

**FAO: Giles Stevens**

Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham  
B5 4UA

Direct line: 01392 443467  
Email: [ivosper@southwestwater.co.uk](mailto:ivosper@southwestwater.co.uk)  
Our ref:

By email:

8 August 2016

Dear Giles

### **COSTS AND BENEFITS OF INTRODUCING COMPETITION TO RESIDENTIAL CUSTOMERS IN ENGLAND – EMERGING FINDINGS**

South West Water is pleased to have the opportunity to comment on, and further contribute to, the ongoing assessment of the costs and benefits of introducing competition in the residential retail sector. We welcome the transparent and inclusive way in which the UK Government and Ofwat are undertaking the review, and consider it is an appropriate time to examine if a market model can deliver improved customer outcomes in terms of bills and services for household customers. We continue to support progressive reform and the introduction of competition where there is clear positive long-term benefit to customers.

We are encouraged that the 'Emerging Findings' have been based on comprehensive engagement with the water industry, stakeholders and customers, and that opportunities for evidence to be gathered from a wide range of sources have been offered. We particularly support the use of customer research and engagement to inform the review, as it is crucial for establishing the legitimacy of any policy change considered in the name of customers, as well as demonstrating that Ofwat is matching the expectations placed on companies to develop plans based on robust customer informed evidence.

In considering the emerging findings, we have structured our response around a number of key themes, which look at the wider context of review as well as the more direct findings from the cost benefit analysis. We have included a technical appendix, which covers observations and questions around the methodological and technical application of the modelling. We have also submitted additional evidence where Ofwat has indicated that further information could help improve the final assessment, and have highlighted evidence which has previously been submitted, but has not yet been accounted for in the work to date.

### ***Relative priorities across the wider industry reform programme***

We recognise that Ofwat's terms of reference for the assessment is limited to considering the costs and benefits of a market model for residential retail service delivery, rather than to decide on if and when a market should be opened. However, the issue cannot be considered in isolation from the wider context of the current and future expectations for the water industry.

There is a significant programme of reform already underway in the sector, as a result of the step change in regulatory approach for the current Price Review period and the introduction of retail competition for non-household customers in 2017. Similarly, the vision for the industry's future in Ofwat's Water2020 programme lays the foundations for a further fundamental change in the structure and operation of water and wastewater services in the next five year period.

South West Water has welcomed these changes, supporting opportunities to improve outcomes for customers and the environment, as well as securing a financially sustainable company that can offer an appropriate return on risk for investors. However, the scale and pace of change across the industry should not go unrecognised, and there is a need to understand how a market for household retail customers fits within the relative priorities of the sector as a whole, and its ability to deliver successful outcomes.

The set-up and operation of a new market will be a significant undertaking for all parties involved and, as with all programmes of reform of this magnitude, there will inevitably be an opportunity cost to pursuing this course of action over others. The industry is facing extensive challenges, with population growth, climate change and economic and legislative uncertainty in the near term future. In order for the sector as a whole to respond effectively, clarity over the priorities and areas where activity is best focused is needed, before a decision about which methods of regulatory or market delivery models best deliver those objectives. This is particularly relevant to current challenges and discussions about resilience in the sector.

### ***Timing of reform programmes***

Equally, while we caution that the package of reforms currently expected for the industry is significant, and raises questions about the capacity of all stakeholders involved in successfully achieving the expected benefits across all of the programmes of change, we consider the issue is one of timing, rather than scope. Understanding the relative priorities for the industry will enable informed decisions to be made about which reforms should be implemented first (i.e. those which deliver the best value and benefit the fastest, and those which are need to address immediate concerns), and which areas could be phased in once ongoing reforms have been achieved.

We note that, even in the 'best case' scenario set out by Ofwat for residential retail competition, the benefits do not start to outweigh the costs until 10 years after initiation. In contrast, there are immediate concerns facing customers in terms of the affordability of household bills, concerns which are likely to increase in the current climate of economic uncertainty. Considering the scale of costs associated with the introduction of residential

retail markets, we question if there are more immediate alternative policy options that could deliver greater reductions in utility bill levels, either through more extensive social tariff options, alternative approaches to manage bad debt, or through use of other regulatory tools.

The payback periods for the market model scenarios investigated in Ofwat's analysis are striking. While three out of the four scenarios presented suggest residential retail competition could be cost-beneficial within the assumptions described, the respective timeframes for the benefits accrued to start outweighing the costs are long, at 10 years, 14 years and 20 years respectively. It is for this reason we urge that the cost-benefit for residential retail is considered within the total package of reforms for the industry. As is the case with many water companies' own cost-benefit analysis on investment programmes for the 5 year and 25 year plans, often even where an option is beneficial, it is not feasible to implement it when other activities can deliver greater benefits in faster timescales.

For example, for South West Water's 'spend to save schemes' (where investment upfront will create long term efficiencies or revenue generation that outweigh the expenditure), such as for renewable energy generation or the introduction of remote operational systems on sites, the expected payback period needs to be within 4 years to be feasible.

Recognising that there is a limited timescale for Ofwat to conduct additional research ahead of submitting the final assessment on the costs and benefits of residential retail markets before September 2016, we suggest that the legitimacy of the report could be enhanced if further customer research were undertaken. In particular, given the potentially small levels of bill reductions suggested by the cost benefit analysis and the extended payback periods demonstrated in the scenarios, we consider that customers should be given further opportunities to express informed views on residential retail competition now that more concrete information on the potential costs and benefits can be presented. Such an approach is akin to the 'acceptability testing' of business plans by companies at PR14, and would provide evidence on the credence of the report findings, and crucially, customers views on the timeframe for delivering such benefits (together with a check on their prioritisation of competition compared with alternative expenditure / savings and benefits).

### ***Outcomes for Customers***

Clearly, ensuring that the outcomes customers' value can be delivered is a key test in the consideration of a residential retail market. A significant amount of customer research has been undertaken recently to help inform Ofwat's assessment, including work by CCWater, and by ourselves and other water companies.

In all cases, there is a consistent message that customers would like the choice of retailer, but that switching behaviour will be primarily driven by expectations of bill savings. The research suggests that customers would not be motivated to actively participate in a market if the potential bill savings are low.

Similarly, the emerging findings are explicit in recognising the limitation of the cost benefit approach adopted so far, in that it currently only considers the aggregate outcomes across the totality of the customer base. We are pleased that, as part of the emerging findings

consultation, Ofwat has asked for additional supporting evidence to help explore these consequences at a more granular level. It is however disappointing that due consideration has not already been given to the issue at this stage, given the widespread calls from CCWater, stakeholders, and companies to place prominence in the analysis on the distribution effects for customers, particularly for those in vulnerable circumstances.

As part of Ofwat's initial call for evidence for the assessment, a group of companies commissioned a study by ICS Consulting, specifically to look at the potential distribution of impacts for domestic customers for retail competition. At a general level, the report found that there is currently an uneven distribution of retail cross subsidies across different segments of the customer base, and that the greatest cross subsidies exist in demographic groups most likely associated with vulnerable circumstances. Ofwat has referenced the analysis within the accompanying 'Report on Stakeholders views and Issues', but does not directly address the issue, and does not provide satisfactory evidence to support the theoretical discussion about how retailers may actually behave in a market.

The modelling presented by Ofwat in the Cost Benefit scenarios only considers customer segmentation at the level of 'active' or 'inactive' participants at the market, and explicitly does not examine the potential distributive effect of the efficiency gains in the residential retail cost base between these customers. Accepting the central assumption that 30% of customers may be active in the market, and that full benefits of the market will be achieved for these customers, we do not see any evidence to support the assertion that the 'inactive' customer will also receive a proportion of this benefit. There is no guarantee that these 'spill-over' benefits will be passed on to inactive customers. Indeed, as the evidence from the CMA Energy Market Investigation recently concluded, 70% of customers have not switched away from the most expensive default tariff option. It cannot be avoided that the consequences of competition result in the benefits being unevenly distributed across customer segments, and is vital that the potential outcomes for all customers are understood.

As highlighted above, many of the outcomes outlined for customers in Ofwat's analysis are not mutually exclusive to a competitive model. While a market approach could potentially offer a greater benefit overall for an aggregate customer base, a regulatory scenario could offer similar benefits (albeit at potentially a lower value), but that are more evenly distributed across the customer base. Water companies are currently required, under the licences to ensure that "*in fixing or agreeing charges ... that no undue preference is shown to, and that there is no undue discrimination against, any class of customers or potential customers.*"<sup>1</sup> The trade-off between a greater benefit for the few (through a market model), and the sharing of smaller benefits across all (i.e. regulatory approach) needs to be demonstrated more explicitly.

## **Conclusion**

Notwithstanding these comments, and those we have included on the technical assumptions and approach used to date in the modelling in Appendix 1, South West Water remains

---

<sup>1</sup> Condition E

supportive of the approach Ofwat has taken to date, and is pleased that a transparent and open approach to the assessment is underway. We note that many of the issues raised in this response have been identified previously by stakeholders who have also contributed to the review.

In particular, we would like to highlight the comments made at the recent residential review workshop on 20<sup>th</sup> July, by Zoe McLeod of Sustainability First. We agree that there are many potential risks in a residential retail market that need to be openly recognised, so as the feasibility of such an approach can be considered comprehensively, and the potential effects, both in terms of customer outcomes and costs, can be clearly articulated. Not only will this give a sound basis for informing policy decisions, but will help to identify the issues which will need to be addressed should the UK Government decide to pursue a residential retail market.

We look forward to continuing ongoing engagement on this issue throughout the course of the assessment.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Iain Vosper', with a long horizontal flourish extending to the right.

Iain Vosper  
**Regulatory Director**

## APPENDIX 1: Technical Assumptions and Approach

Ofwat Assumptions in Cost-Benefit Analysis	South West Water Comment
<p>Bad Debt</p> <p>Ofwat has estimated that the introduction of competition in retail will result in a 1% p.a. reduction in bad debt costs above the general efficiency assumptions assumed for the whole retail cost base.</p> <p>The estimate is based on reference to energy and council tax bad debt rates in the absence of specific evidence on quantitative estimates of the potential effect of competition on bad debt.</p>	<p>The comparison between bad debt rates in energy and council tax sectors is problematic as there and a number of striking differences across these sectors which significantly impact the plausibility of using information drawn from these sectors as the basis of a central estimate for reducing bad debt in the water sector.</p> <p>In particular, the use of pre-payment meters in the energy sector – an option which is not available to water companies as a result of the statutory ban on disconnection under the Water Industry Act 1999. As Ofgem notes, there are a large number of pre-payment meters (PPM) in use by gas and electricity companies, most of which are installed to manage debt, and which they do effectively:</p> <ul style="list-style-type: none"> <li>• <i>“There were around 4.5 million electricity PPM accounts and around 3.4 million gas PPM accounts in Great Britain in 2014. This amounted to 17% of all electricity customer accounts and 15% of all gas customer accounts in Great Britain in 2014.”</i><sup>2</sup></li> <li>• <i>“As in previous years, the majority of newly-installed PPMs, around 60% for both electricity and gas, were installed to manage debt. This amounted to around 175,000 electricity PPMs and 195,000 gas PPMs in 2014.”</i><sup>3</sup></li> </ul> <p>The need to take account of the impact of pre-payment meters when comparing customer debt levels in water and energy was recognised in the 2009 Independent Review of Charging for Household Water and Sewerage Service led by Anna Walker<sup>4</sup>.</p> <p>The review noted that bad debt in water is significantly higher than in energy, largely due to the use of pre-payment meters and the ability to disconnect in the energy sector, and that the absence of a risk of disconnection in water meant it is assigned a lower priority than other utilities:</p> <p><i>“Bad debt in the water industry is increasing at a significantly faster rate than other utilities and is more than three times that of the energy sector, where bills are three times higher. Household debt is relatively stable in the energy sector, but energy companies are allowed to disconnect for non-</i></p>

<sup>2</sup> Ofgem, “Domestic Suppliers’ Social Obligations: 2014 annual report”, 8 September 2015, p.31. <https://www.ofgem.gov.uk/publications-and-updates/domestic-suppliers-social-obligations-2014-annual-report>

<sup>3</sup> Ofgem, “Domestic Suppliers’ Social Obligations: 2014 annual report”, 8 September 2015, p.33. <https://www.ofgem.gov.uk/publications-and-updates/domestic-suppliers-social-obligations-2014-annual-report>

<sup>4</sup> Anna Walker, “The Independent Review of Charging for Household Water and Sewerage Services”, 2009 <https://www.gov.uk/government/publications/the-independent-review-of-charging-for-household-water-and-sewerage-services-walker-review>

payment of bills or install a pre-payment meter (PPM), which is a significant deterrent to non-payment. In 2008, 2.4 million gas customers and 3.6 million electricity customers were paying through a PPM and therefore unable to build up new debt. However, Ofgem reports that around 70 per cent of the PPMs fitted in 2008 were installed to recover old debt.<sup>5</sup>

From 2005/06 to 2008/09 Citizens Advice recorded a 42 per cent rise in water debt problems, suggesting that water debt is becoming increasingly problematic for customers. Citizens Advice has told the review team that in line with widely accepted money advice principles, CAB and other advisers in the free debt advice sector advise their clients to first pay debts that result in disconnection, imprisonment or eviction. It has been suggested that advice to give water debts a lower priority than other arrears is one of the primary reasons for the steep rise in the water industry's level of bad debt.<sup>6</sup>

The review also noted that pre-payment meters were popular with water customers before they were banned, but afterwards became meaningless and debt recovery had to be pursued through other means, with pre-payment meters having little value following the ban on disconnection (and self-disconnection):

*“PPMs were used extensively before the ban on disconnection and were popular with customers. Dŵr Cymru had 25,000 customers on their ‘Watercard’ scheme, but following the ban, they found that once customers defaulted the concept of prepayment became totally ineffective and had to revert to current debt recovery processes.”<sup>7</sup>*

Similarly, there are significant differences between the different enforcement powers that water companies and local authorities have, as local authorities have extensive powers to require payments, including an ultimate sanction of custodial sentences via Magistrates Courts.

In light of this evidence, we suggest that Ofwat refines the estimates associated with bad debt to account for the use of prepayment meters in energy and their impact on bad debt management.

<sup>5</sup> Anna Walker, "The Independent Review of Charging for Household Water and Sewerage Services", 2009, p.133. <https://www.gov.uk/government/publications/the-independent-review-of-charging-for-household-water-and-sewerage-services-walker-review>  
<sup>6</sup> Anna Walker, "The Independent Review of Charging for Household Water and Sewerage Services", 2009, p. 140. <https://www.gov.uk/government/publications/the-independent-review-of-charging-for-household-water-and-sewerage-services-walker-review>  
<sup>7</sup> Anna Walker, "The Independent Review of Charging for Household Water and Sewerage Services", 2009, p.143. <https://www.gov.uk/government/publications/the-independent-review-of-charging-for-household-water-and-sewerage-services-walker-review>

**South West Water Comment**

**Ofwat Assumptions in Cost-Benefit Analysis**

<p>Wholesale efficiency</p>	<p>Ofwat's analysis of includes a 0.5% efficiency saving to all wholesale totex as a central assumption across the wholesale cost base. Ofwat considers this to be a conservative estimate, on the basis that the extension of retail competition to residential customers would significantly increase the scope for retailers to procure water resources from third parties rather than rely on incumbent wholesalers. (as part of the wholesale competition and Water 2020 industry changes).</p>	<p>The wholesale efficiency costs represent a substantial proportion of the benefits included in the scenarios, and are the second largest savings quoted in the analysis.</p> <p>The analysis presented by Ofwat suggests that retailers will be able to exert pressure from regional customers on wholesalers to reduce tariffs. However, it is not clear in practice how this would work, as wholesalers are required under Condition E to show no undue preference to customer segments in tariff setting. We assume this 'level playing field' approach will continue to operate in a residential retail market. We suggest Ofwat could include specific examples of the types of activities where retailers may expect to be able to extract differential tariffs for their customers to provide clarity on the assumptions.</p> <p>We are also concerned that analysis presented by Ofwat suggests there will be further distributional impacts in terms of which customers may receive benefits from the market. As Ofwat recognises, the development of the market for water resources will be regionally based, with retailers being able to competitively tender water resources from new entrants and incumbents alike. However, the potential for new water resources to be developed will depend on the regional circumstances and the availability (and need) for new resources to be introduced. This suggests that customers who live in regions where cost reductions from water resources can be procured by retailers (and the development of new water resources by incumbents and new entrants) will benefit more than customers who live in areas where this is not feasible. However, the costs of retail market set up and operation will be borne by all customers. As part of the further work Ofwat has signalled that it will complete as part of the further analysis to understand the impact of the scenarios on the disaggregated customer base, we suggest that these regional distributional effects are included for consideration.</p>
<p>Set up Costs</p>	<p>The central estimate for <i>Regulatory Set Up Costs</i> have been based on the Non-Household Market Opening Costs (£5.6m). The Ongoing Regulatory Costs have been estimated at £2.4m, based on Cave Review estimates and Water2020 costs.</p> <p>The central estimates for the Market Operator Set up Costs have been based on twice those incurred to date in the Non-Household retail market</p>	<p>Customers and stakeholders have consistently commented on the potential for multi-utility billing and retail services as a key benefit for retail competition, if the not the most significant benefit. Ofwat has recognised this issue in the costs and benefits analysis, wrapping the potential cost savings from bundling multi-utility offerings into the overall efficiency savings in wholesale and retail. However, in order to facilitate the bundling of services, there would need to be a clear intention from the outset of introducing retail competition in water to align the market architecture and codes with those in other utility sectors (i.e. energy). We consider that such an approach, while highly desirable for customers, is likely to incur greater set up costs, but without generating actual savings on the water bill, particularly as this may mean that it will not be possible to adopt the same market and regulatory approaches currently being developed in the non-household retail market. It does not appear that this additional cost has been taken into account in Ofwat's estimates of regulatory start up costs. In terms of the set up and ongoing costs for the Market Operator, we suggest that further evidence to refine the assumptions could be drawn from the electricity market.</p> <p>Elexon, who operate the energy market operator balancing system recorded ongoing costs of £1bn for 2013-14. Recognising that the balancing system in electricity is fundamentally different to that in water, we consider there</p>



**South West Water Comment**

<b>Ofwat Assumptions in Cost-Benefit Analysis</b>	
	<p>is merit in understanding the costs involved in other utility markets comparison, rather than relying solely on estimates of the non-household market set up and ongoing costs. As outlined above, there is also merit in this approach if multi-utility bundling benefits are included in the analysis.</p> <p>In terms of company set up and market opening costs, it is not clear what information Ofwat has included in the estimates, as reference is made to both the most recent estimates of company costs directly accrued from non-household retail market opening, as well as extrapolated costs from a single company's PR14 submission. We would strongly urge Ofwat to ensure that the company cost estimates are based on the most recent evidence available and are directly related to actual costs incurred in the Non-household market, rather than single point estimates from business plan submissions 3 years ago.</p>
Water Efficiency Assumptions	<p>Again, the benefits assumed to arise from greater water efficiency savings from retail competition are significant and account for a large proportion of the total benefits in the NPV positive scenarios. However, we have a number of observations on the approach taken so far:</p> <ul style="list-style-type: none"> <li>• We note that Ofwat has assumed that PCC will remain relatively stable across the industry across the 30 year projected time horizon. However, this is not an accurate characterisation, as outlined the main response above, water companies have significant drivers to reduce water consumption. SWW are projecting a modest decrease in PCC for the current WRMP period, which is one of the smallest decreases in the industry as a result of the already high levels of metering in the region. However we note that other companies have already experienced falls in PCC and have more significant reductions planned; we consider that these should be properly accounted for in the final cost-benefit analysis.</li> <li>• The scale of water efficiency benefits to some extent depends on the tariff structures companies have in place across the industry. Water efficiency savings will only be incentivised where wholesale tariffs include a large variable element compared to the standing charge, which is not uniform across the industry. Again, we consider this issue should be included in further analysis on the distributional impacts of competition.</li> <li>• We would welcome further clarity from Ofwat on the issue of reducing domestic wastewater production. It would be helpful if Ofwat could include examples of how retailers might be able to achieve the projected benefits from wastewater efficiency, as it is not currently clear what activities are included in the analysis.</li> </ul>
Scenario Likelihood & Sensitivity Analysis	<p>The scenarios set out by Ofwat do not include any assumptions around the probability or likelihood of the scenarios manifesting themselves. It would be inappropriate to base cost beneficial analysis on any scenario which is not probable, therefore we suggest further discussion of this is would enhance the final analysis, particularly in light of the current external economic and financial uncertainty. It is also important to explore this issue further, as effectively only one model of competition has been tested under different sensitivities.</p>

South West Water Comment	
<p data-bbox="177 150 240 551"><b>Ofwat Assumptions in Cost-Benefit Analysis</b></p>	<p data-bbox="240 150 392 2087">cost and benefit category.</p> <p data-bbox="240 150 392 2087">We also note that Ofwat have assumed a uniform probability distribution between the low, central and high assumptions. We would welcome further exploration of this, particularly in relation to the key benefit and cost assumptions where the central estimates are not based on direct evidence (e.g. bad debt assumptions) or are the main drivers for difference between the scenarios (e.g. set up costs and wholesale efficiencies).</p>