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8th August 2016

Dear Ofwat

Thank you for the opportunity to provide further evidence and views on your emerging findings of the costs and benefits of introducing competition to residential customers in England.

We welcome the thoughtful, evidence-based approach that Ofwat has taken to this review so far.

We recognise that the views of customers should be paramount in the decision as to whether retail competition should be introduced, and that the results of customer research show a clear appetite for greater choice. Management of customer expectations may be a significant challenge, given that the level of bill savings achievable are likely to be relatively low, but it is notable that 45% customers express a desire to switch for new services even if no bill saving was provided – further revealed behaviour experiments may be required to support whether this would actually occur in practice, particularly given the uncertainty of the level of benefit of introducing competition to residential customers.

We are supportive of the overall direction of travel in providing more choice to customers where it is practical and cost-beneficial to do so. As we are well advanced in the process towards retail market opening for business customers in April 2017, we see extension of that market to all customers as a logical step but question if it would be better to look at outcomes post April 2017 before defining the required next steps for residential customers.

We are mindful that many of the benefits of retail competition may be achieved by the industry in any case under the existing regulatory incentive regime. Incumbent companies will continue to seek efficiency, innovation and to improve customer satisfaction, and continued strong links with the wholesale business will support the quest for greater water efficiency and demand reduction.

We provide some comments and further evidence to each of the sections of your report below.

I hope that you will find our response helpful. If you have any questions, please do not hesitate to contact me.

Kind regards

Keith Hutton
Director of Strategy and Regulation

Section 1 - Assumptions

Metering and Disconnection

We agree that it is fair to assume no immediate change in disconnection or metering policies prior to market opening, as these are a matter for government. However, it may be useful to set out how these policies may need to be adapted post market opening. In particular, as many of the benefits from competition through demand reduction would only be applicable to metered customers, it may be that government and Ofwat would need to support companies in a move towards universal metering faster than would otherwise have been expected. Given the potential conflicting incentives on wholesalers and retailers it may also be necessary to revisit the issue of meter ownership between wholesalers and retailers.

Recognising the need for universal provision of water supplies, we would support retention of the ban on domestic disconnections, but further provisions may be required to ensure that a level playing field is created with regard to debt collection, and that all retailers retain an equal obligation with regards to bad debt.

Market Exit

The experience to date of the non-household retail market has been of retail exit by several incumbent companies. It is possible that some incumbents would wish to pursue a similar strategy in the event of household market opening, and therefore we believe it is appropriate that provision for such exits to be included in the analysis.

Social Tariffs

We offer a number of social tariffs and find them to be an effective tool in helping customers with affordability problems. These social tariffs are currently cross-subsidised by the rest of our customers, to a level of subsidy agreed with customers through customer research. We think that provision for such tariffs should be encouraged in the event of market opening, but note that cross-subsidy arrangements may be more complex in a competitive market, and as the cross subsidy may increase the level of the overall bill some retailers may prefer not to offer such tariffs. To ensure a level playing field, it may be that some social tariffs should be mandated, with potentially greater standardisation. We do not consider that the level of support and protection for customers with affordability problems, including vulnerable customers on the WaterSure tariff, should be reduced as a consequence of competition, and would look to Ofwat and government to implement adequate measures to prevent this.

Section 2 – Qualitative Analysis

The report notes[1] the potential customer service and convenience benefits that may arise from combined billing. We have operated a combined billing service with Wessex Water since 2001, and consider that the results of this support customer preference for the service offered. For example,

[1] Emerging Findings, Page 10

both Bristol and Wessex Water were in the top four companies for SIM at PR14,[2] and both companies' retail costs are below the average industry cost to serve, and were allowed input price pressure adjustments due to the limited scope to absorb cost increases through further efficiency gains.[3] Whilst these results are not solely attributable to the combined billing service, we consider it to be a contributory factor.

The report notes the spread in satisfaction levels in the energy market, and that new entrants tend to out-perform former incumbents. We would be interested to explore the extent to which that trend is observable as the market matures, or whether previous incumbents that remain in the market are incentivised to improve customer service levels to match or better those of new entrants. However, we would agree with the general synopsis that the challenge of new entrants to the market should have a positive impact on the overall level of service to customers.

The consultation requests views on whether there is evidence of the values that customers place on the level of customer service.

Our response to the earlier call for evidence provided some relevant excerpts from the research we carried out to ascertain customers' priorities at PR14, including some elements of service that would be provided by retailers. Translating these priorities into valuations is more challenging as our willingness to pay studies did not explore retail issues. However, it may be possible to infer some valuations based on the priorities and valuations given for wholesale attributes. For example, the taste of water was given the same priority as 'resolving problems quickly with no quibbles', an improvement in the level of contacts from the status quo was valued at £4.96 so a similar valuation could be inferred for contact resolution. Retail attributes 'having a range of tariffs suitable for customers in different circumstances' and 'tell me about the benefits of metering' were deemed more important than avoiding hose pipe bans. The valuation for improving the level of hosepipe ban frequency is £0.96 so this could be assumed to be a minimum valuation for an improvement in the retail attributes. We would, however, recognise the inherent flaws in these extrapolations, and suggest that a more scientific willingness to pay exercise and/or revealed preference experiments would be required to produce more accurate valuations. It may be possible to incorporate these into companies' customer research programmes for PR19 business plans.

It may also be possible to test customers' satisfaction with the level of rewards and penalties provided by the current SIM, and whether these are an adequate reflection of customers' valuations. The reward Bristol Water received at PR14 of £0.6m per year is equal to an additional £1.25 per customer per year for good customer service, or if compared to the maximum penalty of 1%, an additional £3.75 per customer per year. It may be useful to compare these valuations with available evidence from other industries. Similar calculations may be applied to the Wessex Water SIM rewards to calculate the benefit of customer service from combined billing.

The paper identifies that a consequence of competition could be greater innovation in payment methods. Whilst we agree that this would be a likely consequence, we consider that such innovation is already suitably incentivised through economic regulation, and indeed this may be a preferable situation due to the protections it affords. Incumbent companies face an ongoing efficiency challenge, and within that comes an incentive to offer the most efficient means of collecting payments from customers. The SIM also incentivises companies to improve customer service, which

[2] PR14 Final Determination policy chapter A4, page 18
[3] PR14 Final Determination policy chapter A5, page 32

may also be achieved through innovation. The introduction of competition may encourage new entrants to compete through offering cheaper, innovative payment options, at the expense of more traditional options such as telephone or over the counter payments. However, for many older or vulnerable customers these more traditional methods may be the only options available to them, and so their access to the benefits of competition may be restricted by inability to access new payment methods. If previous incumbents were required to continue to offer a wider range of options than new entrants this may distort the level of costs in the market. It would therefore need to be considered whether it should be mandated that all market participants continue to offer a range of accessible payment methods, or whether they should be allowed to choose which methods to offer.

Section 3.1 – Quantitative Analysis

Bad Debt

We note the analysis that suggests the relatively high level of revenue outstanding in water compared with the electricity and gas industries is primarily attributable to poor information on customers held by water companies. We acknowledge this is an issue, particularly in rented accommodation, and would welcome further requirements on landlords to provide tenant details. This is less of an issue for energy companies as pre-payment meters can be used to avoid revenue collection issues in rented properties. There are around 4.5m pre-payment meters in use for electricity in the UK, and around 3.4m pre-payment meters in use for gas.[4]

The paper suggests that the ban on disconnection is not a significant factor in the differences in bad debt costs due to the low level of disconnections in the energy market. We consider that it the threat of disconnection helps to provide a sufficient incentive for energy customers to prioritise their bill payments, but suggest further evidence from debt advisory centres may be instructive on this matter. The impact of pre-payment meters is again a relevant factor in this analysis, as in the majority of cases these are installed as a debt management tool, and therefore used as an alternative to disconnection.[5] Pre-payment meters are no longer available to water companies as a result of the ban on disconnection, which includes the usage pre-payment meters which would effectively serve to disconnect the customer if payment was not made.

Comparison with Council Tax payments should take account of the difference in costs to councils and water companies in applying for court orders to collect payments or claims on property. It should also be considered that councils do not face the same customer service incentives as utility companies, for example SIM, which reduces the risk of pursuing a more aggressive approach to revenue collection, such as the use of enforcement agents. Our experience is that over 40% of local council tax payment cases are passed to enforcement agents, which is an approach we rarely use due to the level of customer complaints it generates.

[4] Ofgem, "*Domestic Suppliers' Social Obligations: 2014 annual report*", 8 September 2015, p.31. https://www.ofgem.gov.uk/publications-and-updates/domestic-suppliers-social-obligations-2014-annual-report

[5] Ofgem, "*Domestic Suppliers' Social Obligations: 2014 annual report*", 8 September 2015, p.33. https://www.ofgem.gov.uk/publications-and-updates/domestic-suppliers-social-obligations-2014-annual-report

Metering Costs

We agree with the hypothesis that competition may drive efficiencies in metering costs in the longer term, through introduction of new technologies. However, the quantitative analysis should take into account the likely relative costs of new and existing technologies at the time of market opening. At present, smart meters are more expensive to obtain than standard meters, and whilst the reading costs are lower the net cost is still higher than for fitting and reading standard meters. Over the longer-term, reduction in the costs of smart meters should provide for efficiency savings.

Another issue which would need to be considered is meter ownership. At present, the wholesaler owns the meter. If this remained the case, this may limit the extent to which retailers are able to offer new technologies, as they would be limited by the decisions of wholesalers on choice of meters to fit. This in turn may be impacted by comparison of the additional cost of smart meters with potential savings from reduced demand (which would also reduce revenue). If retailers wish for wholesalers to install smart meters, some form of financial compensation would be required to cover the difference between a standard and smart meter.

We have produced an indicative calculation of the different costs of standard and smart meters, based on the experience of our billing company BWBSL, which shows that at present smart meters are expected to cost £1.90 more over the life of the meter. This analysis is shown in Table 1 below.

Table 1 - Analysis of Meter Costs

Type of Meter		Standard	Smart	Difference
Initial cost	A	£15	£60[6]	+£45
Additional time of meter reads	B	1 minute	nil	1 minute
Life expectancy of meter	C	15 years	15 years	Nil
Cost per minute per meter reading[7]	D	£0.55	£0.55	Nil
Reads per year	E	2	2	Nil
Cost over life of meter	F=A+(BxCxDxE)	£31.50	£60	£28.50
Cost per year	=F/C	£2.10	£4.00	£1.90

Source: BWBSL

Wholesale Cost Savings

The paper suggests that competitive retailers would put increased pressure on wholesalers to lower their costs. This may be particularly applicable to water resources abstraction and distribution of raw water, as well as bioresource processing by sewerage companies. Combined, these activities are

[6] We currently procure smart meters at £85/unit but consider this could be reduced if purchased in larger quantities
[7] Excludes back office functions, which are largely the same for both meter types

estimated to represent 25% of the customer's bill,[8] although we note that treatment activities are not expected to form part of the separate water resources price control.

We would agree that separated retailers would provide a strong voice on behalf of their customers in the price control process for wholesale companies, and that the impact of separation of upstream and bioresources controls may impose some competitive pressure on incumbent companies. However, wholesalers will continue to face distribution costs within the 'network+' monopoly, and it is not clear the extent to which pressure from retailers would be expected to reduce these. Comparisons across the industry will reveal differences in costs, but retailers may not possess the relevant information or expertise to replicate the role of Ofwat and challenge whether these differences are due to efficiency. We would envisage some form of regulatory price setting process to be maintained for networks, as has been the case in other industries where the network represents a natural monopoly such as energy and rail, and that this would continue to be informed by economic analysis of the scope for efficiency savings.

Water Efficiency Savings

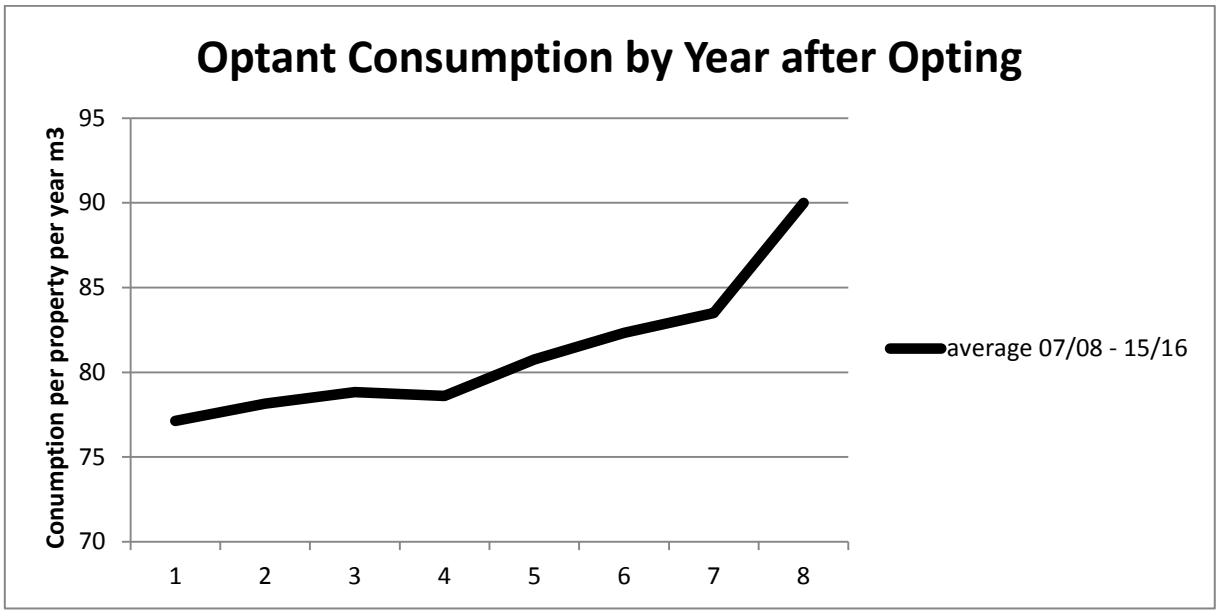
We agree with the suggestion that a key offering from new entrants could be advice on how to reduce water usage, through behavioural changes or installation of new water-efficient devices. As we note above, these products would mainly be beneficial to customers charged on a measured basis, which is currently around 50% of our customers.

The extent to which it is beneficial for retailers to pursue this activity will depend on the margins available. Offering these services may help to gain market share, but would also decrease the overall value of the market and revenue from customers. We also note that water remains a relatively cheap commodity in comparison to energy, and customers may be disappointed at the level of bill savings achievable. Indeed, it may be that visibility of the limited financial impact of demand reduction is counter-productive if customers do not consider it to be worthwhile.

The Walker review found that metering reduced consumption by 13m^3/household/year, and also delivered the benefit of reducing supply pipe leakage by 9m^3/household/year.[9] Our analysis, as shown in Figure 1 suggests that following the expected consumption reduction from the initial installation of the meter, in the eight years after opting demand increases by 17%. To some extent this may be explained by climatic effects on consumption in each year and further changes of occupancy in the property, whereby the new occupants have not deliberately set out to reduce their bill levels in the way that meter optants have, but it may also be taken as evidence that over time customers do not continue with water efficient practices.

[8] Emerging Findings, Page 48
[9] Walker Review, 2009, page 74

Figure 1 - Bristol Water analysis of optant consumption in years after opting



Source: Bristol Water / BWBSL

Resilience

We agree that any measures which contribute towards demand reduction will also contribute towards resilience of supplies, as less water will be required to meet customers' needs. Whilst we envisage resilience issues to primarily relate to the outage of a single key asset, for example the flooding of a treatment works, reduced demand could increase the possibility of obtaining sufficient water from elsewhere in the network or neighbouring companies. Through our PR14 willingness to pay research we obtained a valuation for reducing the possibility of longer term (2-3 week interruptions), which found that customers would pay £80.36 to reduce the potential interruption by each day. If the extent to which competition would reduce demand could be estimated, and an assumption made as to the extent which longer term outages would be reduced by lower demand, it may be possible to obtain the necessary valuation.

Section 3.2 – Scenarios

Implementation Timescales

The scenarios envisage that household competition could be introduced in between two and four years. Based on our experience of implementation of non-household competition we believe those timeframes are realistic.

Implementation and Running Costs

The scenarios for implementation costs range from roughly double the implementation costs of non-household competition, to four times that amount. Our initial analysis suggests implementation costs to our wholesale business would be approximately 2.5 times those for non-household

implementation. This reflects the extent to which system developments made for non-households could be extended to the wider customer base. Our estimate does not include central costs that would be payable to the central market operator, or the costs that would be incurred by retail businesses participating in the market.

Section 3.3 – Impacts on different customer groups

Assumptions needed to undertake rigorous distributional analysis

We have discussed above some of the policy decisions which may be required to support retail market opening, including in relation to payment options, metering and provision of social tariffs. These decisions could provide greater standardisation in the retail household market, which may help to limit the distributional impacts of the introduction of competition.

Factors it would be helpful for distributional analysis to address

The list of examples[10] includes the area of the country in which customers live, which is a factor predominantly because it determines the incumbent water company. This in turn determines the level of wholesale charges customers will pay, the extent to which upstream competition may impact water resource costs, and the retail charges they pay to their current monopoly supplier. It may be helpful to consider these issues more fully in the distributional analysis.

Evidence to support analysis

As discussed above, it may be helpful for the analysis to consider different levels of wholesale and retail bill currently paid. This analysis could be carried out for average metered and unmetered bills, and using current tariffs to calculate bills at various levels of metered consumption for measured customers and rateable value for unmeasured customers.

Information on numbers of customers currently on social tariffs and the discounts provided could be provided by companies and used to assess the distributional effects on those customers.

[10] Emerging findings, page 30