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Trust in water

Costs and benefits of introducing competition to residential customers in England – emerging findings technical appendix 2

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About this document

This document is the second technical appendix to our report the costs and benefits of extending competition to residential customers in England – emerging findings.

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 undertook to consider the possible options for introducing competition through examining different approaches. This would include approaches where companies competed for the right to be a monopoly provider of retail services ("for the market" models) and approaches where companies contested to serve individual customers ("in the market" models). We also undertook to consider the range of services that should be open to competition and whether competition should be extended to all customers, or a narrower range of customers. We set out our findings in this document.

Contents

1. Introduction

1.1 Our approach

In our Terms of Reference for the Review we undertook to examine different approaches for introducing competition for residential retail customers in England. We said we would:

> review the possible options for introducing competition; ranging from competition for the market to competition in the market… competitive retail market scenarios could be expected to include: a "thin" retail market: where the scope of activities is limited to providing core retail services, such as billing and payment handling; a "thick" retail market: where the scope of activities that retailers could undertake is broader; a "narrow" market: where a specific sub-set or sub-sets of residential customers are contestable; and a "wide" market: where all residential customers are contestable.

As part of our review we have looked at a variety of competition models. We have tested these with customers through our customer research, and we also sought the views of a broad range of stakeholders, initially through our call for evidence, and then latterly through follow-up discussions and at our first stakeholder event in April where we set out our provisional thoughts.

The consistent feedback we have received from customers and stakeholders is that there is a preference for an "in the market" model of competition that is open to as wide a range of customers as possible and that focuses on core retail services. This is consistent with the aims set out by Government in A Better Deal, which referenced providing consumers with more choice and benefitting consumers widely.

The assumptions in our assessment are therefore consistent with a competition model that incorporates all customers and focuses on a model that incorporates all customers and focuses on core retail services. However, we note that if Government decides to proceed with the introduction of competition into the residential retail market it could choose a different approach. In this document we set out our analysis of the possible range of competition models as we described in our Terms of Reference.

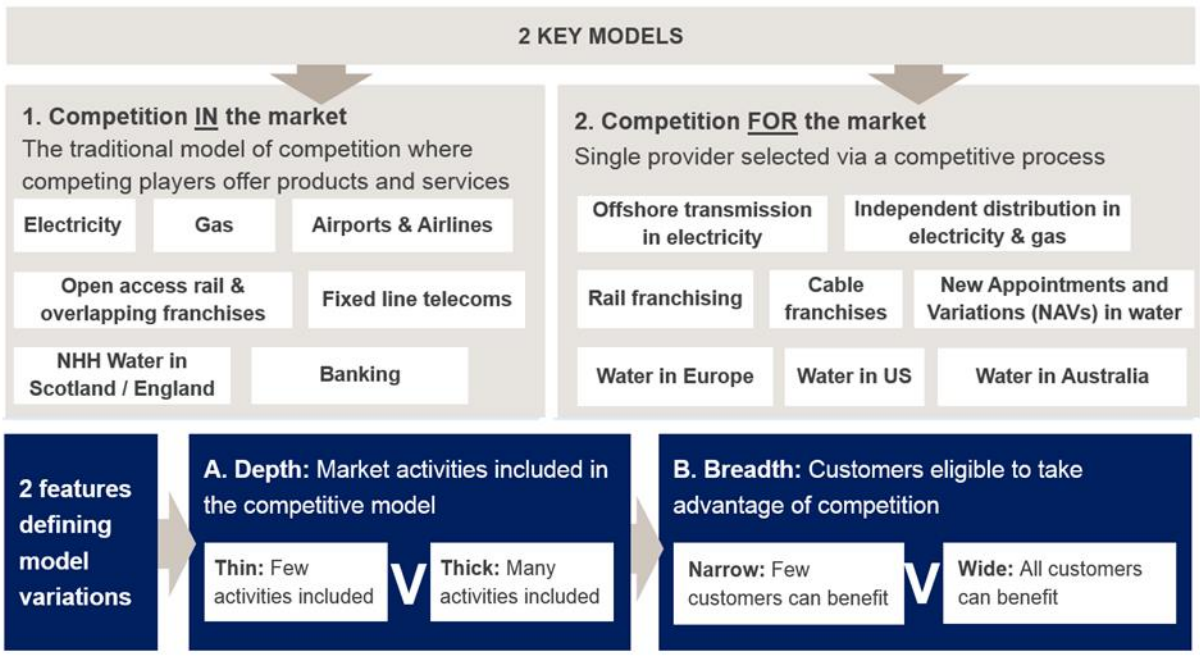
1.2 Overarching competition models

There are numerous models of competition from which lessons for the residential retail market can be learned, including insights on elements that could deliver desired customer outcomes and those that may not.

At one extreme, an approach to stimulate competition could be light-touch and encourage competition only at the fringes. This would require regulatory (as opposed to market structure) changes. For example, it could see third party collaboration facilitating innovation in retail offerings through a 'reasonable endeavours' licence condition that required incumbents to engage with third parties in the development of any such offerings. At the other extreme, the definition of the residential retail market could be interpreted more broadly, incorporating metering or network assets and allowing all customers to choose their provider.

To assess properly the possible costs and benefits of various competition model options that would support the formal opening of the residential retail market, we adopted an approach that looked at a broad cross-section of potential options. We undertook extensive research into other regulated markets both in the UK and internationally. We then identified and adopted a structured approach to assessing a range of potential competition models. The structure is illustrated in figure 1 below and discussed in more detail in the following sections.

Figure 1: Structure used to consider competition models



Under the approach adopted we identified two overarching competition models:

- Competition 'in' the market which can be viewed as the traditional model of competition where competing players offer products and services to customers within a market; and
- Competition 'for' the market where a single provider for a defined product or service within a market is selected via a competitive process.

The major difference in market design is related to the time at which competitive forces impact company decisions. Under an 'in' the market model, competitive forces endure over any given period whereas within a 'for' the market approach, competitive forces are only at play prior to the award of the contract to a designated company or franchisee, e.g. in the run up to an auction or other competitive tender. Experience indicates that a competition 'for' the market model is typically deployed in regulated markets with a significant asset base e.g. in rail.

1.2.1 Competition in the market

The key benefit of competition 'in' the market can be linked to the active choice customers would have, the continuous delivery of competitive benefits throughout a given period, and the potential for reduced regulatory costs. For these benefits to be maximised, three conditions are likely to be evident.

- **Rivalry:** There needs to be a realistic prospect of competitive market entry, or at least a realistic threat of new entry, to impact the decision-making of the incumbents in respective water regions;
- **Engaged customers:** Customers need to be willing and able to consider alternative offerings from new entrants and have access to resources that support informed choices, to impact the decision-making of companies operating in each region; and
- **Strategic company behaviour:** The combination of market rivalry and engaged customers, should provide incentives for companies operating in the market to follow a strategy that results in lower prices and / or higher quality as well as maintaining cost pressures.

The criteria above encapsulate the key conditions required to support effective competition. While some competition narratives refer to market shares, switching and investment requirements, these structural outcomes are ultimately heavily influenced by levels of rivalry in, customer engagement with, and investment barriers evident within a given market. We therefore need to look beyond market structure criteria and toward the fundamental drivers that will actively influence company strategy and ultimately determine whether competition is effective.

1.2.2 Competition for the market

The key benefit of competition 'for' the market can be linked to the consistent, non-discriminatory treatment it offers to all customers and the fact that delivery of desired outcomes is not generally contingent on achieving a particular form or level of market entry. In addition, deploying a 'for' the market model in an industry such as water with a mature regulatory framework could support identification of potential future efficiencies in parts of the value chain. For example, as part of Water 2020, a 'for' the market approach is being proposed for sludge and water resource markets; and estimates suggest benefits that the Net Present Value of these benefits over 30 years could equate to £780 million.[1]

A key drawback of this model is linked to the fact that competitive benefits mainly accumulate at the time of an auction / franchise award; on the flip side, this can stimulate significant and rapid innovation by companies seeking to 'win' the action. This model also had very little support amongst customers – just 11% of customers in our research were in favour of this approach. This correlates with another finding of the research that customers generally supported the concept of choice. Another potential downside is that there can be higher regulatory costs associated with the administration of franchise arrangements and, linked to this, evidence suggests competition 'for' the market models can reduce the flexibility companies have to innovate given the need to specify the details of the franchisee contract.

1.2.3 Hybrid approaches combining competition in and for the market

During the course of this review, our stakeholder engagement and customer research have indicated the view that competition 'in' the market represents the preferred form of competition; particularly given that it offers the right to choose to all customers, and presents the option to align the residential retail market to the business retail market scheduled to be opened in April 2017.

[1] Water 2020: our regulatory approach for water and wastewater services in England and Wales, page 112.

However this model may raise issues about the impact on some categories of customers, recognising that customer circumstances are varied and can change over time. We therefore considered a potential hybrid model of competition that draws on the best features of competition 'in' the market, where possible; and, recognises the specific circumstances of key customer groups which could mean that they receive less attractive retailer offerings. For example, as we noted in our stakeholder views and issues document, some stakeholders have argued that customers in debt may not be actively pursued by new entrant retailers and may therefore require specific regulatory protections. In addition, customers without meters will not be able to benefit from meter-specific innovation and might therefore benefit from tailored regulation that encourages competition at the fringes.

A hybrid competition model could deliver similar benefits to its counterpart model of competition 'in' the market while also recognising the specific circumstances of defined customer groups and supporting the provision of tailored services to these groups via an additional layer of regulatory provisions. The regulatory arrangements would be complemented by provisions that encourage competitive offerings for these groups of customers where possible (by encouraging third party collaboration).

Key drawbacks of this model are the potentially higher costs and complexity of administering different approaches for defined customer groups. It is possible that these costs would be smeared across all customers. Higher costs and complexity could result from the operation of a separate regulated framework alongside a competitive market model. This could affect customer costs and the attractiveness of the market to competitive entry.

Our customer research indicated a prevailing view that all customers should be treated equally alongside a recognition that it may make sense for retailers to limit switching in cases where customers have significant debt. Customer research completed by CCWater indicated that customers are unlikely to be supportive of an approach that treats defined groups differently.

If a hybrid competition model were deployed, customers would need to be able to effectively transfer from the group served via the regulated model to the competition 'in' the market model (and vice versa) given the transitory nature of circumstances.

1.3 Key competition model characteristics

Within the overarching models of competition, there are a range of approaches to competition determined by two key characteristics:

- **Market depth** refers to the proportion of the value chain and the activities within it that is opened up to competition. A thin water retail model could comprise billing while a thicker water retail market could incorporate assets (such as metering or network assets).
- **Market breadth** refers to the range of customers that are able to benefit from the competitive market. The different attributes of competition 'in' and competition 'for' the market models mean market breadth varies depending on the overarching competition model being considered, with thin being fewer customers able to engage in the market and thick being more customers able to engage in the market.

References to the breadth of the market vary according to the overarching model of competition adopted. In this respect, under a competition 'in' the market approach, the breadth refers to the volume of customers that can engage by actively choosing a retailer; either remaining with their existing supplier or switching. The competition 'in' the market approach, could be narrow (with few customers able to switch) or wide (where all customers can actively switch). A competition 'for' the market model has the greatest breadth under which companies would compete to serve all customers in the market; allowing every customer to benefit from competitive pressures.

1.4 Feedback on potential models of competition

We have carried out significant engagement as part of the review of residential retail competition which has enabled us to benefit from the range of views expressed by a range stakeholders. The key themes that have emerged from this engagement have been focused in the following areas.

- **Overarching models of competition:** A key piece of feedback through our Call for Evidence and engagement has been that competition 'in' the market is generally preferred by customers and other stakeholders, but competition 'for' the market may be suitable in certain circumstances.
- **Market depth:** During engagement, there has been extensive discussion about the appropriate depth of the residential 'retail' market. While the benefits of assessing all feasible options has been recognised, concerns have been expressed about incorporating network elements within the competitive market. In particular, commentators have suggested that this could lead to role confusion given the corresponding mix of responsibilities across service provision and asset management that retailers would be required to engage in. In addition, the 'deeper' competitive models may be considered to be outside of the scope of this review given that standard interpretations of 'retail' do not stretch to include

network assets. A deeper model would also be inconsistent with the business customer retail market, which would add to costs.

- **Market breadth:** During engagement on the residential retail review, there has been a general consensus from interested parties that customers should be central to any competition model and, in particular, that potential consumer outcomes should guide thinking in this area.
- **Innovation:** This has emerged as a key theme from our engagement. It is impossible to have certainty about exactly what form innovation may take and the outcomes it could facilitate but it is critical that any model adopted allows for innovation to take place where it would lead to customer benefits.

In addition to engagement with interested parties we have taken forward dedicated customer research on the form of possible competition models. We think it is critically important to understand the views of end customers with respect to the potential implementation of competition; in terms of their overall perception of the benefits of competition in water, the form that any model should take and the likely behavioural change that would be stimulated.

2. Models considered in depth

We took a broad approach to assessing a range of models that could be deployed to support competition in the residential retail market. Initially we shortlisted 10 potential models, comprising a spectrum of approaches drawing on the three overarching competition models as well as varied market depths and breadths. This reflected the importance we attached to understanding, at a high level, the potential costs and benefits that may accrue under each possible model.

The initial shortlist of 10 potential models therefore included some thicker options that envisaged retailers taking responsibility for meter ownership and maintenance as well as thick models that extended even further to network assets. Against the background that in A Better Deal: boosting competition to bring down bills for families and firms, the Government explicitly asked us to look into the costs and benefits of extending retail competition. We needed to be cognisant of the definition of retail that we were using. In this respect, we needed to have regard to the definition of retail used in the business water retail sector. In this case, retail includes billing, customer contact and meter reading and therefore, to extend competition to network assets (or meters) would require us to demonstrate significant potential benefits.

From the results of our initial analysis, we were not persuaded that the benefits from a thick or thicker model of competition would be sufficiently material to extend the scope of the residential retail review. While competitive forces would impact all aspects of the value chain, we had concerns that the establishment of retailers with responsibility for both customer services and asset management could deter market entry due to the wide portfolio of activities that would need to be managed and the broad skill set required.

Recognising this, and noting that competitive pressures could be extended in the future if retailer competition is shown to be effective, we refined our shortlist to four ‘thin’ models; comprising billing, customer contact and meter reading services. This shortlist is illustrated as a spectrum of breadths in Figure 2 below.

Figure 2: Shortlisted competition models

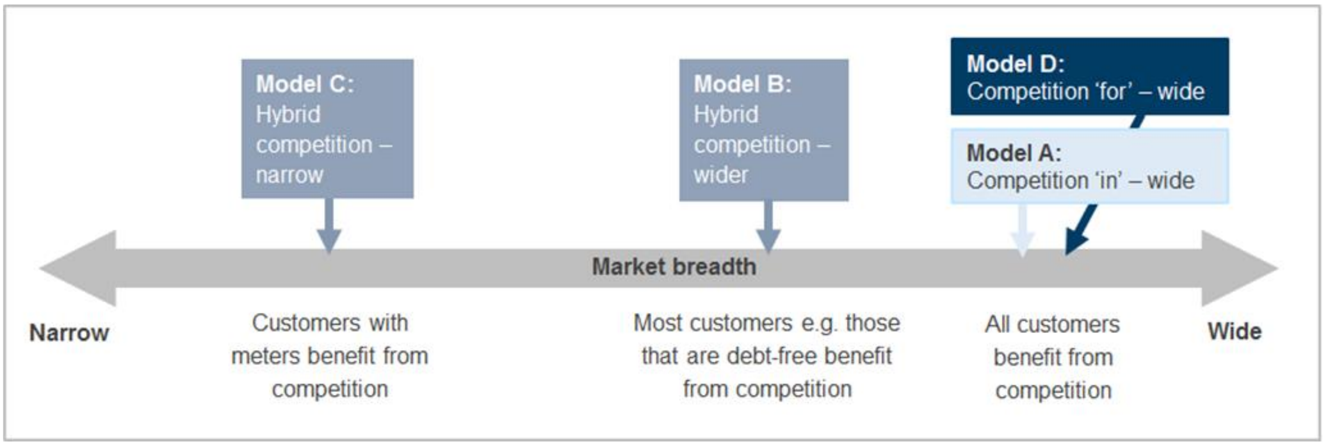


Figure 2 illustrates that the shortlisted competition models comprise at least one option from each of the overarching competition models as well as a spectrum of market breadths. The shortlisted models are as follows.

- Model A (competition 'in', thin and wide): pure retail-only model of competition for all residential customers;
- Model B (hybrid competition, thin and debt-free customers): the debt- inclusive model;
- Model C (hybrid competition, thin and customers with meters): the metering-inclusive model; and
- Model D (competition 'for', thin and wide): the franchise model.

The following sections provide an overview of each model, the incentives they could facilitate and the corresponding outcomes they may deliver.

2.1 Model A: a pure retail-only model of competition

Model A corresponds to a competition 'in' the market approach that is wide and has the following characteristics.

- **Thin:** The model includes only billing, customer contact and meter reading services; not meter ownership / maintenance or network assets; and
- **Wide:** Under this model all customers could benefit from the introduction of competition and would have an active choice over their retailer.

Model A can be considered analogous to the model of competition in the business retail water market in England. In this respect, it is a model in which billing and associated services are provided by a customer-facing provider, and under which all customers can effectively choose a retailer from a range of competing offers. The markets in which this model operates well are ones where customers are engaged in the market, there are low barriers to entry or exit (helping to increase rivalry), and adequate protections exist / can be established for customers that are in circumstances of vulnerability.

The key benefit of Model A is linked to the improved service that customers would receive from retailers that specialise in billing, customer contact and meter reading services. Under this model, the retailers' primary focus will be on their interaction with customers and they will be incentivised to establish tailored processes that are effective in delivering against customer needs; ultimately enhancing customer services that are offered. This is particularly relevant in a competitive market given that the threat of new entry will place incentives on retailers to maintain high standards of service to retain customers. In addition, the efficiencies that retailers attain through specialisation could lead to cost reductions which, in a competitive environment, are likely to be passed through to the end customer.

We considered whether significant additional benefits might be attained from a thicker model that also included metering as part of the retail model. Ultimately we concluded that the benefits from retailers owning meters would likely be limited and that the greatest benefit would be linked to the ability to access metering information. Although Model A would not allow retailers to directly determine the metering strategy, it will create incentives for them to influence the strategy adopted by wholesalers given that the deployment of meters is likely to give them greater flexibility in service offerings; helping them to retain / attract more customers. In addition, recognising the momentum behind energy metering given the smart meter roll out, corresponding technological- and / or cost-based benefits could emerge that have read-across to the water sector.

While all customers could benefit from competition under this approach, unintended consequences could result. In this respect, new entrant retailers may have greater incentives to acquire more attractive to serve customers that are affluent, do not have a history of bad debt and who pay their bills via direct debit. The corollary of this is that customers in debt or who have a history of bad debt may be relatively less attractive. This could lead to 'cherry-picking', whereby companies only actively pursue more desirable customers and do not offer products or services to customers that are in debt or have a history of not paying their bills. As a result, less desirable customers may not benefit from innovative or tailored retailer offerings.

2.2 Models B and C: hybrid models

Models B and C are very similar in construct, and mirror the features of Model A. They are competition 'in' the market models and have the following characteristics.

- **Thin:** The models include only billing, customer contact and meter reading services; not meter ownership / maintenance or network assets; and
- **Wider (Model B) / Narrow (Model C):** The major difference between Models A, B and C relates to the range of customers that benefit from a competition 'in' the market approach. Under Model A, all customers can effectively switch retailer while Models B and C place restrictions on participation via competition 'in' the market. Model B allows all customers without debt to switch while Model C enables all customers with a meter to switch. Under Models B and C, customers that do not have the ability to choose / switch retailer are served by a targeted regulatory approach that recognises the specific circumstances of the customer and encourages competition at the fringes that is targeted to their situation. In the case of Model B, regulatory provisions would protect customers in debt and encourage competition at the fringes that support effective debt management. Under Model C, regulation would acknowledge that these customers are not able to benefit from metering-based innovation and encourage collaborative offerings that support other types of innovative service offerings.

Given the similarities between Models B and C, we present them as part of the same discussion; drawing out relevant differences where applicable.

Models B and C have similar benefits to those detailed above regarding Model A given that much of the market will have the same design; a thin / wide competition 'in' the market model. In line with this, the key benefits of these models are linked to the potential for improved customer service and reduced costs resulting from retailer specialisation in billing / meter reading, and the incentives toward the evolution of a multi-utility model that could emerge.

In addition, Models B and C incorporate provisions that recognise customers specific circumstances and the potential impacts these could have on their ability to benefit from innovative retailer offerings. Models B and C have the following features.

- **Model B – the debt inclusive model:** The benefit of this model is the protection it could provide to customers that are in debt, recognising that they may be disadvantaged by 'cherry-picking'. The potential also exists for the regulated approach established for indebted customers to focus on effectively managing that debt; helping to support customers in reducing this burden and making the transition to the competition 'in' the market part of the sector.

- **Model C – the metering-inclusive model:** Model C does not seek to provide protections but rather acknowledges that customers without a meter will not be able to benefit from meter-specific innovation and associated service offerings.

In further progressing either of these high level models, a number of detailed market and regulatory design choices will need to be taken which will ultimately determine how market opening would benefit customers. In any event, a potentially significant downside of Models B and C is the cost and complexity that could be introduced due to the need to identify discrete customer groups, reflect changes in circumstances over time, and treat customers accordingly. For example, under Model B, a customer could find themselves in debt and be served under a regulated approach but indebtedness can be transitory and provisions will be needed to allow the customer to transition to the competition 'in' the market approach if they eradicate their debt.

2.3 Model D: a franchise model

Model D corresponds to a competition 'for' the market approach that has the following characteristics.

- **Thin:** The model includes only billing, customer contact and meter reading services; not meter ownership or maintenance; and
- **Wide:** Under model D all customers could benefit from the introduction of competition but, unlike Model A, Model D would not provide customers with an active choice over their water retailer. Instead, customers would be served by the retailer that had successfully 'won' the franchise to serve a discrete customer group via an auction.

Model D allows a number of companies to compete for the opportunity to attain however many franchises are let and, where they are successful, operate retail services. This model isn't typically used to inject competition into retail services in utilities; but it is used in some sectors, for example UK passenger rail franchises or in the electricity transmission network in the electricity Offshore Transmission model.

The key difference between Models A and D is the level of choice available to customers. Under Model A customers have full choice over their supplier while under Model D no active customer choice is available. Similarly to Model A, Model D could facilitate improved customer service and reduced costs from billing and meter reading specialisation as well as placing incentives on wholesalers to deliver enhanced programmes of meter roll out. In addition, Model D could help to secure benefits for customer segments that may be unattractive to competing retailers, and for customers who would be less engaged in a competition 'in' the market model.