

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



History and background

In November 2015, the UK government published 'A better deal', its plan to boost competition in different markets and lower bills for firms and families. The report said:

“The government is driving water market competition. Business and other non-household customers will be able to switch suppliers from 2017. Ofwat will provide an assessment by summer 2016 of the costs and benefits of extending retail competition to household water customers. Following this, the government will work with water companies to begin the transition to household retail competition before the end of this Parliament.”

In July, we published and consulted on our emerging findings on the costs and benefits of extending retail competition in England to residential customers. We are grateful to everyone who responded to our consultation. This summary, together with supporting documents available on our website, sets out our final assessment of the costs and benefits. On pages four and five of this document, we set out our overall assessment of what a competitive market might look like.

The decision of whether and how to open the market to competition is one for the government to make.

Changing markets

The water sector is renowned for its stability. This stability, underpinned by independent regulation, has led to investment in the water network, boosted resilience and protects our environment. But for customers, the pace of change in the water sector has been slower than in other sectors.

In competitive retail markets, there has been radical change, innovation and technology-led advances to provide better service. Customers search online for a product or service, cutting search costs, and receive exactly what they want, when they want it. They can pay for a product with a wave of a smartphone, manage their finances through fingerprint technology, and control their home's heating remotely. They can choose products which support environmental initiatives or a favourite charity.

In contrast, the water sector remains largely unchanged. While service levels have improved, the range of services offered has not. There has been no meaningful innovation in tariff structures. And the possibilities from technology have largely been left unfulfilled – for example, we could only find two water companies offering an app for customers to manage their account.



Water customers are being left behind in the retail revolution.

It is time to look at how ideas from other sectors can be harnessed to deliver a better service for water customers. The provision of treatment works and pipes does not lend itself to head-to-head competition, but retail need not remain a monopoly activity. Every other retail service is provided in competitive markets. It is time to look at what role a competitive retail market could play in delivering better outcomes for water customers and wider society.



The water sector is often compared to the energy market

But, although they are both utilities, there are big differences. Water is not an internationally traded commodity and would not be subject to the same fluctuations in price. We would expect customer bills to be more stable and for differences in bills to be smaller. There are lessons to learn from energy and other sectors, including on customer protection and how new technology can reduce customer search and switching costs.



56%

think choice in the water market would be a good thing

The value of choice

Our customer research shows that 56% think choice in the water market would be a good thing. This is partly because they expect competition will reduce price and improve service. But it is also because customers value the ability to vote with their feet if their supplier does not provide the service they expect.

Overall assessment

No one can accurately predict the future. In our cost benefit assessment we have identified a number of illustrative possible scenarios modelled over a 30-year period, which reflect how key features of a competitive residential retail market could develop. Of course, there are no guarantees of how successful competition would be, but the evidence suggests that a net positive outcome is more likely than not.

Here we summarise our view on the prospects for a successful market opening.



£2.9 billion
potential benefits
over 30 years

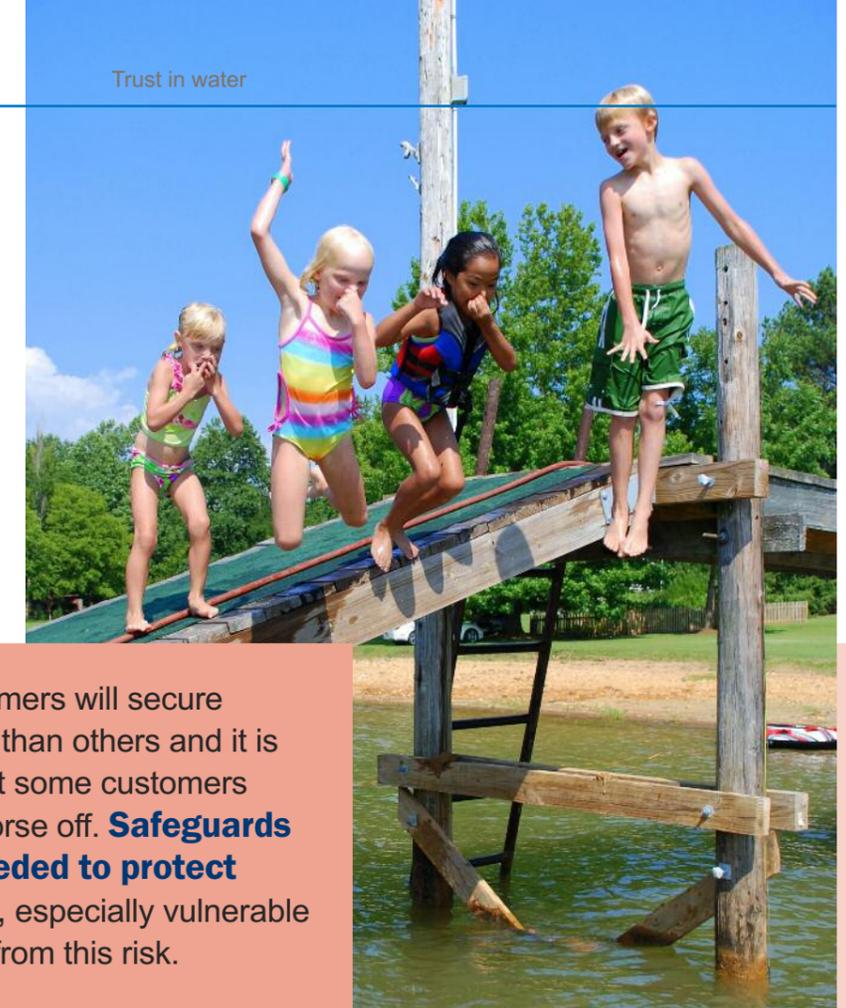
Reductions in customer bills could be limited, especially in the short term. Lower bills could come from retailers' efficiencies, with new entrants likely to have lower costs. Retailers are likely to challenge wholesalers to become more efficient. This is in line with evidence from potential entrants and experience in the business customer retail market in Scotland.



Competition could deliver substantial benefits that are difficult to quantify, such as customer choice, and **the power for customers to take their business elsewhere** if their provider falls short.



It would be a **competitive market, not an unregulated market**. As in the business customer market, requirements will be needed to ensure public health and safety is maintained. Customer protection will be needed to ensure all customers are treated fairly. Appropriate assistance would need to be in place for vulnerable customers and those struggling to pay their bills.



Trust in water



Some customers will secure better deals than others and it is possible that some customers would be worse off. **Safeguards may be needed to protect customers**, especially vulnerable customers, from this risk.



Competition could cut bad debt costs as retailers improve debt management and reduce the number of 'unidentified customers' who use services but are not billed.

There will be some **significant set-up costs** to open a new market which companies and customers will have to meet. These can be minimised through a well-timed, well-planned process and by learning lessons from the opening of the business customer retail market.



Competition could lead to widespread and ongoing **innovation in customer service**. It is likely to result in new offers, such as water efficiency services or leak detection, and multi-service bundles, such as dual utility (energy-water) offers, which make customers' lives easier.



There will be **significant ongoing costs** for retailers who compete in the market, including to gain and retain customers. Retailers would ensure these costs were not disproportionate to the revenues they would earn in the market.

Costs and benefits

To inform our assessment, we modelled the potential costs and benefits of competition in four illustrative scenarios over a 30-year period – this helps us to calculate the ‘Net Present Value’ of introducing competition.

There are some costs and benefits which we can put a financial value on and others which we cannot. Both are important in making an assessment about the value of opening the market to competition.

The headline impacts in each scenario we modelled are set out below (over a 30-year period unless otherwise stated).

Scenario 1

Market with lower cost, widespread innovation, strong competitive activity

£2.9 billion
Net Present Value

Net benefit per customer per year **£8**

Scenario 2

Market with lower cost, some innovation and good competitive activity

£1.2 billion
Net Present Value

Net benefit per customer per year **£4**

Scenario 3

Market with higher costs, some innovation and good competitive activity

£0.2 billion
Net Present Value

Net benefit per customer per year **£1**

Scenario 4

Market with higher costs, little innovation and weak competitive activity

-£1.4 billion
Net Present Value

Net cost per customer per year **£3**

The details on each of the four scenarios with a full breakdown are available online in our full cost benefit assessment.

To explain the factors we considered in determining the Net Present Value, we have set out the costs and benefits for the scenario which all parties would want to deliver – with lower costs, widespread innovation and strong competitive activity.

In presenting this example, we are not offering a view that this would be the outcome, more that it is a possible outcome in a well-managed and competitive market.

Costs and benefits for scenario 1

Quantifiable costs

Cost to customers of engaging in the market (time spent researching)	£7 a year
Cost of setting up a new market	£367 million
Cost to companies of winning new business	£8.30 per customer
Cost to regulators of adapting to new market conditions and requirements	£4.2 million

Unquantifiable costs

- Potentially invasive and undesirable sales practices. Could result in some customers switching onto poor deals and undermine trust.
- Different customers’ experiences (for example, those who have engaged with the market and those who have not) could be seen as unfair and undermine trust.

Quantifiable benefits

Financial savings of £2.9 billion	Equivalent to £8 per customer per year
Improvements in customers’ energy efficiency	£183 million
Reduced carbon footprint	£199 million
Improvements in water efficiency	£389 million
Progress in tackling bad debts	£856 million
Savings from more efficient retail and wholesale operations	£2.5 billion
Less rainwater run-off and more wastewater recycling. Leads to more drainage capacity, helping to protect against floods	£55 million

Unquantifiable benefits

- Freedom for customers to choose and the power to walk away when service falls short.
- Makes customers’ lives easier with new services, offers and bundles of products.
- Better customer service and innovation.
- Greater water resilience and less pressure on scarce water resources.

Protection for vulnerable customers

In competitive markets some customers get a better price and service than others. The design of the market and ongoing regulation need to mitigate the risk that customers are treated unfairly and miss out on potential benefits. It is also important that market design and regulation make sure vulnerable customers have access to the right support and those who are struggling with their bills receive timely, effective help.

Ofwat has a duty to protect customers and particularly vulnerable customers. And so we expect to play an important role in ensuring that strong and effective safeguards are in place and that they do not unduly stifle competition.

To understand how to do this, we first need to know what the market would look like and which services would be included. Once this is known, a fuller analysis of possible impacts on different groups should be completed to inform decisions on what action is needed.

Setting up for success

For the market to be successful, customers must have trust and confidence in it. That trust and confidence must be justified with the right decisions being taken on design, opening and ongoing regulation of the market. It will also rely on good information. And the assurance that we have learned from other sectors and from opening the business customer market in England to competition.

It is also important to identify and mitigate against the risks which would undermine the market and its effectiveness.



Competition and competitors

Risks

New entrants do not enter the market and the big, existing water companies use their status to try and influence the market to their own benefit.

Addressing the risks

A successful market needs competition. Experience from the business customer market suggests not all current water retailers will remain in a competitive market. But the potential for some companies to leave would create opportunities for new entry and innovation.

The market design must not create undue barriers to entry. New entrants should have a voice in how the market is set up, so it works for all and not just existing water companies. Regulation will be needed to ensure companies who can influence the market do not distort it to their own advantage. We expect good quality data on customers and their water use to be accessible to new entrants, helping them understand the market and compete.

Throughout this change, strong measures to protect customers must be put in place.

Public health and safety

Risks

There is confusion between retailers and wholesalers about their responsibilities in the event of a public health issue or a reluctance to work together to tackle issues.

Addressing the risks

Even with retail competition, the current regional wholesale companies would still be responsible for providing reliable, safe drinking water and for taking away waste water. But wholesalers would need to work closely with retailers to maintain public health and safety, and to communicate with customers if there are problems with water services. We would use regulation to ensure wholesalers and retailers work together to protect public health and the environment, and that customers are involved and informed.



Resilience and long-term planning

Risks

A new focus on water efficiency fails to take hold. Retailers adopt a short-term mind-set which sits at odds with the long-term approach needed to manage the environment and water network. As a result, necessary investment decisions are compromised.

Addressing the risks

Wholesalers will continue to be vital in maintaining resilient water services. But retailers would also have a crucial role to play as they would have incentives to provide water efficiency services to reduce consumption and bills – as happened in the business customer market in Scotland. With the right incentives in place, retailers could benefit from reduced costs if they help wholesalers deliver more resilient services (for example, if costly new investment were avoided as a result of water efficiency).

Wholesalers and retailers need the right incentives to work together to maintain resilience and plan over the long-term, so customers of the future have the water services they need at a fair price.

Treating customers fairly, enabling engagement with the market



Addressing the risks

Consumer law offers protection to customers but regulation would also be needed to make sure customers receive good information about their water use, the services they receive, the price they pay and alternative deals. It would also need to make sure they are not subject to misleading or high-pressure sales techniques.

Risks

Vulnerable customers lose out, and better deals are secured by the most savvy customers only. New service offers, innovation and savings are not widely available.

The new market is unattractive to customers, who do not engage. While in theory there is choice, in practice there is little to distinguish retailers. Customers do not feel they have good quality, reliable, easy to access information on how to engage and find the best deal. Customers feel as though the complexity and hassle of switching is not worth the effort.

There must be effective redress when things go wrong. There is a set of minimum standards for water companies, which could be adapted to work in a competitive market.

Competition could reduce bad debt as retailers look to cut costs through better billing and debt management. This does not rely on any change to the ban on disconnecting customers.

Some customers genuinely struggle to pay their bill and there must continue to be protections to make sure they receive help in a competitive market.

It is also important to make sure that vulnerable customers get the support they need, and we could set conditions so retailers have to provide it.

It must be simple and easy for customers to engage in the market. We recognise not all customers will choose to, but it should be easy to compare deals and switch, and the regulator ought to step in if it is not.

Some will get better deals than others in a competitive market and it is possible that some customers will be worse off. It is important to consider what the different deals might be, and who is more likely to get the best and worse deals. Depending what this analysis shows, we may need some form of tariff regulation. In identifying the right safeguards to protect against these risks, it is important that the regulator does not stifle competition.

Timing

Risks

A decision in principle is delayed meaning potential entrants lose interest and both entrants and existing companies cannot plan. Companies that might have entered the business market on the basis of the potential of the residential market do not enter. Intelligence and experience from opening the business market is lost.

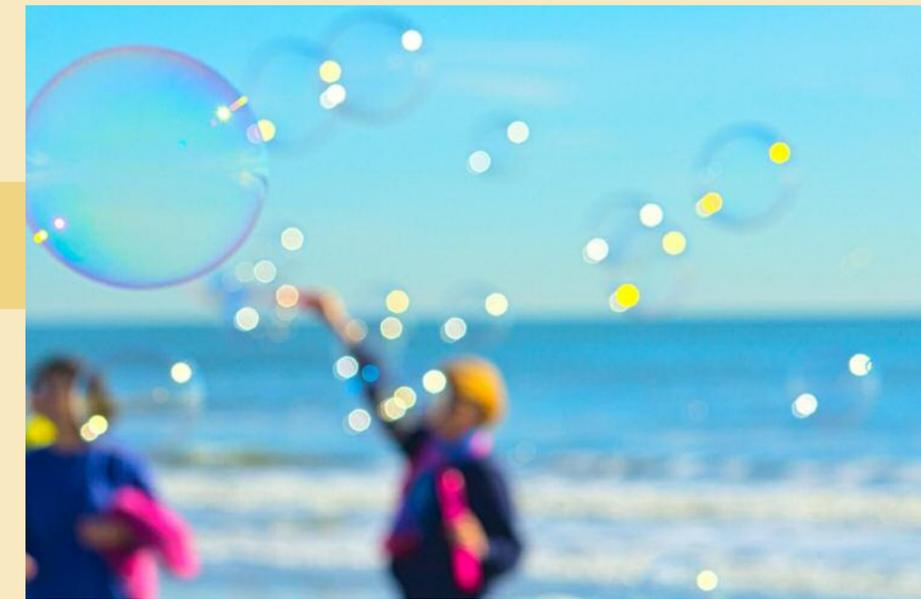
If the process for opening the market is rushed, lessons from the opening of the business market are not learned and mistakes undermine confidence.

Addressing the risks

An early in principle decision would help companies prepare their business plans for our 2019 price review. It would also help companies think about their retail strategy, and could be a material factor in deciding whether and how to engage in the business customer market. Companies and investors would welcome such an early in principle decision.

Once a decision in principle is made, there is a separate question of when the market should open. A competitive residential retail market in England would be the largest competitive water retail market in the world and would affect every household in the country. So it would be important to allow time for the process to be thoroughly planned and tested.

It would also be important to consider how the timing could help take advantage of the learning from opening the business customer market. A further consideration is whether the market should be opened on a single date, or whether a phased roll out could be adopted.



What would an effective market look like?

If these issues are carefully and successfully addressed and the government, regulators, water companies and customer representative groups fulfil their duties effectively, a successful market could be launched.

Such a market might bring the following changes, compared to water markets today.

For the environment



Retailers promote water efficiency.

There is scope to improve water efficiency by 20%. In England, the highest per capita use of water is 40% higher than the lowest. Promoting water efficiency would help companies win customers' trust and offer new services. Regulatory incentives can be used to encourage water efficiency.

More waste water is recycled, reducing pressure on drainage. There is growing focus on capturing and reusing rainwater.

Customers are charged for removing waste water according to the amount they cause to flow into the drain. By reducing the amount of water taken away, they could cut their bills.

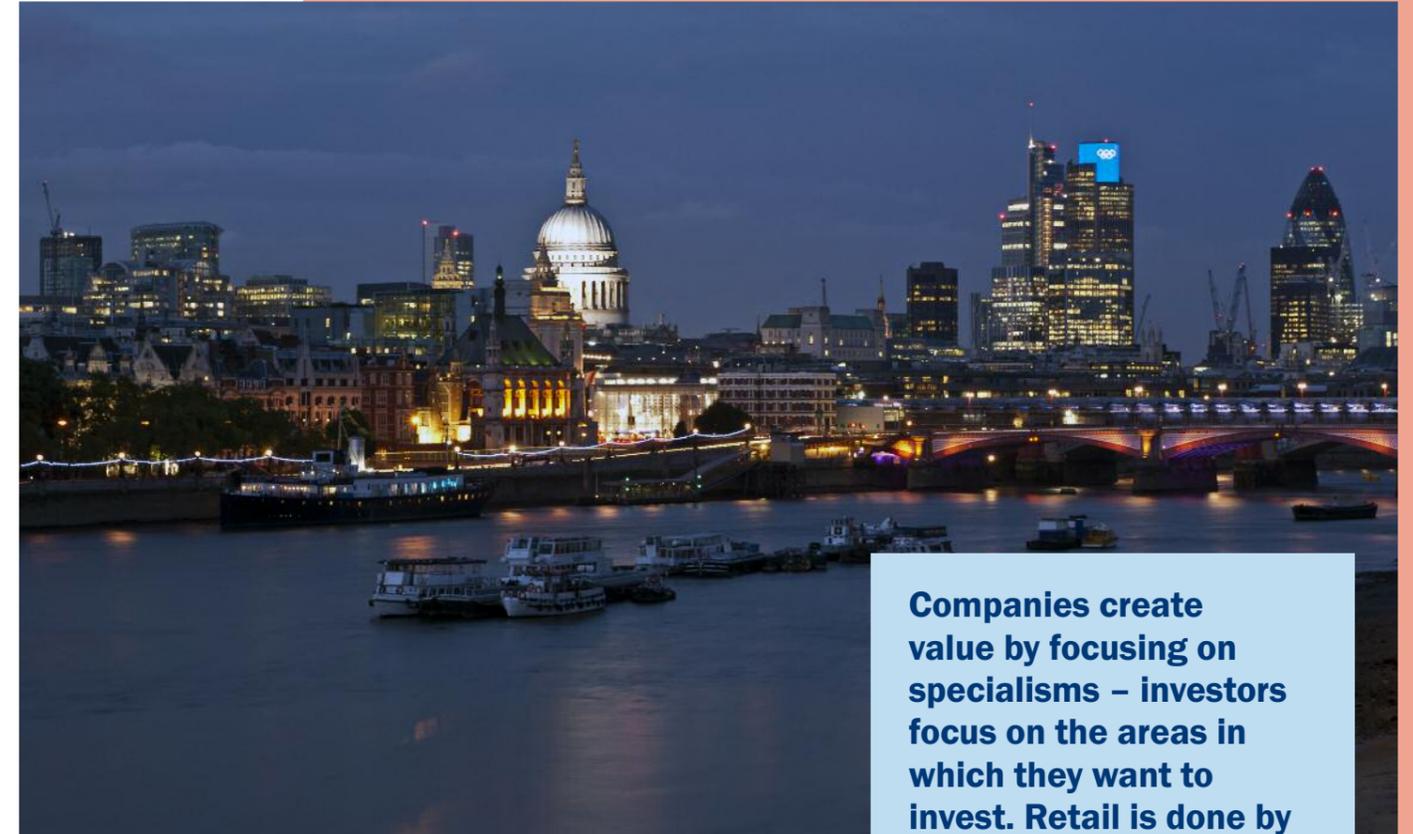
Retailers and wholesalers increase their understanding of customers' behaviour, meaning they can better manage water resources.

Retailers in sectors such as groceries and telecoms focus on understanding customer behaviour so they can adapt offers accordingly. With a better understanding of customers, retailers can provide advice on use, and dealing with pressures from drought or flooding.

Retailers offer new services such as leak detection.

There are already commercial products emerging to tackle leaks. The roll out of smart meters may stimulate interest for similar products.

For investors



Companies create value by focusing on specialisms – investors focus on the areas in which they want to invest. Retail is done by those who do it most efficiently. Some traditional water companies leave the retail market and focus on managing water resources and networks.

Other traditional water companies see an opportunity to grow their market share leading to mergers and acquisitions.

Severn Trent and United Utilities have joined forces to create a new retail business for their business customers and others may see similar opportunities in the residential market.

Different business models attract different investors.

In addition to value from company specialism, we could see value from investor specialism, too.

For customers

Retail costs fall and customers share those benefits.

New, more efficient companies enter the market and improve billing and debt management reducing bad debt costs, for example to similar levels as council tax.

Technology is used more widely to make it easier for customers to manage their account.

Increasingly retailers use technology more widely and smartly, including with apps which allow payments to be made with a scan of a smart phone. Currently only two water companies let their customers manage their account on an app.

Water retailers are keen to keep existing customers and offer better deals or services, such as supply pipe insurance, to do so.

In the Scottish business retail water market, around 40% have renegotiated a better deal. This is common in other sectors too, such as telecoms. If needed, regulation could make sure customers are offered fair deals.

Water retailers offer services to promote water efficiency, helping to keep costs down and improve resilience.

In the Scottish business retail water market, retailers sell water efficiency services to help customers reduce bills by reducing consumption. We could create incentives to promote wastewater efficiency, too.

New companies sell water services and customers can bundle services, making life a bit easier.

There are significant players in other markets who have demonstrated credible intentions to enter the market. In other sectors, such as telecoms, we have seen bundling of previously distinct services.

It is easy to find the best deals and switch. New technology and services mean that customers do not have to do all the work.

In the energy sector, companies like Flipper offer simple, automated searches and switch customers to the best deal. Consumer experts, such as Money Saving Expert, are already showing an interest. Effective regulation can encourage good, simple data to be made available to customers and can oversee third parties, such as comparison sites.

Customers like having the freedom to choose, they save a modest amount and feel they get a fair deal.

Customer research shows customers want choice. Our cost benefit assessment suggests savings are available. In the Scottish business market, 60% have lower bills than they would without competition.

Tensions between local wholesalers and national retailers emerge. This challenge to wholesalers can introduce new information to make regulation more effective and reduce prices for customers.

This tension emerged in energy where retailers disputed charges claiming they result in higher retail prices.



Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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