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Dear Giles

### **Household retail emerging findings**

We welcome the opportunity to respond to the emerging findings you published on 18 July 2016 on the costs and benefits of introducing household retail competition to households in England.

As you are no doubt aware Severn Trent is supportive of the extension of markets where they can be of benefit to customers. We are very active in the non-household retail market having recently entered in the WaterPlus joint venture with United Utilities. Additionally, we are also very keen to see the development of active water resource and sludge markets.

We are supportive of a thorough analysis of the case for extending competition to household retail and are pleased to see your draft findings and the process you are going through to validate the initial findings. We have also commissioned and published work by Economic Insight on the potential form of retail controls should competition be introduced<sup>1</sup>.

Based on initial findings we have some comments relating to the analysis and key assumptions underpinning the analysis which we set out below. We have sought to provide additional evidence for consideration in your next draft.

Yours sincerely

Dr Tony Ballance

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<sup>1</sup> [http://www.economic-insight.com/wp-content/uploads/2016/05/Economic\\_Insight\\_Forms\\_retail\\_control\\_evidence\\_review\\_Final.pdf](http://www.economic-insight.com/wp-content/uploads/2016/05/Economic_Insight_Forms_retail_control_evidence_review_Final.pdf)

## 1. Overall messages relating to benefits and distributional effects

The four scenarios as presented strongly infer that introducing retail competition to households would be beneficial.

The best scenario presented (scenario 1) shows a benefit overall of around £6 per customer per year and this seems to be the scenario that is mostly reported in the highlights, “*Our analysis shows that competition could drive efficiencies in retailing that on their own would suggest a price saving for customers in the order of £6 – or 2% – off the average bill*”. The high scenario is only one of four scenarios and it is unclear how likely each of these are. It would be more balanced to present ranges or probability weighted averages. Additionally, the present value discounted payback periods for some of the scenarios are long, e.g. Scenario 1 has a 10 year payback, Scenario 2 is 14 years, Scenario 3 is 21 years and Scenario 4 does not payback<sup>2</sup>. These wider considerations should be reflected in the overall benefits case.

The findings also do not cover any potential distributional impacts on customers. Water UK<sup>3</sup> have published a report from ICS which shows that customers that choose to switch will benefit, whilst those customers that do not switch potentially see higher bills as seen in the energy sector. The cross-subsidies in place would come under increasing pressure as overall cross subsidies recoverable from the current retail charge reduce, thus impacting more vulnerable customers if mitigating measures are not in place.

## 2. Switching rates and customer acquisition costs

The headline scenario (scenario 1) which is the one mostly reported on in the findings assumes 50% of customers are actively engaged in the market within 10 years. The report also makes the assumption that customer acquisition costs are between £8 and £15. We provide additional evidence on each of these below.

### 2.1 Additional evidence on switching rates

In energy, the Competition and Markets Authority (CMA) found that at most, 44% of customers were active in a market which has been de-regulated for nearly 20 years<sup>4</sup>. This is in a market where there is much greater scope for savings, given substantially higher energy bills (average energy bill £1,345 in 2015)<sup>5</sup> compared to the average water bill of £389 in 2016/17<sup>6</sup>. It is questionable therefore whether the switching rates assumed in the report can

<sup>2</sup> Ofwat, July 2016, Costs and benefits of introducing competition to residential customers in England – emerging findings, Figure 1 to 4

<sup>3</sup> ICS on behalf of Water UK - Distributional Impact of introducing household retail competition to the water sector, April 2016

<sup>4</sup> CMA Energy Market Final Report, June 2016

<sup>5</sup> Ofgem, Oct 2015

<sup>6</sup> <http://www.water.org.uk/news-water-uk/latest-news/household-water-and-sewerage-bills-2016-17>

be achieved in reality, particularly given customers' expectations of a 25% reduction in their bills – a level of discount which is significantly greater than the complete retail element of the bill.

The CMA's final report<sup>7</sup> also observed that there are a material number of customers who appear to be fundamentally disengaged from the domestic retail energy markets in the sense that they are either not aware of their ability to exercise choice or have not considered exercising the choice they may have, notably:

1. 34% of respondents said they had never considered switching supplier;
2. 36% of respondents either did not think it was possible or did not know if it was possible to change one (or more) of the following: tariff; payment method or supplier; and
3. 56% of respondents said they had either never switched supplier, did not know it was possible or did not know if they had done so.

Additionally, CCWater's research<sup>8</sup> shows that whilst 65% of customers in principle support competition and choice in water retailing, only 32% of customers stated that they would consider switching in practice for the anticipated savings of £4-£8. There is a sense that retail competition in water may not bring the desired benefits anticipated by customers with around 44% of customers saying they would require savings of £40 per annum to consider switching.

This puts into question whether the switching rate in Scenario 1 is overstated and that perhaps a lower number (say 35%-40%) should be used instead.

## 2.2 Additional evidence on customer acquisition costs

Customer acquisition costs in the energy sector are higher. The commission paid by energy suppliers to price comparison websites for each switch generated varies but is typically £15 to £35 per fuel per successful switch<sup>9</sup> and price comparison websites account for a large number of switches.

Ofgem found that around 31% of customers used price comparison websites the last time they switched supplier<sup>10</sup>. The CMA customer survey found 62% of those who switched energy supplier in the last three years used a price comparison websites for information and of those, 53% used a price comparison website to switch<sup>11</sup>.

<sup>7</sup> CMA Energy Market Final Report, June 2016

<sup>8</sup> Floating the Idea: Household customer views on water market reform in England, May 2016

<sup>9</sup> CMA Energy market investigation on price comparison websites, Feb 2015

<sup>10</sup> Ipsos MORI 2014, Customer engagement with the energy market tracking survey 2014 prepared for Ofgem

<sup>11</sup> CMA Energy market investigation on price comparison websites, Feb 2015

Ofgem also found that whilst declining, around 14%-15% of energy switches in 2014 was still through a door to door salespersons<sup>12</sup> (another relatively high cost way to switch).

The report we commission from Economic Insight<sup>13</sup> found international evidence that customer acquisition costs in energy retailing were between £66 and £99 per customer.

It is challenging to see how the low spend figures of £8 or £15 can generate the high levels of participation set out in the scenarios, particularly when compared to the energy sector. At the lower level of customer acquisition costs we would expect to see far less market participation (particularly given the much lower level of savings on offer due to the water bills being significantly lower than energy in bills) and hence a much lower level of switching in the market than those set out.

### 3. Bad debt

The single biggest factor underlying the impact assessment is the expectation on bad debt improvements, as shown in the sensitivity analysis of the report.

The report states that “£2.2bn of residential water revenue was outstanding in 2014, compared with around £475m in gas and £480m in electricity, despite average bills generally being two to three times higher than water across both fuels.”

In the most optimistic case (scenario 1), bad debt across the sector reduces by more than 50%, driven by the assumption that water companies can become as good as energy companies in reducing bad debt. Below we set out a number of areas of additional considerations on this assumption.

#### 3.1 Additional evidence on bad debt approaches

The Walker Report (2009) highlighted the need to consider the impact of prepayment meters when comparing water and energy sector debt levels. It noted that prepayment meters and the ability to disconnect in energy meant water sector debt is higher than energy sector debt. As customers have no risk of disconnection, water payment is inevitably given lower customer priority compared to other utilities<sup>14</sup>.

Energy companies have moved large numbers of high risk customers onto prepayment meters (as set out in the chart below), which means customers in effect self-disconnect if they do not pay.

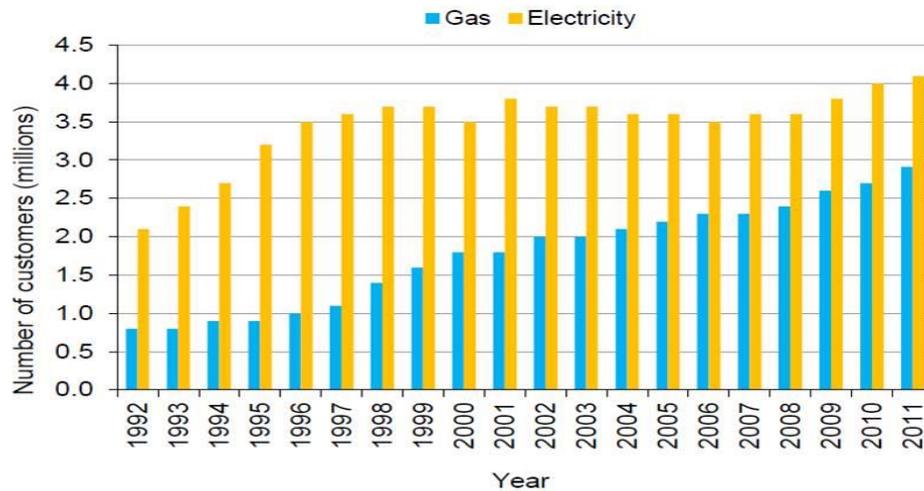
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<sup>12</sup> CMA Energy market investigation on price comparison websites, Feb 2015

<sup>13</sup> See footnote 1, pg 25

<sup>14</sup> The Independent Review of Charging for Households Water and Sewerage Services, 2009, Anna Walker

**Customers on prepayment meters for gas and electricity**



Source: Ofgem

Prepayment meters are generally installed where a customer has a poor payment history. Ofgem reported that in 2014 more than 60% of prepayment meters were installed due to debt or in specific types of accommodation such as holiday homes and student accommodation. If a customer moves into a property with a prepayment meter they may request it to be replaced with a standard meter but the supplier may require them to pay for the costs of doing so.

Around 1 in 6 of the UK market is on a prepayment meters – and this has risen sharply:

- The proportion of gas customers on prepayment meters doubled over the period, from 7% in 1996 to 15% in 2015 (equating to 3.4 million gas prepayment meter accounts).
- The proportion of electricity customers on prepayment meters is 17% (equating to 4.5 million prepayment meter accounts)<sup>15</sup>.

Ofgem state that disconnecting supply by energy companies should only take place as a last resort, and as a result of their work, disconnections for energy debt remain low. Hence, whilst energy companies had to disconnect 233 customers in 2014, according to Citizens Advice, 1.62 million people actually had their service cut off due to non-payment through self-disconnecting<sup>16</sup>.

Additionally, Citizens Advice strongly advises customers not to move onto pre-payment meters and advises customers how to push back against pressure from energy suppliers to move them onto prepayment meters.

<sup>15</sup> Ofgem Domestic Suppliers Social Obligations: 2014 annual report, Sept 2015

<sup>16</sup> <https://www.citizensadvice.org.uk/about-us/how-citizens-advice-works/media/press-releases/1-62-million-prepayment-energy-consumers-cuts-off-each-year/>.

In the initial evidence report on HH retail, it is difficult to envisage such optimistic assumptions of changes in bad debt without major changes in debt collection practices and a repealing of the bans on customer disconnection, trickle flow valves or prepayment meters. It is questionable whether these policy options would be considered appropriate or desirable by policy makers or customers. If the current assumptions on bad debt improvements are retained in the scenarios, it would be helpful to have a fuller explanation of the range of options on how this could be achieved without prepayment meters or revoking the ban on disconnection.

We therefore believe that the following statement in the report does not reflect the full nuance of the situation:

*“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.”*

### 3.2 Additional evidence on properties vs individuals being billed

The analysis appears to make the assumption that water companies bill properties and not individuals and hence are not good at managing debt (*“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”*).

Water companies bill individuals rather than properties and the practice of sending bills to “The Occupier” has changed across the industry over time. For example, we do not bill unknown customers as “The Occupier” rather we seek to identify the individual through multiple interventions first before issuing a bill. Hence this statement does not reflect the practices we apply to 1/6<sup>th</sup> of England’s household retail customer base.

### 3.3 Additional evidence on council tax benchmarks

The report also suggests local authorities collected 98.1% of 2014-15 council tax debt within the year. This figures relates to non-domestic collections. The correct figure is 97.1% for domestic rates for 2015-16 (or 2.9% for non-collection) - broadly in-line with the water sector operating under a regulated model<sup>17</sup>.

We believe that your assumptions and conclusion of bad debt, the single biggest factor for whether to introduce a retail market or not, requires re-examination. Should more modest

<sup>17</sup>[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/536984/Collection\\_Rate\\_Statistics\\_Release\\_June\\_2016\\_-\\_revised\\_12\\_July\\_2016.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/536984/Collection_Rate_Statistics_Release_June_2016_-_revised_12_July_2016.pdf) pg 5

and plausible assumptions on bad debt improvement be used, the results of the cost benefit analysis are likely to be far more marginal.

#### 4. Market set up and implementation costs

The findings suggest market implementation costs will total £200m, being about double the best estimate of the cost of opening the non-household market in the two best scenarios and £400m in the two worse case scenarios.

##### 4.1 Additional evidence on market set up and implementation costs

Water UK has recently reported on its best estimate of the set up costs for non-household retail with information collected from individual companies to produce an industry wide view<sup>18</sup>. It states that the cost of implementing the market would depend on its design e.g. whether the market was ‘thin’ with it having a limited scope of activities or ‘thick’ and hence including more activities. It also notes that the two markets would be of materially different scale – there are over 20 million household customers in England but only 1.2 million non-household customers.

Water UK’s reasonable assessment of the estimated costs incurred by companies so far is over £200m with a further £80m estimated post market opening.

##### Estimated costs of the retail non-household market in England

	Pre-market opening costs (2014-15 to 2016-17 total, £m)
Central programme	38.2
Internal programmes	43.5
Market readiness	105.8
Wholesale service centre development	13.9
<b>Sub total</b>	<b>201.4</b>
	Post-market opening costs (2017-18 to 2019-20 total, £m)
Expected market operator charges	25.2
Wholesale service centre	49.8
Compliance and equivalence	4.5
<b>Sub total</b>	<b>79.5</b>
<b>Total</b>	<b>280.8</b>

It would be prudent to review the likely set up costs for the household retail market in light of the new data available. Should the same multipliers be applied to the findings, it would imply the best estimate would be in the order of £560m for market set up costs, and in the two

<sup>18</sup> Water UK report Estimated costs of non-household retail opening July 2016



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worse case scenarios it would cost over £1.1bn to set up the household retail market. It would also be helpful to include reasons why the multipliers used are valid, and to test the sensitivity of the case and the effects of these multipliers.