



Costs and benefits of introducing competition to residential customers in England

A response to Ofwat's emerging findings

1. Introduction

- 1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and wastewater customers in England and Wales. CCWater has four regional committees in England and a committee for Wales.
- 1.2 We welcome the opportunity to respond to the emerging findings from Ofwat's cost benefit analysis of introducing residential household retail competition to the water and wastewater sectors in England.

2. Executive summary

2.1 CCWater has been supportive of the introduction of competition for non-household customers in England from April 2017, and has approached the idea of extending the competitive market to household customers with an open mind. Research commissioned by CCWater and Ofwat in 2016 has shown that the majority of household customers support the idea of having a choice of supplier, so we would support the introduction of a market that works for customers.

2.2 In considering Ofwat's emerging findings, we believe that a household retail market must reflect the following key criteria if it is to be a success:

- It must deliver a real choice to customers to reflect the views expressed in research undertaken by both Ofwat and CCWater.
- It must offer customers bill savings that do not disappoint.
- There must be sufficient competitive pressure on retailers to prevent price rises and deterioration in customer services, including complaint management.
- The overall cost benefit of introducing household retail competition must be positive for customers.

2.3 It is in that context that we have reviewed each of the scenarios in the emerging findings, and have come to the following view based on evidence from customer research and experience in the energy sector:

- Scenario 1 - highly unlikely
- Scenario 2 - unlikely
- Scenario 3 - possible but unlikely
- Scenario 4 - quite likely but undesirable

2.4 For each of the four scenarios:

- We do not believe that customers will switch in the numbers assumed for the limited savings on offer. Although a majority of customers would welcome a choice of who provides their retail services, savings of over £40 per annum would be required to encourage consideration of switching. The emerging findings assume that the extent of savings to be £6 per annum at best. Only 6% of customers in CCWater's research said they would switch for a saving of between £1 and £10. Less than 2% of customers in Ofwat's research said they would switch for savings of £4 to £8. This is unsurprising as customer switching rates in the energy sector have been between 12% and 15% per annum despite available savings being many multiples of the savings available in water.

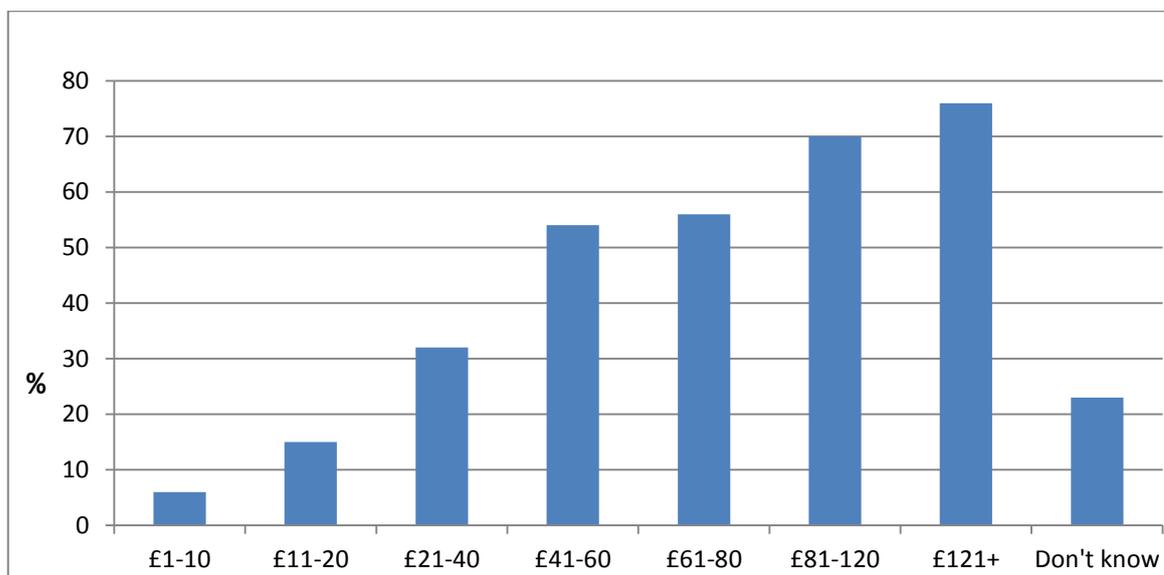
- Although there is some customer appetite for bundled services or bundled billing on their own merits this should not be overestimated. Research carried out by Ofgem in 2004, when the energy market was still evolving, identified that price drove customer switching behaviour with bundling attractive to a small minority of customers. Further research in 2014 confirmed the earlier findings.
 - We consider that the low margins available and the projected lengthy return on investment may have two effects. First, it may limit entry into the market as customer acquisition costs will further squeeze margins to a point where participation is viewed as uneconomic. Secondly, given low margins, there is likely to be very little value in market participants providing value added services unless these are positioned as a premium service, and paid for by those customers receiving them.
 - We consider that the assumptions regarding year-on-year reductions in bad debt might be overstated, and the parallels drawn with the energy sector are misleading. Although the number of energy customers disconnected for non-payment is historically low, the energy companies have two debt recovery tools at their disposal - the threat of disconnection and the installation of pre-payment meters. Neither is available to water companies, and nor should they be.
 - We consider that the set-up and on-going costs of a household retail market require further consideration. We understand that the costs incurred by water companies in setting up the non-household retail market are at least twice those stated in the emerging findings.
- 2.5 In summary, we consider that the costs and benefits associated with the development of a household retail market fall somewhere between scenarios 3 and 4. We would like to see further work to tighten up the assumptions across all the scenarios. If this shows that there is a benefit to be derived by customers, then there is a case for the market to go forward. But if this reveals that there is likely to be a negative cost benefit case, then then this a case to not take the market forward.
- 2.6 There is a risk that a household market could result in an absence of competitive pressure on retailers leading to higher prices than necessary, increasing complaints, and disadvantage customers who are viewed as too costly to serve. These potential negative impacts for water customers could echo the Competition and Markets Authority's findings from its inquiry into the competitive energy market. This found that energy companies had generated £1.4billion of revenue due to charges higher than the available competitive price. A competitive water market that doesn't work for all customers would damage trust and confidence in the sector, and damage the reputation of those regulating it, as it has done in energy.
- 2.7 A household retail market must, therefore, meet customers' expectations so that it does not disappoint them. If there is a low level of market entry and low customer engagement, Ofwat may need to regulate the market in order to protect customers' interests and reduce the risk of potential negative customer impacts, as listed in scenario 4, arising.
- 2.8 We recognise that the costs and benefits of a household retail market are likely to change over time. Any move towards the market must therefore proceed cautiously, and only when there is clear evidence to suggest it will function correctly. The introduction of the non-household market, and particularly the activity of small and medium enterprises within it, should provide this evidence.

3. Comments on the emerging findings

Household customers’ views and expectations

- 3.1 If the introduction of household retail competition is to be a success, it is important that such a market offers customers value that motivates them to engage with it successfully.
- 3.2 Our research on customers’ views and expectations of household competition¹ revealed that 56% of customers approve of having choice of supplier, and 58% would consider switching if choice was available. However, this is tempered as the majority of customers expect a price incentive to switch retailer.
- 3.3 The graph below summarises our research on the level of saving customers said they would need to gain annually in order to consider switching (based on their own water and wastewater bills).

Figure1: Percentage of household customers who would consider switching for the specified savings (cumulative)



- 3.4 When informed that the potential saving could be in the region of £4 to £8, 64% of customers indicated that they are unlikely to consider switching. The majority of customers would want to see savings of £40 or more to consider switching. Only 6% said they would switch for a saving of between £1 and £10.
- 3.5 Ofwat’s research² revealed broadly similar results. Less than 2% of customers said savings of £4 to £8 were worth switching for, and only 6% of customers considered it worthwhile even if savings were 5% or less of the total bill (i.e. up to £19). The average expectation from those surveyed was a 25% saving (£96) to make it worthwhile.

¹ Floating the Idea – Household customers views on water market reform in England (Systra Research for CCWater, May 2016) [here](#).

² Customer response to competition in the residential water market (Accent research for Ofwat, July 2016) [here](#).

Switching rates

- 3.6 Customers' views of the price signals needed to motivate engagement with the market do not sit well with the four scenarios within Ofwat's cost benefit analysis. At one end of the scale, Scenario 1 assumes a net benefit of £2.3bn over 30 years derived from a strongly competitive market that offers customers, on average, a £6 annual bill saving. This assumes that 50% of customers will be active in the market after 10 years, with up to 30% of customers switching.
- 3.7 Yet, as Figure 1 shows, to achieve a 30% switching rate customers would expect an annual saving of between £21 and £40, which at current rates represents between one-half and the entirety of the retail element of the average annual water and sewerage bill.
- 3.8 At the other end of the scale, Scenario 4 assumes a disbenefit of £640m over 30 years with a cost of £1 on the average bill. In this scenario, market entry is lower, there are no residual benefits (such as more innovation and efficiency) with the result that there is limited customer activity in the market (15% of customers engaging with the market after 15 years).
- 3.9 It is hard to see customer activity in the market at 15% to 50% (across the four scenarios) or customer switching levels at the rate assumed by Ofwat when considering the price savings on offer.
- 3.10 Furthermore, in its review of the UK energy sector in 2016³, the Competition and Markets Authority (CMA) found that 56% of customers had never switched energy supplier, despite the savings available. Customer switching rates in energy varied between 12% and 15% in the period 2008 to 2014 for a potential bill reduction of around £200 or more on a dual fuel bill⁴, considerably greater than what is available in water⁵.
- 3.11 Given the price expectations set out by customers that participated in the CCWater and Ofwat research, and the evidence of switching in the energy sector, we question the level of customer activity and switching in scenarios 1 to 3, and whether the introduction of household retail competition will deliver customer benefits to the extent that Ofwat assume.
- 3.12 On a more positive note, we consider the assumption of a 'hassle free' switching process to be fair. This is the customer experience in the Scottish non-household retail market which suggests that the switching process is easier for customers in reality than the customer perception of this process.

Value added services

- 3.13 The household retail market will have inherently low margins which customer acquisition costs of £8 to £15 per customer will squeeze. As such, we question whether retailers will have the up-front financial capacity to offer customers some of the value added services mentioned in the emerging findings.

³ Energy market investigation, final report (Competition and Markets Authority, June 2016) [here](#).

⁴ Many households could save around £200 per year through switching energy supplier (Research and analysis for the Department of Energy and Climate Change, February 2016) [here](#)

⁵ State of the Energy Market Assessment 2014 (Ofgem, Office of Fair Trading and the Competition and Markets Authority) [here](#).

- 3.14 Combined/bundled utility bills Ofgem's 2004 assessment of the early years of the energy market, 1996 to 2004⁶, revealed that only 9% of energy customers switched supplier because they wanted to receive 'bundled' services. In contrast, 65% switched to secure a better price. Fast forward ten years and Ofgem's 2014 assessment reveals that, among customers who did switch energy supplier, 75.5% did so for price reasons. Only 5.5% switched for improved customer service, and only 4% because they were specifically attracted to 'bundled' dual fuel billing.
- 3.15 This finding was echoed in CCWater's and Ofwat's research of water customers' expectations of competition where price is by far the greater motivation for engaging with the market.
- 3.16 In this context we question whether the availability of bundled services would be a catalyst for much additional customer market activity without higher bill reduction incentives.
- 3.17 Wastewater meters The provision of wastewater meters to household customers is likely to be prohibitively expensive. At present this solid state technology is being trialled and, although the results are encouraging, it may be several years before these meters are mass produced. Current costs are around £500 but should reduce over time once mass production starts. However, for existing properties the cost of materials, equipment and labour for manholes to house these meters is estimated to cost at least £2,000, and these costs are unlikely to reduce over time. For new developments, the sizing of manholes could be amended to accommodate wastewater meters thus reducing overall costs. Nevertheless, in our view, wastewater meters are a distant prospect for household customers, and only likely to be available to a very small subset of customers.
- 3.18 Evidence from Scotland CCWater will publish qualitative research in August which, *inter alia*, gathered customers' views on the availability of value added services in the Scottish non-household retail market. This will show that customers in Scotland feel that they are receiving relatively few added value services, and have made their decisions to switch purely on price.

Bad debt costs

- 3.19 We recognise that the cost assumptions on reductions in bad debt are affected by factors that are hard to predict (such as wider economic factors that can affect household income and spending).
- 3.20 A report from the debt charity Step Change⁷ reveals that of the 1,800 clients surveyed 43% said that they were threatened with disconnection by energy suppliers for non-payment. Although only 1% of customers were actually disconnected, many were moved on to pre-payment meters. The threat of disconnection is clearly a debt management 'tool' for energy companies. It is difficult to see the 1% to 2% per annum bad debt savings being realised in Scenarios 1 to 3 in this context, given the absence of these 'tools' in the water sector.

Market set up and operating costs

- 3.21 Ofwat assumes that companies' set-up costs for a household market will be twice that of the equivalent cost for the non-household retail market. The assumptions range from

⁶ Domestic Competitive Market Review (Ofgem, April 2004) [here](#).

⁷ Creditor and debt collector conduct (Step Change, July 2016) [here](#).

£200m to £400m for set up costs and £20m to £40m for on-going costs. We have two issues with these assumptions.

- 3.22 First, although it would not be appropriate to scale-up non-household competition costs to the household market, we would welcome clarification on the rationale, evidence or justification behind the assumption that household market costs would be twice as high as non-household. We do recognise that some of the governance and codes work done for non-household competition will be, more or less, transferable to household competition. However, other costs relating to IT systems and data cleansing might be stand-alone costs.
- 3.23 Secondly, we understand that incumbent companies' non-household market set-up costs are already in excess of £200m and may still rise ahead of market opening. The September paper should reflect this fact.
- 3.24 We acknowledge that Ofwat's assessment of costs and benefits was not tasked with examining the policies and implementation actions needed to ensure there is a smooth switching process nor the consumer protection policies associated with the market. Nevertheless, it is unclear to what extent the costs and benefits associated with such processes and policies have been factored into the assessment of market operator and regulator costs. It would be helpful if the September paper was explicit on this point.

Customer awareness

- 3.25 Scenarios 1 to 3 assume that customers will be aware of the availability of the market and what it offers in order to reach the assumed levels of activity and switching. Raising customer awareness to a level that promotes customer activity could have significant cost implications, and it is unclear whether this has been factored into Ofwat's cost assumptions.

Wholesale charges

- 3.26 Ofwat assumes that retailers will be able to persuade companies to reduce their wholesale costs more successfully than Ofwat would be able to do (to a level that suggests a price drop beyond the retail margin), and that these improvements would be passed on to customers. It is unclear on what basis this claim is estimated.
- 3.27 CCWater has had success in persuading some companies to share the benefits of financial outperformance with customers. But this has been rarely been delivered as a price reduction for customers, is often non-recurrent and frequently through an investment that increases the company's Regulatory Capital Value. We think that retailers' ability to reduce wholesale charges to the extent envisaged may be over-estimated in the emerging findings.

Distributional analysis

- 3.28 Ofwat's estimated bill impacts are general assumptions across all household customers, but the distributional impact across customer groups may be very different. There is a risk that some customers will be inactive in the market because:
- They are 'unattractive' to retailers (low consuming water users, customers with bad debts, on a social tariff or similar, or are costly to serve because of their rural location); or

- They are inactive customers who are not motivated by the price savings or value added services on offer⁸.

3.29 For the September report, we suggest that Ofwat undertake distributional analysis.

Market detriment

3.30 In its 2016 review of the energy market, the CMA found that energy companies have generated around £1.4 billion of revenue due to charges raised with customers that were higher than the available ‘competitive’ price due to the low rate of switching in the sector⁹. This highlights that there could be a risk in the water sector of inactive customers being over-charged if they do not switch to a retailer offering a more competitive price.

3.31 Ofgem analysis shows that energy customers with financial difficulties, 15 to 34 year olds, social groups D and E, those in rented accommodation and ‘off line’ customers are more likely to have never switched energy supplier. We question to what extent is there a risk that some groups of customers could be ‘abandoned’ by the market. We would like to see Ofwat explore this further in the September report.

Investor sentiment

3.32 At the Ofwat stakeholder event on 20 July an investor made the point that Scenario 1 suggested a potential 8 to 10 year return on investment. On that basis, he questioned whether new entrants would be attracted to a market with such low margins. We share this view. Unless a new entrant is able to offer a premium service, and thus increase charges beyond the default tariff, there seems limited incentive to join the market.

4. Comments on the four scenarios

We offer the following comments on the four scenarios Ofwat has modelled:

Scenario 1	<p>Highly unlikely</p> <p>Ofwat assume 30% to 50% of customers active in the market within 10 years with 30% switching pa by the end of the period for a saving of £6 pa.</p> <ul style="list-style-type: none"> • Ofgem research shows that: <ul style="list-style-type: none"> ○ 50% of energy customers had engaged with the energy market in the early years of competition (and half of those had switched by 2004). ○ 13% of customers switched and 11% renegotiated in 2013-14 in the now mature market. <p>But in both cases but this was on the basis of savings significantly higher than what will be available in water.</p> • Customers are unlikely to switch for limited savings in water. <ul style="list-style-type: none"> ○ Only 6% of customers said they would switch for a saving of between £1 and £10 (CCWater research) ○ Less than 2% of customers said savings of £4 to £8 were worth
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⁸ The CMA’s survey of 6,000 energy customers reveals that 56% of customers have never switched, and 34% have considered switching but have not done so.

⁹ Energy market investigation – final report (Competition and Markets Authority, June 2016) [here](#).

	<p>switching for (Ofwat research).</p> <ul style="list-style-type: none"> • This scenario assumes a low customer acquisition cost (£8 per customer), but is based on switching rate assumptions unlikely to materialise. • This also assumes there will be a competitive market with many retailers participating. Is this realistic given the low margins and projected lengthy returns on investment available for new entrants?
Scenario 2	<p>Unlikely</p> <p>Ofwat assume it will take 15 years for 30% of customers to be active in the market, with 10% switching for a bill saving of £2 to £4.</p> <ul style="list-style-type: none"> • The Ofgem evidence and customer research referred to above is equally valid for this scenario. • Scenario 2 suggests lower set up and operating costs for the market than non-household retail. This does not appear realistic. • This scenario suggests a limited level of market entry by retailers, which may be more realistic given the low margins available and projected lengthy returns on investment that are available.
Scenario 3	<p>Possible but unlikely</p> <p>Scenario 3 has the same level of customer activity and switching as Scenario 2 but a customer saving of just £2.40 pa because of a doubling of set-up and on-going costs.</p> <ul style="list-style-type: none"> • The Ofgem evidence and customer research referred to above is equally valid for this scenario. As the customer benefit to be derived from a competitive market reduces so will customer engagement and switching rates. • The set-up and on-going costs for retailers, the market operator and Ofwat are more realistic, but would need to be refined for the September paper.
Scenario 4	<p>Quite likely but undesirable</p> <p>While this is the most negative assumption (with a net cost to customers and no benefits), there is a risk this could occur if the household market is opened to competition because:</p> <ul style="list-style-type: none"> • There is an average within-year cost to customers of £1 p.a (becoming a £1.70 saving by the end of the 30 year period). This is unlikely to motivate customers to be active in the market or switch (as shown by the Ofwat and CCWater research and levels of switching in the energy sector). • Higher set up and operating costs combined with low market entry due to low margins and projected lengthy returns on investment.

	<ul style="list-style-type: none">• Lack of activity in the market means the residual benefits such as reducing bad debt, improving retail efficiency and more technical innovations do not happen.
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5. Conclusion

- 5.1 Research commissioned by CCWater and Ofwat in 2016 has shown that the majority of household customers support the idea of having a choice of supplier, so we would support the introduction of a market that works for customers.
- 5.2 Based on the evidence currently available, we consider that the costs and benefits associated with the development of a household retail market might fall somewhere between scenarios 3 and 4. Low levels of savings and limited value added services are likely to result in low levels of switching.
- 5.3 While we recognise that the costs and benefits of household competition are likely to change over time, we question whether this will be enough to offset the low value for customers and the resulting limited customer engagement. The dangers of customers being disappointed by the savings on offer together with insufficient competitive pressure on retailers to drive prices down will need to be addressed in order for a successful market to develop.
- 5.4 As the emerging findings clearly show, there are many uncertainties surrounding both the costs of and benefits to be derived from a competitive household retail market. We would like Ofwat to examine the assumptions underpinning Scenarios 3 and 4 closely, as they appear to be more likely to materialise than those of Scenarios 1 and 2. If further analysis reveals a benefit for customers, it will be worthwhile to introduce a market. If there is a potentially negative cost to customers, then it should not go forward.
- 5.5 Given the potential risks to customers highlighted in this response, we think there may be a continued role for regulation to help ensure the potential detriments to customers are addressed. Any moves towards such a market must proceed cautiously, and only when there is clear evidence to suggest that the market will function correctly.
- 5.6 The introduction of the non-household retail market in April 2017 should provide further evidence. If micro-businesses and small and medium enterprises are active in the market then it may bode well for a future household retail market. If they are not active, then the reasons for non-participation in the market should be explored.

Enquiries

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