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Trust in water

# The costs and benefits of introducing competition to residential customers in England: stakeholder responses on emerging findings

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# About this document

On the 18 July 2016, we published our emerging findings on the costs and benefits of introducing competition to residential customers in England. In this document we also sought respondents' views on;

- our assessment of qualitative factors, including views on how we might quantify those factors;
- additional evidence from stakeholders which could be incorporated into our analysis;
- the assumptions needed to undertake a rigorous distributional analysis;
- the factors that it would be helpful for the distributional analysis to address; and
- any evidence which could be provided to support this analysis.

In line with the key principles and objectives outlined in our terms of reference for the review, we also welcomed responses from stakeholders on any part of our analysis ahead of producing our final report to government.

In this document we outline the responses to our consultation questions and also some key issues that stakeholders have raised in response to our emerging findings. Having considered these responses, we have made a number of changes to our analysis. These are summarised in **Chapter 2** of the final report published alongside this document, **Costs and benefits of introducing competition to residential customers in England**. Further detail relating to the changes we have made is provided at **appendix 1** of our final report.

In addition to stakeholder submissions on the emerging findings, as part of the review process we also consulted with a variety of stakeholders through bilateral meetings and two well-attended workshops. We used these forums to seek challenge on our analysis.

We also recognise that it is essential that our analysis is informed by the views of customers. So an important strand of our work has been to engage with customers to understand what they think about competition in the residential retail market. During the course of the review, therefore, we have worked with market research firm Accent to understand whether customers would be interested in competition, what they would see as the advantage and disadvantages if it were introduced, what they would look for from a competitive market, and how likely they would be to engage in a competitive market.

We have also considered research commissioned from Systra by the Consumer Council for Water[1] that explores customers' expectations of savings in a competitive market. We have worked with the Consumer Council for Water to ensure that the two sets of consumer research did not overlap.

Over the course of the review we also extended our research into other utility sectors to draw from their experiences of introducing retail competition and to identify potential sources of evidence.

We have assessed a wide range of evidence, much of which has been provided by stakeholders, to inform our final report. In some cases we have identified and discussed specific policy issues, or made policy assumptions. In line with our terms of reference, we have done so for the purposes of illustrating the analysis in our emerging findings, so that our final report can best inform the government. Our analysis assumes no changes to current government water policy. As we set out in our emerging findings our aim was to work with stakeholders to ensure that we provided a robust evidence base to inform the UK government's decision about whether and how best to take forward extending retail competition to residential customers.

We acknowledge that a number of key issues raised by stakeholders would need to be assessed during the design process ahead of the delivery of a residential retail market. For example, a market design would need to address social and environmental policy challenges. We also note that the design of the market and ongoing regulation would need to mitigate the risk of unfair treatment of customers to ensure the potential benefits are spread widely. Having submitted our report on the costs and benefits of extending competition to residential customers in England, we are ready and willing to work with government as it decides how best to take this forward. This might involve carrying out further analysis of possible impacts on different customer groups to understand what action is needed to protect customers.

We are grateful for all the contributions we received during the consultation on our emerging finding and in section 2, we provide a list of the stakeholders who submitted responses. In addition, and in line with our objective to undertake this

[1] Floating the idea: Household customer views on water market reform in England

review in an open and transparent manner, we are publishing all non-confidential information and evidence received.[2]

## Contents



[2] We have received a small number of submissions that were commercially confidential. As such, some submissions have not been published alongside this report but are available to government on request and used to inform our analysis.

# 1. Stakeholder responses on emerging findings

When we published our emerging findings we noted that an important part of the review process would be to allow all stakeholders to understand the views of other parties and consider evidence which they have put forward.

This section provides a summary of all the responses we received. To aid in the presentation of the issues raised by stakeholders we have summarised views under the following key policy areas:

- scale and distribution of costs and benefits;
- customer debt;
- customer support schemes and vulnerable customers;
- customer engagement;
- water and wastewater efficiency; and
- other points covered in responses.

In each of these sections we set out:

- the position adopted in our final report; and
- how we considered stakeholders' responses.

## 1.1 Scale and distribution of cost and benefits

### Position adopted in our final report

The distribution of costs and benefits between different customer groups will depend on how vigorous competition is, the different business models retailers deploy and the extent of regulation in the market. In any competitive market, it is inevitable that some groups of customers may do better than others. In our final report, we have not sought to identify and analyse which customers would be likely to do best, and which worst, in a competitive residential retail market. However, we acknowledge that this is an important issue that we will need to consider closely with government in the event that a decision is made to proceed with market opening.

## How we considered stakeholders' responses

We note a diverse range of stakeholders' feel that there is scope for more distributional impact analysis to be carried out before a decision is made. In particular, a number of stakeholders (including incumbent retailers, Customer Challenge Group Chairs, and charities) highlighted a need for further analysis into the potential detrimental effects that a new market could have on customers in vulnerable circumstances.

One incumbent retailer, for example, noted that the emerging findings do not describe or evaluate expected market outcomes across different customers and that the average net benefit of competition presented in the scenarios includes some customers who will receive a greater than average net benefit, but also customers where the net benefit will be less.

On the other hand, some incumbent retailers expressed the view that there is scope to implement a residential retail market, working on the basis that any analysis deemed necessary to support policy and process decisions would be undertaken as part of the market design.

An incumbent retailer suggested that presently in some regions there are social cross-subsidies in place for residential customers which allow companies to charge customers the same within a region despite differences in cost to serve. It was suggested that further work was needed to understand the distributional issues of retail market reform. We agree that this is an important point to consider further should a decision be made to introduce residential retail competition.

Some incumbent retailers have suggested that our findings should clearly take account of any upfront market costs, arguing that these will need to be recovered from customers and will result in bill increases in the near term. In relation to this point a number of stakeholders have questioned the basis upon which we developed our estimated implementation costs. Some stakeholders believe that using the business retail market as a model does not accurately represent likely costs for the residential market. Some stakeholders argued that there will be higher costs driven by factors such as the need for compliance with competition legislation, dealing with vulnerable customers and affordability particularly in relation to tariffs. On this theme a number of stakeholders referred to the Water UK submission which considers the upfront cost of the market and argued that these findings should take greater prominence in our final report.

Water UK's submission notes that "household and non-household markets would be of a materially different scale." However, despite specifically identifying this as an area of uncertainty in our emerging findings and inviting further evidence, we have not received any specific numerical evidence that allows us to assess the likely factor by which costs should be scaled up. Our final report therefore retains similar assumptions to our emerging findings, adjusted to reflect specific cost information on business market opening that stakeholders submitted. As such, we have taken the available evidence into account in the cost assumptions we set out in our final report.

Several incumbent retailers suggested that we should look to consider more evidence on distributional issues in our analysis, and in particular the report produced by ICS Consulting for Water UK[3]. Water UK commissioned ICS Consulting to consider the distributional impacts of the introduction of residential retail competition on cross subsidies between different categories of customers and services. The ICS Consulting report was previously considered in our report on stakeholder views and issues[4] that we published in July. In our final report we have included further information on the policy and regulatory considerations that relate to the issues highlighted in the ICS Consulting report.

We noted arguments were provided for and against the bundling of utility services. Some Customer Challenge Group (CCG) Chairs and incumbent retailers suggested that that such arrangements remove choice and contribute to poor customer satisfaction in the telecoms and energy sectors. Conversely, we received a response from an incumbent retailer suggesting that the benefits of bundling services have been underplayed in our emerging findings.

In our final report we maintain the view that there may be scope for companies to offer multi-utility bundles to customers in a residential retail market. Our analysis suggests that such arrangements could provide cost efficiency savings for companies by reducing their costs of engaging customers or delivering economies of scope through providing services that could be shared across utilities. It could also provide savings for customers by reducing the amount of time that they spend engaging with the market, although that would depend on how bundled products are priced, marketed and sold. Bundling could also help to lower bad debt costs if it

[4] The costs and benefits of introducing competition to residential customers in England: report on stakeholder views and issues

provides retailers with more opportunities to interact with customers and understand their capacity to make payments.

In the light of the above, our final report includes bundling in the overall efficiency savings applied throughout the value chain. In particular, scenarios 1, 2 & 3 include scope for multi-utility bundling in estimates of greater efficiency savings in retail services (although scenario 1 assumes greater efficiency, implying more widespread multi-utility offerings supported by emerging technology).

## 1.2 Customer debt

### Position adopted in our final report

In our final report we present significant further analysis on potential reductions in bad debt costs, taking into account the evidence received from stakeholders. This additional evidence related mostly to the comparison with the energy sector and did not materially increase the evidence specific to the water sector. Overall our additional analysis supported our view that our initial assumptions were reasonable.

Our final modelling assumes that additional bad debt savings arise from residential market opening in scenarios 1, 2 and 3. We based our estimates of bad debt savings on comparisons with levels of bad debt in other sectors and plausible reductions in overall retail costs.

In terms of bad debt we have not made specific assumptions about the level of bad debt. Our analysis is based on changes to the annual cost of industry bad debt, rather than specific assumptions about the stock of bad debt, write-off of old bad debt, or the amount of 'new' bad debt. We have used a comparison of the stock of bad debt between energy and water to support our assumptions while accepting that annual bad debt costs are likely not directly proportional to total stock of bad debt.

Based upon the submissions from several incumbent retailers we undertook a further examination of the relevance of the comparison with the energy sector, particularly given differences in the use of pre-payment meters (PPMs) and disconnection. These are two key issues frequently drawn upon by stakeholders to challenge the comparisons between debt levels in the energy and water sectors. Our conclusion, however, is that the sectors are broadly comparable as the differences between water and energy sectors in relation to disconnection regulations and the use of PPMs do not appear to fully explain the higher level of bad debt in the water sector.

We concluded that there remains scope for significant improvement in bad debt management in the water sector.

In our most 'optimistic' scenario (scenario 1) bad debt is lowered on a proportionate basis to double the equivalent level in energy today.

## How we considered stakeholders' responses

Our analysis assumes that retailers operating in a competitive environment would have greater incentive and ability to reduce bad debt costs. We did, however, consider the views of the majority of incumbent retailers who challenged the likelihood of this assumption without a change in government policy to allow disconnection and the use of PPMs in the water sector.

Several incumbent retailers made the point that energy sector customers who are in debt or who are financially insecure are encouraged onto PPMs. Such customers can effectively self-disconnect from time to time where they are unable to afford to top-up their meter. They suggest that this is why actual disconnections in the energy sector are low and therefore, why the level of debt in the energy sector is not comparable.

Some incumbent retailers noted that PPMs are often installed to manage debt, citing Ofgem's research paper "Domestic Suppliers Social Obligations 2014 annual report", September 2015 which indicates that, in 2014, 60% of newly installed PPMs were installed to manage debt. They put this forward as evidence that our assumptions on reductions in bad debt in the water sector were not reasonable, because the option to install a PPM is not available in water under current legislation.

Thames Water also mentioned that PPM's can be calibrated to recover pre-existing debt. As this would not be accounted for as bad debt, it would have the effect of lowering the stock of bad debt in the energy sector. Thames Waters view was that the debt assumptions in our scenarios are only consistent with the introduction of PPMs in the water sector, which is inconsistent with our assumption that the prohibition on disconnections will remain in place. Severn Trent also indicated that our assumptions on bad debt levels were difficult to envisage without changes to the legislation on disconnection, trickle flow valves and PPMs.

United Utilities provided evidence that indicates PPMs are prevalent in deprived areas and it noted that these areas are where it observes significant bad debt costs. United Utilities argued the energy market does not observe significant bad debt costs in these areas because there are high levels of PPMs.

United Utilities concluded that it saw no reason for the assumption that bad debt efficiency opportunities in a competitive market would be greater than other opportunities for retail cost reduction. It was suggested that the assumptions around general retail one-off and ongoing efficiency benefits from the introduction of competition adequately represent efficiency benefits for the full spectrum of household retail costs, including bad debt costs.

We acknowledge that PPMs may make a difference to the level of bad debt in the energy sector but we consider that this (in combination with disconnections) is not the only reason that debt levels are lower.

Our view that competition would reduce bad debt costs in the water industry is also partly based on the assumption that existing retailers would be required to locate and register all of their customers. One incumbent retailer noted that water retail competition would require retailers to identify individual customers, rather than billing households, because retailers could not switch customers without this information. This would help water retailers recover bad debt.

Northumbrian Water noted that the practice of sending bills to “The Occupier” has changed across the industry over time. The company explained that it seeks to identify the individual using a number of different methods before issuing a bill. Therefore our assumption that “it appears more plausible that the level of bad debt is explained by incumbent retailers’ poor information on individual customers, because they bill properties” was not necessarily applicable in its specific region.

Some stakeholders, particularly incumbent retailers and CCG Chairs, expressed concern that none of the scenarios that we presented considered the potential for bad debt to increase. However, our analysis models difference that residential retail competition could make verse the counterfactual. We took the counterfactual on how bad debt is expected to develop in the future from Defra’s modelling based on Water Resource Management Plans. We do not think it is reasonable or likely that residential retail competition would lead to higher debt than otherwise would be the case without competition.

Sustainability First noted its understanding from debt advice agencies was that there had been significant improvements in recent years in the way in which water companies manage debt, and that in many instances they do this better than companies in competitive retail sectors. While we acknowledge that there have been some improvements in company practice, the evidence we considered during our review did not suggest an improving debt landscape. The counterfactual in our final report reflects the actual trend in the sector where the total level of revenue outstanding from customers’ unpaid bills has increased in the four years between

2010-11 and 2014-15. Therefore, as noted above, our analysis modelled scenarios where competition will provide a greater incentive for retailers to improve the management of bad debt.

We received responses from some incumbent retailers in relation to the evidence that the total amount of outstanding council tax in July 2015 was roughly the same as the amount of outstanding water bill payments, despite annual payments for council tax being significantly higher. In its response Anglian Water noted that this comparison does not account for enforcement powers that councils have to recover debt through legal action.

The Centre of Competition Policy suggested that we should explain whether our analysis assumes competition will reduce the existing stock of bad debt or the flow of new bad debt. We address this issue in **Chapter 2** of our final report, where we discuss how we have updated our analysis since publishing our emerging findings.

A further factor supporting our conclusion is the fact that there is lower frequency of contact, particularly with new customers, in the water sector. We would expect this to change if retail competition is introduced and better position retailers to address consumer debt.

We appreciate that some stakeholders have opposing views, but in the round we think the additional analysis we have undertaken supports the assumptions made in our emerging findings. In reaching our conclusions we have reviewed a considerable amount of evidence and undertaken further research to better inform our thinking. As a result of this additional work there has been a significant increase in our analysis of potential additional bad debt savings which we include in the final report.

## 1.3 Customer support schemes and vulnerable customers

### Position adopted in our final report

In our emerging findings, we stated that any assessment of the compatibility of existing customer support schemes is beyond the scope of the review. This position has not changed for our final report. Our analysis assumes no changes to current government policy. We have not been asked by government to assess any specific policy changes and our analysis should not be taken as proposing any changes to government policy.

However, during the course of the review various questions have been raised about how a competitive water retail market can be consistent with different groups being adequately protected and sharing in the benefits. With this in mind, our final report provides more detail on our considerations of how to maximise the chances of success if a market was introduced.

Our final report notes that in other sectors customer protections, such as Universal Service Obligations (USO's), are placed on retailers with the aim of delivering good service standards for all customers. Something similar could be adopted for the water sector. There might also be a continued role for social tariffs and there are alternative ways these might be delivered, such as through a Universal Service Fund for example. It would be for government to consider the role and form of any such arrangements.

## How we considered stakeholders' responses

We received responses from some CCG Chairs, incumbent retailers and potential entrants noting that in a competitive market retailers would seek to mitigate risks by only targeting customers that they considered to be the most profitable (a practice known as "cherry picking"). As was the case in the responses to our emerging findings, some stakeholders raised concern that cherry picking could have a detrimental impact on vulnerable customers. We acknowledge that these are important arguments that will need to be considered if a competitive residential retail market is introduced. However, we maintain our view that appropriate market design can incorporate mitigations to limit or neutralise this risk. While we have not received any evidence to change our underlying modelling assumptions, we hear the arguments being made in relation to the issue of "cherry picking" and stand ready to work with government to explore addressing these concerns if necessary.

AgeUK also expressed a concern that a higher proportion of elderly customers, compared with other customer groups, could find switching to be difficult due to digital exclusion poor cognitive skills or physical impairments. Unless recognised and addressed, these barriers, could result in the emergence of price differentials between different customer groups, with 'inactive' customers at risk of facing higher bills than 'active' customers over the long term.

We have a statutory duty to protect the customer interest now and over the long term and to take into account the interests of individuals who are disabled, chronically sick or of pensionable age. We recognise that because of age, disability or illness, some customers may require specific help in the way their company delivers water and sewerage services to them. This is to make sure that they are not disadvantaged when compared with other customers. As such, we acknowledge the concerns raised by stakeholders regarding the need to ensure that appropriate protection is provided for such customers and regulatory oversight is in place if the government decides to proceed with a residential retail market. Customer protection will be critical element of the regulatory design of a new market and it should take particular account of those customers in situations of vulnerability.

The evidence we have received from those with experience of other utility markets indicates that it is critical for a market to be trusted by customers and society. Should a decision be made to proceed with retail market opening, 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.

## 1.4 Customer engagement

### Position adopted in our final report

Our analysis has been updated since the emerging findings to reduce the proportion of customers active in the market who switch in a year. We think this better reflects the experience of other utility markets and applies to all our scenarios.

In our final report we briefly considered issues about customer engagement which would be an aspect of any market design process if there is a decision to adopt retail competition.

We also considered the issue of potentially different experiences of active and inactive customers and discussed what regulatory mitigation may be available. We do note that the economics of the residential retail market in water is likely to render price dispersion less prevalent in the water sector than in the energy sector.

### How we considered stakeholders' responses

Some respondents to our emerging findings questioned some of the analysis that emerged from our customer research undertaken by Accent. Some stakeholders felt the finding that 50% of customers would be interested in switching given the choice was unrealistic. Some stakeholders were also sceptical that 45% of customers would be likely to switch in a market even without lower prices if a retailer were to offer new services.

On this point a number of stakeholders referred to the Consumer Council for Water's research[5]. AgeUK also provided switching data from across different sectors which appeared to suggest that switching rates would in practice be lower than we assumed in our analysis.

We acknowledge that the proportion of customers who would be likely to switch for reasons other than lower prices (45%) appears high in comparison with experience in other sectors. However, our customer research found that there were customers who were interested in service levels rather than just price savings, for example, water efficiency and leak monitoring. The benefits of water efficiency and leak monitoring go beyond reductions in customers' water bills. Using less water may result in less hot water being used which in turn reduces energy bills, and has associated carbon savings and other environmental benefits.

Our analysis suggests that future products and services driven by technology and possibly multi-utility bundling could entice the 50% of customers who said they would be interested in switching to actually change retailer. There are factors which some stakeholders noted in their responses that could drive this level of engagement, such as lower cost and ease of switching, lower customer acquisition costs, new business models and ease of comparison (with or without the assistance of third party intermediaries),

This view was supported by a number of responses from potential new entrants which set out potential service offers that they could provide in a residential retail market. One potential entrant cited a number of examples of how technological innovation is positively changing customers' experience in many sectors, such as the use of digital mobile platforms to enable customers to easily manage accounts and interact with retailers. One potential new entrant urged caution that excessive regulation of the residential water market will not provide consumer choice or drive innovation in the same way that competition naturally would.

In view of the evidence provided in stakeholder submissions and additional research, the final analysis was amended to use lower switching assumptions across all scenarios than was used in our emerging findings. This change has resulted in a positive effect on net present value of competition under all scenarios, compared with our emerging findings.

[5] Consumer Council for Water's Press Release, Household support for water competition hinges on bill savings, 20 May 2016

Our final report sets out the basis of our assumptions for the scenarios on the level of switching used in the analysis. We explain that per customer savings set out in the scenarios do not reflect an estimate of bill impacts as this is beyond the scope of this analysis.

## 1.5 Water and wastewater efficiency

### Position adopted in our final report

Our cost benefit analysis includes potential benefits from water efficiency improvement. We have made assumptions on potential water efficiency improvement with reference to savings from existing water-saving devices, comparison with previous water efficiency improvements in the UK and international comparisons of residential water demand. We have linked these water efficiency improvements to previously-existing estimates of the long-run cost of water, energy saved and its value and government's approach to valuing carbon saving.

We also assessed the potential benefits of competition with regard to wastewater efficiency savings. Our quantitative analysis now includes an estimate of the potential benefits of competition for reducing stress on sewerage and drainage.

### How we considered stakeholders' responses

An incumbent retailer questioned our counterfactual which assumes that consumption will remain constant over next 30 years. It was suggested that this will not be the case for all parties. Evidence provided from Southern Water indicates that consumption has reduced by 16.5% under the Universal Metering Program. Southern Water also submitted evidence which suggests there has been an average reduction in use of 2% in the existing Scottish market. We believe that Southern Water might have interpreted that our counterfactual is based on constant per customer water consumption over time. In fact, metered per customer consumption in our counterfactual decreases by 5% over the modelled period, based on Defra's future water bills modelling.

One incumbent retailer questioned our assumption in scenario 1 that "metered customers in the 'active' part of the market save 20% of their water consumption" and noted that many companies are investing in progressive metering programmes regardless of residential retail competition. It was suggested, therefore, that these benefits may be achieved in the absence of competition and should be included in our counterfactual, rather than as benefits in scenario 1.

However, we consider that our counterfactual assumption relating to water efficiency, based on companies' own Water Resource Management Plans, represents the best available information on water companies' expectations of consumption trends (both overall and per residential customer). In our final report we have made assumptions on potential water efficiency improvements with reference to savings from existing water-saving devices, comparisons with previous water efficiency improvements in the UK, and international comparisons of residential water demand. We have linked these water efficiency improvements to pre-existing estimates of the long-run cost of water and energy saved and its value (using government's approach to valuing carbon saving).

An incumbent retailer requested more clarity on how metering and water efficiency would be funded in a new market and whether the cost of investment and retail margin was included in our market analysis. Some CCG Chairs doubted that new entrants would focus more on water efficiency than incumbents. One respondent questioned if there are sufficient incentives for water retail companies to encourage metered customers to reduce their use of water and production of water waste as lower volumes would result in lower revenues for the retail company. Also, they suggested that the potential for customers to switch again would reduce incentives on retailers to expend resources on water efficiency work. Conversely, one potential new entrant highlighted a number of new technologies that are emerging, such as Leakbot, that help to not only lower water bills by identifying leaks, but also potentially lower household insurance costs.

Our research, supported by responses from some stakeholders, suggests that there are new products and services available (with others likely to be developed in the future) that can enable changes in customers' water usage. We note the impact of new technologies in banking and energy which are driving different customer behaviours. It is possible to envisage an equivalent kind of impact in water. We have received responses to our emerging findings identifying opportunities in the water sector to utilise new technologies, either seen elsewhere or being introduced in the water sector now, to understand and influence customer behaviour. For example, through delivering tailored services to meet the specific needs of customers. These include demand management technologies and innovative tariffs structures.

Some incumbent retailers and CCG Chairs suggested that water efficiency could only be properly promoted in a new market by rolling out metering to all residential customers. While additional metering might help drive greater water efficiency, for the purposes of calculating the costs and benefits in our final report, we do not assume that there will be any change to the level of currently projected meter roll out (which in the south east of England is forecast to reach 83% by 2030), nor do we assume any smart metering. Indeed, we do not consider metering a pre-requisite for residential retail competition, or promotion of water efficiencies, since it is possible to estimate water usage based on other factors such as house size and occupancy.

Some CCG Chairs raised concerns that competition could break existing links between supplier and consumer and undermine shared interests that both parties have in conserving water and investing in resilience. However, we have also received a number of responses from potential new entrants that set out their view of how both water and wastewater efficiency could benefit from a residential retail market. This has informed our final report view that we have sufficient evidence that innovation and new technology could deliver benefits within the context of a competitive residential retail market.

## 1.6 Other points covered in responses

### Wholesale cost savings

#### Position adopted in our report

We have retained our assumptions from the emerging findings. These conservatively scaled down wholesale efficiency savings, considerably below the equivalent assumed in the government's analysis of business market opening. This is despite the likelihood that pressure from residential retailers would be significantly greater than that exerted by business retailers and represented a small overall cost saving of 0.5% achieved only once competition is fully developed.

No specific adjustment has been made to avoid double counting from the government's impact assessment of introducing business retail competition[6]. This is because this figure represents efficiencies driven by new pressure on wholesale costs from new retailers, rather than any change in behaviour among retailers serving business customers. Our calculation of wholesale efficiencies does not double count because our method scales these according to the share of the downstream market supplied to residential customers (not business customers). In

[6] Introducing Retail Competition in the Water Sector, Defra, February 2015

our analysis ‘low’ and ‘high’ sensitivities of 0.25% and 0.75% have also been created to inform additional scenarios.

### How we considered stakeholders’ responses

In relation to wholesale costs one incumbent retailer mentioned that it would be helpful to provide further detail on the basis for the wholesale cost savings. They queried the assumption on why retailers would have the incentive to spend resources to reduce wholesale costs which other retail competitors would benefit from. It was suggested that the most profitable position for a retailer to adopt would be to conserve those resources and hope to benefit from the actions of other retailers. To the extent that retailers adopted this approach, the wholesale cost savings would be reduced. In our analysis, the wholesale cost benefit varies across the scenarios to reflect that with more vibrant retail competition, there will be greater wholesale cost savings.

## Timing

### Position adopted in our final report

Our analysis has been guided by the action outlined by UK government in “A Better Deal: boosting competition to bring down bills for families and firms” to introduce competition to the water sector in England. As such we have not made any assumptions about the timing of the potential market opening. The decision on whether, in what form and on what timeline the residential retail market in England will be opened to competition is a matter for UK government.

### How we considered stakeholders’ responses

United Utilities noted that the industry is already committed to a wide range of other reforms, including opening water resources and bio-resources to competition, and seeing through the successful implementation of business retail competition. United Utilities noted that while these reforms have the potential to deliver better outcomes for customers and the environment, they are also complex and will require considerable focus and effort from all interested parties. United Utilities has suggested that while there is some uncertainty surrounding the UK’s relationship with Europe it would be best not to introduce further complex changes to the sector. It believes that once the above reforms are completed there will likely to be more capacity within government, regulators and companies to support the necessary policy and process decisions needed to enable residential retail market opening.

Some CCG Chairs and incumbent retailers also suggested that we should wait for the business retail market to launch and settle down so that lessons learnt can feed into our assessment of the costs and benefits of residential competition. A range of stakeholders have advised us that experience gained from the new business retail market should help inform the design of a residential retail market.

We acknowledge the views provided by stakeholders with regard to the timing for any potential market opening. We have set out some of our thinking at **section 6** of the final report on the key issues that will need to be considered when deciding whether to proceed with a retail market and the timing of market opening. A competitive residential retail market in England would be the largest competitive water retail market in the world and would affect every residential customer in the country. So, time would be needed for planning and delivery to be thoroughly tested at key points. It would also be important to consider how the date of residential market opening could be best-timed to enable those involved in the business customer market to take advantage of the experience and skills, and capture the lessons from that process.

## Retail exits and separation

### Position adopted in our report

Some mechanism for retail market exit is assumed in our final analysis, but the precise framework for such exit and separation to occur would be subject to future policy decisions.

In our emerging findings we considered that, since some of the benefits of competition may be dependent on separation, there may be a case for including incumbent company costs of separating integrated wholesale and residential retail functions in our analysis despite no regulatory requirement to do so. We therefore included separation costs in our estimates. We did not take account of additional benefits to companies from voluntary separation, although efficient companies would only do so if such separation was profitable.

For the updated analysis the costs incurred by an incumbent to legally separate its wholesale and retail functions are assumed to be voluntary. We recognise that we already have legally binding separate retail price controls and require accounting separation which means that integrated companies would be able to take part in a competitive retail market. The choice of business model structure will be for companies, so any costs associated with transferring, exiting or merging retail businesses should not be analysed as a cost associated with the introduction of competition.

In the light of the above we have not included such costs in our final analysis, over and above the company set up and on-going costs. We excluded separation costs from the final quantitative analysis to reflect the fact that we do not think these would be a necessary consequence of residential market opening. The overall impact of these changes decreases the overall net present value by a small amount across all scenarios. We provide further detail on this point at **Appendix 1** of the final report.

### How we considered stakeholders' responses

In the responses to our call for evidence we note some stakeholders cited the recent experience in the business retail sector of retail exit by several incumbent companies. Some stakeholders suggested that it would be useful if our final analysis could take account that some incumbents may wish to pursue a similar strategy in the event of residential retail market opening

Thames Water noted that there is significant evidence that there are material economies of scale in the provision of retail services and that merging and consolidating retail businesses would likely reduce costs overall. Thames Water suggested that this may increase the possibility of the acquisition of water retail businesses by the 'Big6' energy firms. To the extent that such mergers are permitted and that the companies could offer true multi-utility bundles, Thames Water asked that the benefits be included in our cost-benefit analysis.

## Weighted average cost of capital

### Position adopted in our final report

It is not clear that residential retail competition would lead to an increase in overall risk within the sector; rather it could simply represent a transfer of risk between different parties. Therefore, the analysis in our final report assumes that no new risk is introduced as a result, so no additional costs associated with an overall increase in financing costs has been included in our analysis. We do recognise the importance of market design in this regard, where credit terms between wholesalers and retailers will be an important determinant of whether any extra financing costs are incurred.

### How we considered stakeholders' responses

Some incumbent retailers suggested that financing costs may increase and argued that there is likely to be a net increase in non-diversifiable risk as a result of exposing the retail element to market risks, particularly volume risk. Thames Water submitted an independent report that explored potential credit risks in a future residential retail market. The report stated that counterparty credit risk might be positively or negatively affected by such a change, and that any such change could feed through to companies' cost of debt via impacts on their credit ratings. The report also noted that other standalone retailers in major markets had investment-grade credit ratings, but cautioned that the regulatory regime, particularly around default, could affect eventual outcomes.

Some stakeholders suggested that the analysis should include analysis on the weighted average cost of capital (WACC) to be assessed either as a quantifiable cost or qualitatively. In support of this suggestion it was noted that for the introduction of business, charity and public sector retail competition Ofwat set a higher net margin (from 1% to 2.5%) for companies wholly or mainly in England[7]. We note a range of stakeholders' views, including incumbent companies, that a higher margin than 1% would be required to attract new entrants if the residential market were opened. In our final report we consider that any short-term increase in margin would represent a transfer from customers to water companies, rather than an overall net cost, but may also have no impact on bills overall under certain circumstances, such as if deducted from the WACC. For the purpose of this analysis, we made no assumption on the margin required to attract sufficient new entry.

One stakeholder noted that the regulatory regime currently insulates water companies from demand side volume risks. In contrast under a competitive market, it was considered probable that domestic water retailers would be exposed to demand side volume risks and it was suggested that these volume risks would be correlated with the wider economic growth. On this basis it was put forward that the overall net industry risk profile would increase.

We did not receive any specific quantitative evidence or assessment from stakeholders that could be used to support such a case, nor on which to base any assumption. We remain of the view that any eventual impact would depend crucially on market rules and regulation and potential effects could be positive or negative. We have, therefore, continued to exclude any impact on financing costs in our quantitative estimate.

[7] 'Consultation on the review of non-household retail price controls', Ofwat, November 2015

# 2. Respondents to emerging findings

We received 26 formal stakeholder submissions in response to our emerging findings published in July 2016. We received responses from two potential new entrants marked confidential.

Submissions were received from the following parties:

| Respondents | |
|---|---|
| Anglian Water | Bristol Water |
| Northumbrian Water | Portsmouth Water |
| Severn Trent Water | Southern Water |
| South East Water | South West Water |
| Thames Water | Yorkshire Water |
| Wessex Water | United Utilities |
| Sutton & East Surrey Water | South Staffordshire Water |
| CCG for Thames Water | CCG for Sutton & East Surrey Water |
| Consumer Council for Water | CCG for South Staffordshire Water |
| WaterUK | OVO Energy |
| Age UK | Utility Warehouse |
| Sustainability First | First Utility |
| Gemserv | Centre for Competition Policy at University of East Anglia |