



Household Retail Project
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Strategy & Regulation

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Dear Sir or Madam

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

Thank you for your invitation to respond to Ofwat's analysis of the costs and benefits of introducing competition to residential customers in England.¹ We recognise the scale of challenge that such a review presents, and welcome the way in which the Ofwat team has approached the task. It is pleasing to see that the Emerging Findings provide clear audit trails between the calculations and the underlying assumptions and data.

We support the introduction of competition for households if it is in the best interests of our customers overall. The case for introducing household retail competition appears to be finely balanced, with the net benefits quantified in the analysis only emerging after more than 10 years, even in the most optimistic scenarios. Notwithstanding this, the emerging findings do suggest that, on balance, there will be net benefits in most scenarios.

Our detailed comments are grouped into the following categories:

- the impact on vulnerable customers;
- refinements to the scenario assumptions; and
- additional benefits and costs that we consider should be included in the scenarios.

1. The impact on vulnerable customers

Ofwat recognises that market outcomes differ across different customers according to a range of factors (main report, section 3.3, pages 30-31). At the moment, however, the scenarios do not describe or evaluate this in any detail. 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, or possibly even negative. It would be helpful to understand which segments customers may 'win' and which may 'lose' as a result of competition.

¹ Ofwat, "Costs and benefits of introducing competition to residential customers in England – Emerging Findings", July 2016

This is a particularly important because scenarios that improve overall social welfare might rightly be viewed as having an additional benefit to customers and society (that should be included as a net benefit in the cost-benefit analysis), and equally, scenarios that create greater social injustice might rightly be regarded as having a cost to society (that should also be taken into account in the cost-benefit analysis). One way of quantifying this would be to assume that the amount of government support to vulnerable customers would net off against the price impact on those customers. Alternatively, it may be possible to adjust wholesale charges to protect vulnerable customers, but this would mean setting wholesale charges in a less cost reflective way, which may have consequences for overall efficiency.

In the energy sector, there is increasing evidence that customers that are able to switch secure substantially lower prices than customers that choose not to switch or are unable to switch (perhaps because they live in short-term accommodation or have restrictions in their tenancy agreements). The evidence published with the emerging findings makes it possible to estimate this impact for the water sector. Specifically, the evidence from Accent shows the discounts required in order to stimulate different levels of switching.²

Since all of Ofwat's scenarios specify the percentage of customers switching, it is possible to estimate the price discount that those customers will have to receive in order to switch, based on the Accent data,³ and consequently to assess the implied increase for the non-switchers, given the overall average price impact. We note, for example, that according to the Accent data, a discount of 16% to 20% (i.e. a discount of the order of £60 to £75 relative to non-switchers) would be needed to secure a 50% switching rate (commensurate with Scenario 1). If 50% of the customers secured this level of discount, this implies that there could be material price increases for those customers that do not switch.

2. Refinements to the scenario assumptions

We recognise and understand the merits of many of the assumptions used. There were, however, a number of specific assumptions that either struck us as not being correct, or that merit further refinement. These were the assumptions relating to:

- bad debt;
- counterparty credit risk;
- systems costs;
- wholesale cost savings; and
- water efficiency.

² Accent, "Customer Response to Competition in the Residential Water Market Final Report", July 2016, figure 25, page 54

³ "Customer Response to Competition in the Residential Water Market Final Report", July 2016, figure 25, page 54.

We expand on each of these below.

(a) Bad debt

Ofwat has considered the energy sector in the course of its analysis, and observed that the energy sector has materially lower bad debt than the water sector. Ofwat notes that whilst energy companies have a technical right to disconnect for non-payment, actual disconnection is rare. Ofwat uses this to justify assuming that Residential Retail competition will lead to materially lower debt levels without the need for disconnection, whilst “*the prohibition on water retailers disconnecting residential customers remains in force*”.⁴

Our concern with this assumption is that the energy sector relies heavily on pre-payment meters to maintain these low levels of bad debt. If customers have a pre-payment meter fitted, they pay in advance for energy used, and cannot, therefore, increase a company’s bad debt by failing to pay. Indeed, prepayment meters can also be calibrated such that the payment rate recovers pre-existing debt, meaning that pre-existing debt would not be accounted for as bad debt. In our view, the debt assumptions in Ofwat’s scenarios are only consistent with significant numbers of pre-payment meters being used, and as such, are inconsistent with Ofwat’s assumption that “*the prohibition on water retailers disconnecting residential customers remains in force*”.⁴

(b) Counterparty credit risk

Based on industry concerns, Thames Water (in conjunction with FTI) undertook a detailed analysis of the potential impact of counterparty credit risk arising as a result of Residential Retail competition. Our report was published on Water UK’s marketplace for ideas.⁵ We identified that whilst there was a material risk, this risk could be mitigated by a range of mechanisms. It would be helpful if Ofwat make it clearer which mechanisms to mitigate counterparty credit risk have been assumed in each scenario.

(c) Systems costs

We note that the costs associated with setting up the market assumed in the analysis are based on budget figures derived in June 2015.⁶ We understand that more up to date data has very recently become available from Water UK. Updating these costs to the latest estimates will strengthen the analysis. It would also be helpful to confirm that such costs would be allowed in full in relevant price controls.

(d) Wholesale cost savings

It would be helpful to provide further detail on the basis for the wholesale cost savings. In particular, it was not clear to us why retailers would have the incentive to spend resources to reduce wholesale costs for their competitors. It may be the case that the most profitable position for a retailer to adopt would be to conserve those resources and hope to benefit from the actions

⁴ Ofwat, “Costs and benefits of introducing competition to residential customers in England – emerging findings”, page 5

⁵ [http://www.water.org.uk/policy/future-of-the-water-sector#Household retail competition](http://www.water.org.uk/policy/future-of-the-water-sector#Household%20retail%20competition)

⁶ Ofwat, “Costs and benefits of introducing competition to residential customers in England – emerging findings”, page 58, footnote 67

of other retailers (or Ofwat). To the extent that retailers adopted this approach, the wholesale cost savings would be reduced.

(e) Water efficiency

We note that the analysis includes an assumption that “*metered customers in the ‘active’ part of the market save 20% of their water consumption*”.⁷ As many companies are investing in progressive metering programmes regardless of Residential Retail competition, many of these benefits may be secured even in the absence of Residential Retail competition. It would be appropriate for those water consumption savings to be included in the base case, rather than as benefits in the four scenarios.

3. Additional benefits and costs

In addition to the impact on vulnerable customers set out above, in our view, there are a number of other additional benefits and costs that should be included in the analysis. These include:

- changes to the cost of capital;
- benefits of customer choice; and
- changes in economies of scale through retail-retail mergers.

We expand on each of these below.

(a) Changes to the cost of capital

At PR14, Ofwat calculated that the retail margin for the competitive non-household retail margin needed to be 2.5%. This is materially higher than Ofwat’s assessment of the non-competitive margin of 1%. A robust cost-benefit analysis will require the impact on the cost of capital to be assessed and included in the calculations.

(b) Benefits of customer choice

Even if customers do not switch in practice, there is a benefit to those customers in having the right to switch. In economic terms, this is akin to an options contract. In our view the value of this option should be included as a benefit in the cost-benefit analysis.

(c) Changes in economies of scale through retail-retail mergers

There is significant evidence that there are material economies of scale in the provision of retail services, and that merging and consolidating retail businesses is likely to reduce costs overall. This may include the acquisition of water retail business by, for example, the ‘Big6’ energy firms. To the extent that such mergers are permitted and that the companies could offer true multi-utility bundles, the benefits should be included in the cost-benefit analysis. It will be important, however, that the scenarios are clear as to the extent that such mergers, and multi-utility bundling practices are permitted.

⁷ Ofwat, “Costs and benefits of introducing competition to residential customers in England – emerging findings”, Table 1 Summary of scenario assumptions, page 25

In summary, our position is that we would support the introduction of Residential Retail competition in circumstances where the aggregate overall benefits can be demonstrated to exceed the costs, any potentially adverse impacts on vulnerable customers are mitigated effectively (and the costs of this recognised) and the preparation and ongoing costs are properly allowed in price controls. If the case is finely balanced – indeed even on the current quantitative analysis there are no net benefits for the first 10 years in any scenario – there may be a case for awaiting further information, such as the outcome of NHH retail market opening and the economic impact of the UK’s changing relationship with the EU, before proceeding.

Yours faithfully

A handwritten signature in black ink, appearing to read "Nick Fincham". The signature is written in a cursive, slightly slanted style.

Nick Fincham
Director of Strategy & Regulation