

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

Southern Water's Response

August 2016



Southern Water's response to the costs and benefits of introducing competition to residential customers in England

We welcome the opportunity to respond to the emerging findings into the costs and benefits of introducing competition to residential customers in England.

Southern Water welcomes the introduction of competition and market mechanisms where this will drive clear benefits for water and wastewater customers within our sector, and support an objective review into the costs and benefits of introducing household retail competition.

We welcome the emerging findings report and have provided feedback on both the qualitative and quantitative assessments which we hope will be useful to help further refine the estimated costs and benefits for the final report in September.

Our response focuses on five major topics which we believe are important to consider. These are:

- Distributional effects
- Bad debt
- Water efficiency
- Benefits of the counterfactual
- Multi-utility services

In summary, we believe that the assessment of the quantifiable aggregate benefits is insufficient to provide a definitive view on the customer benefits and costs of introducing residential retail competition. As there is no such thing as an average customer, we believe that it is important for the final report to contain evidence and analysis of the distributional impacts of introducing household retail competition.

We suggest that the estimation of bad debt savings from the introduction of residential competition is re-examined and more plausible benefits are applied.

We believe that the analysis does not take into account the full benefits of the counterfactual. These include the benefits of regulated incentives for water efficiency, the cost of metering and the wider benefits of vertical integration.

We believe that combined billing services could generate significant economies of scale and scope at or above the upper range of your quantitative assessment.

Distributional Effects

We understand that the initial analysis has focused on the aggregate effects across the market to estimate a potential average saving of between £2-4 per customer based on the central scenarios. We believe that this aggregate level does not provide a holistic assessment of market success and customer impact required for the Government to decide to proceed with the introduction of residential competition. We believe that the distributional effects on customer bills, which can differ significantly between customer segments, needs

to be considered at a more granular level in order to fully assess the overall benefit of the market to customers.

Within existing water and sewerage charges, there are a wide range of cross-subsidies between different customer groups. Introducing retail competition for residential customers will create new drivers to unwind these retail cross-subsidies. Incumbent companies would need to unravel these cross subsidies prior to market opening in order to avoid the cherry picking of lower cost to serve customers, or be open to accusations of margin squeeze for higher cost to serve customers receiving more averaged tariffs.

Factors driving the retail cost to serve, and therefore cross-subsidies, include:

- Payment method
- Debt risk
- Contact channel
- Contact frequency
- Payment Frequency
- Metering

Analysis of the potential distributional impacts has already been undertaken by ICS Consulting and the report to Water UK is available as an input to the evidence base to inform assessment of the market benefits. Key findings of the ICS Report¹ include:

- Households who are most likely to be in debt received a beneficial subsidy of £145 per household. Households who were least likely to be in debt contribute on average £20 per household.
- Households in the bottom 30% of incomes receive retail cross-subsidies equal to £43 per household. Households in the top 30% of incomes contribute £17 on average
- Households who do not pay by direct debit receive a subsidy of £19. Households who pay by direct debit contribute an average of £14.

Based on these findings, it would appear that the benefits of introducing competition will be accrued to the higher income households, as opposed to across the customer base.

Customers with the least ability to pay are likely to be disadvantaged by the unwinding of the retail cross-subsidies. For instance, a low income customer could benefit from the potential £3 cost saving delivered by competition, but be subject to an increase of £43 from the unwinding of the cross subsidy. We suggest that such evidence of the impacts on customer bills and the distribution of the benefits would need to be included in the final report to inform Government policy. We would suggest that the proportion of customers benefitting from an overall reduction in charges, through both the competitive market and distributional impacts, is compared with the proportion and extent of those disadvantaged. Any evidence of the impact of distributional impacts in the energy sector would also be useful to consider.

We suggest that the potential impacts of unwinding retail cross subsidies are included in any further customer research. It is important for customer expectations to be managed and that customer views on potential savings are provided in light of the distributional impacts on retail charges. It is interesting to note that the Ofwat customer research showed that customers struggling or in debt were more positive about the idea of choice than average. It

is highly unlikely that this would have been the case were the customers made aware of the potential unwinding of subsidies and higher bills for this group.

We believe that the assessment of the quantifiable aggregate benefits is insufficient to assess the customer benefits and costs of introducing residential retail competition. As there is no such thing as an average customer, we believe that it is important for the final report to contain evidence and analysis of the distribution impacts of introducing household retail competition.

Bad Debt

We believe that the assumptions concerning savings through the reduction in bad debt needs further consideration and review. We are not convinced that the assumptions used in the quantitative estimate are realistic or plausible.

The examples of other sectors used to estimate the potential savings to bad debt costs are not comparable to the household water sector. The comparison with levels of bad debt for council tax is in no way comparable to bad debt costs for residential water customers. Individuals who fail to pay council tax can ultimately be imprisoned and, because of this, debt advice suggests prioritising payment of Council Tax (and other taxes) before civil debts.

The level of debt in the energy sector is also not comparable. Disconnection, or even the threat of disconnection, is available to energy suppliers. On the contrary, disconnection of water supply is not legal for household customers. Furthermore, although disconnection by suppliers may not be widespread in energy, the use of pre-payment meters in the sector, in essence, provides a self disconnection method for customers who fail to pay.

We, therefore, believe that the estimation of bad debt savings from the introduction of residential competition is re-examined and more plausible benefits are applied.

Water Efficiency

One of the quantified benefits of introducing competition is improvements to water efficiency. The most likely scenario estimated a reduction in consumption of 10% for customers that are active in the market. Ofwat's assumption in the counterfactual is that consumption will remain roughly constant over the next thirty years, based on companies' Water Resource Management Plans.

However, this is not true of all companies. As a result of Southern Water's Universal Metering Programme, customers have made on average 16.5% savings in their water consumption, equivalent to 60 litres per household per day, and consumption is expected to continue to fall. This has been delivered under the current regulatory framework and compares to an average reduction in consumption of 2% for customers in the Scottish market.

In some areas across the country water consumption may be forecast to remain constant. In these areas the most cost-beneficial way to balance supply and demand may not be water efficiency. It is not clear that competition would reduce consumption in these areas (or that it would be beneficial to do so).

If the current regulatory framework can deliver the same (or more) benefits, for example through Outcome Delivery Incentives, this needs to be considered in both the counterfactual and competitive scenarios.

In its next stage of analysis, Ofwat should also consider how water efficiency benefits are distributed across customers. Under Southern Water's Green Doctor programme, which provided customers with tailored water efficiency advice, more than £3 million of benefits were secured for customers in financial hardship. This may not be the case under competition if only the active part of the market benefits.

Counterfactual

We believe that the analysis does not take into account the full benefits of the counterfactual. These include the benefits of regulated incentives for water efficiency, the cost of metering and the wider benefits of vertical integration.

As stated above, regulation has successfully delivered water efficiency in water stressed areas such as the South East. It is feasible that further reductions in water consumption and accompanying improvement in resilience could be driven through regulatory mechanisms such as Outcome Delivery Incentives. Vertical integration has enabled delivery of these water efficiency savings through the wholesale investment of the Water Resource Management Plan. It is not clear how investment in metering and water efficiency would be funded in a competitive retail market or whether the cost of investment and retail margin has been included in the competitive market analysis. There could also be a loss of economies of scale if the roll out of metering is dependent on differing retailer strategies rather than an incumbents' regional strategy to deliver resilience and water resource efficiency. These benefits should be fully considered in the counterfactual.

Bundled Services

The qualitative assessment provides some evidence of the benefits of combined billing of services. We agree that the convenience and potential savings from such multi-utility bundling would be valued by customers. Whilst there is less compelling evidence to date that customers bundle services across utility sectors (such as energy and telecommunications), we would expect customers to consider bundling water services with energy supply. We believe that such combined billing services could generate significant economies of scale and scope at or above the upper range of your quantitative assessment.

Should you have any queries regarding our response, or would like to discuss any aspect of it with us, please contact our Market Reform Manager, Dylan Freeman, on 01903 272351 or by email dylan.freeman@southernwater.co.uk