

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

Response from Northumbrian Water

This response provides our high level thoughts on the emerging findings published by Ofwat. We support the Ofwat stance that the final decision in this area is for the UK Government, but we feel that more analysis needs to be carried out to aid its decision. The UK Government should consider very carefully whether a compelling case exists and should ensure that any implementation timeline is practical and allows sufficient time for good planning

Northumbrian Water is a very customer focussed company. We have tried to help customers find value through water efficiency and meter installations, along with a series of initiatives to help customers pay their bills in a way convenient to them. Given our high levels of satisfaction and trust it is important to us and our industry to retain that positive position, although of course we strive to do more and better

We recognise that many customers in principle support the concept of having a choice of supplier and that there may be some benefit attributed to the provision of choice regardless of any financial gain. However, in our view customers mainly value choice because they believe that competition will deliver improved value. In this context we feel that Ofwat should give greater weight to the expectations of customers as to the savings that might be achievable and which would be necessary to incentivise switching. In our view the estimated savings of around £6 per year are unlikely to be sufficient to induce significant switching and would also be insufficient to provide a margin that is attractive for retailers.

The potential financial benefits from both a customer and retailer perspective would appear to rely on the development of a multi sector retail environment with water and sewerage services being part of a wider package of services. We think it is contentious to base a policy decision for the water sector on the assumption of other unrelated market developments. We would see benefit in further analysis of the potential development of such a multi utility retail market, as a standalone household retail market for water and sewerage would not appear to be viable based on the analysis presented. We also believe more time should be expended to arrive at a more robust cost analysis reflecting required implementation timelines.

We have observed with concern that in the energy market there have been repeated attempts to drive market activity by both the CMA and Ofgem which have had some limited success but the most recent proposals have been generally treated with derision by the media and smaller energy retailers. The re-imposition of a price control for pre payment meter customers and the proposals for enforced sharing of customer details for marketing purposes could both be seen to be evidence of market failure.

In conclusion, despite our strong focus on customers we are mindful of the very low level of value available in household retail and the significant risk to the trust and confidence in the regulator and the industry that this could bring. We are very keen to see how the non household retail market works, we are determined to make that a success, and then see how we could transfer any emerging lessons to household retail.

In addition to these overarching issues regarding the viability of the market there are a number of specific issues we would like to address.

Bad debt comparisons with the energy sector

In comparing the water sector's performance on bad debt with that of the energy sector, and assuming that competitive retail water companies could match energy sector levels of bad debt, Ofwat has ignored the crucial role of pre-payment meters, as well as the threat of disconnection itself, in the energy sector.

Ofwat state:

Page 56: One argument sometimes put forward for high bad debt costs in the water sector is that residential retail customers cannot be disconnected. Though there is still a threat of disconnection for residential energy customers, in practice this risk is very slight (in 2014 a total of 233 customers were disconnected (192 electricity customers and 41 gas customers). Disconnection rules therefore do not appear to explain the difference in relative levels (and cost) of bad debt between the two sectors. It appears more plausible that the level of bad debt is explained by water companies' poor information on individual customers, because they bill properties. Competition would require that companies obtain information identifying their customers, so that switching can occur.

This analysis fails to take account of the increasing role in energy of prepayment meters as a tool for bad debt reduction. The CMA report para 103¹ identifies the doubling of prepayment meters for energy customers from 7% in 1996 to 15% in 2015. It also confirms that prepayment meters are generally installed where a customer has a poor payment history or in certain types of rented accommodation (para 105).

Energy companies do not need to disconnect for non payment when a customer is on a prepayment meter. The Citizens Advice Bureau estimates that 1.6 million prepayment customers are cut off each year, through self disconnection.²

Further evidence of the impact of the threat of disconnection can be found in the much lower rates of bad debt for water and sewerage services for non households where the threat of disconnection exists, relative to households where it does not.

Powers to bill

We are surprised by the statement that '*water companies bill properties*' as this is incorrect. Under the Water Industry Act, the legal powers are to bill the occupier of the premises.

Distributional impacts

We are concerned that Ofwat has not yet carried out a distributional impact assessment of introducing a residential retail market.

The concerns we have expressed in our previous submissions³ over the impacts of social de-averaging remain. Ofwat makes little reference to the CMA imposition of

¹ CMA Energy Review Final Report 24/6/16

² <https://www.citizensadvice.org.uk/about-us/how-citizens-advice-works/media/press-releases/1-62-million-prepayment-energy-consumers-cuts-off-each-year/>

price controls on the energy prepayment customers, who are paying up to £75-80 extra for their energy supply (para 105). This differential in bills has emerged over time in a competitive market (and is arguably in large part cost reflective). This would seem to provide a good indication of the potential for cost disaggregation and social impact in the water sector.

On page 31 of their report, Ofwat state that they have not considered the impacts of competition on different groups of customers. This appears at odds with the terms of reference for the review which states that models of competition will be assessed against the Ofwat objectives, including protecting vulnerable customers.⁴

Ofwat indicates it would like to carry out a distributional analysis and asks for factors to consider and supporting evidence. We refer Ofwat to the significant distributional study carried out by ICS on behalf of Water UK⁵ and published in the marketplace for ideas.

We do not feel that Ofwat has addressed the points made in the ICS study in any substantive way and were surprised to find no reference to the study in the main Ofwat emerging findings report, which only contains one brief reference to vulnerable customers.

We feel the ICS report deserves greater consideration in the final main report as we do not feel Ofwat has adequately considered the implications. In the supporting document Ofwat states:

Distributional and commercial impacts on incumbent suppliers only emerge if there is an active market with engaged customers switching to different service and price offerings. This point was recognised within the analysis for Water UK by ICS Consulting.

As Ofwat itself expects any successful retail market to be active with different service and price offerings, we feel this actually supports the finding of the ICS report.

In the Stakeholder Views document, Ofwat make the following statement:

*Page 7: In practice provided **appropriate mitigations** are incorporated into the market design to limit or neutralise exposure to debt (which we think plausible) then the incentive to aggressively cherry pick through such means would be considerably reduced as exposure to debt is the most significant factor in the cost to serve of different groups of customers.*

We do not currently see any details of such mitigations in the Ofwat documents. We believe the final report should include discussion of what the mitigations might be, how they might work and how effective they might be expected to be.

Finally, Ofwat challenge the likelihood of de-averaging ('cherry picking') with the following:

³https://www.nwl.co.uk/_assets/documents/Northumbrian_Water_response_to_HH_Retail_call_for_evidence.pdf

⁴ Review of retail household markets in the water and wastewater sector: Terms of reference page 7

⁵<https://dl.dropboxusercontent.com/u/299993612/Future%20of%20the%20water%20sector/Distributional%20Impacts%20of%20Retail%20Competition%20Final%20Report.pdf>

We have observed that customers in other markets are active rather than passive, and seek out new suppliers. Suppliers therefore have far less control over the customers they acquire than the theory of cherry-picking would suggest. Our assessment is that impacts only occur if retailers can target certain customer groups and if it is not profitable (rather than just relatively less profitable) for retailers to serve them.

The CMA Energy Review Final Report contains detailed analysis of the likelihood of switching by customer group. Figure 9.1 and Table 9.1 of the report illustrate that vulnerable customers are significantly less likely to switch energy suppliers. Thus, a new retailer does not actually need to target certain customer groups, it is simply more likely that customers that are profitable to serve (generally non vulnerable) will switch to it. This is a self-selecting 'cherry picking' process that will unwind cross subsidies as it progresses.

New Switching Applications

Whilst we appreciate that Ofwat has not based its CBA on the use of new switching technology (e.g. Flipper), we note that the use of these apps may suffer from the same issues as price comparison websites (PCW). Flipper requires a contractual payment of £25 per year, which seems likely to put off customers who expect applications to be free. The alternative is for apps and PCWs to be paid on commission from suppliers, which has generated some media criticism recently and undermined customer confidence in the energy market.

Cost Benefit Analysis

On reviewing Ofwat's Cost Benefit Analysis (CBA) we are concerned that cost estimates are subject to considerable uncertainty and may not be robust. We feel they may underestimate the true cost of system set up (e.g. is the MOSL system scalable?). There is considerable emerging evidence that actual Non Household Retail costs to serve are higher than initially assumed and we feel Ofwat may again be underestimating the 'hidden' costs of achieving market readiness within companies as well as in developing central systems.

Given the marginal nature of the CBA conclusions this is important as numbers do not have to change much for Net Present Values (NPV) to be negative. It is important that any policy decisions recognise the sensitivity in the CBA analysis.

We are also concerned that the proposed timelines for implementation may not be realistic and we would urge Ofwat to engage with Elexon to ensure that lessons are learnt from the energy sector. We also believe that the assumptions that underpin each of the four scenarios require greater prominence in the report in order to make the analysis more transparent. We believe this will expose the fragility of some of the assumptions underpinning the analysis.

We are also concerned that given the pace of change in business and society a 30 year NPV calculation may not be appropriate and may serve to artificially inflate the assumed benefit. We would like to see presentation of the NPV using a shorter timeframe for comparison.