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## **Towards the regulation of markets in water**

### **Speech by Cathryn Ross at The Future of Utilities, 29 March 2017**

Good afternoon everyone. It's great to be here today and thank you to Marketforce for inviting me here to speak.

I want to take the opportunity to outline some of the very fundamental changes taking place in the water sector and to say a bit about what they mean for our regulation of the sector. All the changes I'm going to talk about here have a common theme - which is about making better use of markets in the sector to deliver the outcomes that customers and society expect.

So what changes am I talking about? Let's start with the most obvious. And the most proximate. RMO - the opening of the non-household market in England to competition. If you hadn't noticed, this is happening on 1 April - this Saturday.

From that point 1.2mn business, charity and public sector customers will be able to choose their water and waste water service supplier. It will be the world's largest competitive water retail market.

We now have 25 licensed retailers in the market, with a variety of retail offers from 'no change', through to 'cheap as chips' through to offers based on reducing the customer's bill by improving water efficiency. And we are already seeing activity from TPIs too.

We have also already had 1000s of customers switch, and they will be with their chosen new supplier at the moment the market opens.

And we have seen general levels of awareness among eligible customers of the possibility of choice rise. They were 8% in early 2016. They had risen to 33% in January 2017 and we know they are rising further as our campaign continues. We had feedback from one water company that unprompted awareness in their region has risen from 32% last year to 70% in February.

Open Water website saw user numbers on the site increasing from 3,000 new users in September 2016 to almost 15,000 new visitors in February. So far we have had 13,500 visitors this month. The number of page views (the number of different pages the website visitors look at) also increased by 40% to 47,000 in February and remain at that level in March. Open Water on Twitter has 659 followers and the number of impressions (a measure of the number of people viewing) on the account increased from just 844 last September to over 37,000 in February. We also achieved over 14,000 impressions on the Open Water LinkedIn page up to the 7th March.

From the conversations we have had with customers they do seem keen to explore the options competition will give them, especially in terms of greater efficiency, better billing and single billing.

All this takes Ofwat, to all intents and purposes for the first time, into regulating a market characterised by head to head competition. And let's not pretend that's easy. In fact, although everyone tends to think about economic regulation as big set piece price controls, I'd say regulation in competitive markets is very much the sharp end. Thinking has moved on a lot here.

There was a time when, if a market was seen as susceptible to competition, the role of the regulator was to promote competition and, having successfully done that, butt out, leaving the market lightly regulated on the basis of generally applicable laws, such as competition law, consumer law, health and safety and the like. Maybe the regulator would have to ensure its regulation of monopoly markets providing inputs into the competitive market promoted competition, for example through access

pricing, but that was it. But I think that the basis for that thinking has been shaken by two lessons we have learned over the last few years.

The first is that not all products and services are equal. There are some products and services that are so important, so fundamental for life and health that society has a very low tolerance of failure where they are concerned. Essential public services - energy, water, telephony arguably now broadband, some financial services - are not like chocolate bars, or cinema tickets, or holidays. And society's tolerance of what it sees as failure in those essential public services markets is understandably very low. Not such a revelation you might think, but one I think we learned the hard way.

It might be very tempting to conclude from this that competition has no place in these markets. Personally, I think that's wrong - competition can bring great benefits in terms of efficiency, service and innovation that I think these markets need precisely because they are so important.

But it means we need to think very carefully about the outcomes society wants to see in these markets, and we may need to accept a higher degree of ongoing intervention in those markets than we have previously accepted.

The second thing we have learned is that the demand side of markets is as crucial for their success as the supply side. What do I mean by that? Customers matter. D'oh.

But this presents real challenges. As we have seen from the results of the recent CMA investigation in energy - customers don't necessarily find the markets we regulate particularly exciting. It can be difficult to get customers to engage - even some businesses, for example, if you think about SMEs who don't have utility buying teams, and who have 100s of other things to think about. Which is not great news if you are a regulator, most of whose tool kit is squarely aimed at getting suppliers to do stuff.

Technology, I think, is really going to move things on here - increasingly intelligent and dynamic search engines that learn about customers' preferences, and block chain switching for example.

But it has upsides and downsides. On the one hand, technology provides more ways, better ways, to talk to customers, to find out what they want and translate that into a purchase decision. Taking on the onerous and unattractive tasks of searching and switching. But on the other hand, technology creates huge new opportunities for price discrimination. Not necessarily a bad thing. But to the extent that we used to be able to rely on a few active customers to keep suppliers honest and on their toes, we now need more active customers to achieve the same result.

So where is Ofwat in terms of its regulation of the about-to-be competitive business customer retail market in England? Over the last few months we have been setting up a new programme - our Market Outcomes and Enforcement programme to do just that, and we are now transitioning our work on Retail Market Opening into that. I want to make five key points about how we see our work here.

First, we see it as critically important that we maintain effective oversight of the new market. We need to know how it is working and what it is delivering for customers - the good and the bad.

We are putting in place a monitoring regime to enable this happen. We will be monitoring a wide range of metrics including information on switching, customers, procedure and conduct.

We will seek information on retail tariffs, and the identification of different types of customers as well as their use of third-party intermediaries. We intend to monitor correspondence and complaints in relation to eligibility, marketing, switching, market structure, contracts and other relevant matters.

We will also be carrying out a survey of customers to understand, among other things, their experiences in the market and their satisfaction. And we will

complement this with a panel specifically comprising SMEs so we can understand their experience in the market.

And we will of course be looking at any compliance issues, for example with the codes. So... we will be well informed.

This doesn't mean we will rush to intervene. We recognise that newly competitive markets take time to bed down and that too much regulatory activity can crowd out a healthy competitive dynamic.

But we also recognise that a key ingredient of any competitive market is trust. Those involved in the market, crucially including customers, need to trust that it works effectively and fairly. And trust is an issue. Some business customers in the new water market are well able to look after themselves. But others less so, and some may have had bad experiences in other markets - we cannot pretend we are starting with a blank sheet of paper.

So, while we won't rush to intervene, we will have a low tolerance where we see behaviour that would undermine trust in the market. And a particularly low tolerance where we see bad behaviour that leads to a poor experience for customers.

Second, as you would expect given what I have said, we will pay attention to the demand side of the market.

We have in fact been doing this a lot already. We have been working closely with WaterUK to raise awareness among customers of the fact that they will soon have a choice. We have reached out to more than 600,000 customers through trade associations and representative groups and I said earlier on we are seeing improvements in levels of awareness.

But we do recognise that this is only a start. And that as the market develops we will need to retain a voice with customers. Which is why we will be keeping the Open Water brand and digital channels.

And we also recognise that we need to continue to work with others, including CCWater to ensure that customers are not only aware they can switch, but make an active choice to be engaged in the market, and if they are engaged, make informed choices.

Third, and it links to the previous point, we will be using all the tools in our tool kit to help ensure the success of the new market.

I have already spoken about some of the things we will be doing to raise awareness of and promote informed engagement with the market. But even in relation to service providers, where regulators have their more traditional powers, we see a need to be pragmatic and innovative.

Some companies have - more or less explicitly - asked us for some kind of moratorium on enforcement action in the early stages of the new market. Which is not going to happen. But what I would say, is that we are focussed here on what we are trying to achieve - good customer experience in a well-functioning market. And we will use whatever tool we believe is most effective in achieving this.

This could be Competition Act enforcement. And we have refreshed our CA98 guidance recently with a view to enabling us to do this. It could be other enforcement tools - we have powers within licences for example that could be appropriate here. And we have our Casework Strategy that will inform this.

We certainly expect to take a keen interest in whether the codes that underpin the new market are being complied with - all retailers have now signed them! - and perhaps especially our customer code of practice.

But we may well use softer tools, such as open letters to particular group of players in the market, speeches or reports to highlight issues in a timely way, with the expectations that market participants will step up and take ownership. Of course if they don't, we will look at other options...

Fourthly, we will proactively look to learn from others.

Learning is in our DNA - it is one of the six values that underpins everything we do. It is particularly key in this area, where other markets, perhaps with some similar characteristics, have been opened to competition for some time, so we have a great opportunity to learn from relevant experience.

There are some very important differences between the new water retail market and energy supply markets. Notably the retail market in water is a 'thin' market based on retailers reselling wholesale water that remains supplied by regulated monopolies, and competing as much on customer service and value added services as on the ability to do retail more efficiently.

But we have learned some lessons for example about the importance of TPIs both in making the market work and - in relation to a sub-set of their number - engaging in some less desirable behaviours. We don't have powers to regulate TPIs. But we are putting in place principles for voluntary TPI codes of conduct, and we will be transparent about who has signed up to these codes – through any information we receive from these TPI codes, and we will collect information as far as we can on this part of the market specifically through our monitoring.

We have also learned lessons in relation to the potential for some business customers - notably micro businesses - to be vulnerable. Which is why we have included some additional protections for them in our customer code of practice.

We have:

- Introduced a 7 (Calendar) day cooling off period;
- Required retailers to offer specific minimum information in writing such as details of tariffs, frequency of bills and payment methods available , contract type and duration and details on any exit fees and termination notice;
- Required retailers to provide any information the micro-business customer requests in writing as soon as reasonably practical;
- Required retailers not to submit a switch request to Market Operator before receiving a written acknowledgment from the micro-business customer that it has read and understood the information provided to them;

- Prescribed a template for TPI letter of authority – when the micro-business customer has third party acting on their behalf;
- Banned automatic contract roll-over without the written consent from the micro-business customer. Any rollover agreed is required to be for a maximum period of one year from the expiry of the initial fixed term period;
- Required retailers to issue any final bill to a micro-business within six weeks of the contract termination or switch date; and
- Required retailers to offer a micro-business a reasonable repayment plan for a Back-bill.

So, we have learned a lot already. And we will challenge ourselves to keep learning as we go. We will not always get things right.

I am confident the new market will bring considerable benefits, especially in service and innovation. But it will not work perfectly from the outset, and may well never work perfectly. The key is to know what is going on, respond appropriately and in a timely way. And learn from the experience.

Fifthly, and finally, in relation to the new retail market, we must also capture the lessons for other policy areas, and other aspects of our regulation.

The Welsh Government in its draft SPS to us has set us the specific challenge of ensuring that customers in Wales who will not benefit from competition do benefit from more effective regulation on the basis of the information that competition in the English business customer market has revealed.

I am expecting retailers and retail competition to reveal information about wholesale services that will be very useful as we set wholesale controls in PR19.

And of course we will all be watching the business customer market in England very carefully to see what can be learned in relation to extending competition to residential customers in England.



But although retail competition is the most obvious way in which Ofwat is becoming a market regulator, it isn't the only way.

I have been talking for a long time now about the potential we see for markets to enable and encourage value creation within the wholesale part of the value chain too.

That is different to retail competition - we don't see markets there being characterised by vigorous head to head competition that will enable us for example to stop doing price controls! But we do see a lot of scope for markets to present companies with a wider set of options and choices about how they provide water and waste water services. And we see them revealing valuable information about where scope for greater efficiency lies. And through our Water2020 policy framework, this is becoming a reality.

We expect companies to look more at options for water trading - I still can't believe that with climate change, population growth and the pressures on the water supply we have at certain places and at certain times, we still have the same 5pc of our total public water supply being traded across boundaries - the same 5pc we had at privatisation.

And we see a scope for markets in bioresource treatment, transportation and disposal. Scope for companies to provide those services across boundaries rather than investing unilaterally and therefore inefficiently.

And this is changing the way we regulate at the wholesale level - separate price controls on water resources and bio resources, to reveal information and focus company decision making. We are also requiring companies to provide information to inform third parties of opportunities to participate in water resource and bioresource markets.

For bioresource markets, this will be based on location and volume information for sludge processing so other parties can see potential opportunities to trade with incumbents.

For water resources, it will be based on data that companies gather as part of their water resource management planning. We will shortly be publishing guidance on the type and form of information to be provided. Encouragingly, we see companies engaging in both markets and already identifying opportunities for trades.

We also see scope for what we call direct procurement for customers - where a water company might think that a substantial new project was needed to supply its customers (>£100mn whole life totex), and where we would expect it to have asked itself very explicitly whether it was best placed to do this project - spec it up, build it, finance it, operate it - or whether someone else was.

I think this is potentially a very significant reform. And we are debating at the moment how we can best encourage it - in particular how much of a framework we need to put around it, which might help reduce transactions costs and get the market going, vs the risk that might bring of stifling some opportunities and innovation. It is gratifying to see the levels of interest in this from companies, and investors and third parties. And some of that interest is translating into thinking that is informing our policy. Thames Tideway, Severn Trent and Anglian for example sponsored a First Economics report published in February 2017 on "Direct procurement of water industry projects".

We have commissioned a report by KPMG on "Potential considerations for financing direct procurement" which will be published alongside our methodology consultation in July.

So... if you add all this up - the introduction of competition in the business customer market in England, and the greater use of markets in respect of water resources, bioresources and direct procurement - we are taking some major steps in the evolution of the water sector right now.

Steps that have big implications not only for the sector but for us as the regulator too. And I'm very conscious that when you establish markets - when you create the opportunity for buyers to meet sellers and for transactions to take place - they develop their own dynamics. They don't stand still.

As a sector and as a regulator we will all need to get used to more players, a fast pace of change and more extensive, more powerful disruption than we have seen in water before.

That's a good thing - it reveals information, it creates choices, it spawns innovation. I'm not denying the challenges it will bring too. And the fact that another thing markets do is shine a light on those challenges - making them, and how we deal with them much more visible.... But I am feeling confident that we can rise to those challenges.

And I'm not alone here - I really do think that there is a sense of optimism and a quiet confidence in the water sector right now. And for good reason.

After decades during which not much changed in the sector, we ushered in some big changes to the way we regulate in PR14. Difficult for companies and for investors to get their heads around initially. Not perhaps initially best handled by us either. We definitely had a collective wobble. But we came together, we ultimately agreed this was the right way to go. And I think everyone agrees that the 2014 review brought valuable additional flexibility for companies, better enabling efficiencies and provided better incentives for companies to do more of what their customers need and want.

After PR14 we said we wanted to build on that success to go further in the same direction. I wouldn't have been surprised if companies had said 'enough!' But they didn't. And in fact through the marketplace for ideas, they have helped co-create the Water2020 policy framework. And they have engaged in a genuinely constructive way to agree the licence reforms we need to implement that policy through PR19.

And let's not forget that over pretty much the same period - the last 5 or 6 years, the sector has gone from believing that retail competition would never happen in water (and some of them thinking it had no place here too) to actually opening the world's largest water retail market. A feat that has involved not only big challenges for individual companies, but an enormous challenge of maintaining trust and a genuine sense of shared endeavour between companies, government, the new market operator and the regulator.

The sector today has proven capability to embrace change in a way that delivers benefits for customers, society and of course investors.

So, although as I said earlier I'm sure we will have some bumps along the road as markets develop in the sector, we will get through them. And I can't wait to see what the future brings.

Thank you.