strong competitive activity” scenario reflecting both higher available savings and greater input from other sectors, while our “higher costs, little innovation and weak competitive activity” scenario reflecting the opposite.

1.7 Other issues raised

Stakeholders raised a number of other issues, which we briefly explore below.

1.7.1 Customer contact and emergencies

A number of stakeholders have expressed concern relating to effective customer communication. They are concerned that if wholesale and retail activities are provided by different companies, this could introduce new challenges to communicate effectively with customers.

A split of retail and wholesale functions carries a risk of a breakdown in the communication chain which could adversely affect customers. This might affect communications with

- large customer populations (for example to communicate emergency measures during a period of drought);
- individual customers (for example relating to isolated emergency situations such as sewer flooding); and
- the responsibility for the maintenance and use of priority customer lists.

⁴ See for [Retail Banking Market Investigation Provisional Report Appendix 7.2](#)

Some stakeholders have suggested that the perception that switching supplier leads to less effective communication could undermine confidence in the market and inhibit the development of competition.

Our view is that similar risks were perceived in other markets (in particular gas). This issue has also been a consideration in the opening of the business retail water market. We have looked at the evidence from energy markets, arrangements for the opening of the business market, and arrangements that already exist within the residential sector in water. Taken together, the evidence suggests that the issues identified can be sensibly managed by defining arrangements emergency customer communications, and for maintaining and updating customer priority lists.

1.7.2 Disruptive technologies

A number of comparable sectors to water, such as banking and energy, have experienced a growth in new and disruptive technologies. These include ways in which customers interact with retailers, with markets, and with the use of products.

Innovations are often driven by online connectivity. New technologies are usually market-led, often by individual companies seeking to develop a market-leading innovation. However, there are also examples of industry coordination driving innovation (such as the development of the Faster Payments System in banking, and overlay services such as contactless technology which use it) and government-mandated technology, such as smart meters in energy.

New technologies can bring benefits to customers and greater potential for customer engagement. However, customers may be significantly disadvantaged if they are excluded from technologies that become industry standard. For example, customers without access to the internet are significantly less likely to switch energy supplier and are therefore likely to be on a higher tariff.

Technological changes driven by a market may exclude some groups of customers, particularly those without access to the internet. While such customers are a minority and technologies are unlikely to be adopted without a market pull, it will nonetheless be important to consider how benefits can be extended as widely as possible.

Our analysis identifies specific areas where the adoption of new technology might bring benefits to the water sector. These areas include (similar to the energy and banking sectors) ways of engaging with consumers and allowing consumers to engage with the market. There is also the scope for generating and using more

customer data (see next section). Smart technologies in the home, such as internal leak monitors, could also help consumers to improve water efficiency.

1.7.3 Customer data management

Retail competition will require the transfer of customer data between different retailers, wholesalers and possibly third parties (such as contracted meter readers). Data, both on a micro and macro scale, is important to efficient market operation, but also has a value in and of itself.

Companies currently store relevant customer data (where it is available) for the customers in their area. They may need to provide this to other companies or to an alternative retailer if their customers change suppliers. Some of this information such as whether the customer is on a priority service provision list is important to the potential new supplier. Both the Data Protection Act 1998 and the Water Industry Act 1991 restrict the circumstances in which such data can be shared.

We do not consider that data ownership is an issue that presents a barrier to competition, as similar issues are faced in other markets. Our view is that it presents opportunities for companies to innovate. We note that some technologies⁵ may mean companies take different approaches and market rules may need to accommodate this.

1.7.4 Intermediaries

The development of retail competition for water may, or may not, drive the development of intermediary services related to efficiency advice, switching advice or comparison websites. Licensees in the business market will be encouraged to work with intermediaries that sign up to a voluntary code of practice. Licensees are also required under the customer protection code of practice to obtain a letter of authority from that customer confirming that a TPI is acting on its behalf and setting out the scope of the authority of that TPI. The same approach being taken for micro-

⁵ For example Application Programming Interfaces (API) which enables sharing transaction data with third parties, and blockchain, which aids speed of transactions.

businesses in this market is likely to provide a good guide to the approach for the residential market.

Through our Call for Evidence we identified a concern that customers should be protected from mis-selling, and that we may need wider powers to directly regulate intermediaries (e.g. the same powers as the CMA and/or Ofgem). This may not be necessary and can be considered based on experience and learnings of the business water market in the design of any residential retail market.

1.7.5 Water resale

Water resale occurs when a customer of a water company provides water and/or waste water services to others using services provided by a water company. Possible examples of this can include caravan parks, blocks of flats and student accommodation. Currently, the Water Resale Order 2006 outlines the requirements on water resellers. It includes rules related to how much resellers operating as intermediaries can charge for water or waste water services they provide to someone's main home.

Customers of water resellers are not able to choose their own supplier as they are not a customer of an incumbent water company, rather of the water reseller. The regulatory protection for these customers is different to that provided directly to customers of the incumbents. There are provisions that prohibit resellers from re-selling services for any more than they paid for them, plus a small administration fee. However, the only enforcement option customers have when disputing a charge is to take private legal action, typically through the small claims court.

Should a residential retail market be introduced, we consider that the situation outlined above would not necessarily change. However, there is an option to review this position depending on the forms of tariff regulation that remain for customers who cannot or do not make a choice through the market.

1.7.6 Regional differences

The current water sector is effectively a group of regional monopolies. Because of this each company has its own specific requirements which are relevant to the area it is serving. Companies also choose to provide certain levels of services, subject to a required minimum, in order to deliver the outcomes local customers want and are willing to pay for. They may reflect local and regional differences in having differing approaches to similar problems such as leakage, or where they provide an amount

of compensation for service failures that goes beyond the statutory Guaranteed Service Standards (GSS) arrangements.

Regional differences in the amounts of compensation paid for wholesale arrangements (which include leak allowances) can be retained in a residential retail market, and this approach has been taken for the business retail market. For retail service standards, the business customer market approach was to set these on the GSS as a minimum, with incumbents publishing default tariffs that specified what level of service they currently provide. For the residential market, there is a choice between standardising a Universal Service Obligation (USO) or for this to include some regional element. GSS standardisation has advantages of simplicity in the national retail market from a customer perspective, but there is potential for regional variations to be incorporated. This does not appear to affect the quantification of costs and benefits of retail competition in a material way.

1.7.7 Legislation for a competitive residential retail market

The Water Act 2014 provided for the creation of an effective business retail market in water. However, residential premises are expressly excluded from the scope of regime introduced by the Water Act 2014. We therefore assume that new legislation will be required to extend competition into the residential retail market in England. We note that the Water Act 2014 allows for competition for business customers of companies whose areas are wholly or mainly in England. The boundary for residential retail competition is a matter for the UK and Welsh governments.

2. Stakeholder engagement process

In undertaking this review, we committed to do so in an open and transparent manner and to adopt a collaborative approach designed to draw on the expertise and insight of interested parties from across the water sector and beyond. To this end, we have used a range of different methods and have consulted extensively with the industry and other stakeholders to seek evidence to inform our analysis. This has included inviting written views and individual stakeholder contacts as well as wider stakeholder events. A summary of our engagement process is provided below.

2.1 Terms of reference and Call for Evidence

We wrote to [all companies on 4 December 2015](#) to explain the background to our review and to highlight the principles that we were proposing to adopt in undertaking it. And, on January 15 2016 we published our draft terms of reference. This was designed to provide companies and other stakeholders with information about the way that we intended to undertake the review, the areas of focus, key milestones and how we would engage with stakeholders. We also invited stakeholders' views on any possible refinements or gaps in our proposed approach.

We received 16 responses to the consultation on the draft terms of reference. These were mainly from water companies, and water and wastewater companies. We also received responses from CCWater and Citizens Advice as well as a response from a water customer and an academic. The responses to the consultation on the draft terms of reference were generally supportive. Some respondents stressed the need to capture the impacts on customers in vulnerable situations. Others highlighted the importance of taking account of customers' views and conduct in our analysis. The majority of respondents supported the range of scenarios that we were proposing to consider in the review, though some suggested that our focus should be narrower.

We issued a Call for Evidence on 18 January 2016. In doing so, we invited stakeholders to submit any information or evidence relating, in particular, to:

- existing studies and research that illustrate the benefits and risks of introducing competition to allow residential customers to choose their retail provider of water and wastewater services;
- market design, that may affect the analysis and your views on how these can best resolved;
- alternative competitive models and factors determining the impacts that each may have;

- evidence of customer views and attitudes to competition and the operation of retail markets in other sectors (not limited to utilities), as well as in the water sector; and
- the importance of choice to customers, including the kinds of choice that are important, and how competition can influence this.

In addition, we requested views on a number of specific questions:

- the advantages and disadvantages of extending competition to retail services in the water and wastewater sector to residential customers and how this could best be achieved;
- the scenarios for retail competition that could be considered in our analysis and the advantages and disadvantages of each for water and wastewater services for customers, the environment, wider society and investors;
- the additional risks or opportunities that we should capture in our analysis of potential competition scenarios; how these should be assessed; what would be necessary for each of the scenarios to be implemented successfully and the time period over which implementation could take place; and
- the interactions between residential water retail and other markets in the water sector and beyond.

The Call for Evidence closed on 17 February 2016. We received 16 responses, including 11 from regulated companies and three from consumer bodies. One response was marked confidential. The list of non-confidential respondents is set out below. We have published copies of the non-confidential responses received on our website. Some of the respondents also provided additional information or supporting evidence, which we set out in Chapter 3.

Respondents	
Anglian Water	Severn Trent Water
Bristol Water	South Staffordshire Water
Centre for Competition Policy	South West Water
Citizens Advice	Southern Water
CCWater	Thames Water
ICS Consulting	Thames Tideway
Money Advice Trust	United Utilities
Northumbrian Water	Welsh Water

In addition to the responses to the Call for Evidence and the additional material provided by individual companies, CCWater and Water UK also commissioned additional research to inform the review.

CCWater’s research, undertaken by SYSTRA, focused on customer attitudes to competition (and how attitudes had changed since the Ofwat/CCWater customer research in 2008). It also looked at customers’ expectations for price savings for competition in the water market. CCWater published its report on 20 May.

As part of the industry’s contribution to the evidence base for the review, Water UK also commissioned ICS Consulting to produce a report on the distributional impact of introducing household retail competition in the water sector. This was submitted to the review team on 18 April, who held a meeting with the authors on 5 May.

2.2 Stakeholder meetings and wider expertise

The timeframe for our review only allowed a short window for the submission of evidence. We therefore offered stakeholders an opportunity to engage bilaterally with the review team. This provided stakeholders who had submitted a written response to our Call for Evidence with an opportunity to discuss their submissions in more detail. It also offered stakeholders that had not responded to our Call for Evidence with an opportunity to share their views and direct us to potential sources of evidence that could inform our assessment. During the course of our review we met or had telephone conversations with the following companies and organisations.

Stakeholders calls and meetings		
Anglian Water	ICS Consulting	Thames Water
Avon Valley Water	Northumbrian Water	Water UK
Bristol Water	Ofgem	Waterwise
CCWater	Office of Rail and Road	Welsh Water
Competition and Markets Authority	Severn Trent Water	Wessex Water
Consumer Challenge Groups Chairs	South East Water	Which?
Civil Aviation Authority	South Staffordshire Water	United Utilities
Citizens Advice	South West Water	Yorkshire Water
Drinking Water Inspectorate	Sutton and East Surrey Water	

The main issues and topics raised by stakeholders in our one to one discussions mirrored those highlighted in the responses to our Call for Evidence. In addition to

our meetings with companies, consumer organisations and other interested stakeholders, we have also engaged on a regular basis with Defra and HMT.

We have also engaged with wider interested stakeholders who have approached us privately. Some of these stakeholders have wide experience in other sectors and have been helpful in indicating lessons which can be learnt from those sectors. Some have expressed specific interest in entering a competitive water and waste water retail market in England.

Additionally we have drawn on the expertise and experience within Ofwat, including our non-executive Board members and we have been advised by our Water2020 independent advisory panel which consists of multi-disciplined experienced experts from across a range of utility sectors.

2.3 Customer voice forum

To extend our understanding of the customer perspective on the issues associated with residential retail competition we engaged with a range of consumer representatives through our Customer Voice Forum. This online forum facilitates an open discussion to develop to explore issues in more detail.

The topics discussed with the forum broadly mirrored the customer online panel discussion, a copy of the script for this can be found in the Accent report. The stakeholder views in this paper were informed by the discussion. Key highlights included:

- how customer protection with a market could help to deliver increased customer satisfaction in the sector;
- aspects of a market that engaged customers with multi-utility switching, such as transparency over the individual utility components;
- discussion on the role special assistance registers could play in consumer protection in a competitive retail market; and
- what benefits of competition would make the market worthwhile, including a wide range of views about the long term impact on metering and water efficiency.

We are very grateful to the input we had from the consumer representatives, which helped us to test the emerging customer research findings as well as ensure suggesting potential mitigations based on the wide range of experience in consumer issues from both water and other sectors.

2.4 Stakeholder workshop

On 20 April 2016, in line with our commitment to undertake the review in an open and transparent manner and to draw on expertise and intelligence from across the water sector and beyond, we hosted a workshop in London.

The workshop was designed to provide an opportunity for us to update stakeholders on progress with our review and on our proposed approach to shortlisting the models for assessment. It also provided an opportunity for us to share some of our initial research findings and to hear from external experts on their experience of opening other utility markets to competition.

The workshop was attended by approximately 70 attendees. These included representatives from water companies, consumer groups, government departments (including HMT, Defra and Welsh government), other regulators (including Ofgem, the Office of Rail and Road (ORR), the Competition and Markets Authority (CMA), and the Payment Systems Regulator (PSR), consultancies and members of our Water 2020 advisory panel.

The workshop participants and main topics discussed are summarised below. We also published a more detailed note of the workshop on our website.

2.4.1 Introduction

Cathryn Ross (Ofwat Chief Executive) opened the workshop by welcoming attendees and reminding them of the context and objectives of the review. Giles Stevens (Ofwat Director) provided an update on progress and an overview of our approach to the review.

2.4.2 Customer research

Rob Sheldon (Accent) presented the findings from the first (deliberative) stage of consumer research undertaken for Ofwat. Paul Le Masurier (Systra) outlined the preliminary findings of the consumer research undertaken for CCWater.

2.4.3 Models of competition

Michael Pollitt (Professor of Business Economics, Cambridge University) provided an overview of models of retail competition in international electricity markets. He focused specifically on retail competition models used within the EU.

Hannah Cook (an Ofwat consultant) set out our framework for considering models of competition that could support the development of a competitive residential retail market.

2.4.4 Panel discussion

The final session was a panel discussion with Eileen Marshall (Independent Consultant), Alistair Buchanan (KPMG), Simon Carne (Independent Consultant), Chris Hemsley (ORR) and David Black (Ofwat). Before taking questions, four of the panel members gave short presentations reflecting on experiences of introducing competition in other utility sectors.

The panel then debated questions from the floor, including:

- the role of metering in the market;
- what a “good” retail market might look like;
- whether competition can help reduce the complexity of regulation; and
- whether the benefits of competition may be limited in a market that already experiences good levels of customer satisfaction.

3. Evidence submitted by stakeholders

In response to our Call for Evidence we received several reports commissioned by stakeholders (principally water companies). Some respondents also provided qualitative and/or quantitative evidence within their responses.

Summarised below is the non-confidential evidence that was submitted to us. We have published full non-confidential responses separately on our website. A number of reports have also been published at Water UK's [Marketplace of Ideas](#).

3.1 Anglian Water

Anglian Water undertook modelling to understand how the retail costs for different residential customer types vary for their customer base. Its analysis shows that underlying retail costs vary significantly when residential customers are considered by payment type.

Anglian Water argue that these variances could be more significant if residential retail competition results in the unwinding of the inherent cross subsidies which currently exist. This could increase bills for customers in vulnerable situations. It suggests that the sector needs to consider this issue further.

3.2 Bristol Water

Bristol Water submitted information which (among other issues) summarised research of its own customers (sample size of 300). This research revolved around levels of satisfaction across various utilities and attitudes towards utilities. The general conclusions were that satisfaction with water companies was generally higher than other utilities (though only marginally), and that price reduction in water was relatively low on the list of priorities for water customers.

3.3 Centre for Competition Policy

The Centre for Competition Policy's response included a theoretical assessment of the prospect of residential competition, which drew on its previous research and analysis in this area. This material explores:

- issues around the impact of partial metering roll out in a competitive context;

- the potential areas where competition could deliver benefits, including with respect to efficiency gains and price pressure; and
- the correlation between potential savings and switching, barriers to switching, the propensity of different groups of customers to switch, and the potential impact of bundled utility services.

3.4 CCWater

CCWater commissioned Systra to undertake customer research as a contribution to the Call for Evidence. The research included a series of qualitative focus groups, in depth interviews with customers in situations of vulnerability and a qualitative survey of 3,595 customers.

This research found that the majority of customers (c. 67%) are supportive of having a choice of retailer in a competitive water market. However, the likelihood of switching retailers in such a market fell from 58% to 32% once customers were aware of the £4 - £8 average price saving expectations used for the purposes of this research. The importance of clear messages to customers about the benefits from the market and policy protections that will be available were also highlighted.

The CCWater also submitted a literature review covering a number of previous studies. This included two past CCWater studies on the household sector (2008 and 2014), and four studies on non-household competition (January 2016, December 2014, November 2014 and July 2014). In each case it provides a summary of key findings. The household research of 2008 covered attitudes to competition, while the more recent 2014 research focussed on retail exit.

3.5 ICS consulting

ICS consulting submitted a summary of a 2010 survey of 3000 respondents on attitudes to competition in water, which was commissioned by DEFRA. The summary provides a demographic breakdown of attitudes by age, socio-economic group, and region.

3.6 Northumbrian Water

Northumbrian Water commissioned a report by Economic Insight that summarises four investigations into the energy market, starting with the energy supply probe in 2008 through to the current CMA investigation. It argues that the issues in the

energy market have arisen from a combination of supply side, demand side, and regulatory issues.

The key lessons/issues that it identified were:

- to understand the likely level of consumer engagement in the market;
- whether the inherent characteristics of water retail mean that the ability and/or incentive of customers to search and switch deals is likely to be low;
- whether safeguards to prevent suppliers engaging in practices that might reduce consumer engagement are needed (but to ensure any safeguards don't reduce suppliers incentives to compete; and
- to look at comparator retail markets (such as water in Scotland).

3.7 Severn Trent Water

Severn Trent Water commissioned a report by Economic Insight on the introduction of retail competition in six other markets. The report looked at electricity and gas in New South Wales in Australia, electricity in GB, electricity in California, telecoms in UK, and water in Scotland. Each market used a retail price control as part of market opening.

The report considers features of these retail price controls including operating costs, other costs (networks), and margins. It also reviews the context for decision making for each control and how this influenced the final design.

EI identified seven key issues in determining the appropriate form of control, before outlining some specific issues it considers that we should take account of at market opening. The key messages include

- the inter-relationship between regulated prices and initial levels of competition;
- the importance of brand for suppliers;
- regional v national controls;
- pricing flexibility;
- duration of initial controls;
- common controls for household and non-household; and
- the importance of consumer engagement.

3.8 Thames Water

Thames Water commissioned FTI Consulting to consider the impact of opening the residential retail market to competition on counterparty credit risk (i.e. the likelihood that the company will be able to collect its revenues from the entities it sells its services to).

The report suggests that regulatory and legislative protection for wholesalers may decrease if the market is opened. Because the companies would no longer be vertically integrated, they would likely not be able to request price control re-openers in response to an increase in bad debt costs. FTI also argue that there is a possibility that retail water businesses may not be creditworthy counterparties. These factors coupled with the likelihood of material losses if a retail water business were to default lead FTI to suggest that without mitigating actions counterparty credit risk may rise. The paper then asserts that a suite of proposals developed by companies, Ofwat and government could address this risk by reducing the chance of default by retail water businesses and decrease losses given default.

Thames Water also submitted a report from consultant Britain Thinks. This report is informed by an online panel discussion with 56 customers on their perceptions of competition. The report acknowledged that the sample size was both small and better informed than average, as panel members had previously undertaken customer research with Thames Water. It also acknowledged that the evidence was qualitative rather than quantitative. The survey suggested that customers were generally positive around the concept of competition (while recognising the potential downsides). However, propensity to switch tended to be fairly low and moved marginally downwards when the actual size of likely savings was revealed (and less likely than business customers also surveyed, although there are large margins for error on the sample sizes).

3.9 United Utilities

United Utilities provided some analysis on customers in financial circumstances that make them vulnerable. Its data includes government analysis of the demographics of customers in debt on their household bills, and the drivers of that debt. It also included its own analysis of factors affecting the cost to serve such customers and the underlying drivers of these costs. It provided a narrative around customer assistance schemes, the cost breakdowns of its own support schemes, and the overall value of these schemes.

3.10 Water UK

Water UK commissioned ICS Consulting to consider the distributional impacts of the introduction of residential retail competition on cross subsidies between different categories of customers and services. The report is based on data representing just over half of the total number of households supplied with water and sewerage services in England and Wales (12 million).

The results suggest that households which are most likely to be in debt are among the bottom 30% of household incomes, do not pay on direct debit and receive large cross subsidies from those in the top 30% and paying through direct debit. ICS's modelling suggests that the overall cross subsidy recoverable from current retail charges could decrease with the introduction of residential retail competition if policy and regulatory measures are not implemented to mitigate the distribution impacts of retail switching. This could reduce the ability of incumbent companies to assist households in circumstances that make them vulnerable.

3.11 Welsh Water

Welsh Water provided information from its own records on the cost to serve customers across different payment methods. The information that it provided indicates a differential of £15 between direct debit and payment card (from £7 to £22). Welsh Water suggested this understates the true differential, as it excludes customer contact methods. It also suggested that debt collection costs were, on average, £150. It noted its data excluded bad debt and some other costs.