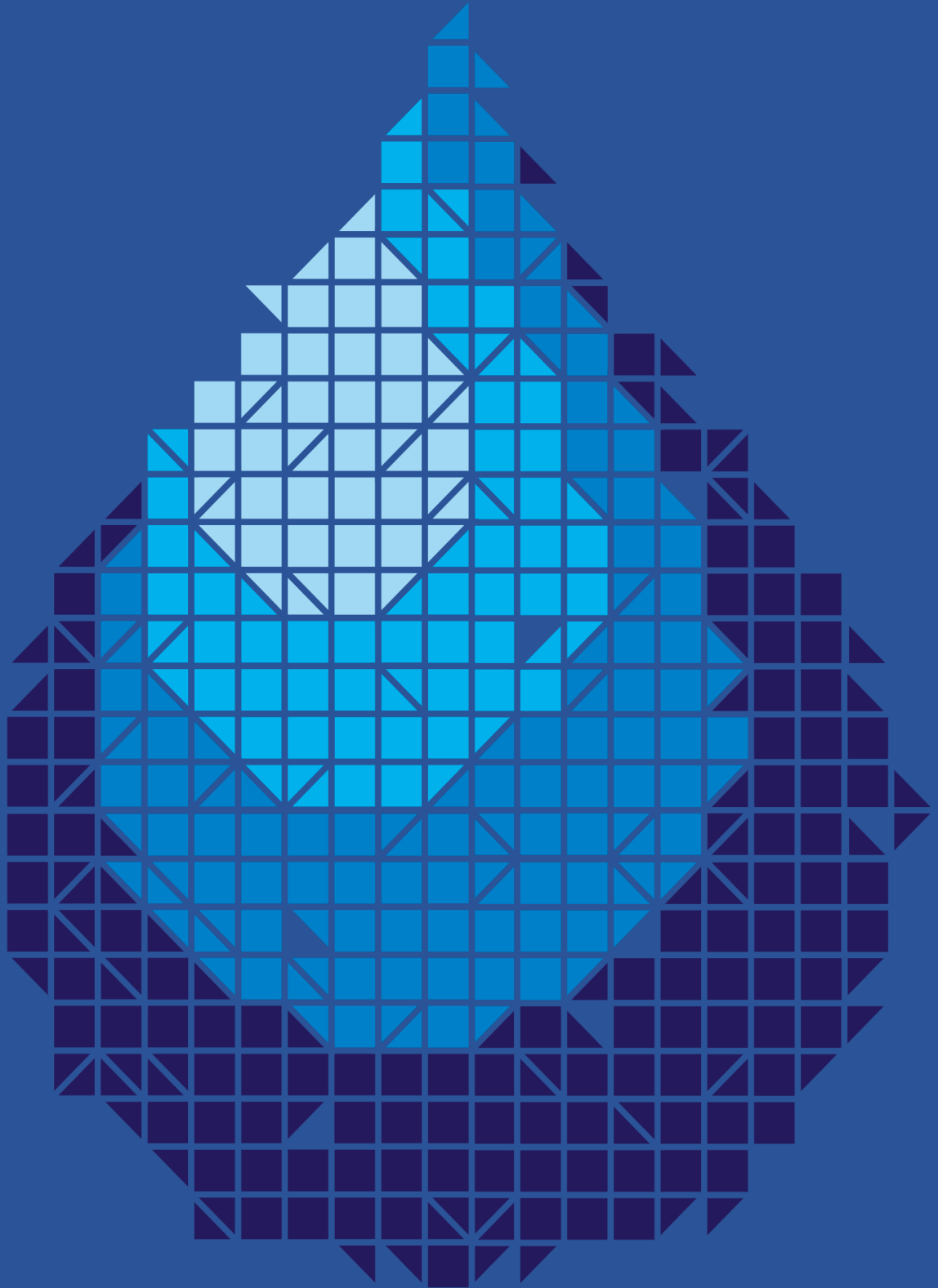


Gemserv response to the Emerging Findings Report on Costs and Benefits of introducing competition to residential customers in England



Gemserv



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1. INTRODUCTION

The consideration of the costs and benefits of the introduction of retail competition to residential customers is an important component in the Government's broader vision for opening up markets to new markets, promoting more competition, driving efficiency and innovation.

Gemserv recognises the challenges posed to Ofwat in undertaking its analysis given the wide range of uncertainties and the consequent need to undertake scenario analysis against different sets of assumptions and welcomes the opportunity to respond to this consultation on the costs and benefits of residential market competition.

We believe Ofwat will benefit from our experience and expertise in these areas as we have evolved from a company created by market participants in 1998 to design and support the code arrangements for the retail electricity markets in Great Britain. As such we act as a contracted agent to the Master Registration Agreement Service Company (MRASCo Ltd) to facilitate the operation of retail electricity markets. We therefore have in-depth experience in the development and operation of residential market competition and are keen to bring this experience into the water market.

We have worked in the recent past with Ofwat on supporting policy development, applying our experience from other markets. In addition to our experience at market level, many of our staff and associates have worked at company level as strategic and operational practitioners in the utilities markets, including water. Over the past 5 years we have prepared a variety of Thought Leadership papers which have input on a series of topics including learning points from other markets "Getting it right first time", market governance, level playing field, new entrant perspectives and business customers considerations.

We are currently actively participating with some water companies in England to help prepare their readiness for the introduction of non- household competition in April 2017 and our experience has included working on the on the development of PR14 and associated business plans for one of the companies granted "enhanced status" by Ofwat in its price determinations process. We have also been working on market readiness plans for a number of other water companies.

In addition to the water company work we have provided some support to both Ofwat in its preparations for the new NHH market and to Open Water in its MAP documents, where we contributed an appendix on market readiness.



Our interest and understanding of the industry means that we keen to further support Ofwat in its wider Project 2020 work which will drive further market reform for the benefit of customers wherever appropriate, and our response to this consultation on residential market competition is part of this, seeking to fulfil our company's mission of "ensuring that complex markets work for everyone's benefit".

2.0 RESPONSE AND GEMSERV OVERVIEW REMARKS

We are pleased to submit our responses to your questions posed in your consultation paper in section 2.2, but firstly offer the following overview remarks in section 2.1 to place our views in context.

2.1 ENSURING CHOICE FOR CUSTOMERS TO UNDERPIN IMPROVED SERVICE, PRODUCT RANGE AND WATER EFFICIENCY

Correctly designed and regulated, we believe that the introduction of residential market competition should bring a range of benefits for customers. The most important of these is allowing customers choice of their retailer of water and waste services. Water is the last utility to be opened up to competition, and findings from most research studies reveal that customers instinctively believe that choice is a good thing. Ofwat's own research has indicated that "half of customers would switch even if there was no price saving". This can result from a belief that switching will bring non price benefits or sometimes it just reflects dis-satisfaction with the service being delivered by the incumbent retailer.

Evidence from the opening of the Scottish water market for Non Household customers is clear that the opening of the market put pressure on the incumbent retailer to deliver improved service and offer more innovative products, or risk losing the business to rivals. This pressure to perform and deliver improved service provides benefits to all customers in the market, not just those who elect to switch.

In the residential electricity market even after almost twenty years of competition, switching rates are at a very high level. For example, in May 2016 a switching level of around 350,000 was reached, with a total of over 2 million so far in 2016. This underpins the message that customers want and will exercise choice in utility markets.

2.2 IMPORTANCE OF ATTRACTING NEW ENTRANTS TO ENGAGE IN THE MARKET

Gemserv strongly supports the comment made in the slides for the Residential Retail Review workshop, 20th July 2016, that "facilitating entry from established players in other markets such as gas and electricity will be important to stimulate competition". We agree with the comment in the KPMG report "Ofwat household market review: lessons from the energy sector" that:

"there is potential for current energy suppliers to seek to enter the water retail market and potentially to build on their energy market presence to offer a bundled product (electricity, gas and water) to customers. Consistency and clarity in regulatory requirements between Ofgem and Ofwat may assist with this and discussions between the regulators may be useful".

Gemserv suggests that there is considerable scope to utilise energy market arrangements and extend them into water, rather than attempting to build as a greenfield infrastructure. For example, in electricity there already exists



a database with over 30 million household metering points which could potentially be leveraged, subject to commercial agreement, rather than building a new database. In addition, codes and other market rules could be extended and adapted.

2.3 CONSIDERATIONS REGARDING RETAIL MARGINS AND PRICE REGULATION

In order to ensure that the market is attractive for new entrants, consideration needs to be given in the PR19 project to the appropriate retail margin to be applied in initial retail price controls. The current cost benefit study is somewhat silent on this aspect.

We have picked up from our discussions with business customers some concern that the margins which have been set in the price controls may be insufficient to allow such discounts to be offered, especially given the relatively high proportion of costs which are currently allocated to Wholesale activities. We are therefore concerned that the currently designed set of price controls may not encourage full engagement by business customers. We think this situation, and the implications of setting similar margins for residential competition should be reviewed in PR19.

There are few public signs that any new entrants from outside the existing water market players are currently reviewing potential entry into the new retail market. Ofwat may be aware of private discussions with such potential players, but we are aware of the views of some that the margins and market opportunities may not easily allow a business case for entry to be built.

The decision of the largest incumbent retailer, Thames Water, to exit the NHH market may cause concern to some and may indicate that the current margin assumptions in the NHH price controls are inadequate to make the market attractive enough for some players. We do not fully understand the reasons why margins in the Scottish business market are more attractive than in England, and we think that Ofwat may wish to review the drivers, including cost allocations, in this respect.

In addition, we support the idea that Ofwat should set out its intention to roll back retail price controls against a set of criteria when competition can be seen to have been established.

2.4 UPSTREAM MARKET: UNBUNDLING THE WHOLESALE ACTIVITIES TO DRIVE MORE COMPETITION

As indicated earlier, we think that Ofwat should consider whether there are opportunities to increase retail margins to make the residential market more attractive. One way to improve margins may be to allow some unbundling of wholesale activities to encourage innovation in areas such as metering.

We note that the current study is not able to be explicit about the nature and benefits of upstream competition. Depending upon the model adopted, there could be competition introduced into a number of elements in the value chain for water and waste, and that the assumptions made in the current study may prove to be too conservative. For example, in energy metering costs were driven down sharply when the monopoly was removed on meter operation.



We think that the barriers towards adopting smart metering in water are worthy of further study, and we think that from a consumer perspective there could be scope to leverage some of the investment in energy smart metering roll out into water. Gemserv would be pleased to discuss this further with Ofwat, and can do this from a very informed position given its role as the energy smart meter code administrator.

2.5 NEED TO DRIVE SYNERGIES ACROSS THE UTILITIES MARKETS

If market entry from outside water is to be encouraged, it will be essential to have a joined-up approach between the energy and water markets. This needs to be present in a wide variety of areas, so that potential synergies can be exploited for the benefit of consumers. Gemserv would be happy to undertake a workshop with Ofwat to highlight the potential areas of importance if that would be helpful. Examples include processes such as switching, and industry codes. A specific example can be used to illustrate this. Following the CMA investigation, one recommendation was to introduce faster switching and an initiative is underway with energy companies to scope the delivery of this. It would not seem sensible from a consumer perspective for different rules and timescales to apply in water from energy. We are pleased to note that Ofwat is alert to the need for quality in the switching process, and we would be pleased to discuss with Ofwat the initiative which is underway in energy being facilitated by Gemserv.

2.6 PROTECTING VULNERABLE CUSTOMERS

An important related topic which could be studied and potentially leveraged from other utilities markets relates to the treatment of vulnerable customers. A joined up approach between regulators would again bring benefits, as there are initiatives underway both in water markets on social tariffs and in energy markets, which Ofwat and the water industry could review. Initiatives in energy range from codes of conduct to prevent mis-selling to tariff capping initiatives being pursued by Ofgem.

2.7 IMPORTANCE OF COMPETITION TO ENSURE COST MANAGEMENT ALSO IN MARKET OPERATION SERVICES

We note that central market costs can be a major element in cost benefit studies of this nature, and hence we think it important to stress our view that there should be competition also applied for central market services. In electricity, Gemserv has to compete on a tender basis for its central market roles and this has helped keep costs keen. We believe this principle should be applied in water, and that any central role in residential competition be awarded to the party that can prove to be the best value for money, which may not be the current body.

Our views on competition at the market operation level are set out in a recent article:

<http://utilityweek.co.uk/news/make-all-administrative-energy-codes-competitive/1242222#.V6C2EMBTFIY>



CHAPTER 2

“We welcome respondents’ views on our assessment of qualitative factors. This includes ways in which we might quantify factors we have currently assessed qualitatively and how we have conducted our qualitative assessment. We also welcome any evidence from stakeholders which we could incorporate into our assessment”.

We have a number of comments to make on this section of the report:

We believe that the cost benefit analysis needs to recognise that the case for the introduction of competition varies depending upon the focus of individual stakeholders. Whilst it is assumed that this CBA is conducted from a Government perspective- i.e. is there a case for introducing competition from the overall interest of the UK economy and environment?- the discussion in the report sometimes strays away from this focus and picks up factors which may impact individual stakeholders such as the companies. A more explicit focus on stakeholders could help. For example, improved water efficiency will bring environmental benefits which can be valued from a national standpoint. One of these benefits would be improved carbon emissions, which would help the UK in its climate goals. The environmental benefits of competition seem to be underplayed in this report and we recommend further attention on these.

Another benefit cited in the report is dual billing. From the companies’ viewpoints this may mean lower unit billing costs. For consumers, the benefit is improved customer service, and possibly the extra element of saving which may be used by companies to support discounts. Again focus on the standpoint of individual stakeholders may bring additional clarity.

The report also does not recognise sufficiently that all customers, not just those who switch may receive lower bills as a result of the impact of competition. This has been a feature in the Scottish water business market where the incumbent retailer has had to reduce its costs and charges in the face of competition. There are a number of analyses produced by WICS and Business Stream which may be of interest for Ofwat in this respect.

CHAPTER 3

We welcome views from respondents on:

- the assumptions that need to be made to undertake rigorous distributional analysis;
- the factors that it would be helpful for distributional analysis to address (noting our suggested list above); and
- any evidence they can provide to support this analysis.

We offer a number of comments more generally on this chapter which have implications for any distributional analysis.

As indicated above, we would support Ofwat in widening its focus and viewing the consequences of the introduction of residential competition from the key stakeholders’ viewpoints. In this case, Ofwat is focussing on the perspective of different customer segments.



In order to progress a distributional analysis, it would be necessary to have a strong foundation analysis of the costs and revenues associated with different customer segments. Ideally this would also need to have a locational focus as costs may vary across different company boundaries. Segmentation could for example be based upon the different payment methods and the ability and willingness to pay using different payment channels. We suggest that this should be the starting point for any discussion of distributional effects. We do not know whether Ofwat has a strong enough foundation analysis in place for distributional impact work.

Linked to this we suggest that clarity is needed from an analysis of cost allocation practices by the incumbent water companies. There may be wide differences in approach which can be corrected to give a more consistent outcome. In particular, companies' allocation of costs between different parts of retail markets need to be examined (e.g. between Residential and Business) and within Residential (reflecting for example different costs to serve of customers who pay by electronic means v cheques or costs of those who pay promptly against those who pay after a delay or not at all). From a company perspective the costs to serve may be quite different between groups. Of particular importance will be how debt is allocated between customer groups.

It does not follow, however, that only those with low costs to serve will be attractive to competitor companies, as in energy some companies specialise in serving socially disadvantaged customers.

Also a common mistake in other markets has been to cite what seem relatively low average savings available and make distributional judgements about these. However, savings for a low income group can be much more important than to a wealthier group.

We think that Ofwat should consider cost allocation rules and actions regarding corporate overheads. It is our experience in the electricity market that initially corporate costs were insufficiently allocated to the retail businesses of incumbent companies, making it difficult for new entrants to make profits.

We also suggest that Ofwat should treat costs associated with the setting up of competition separately as was done by the electricity regulator; removal of such costs and treatment as a separate element in the wholesale controls may remove one cost burden from retail businesses.

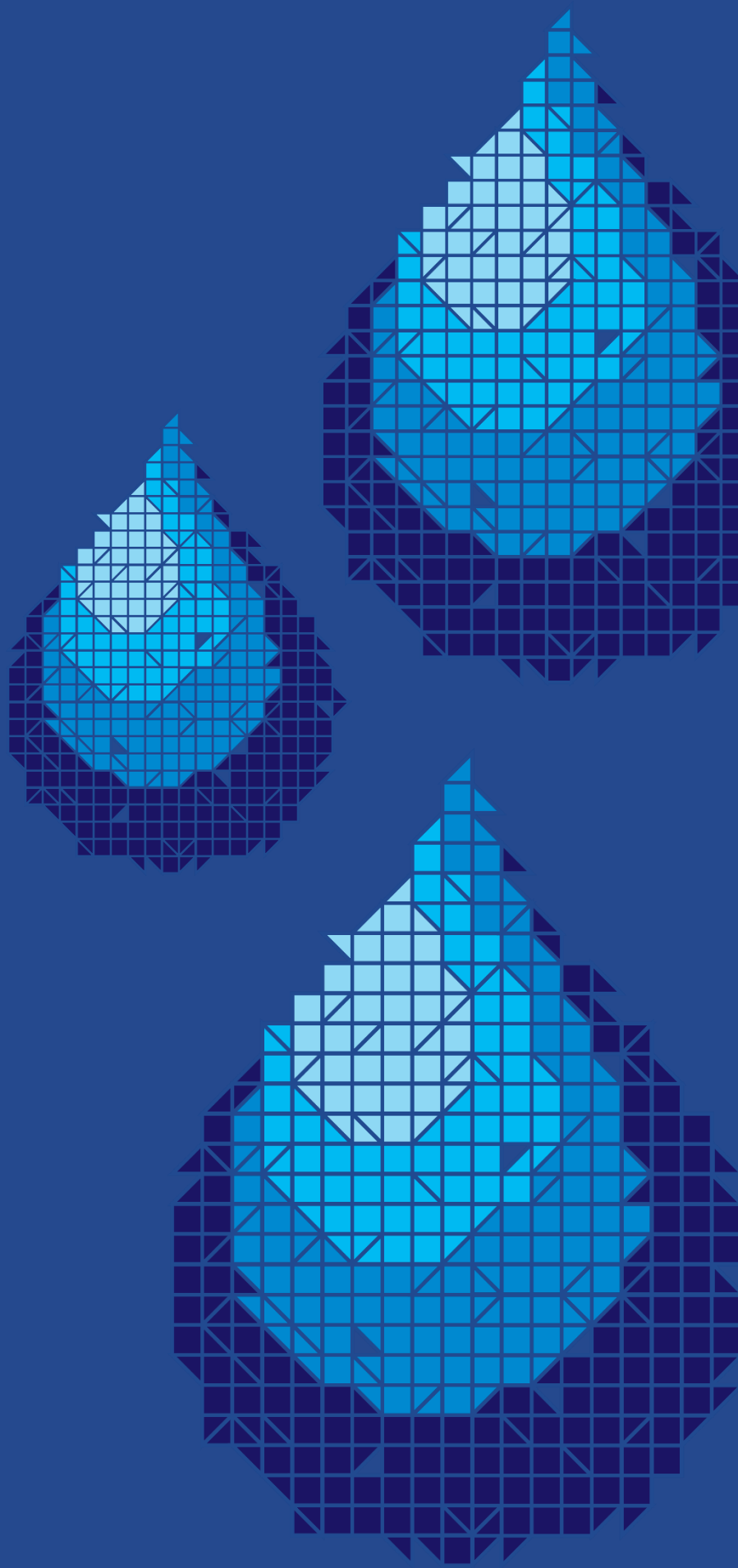
Finally, we are not convinced that the costs associated with customer search and inquiry should be included in the cost benefit analysis. We are not aware of this being included in similar evaluations in other markets.

As always, Gemserv would be pleased to discuss our views further and to contribute to work being undertaken by Ofwat to aid the Government in its assessment of the case for introducing residential competition.

We will be pleased to be in touch with you further in this regard.

Yours sincerely,

Paul Witton-Dauris



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