Northumbrian Water submission of evidence for:

Ofwat's review of retail household markets in the water and wastewater sector

NORTHUMBRIAN WATER SUBMISSION OF EVIDENCE FOR OFWAT'S REVIEW OF RETAIL HOUSEHOLD MARKETS

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Introduction

Northumbrian Water welcomes the opportunity to contribute to the call for evidence on Ofwat's review of retail household markets.

We strongly support Ofwat's statement that the review will be evidence based and conducted without a pre-conceived agenda. Given that the 2009 Cave review investigated and rejected the case for retail household competition we feel that any change in policy would need to be supported by a robust evidence base.

In conjunction with this response, we have commissioned a report by Economic Insight into 'Competition in the Energy Retail Market'. This report is a contribution towards the evidence base, and we have included it in the Water UK 'Marketplace for Ideas'. We encourage other interested parties to reference it and develop the themes further.

In particular, we note and concur with the following observations from the Executive Summary in the report:

> *Ofwat should place significant emphasis on understanding the likely level of customer engagement in the market.*
>
> *Ofwat should seek to establish whether the inherent characteristics of water retail mean that the ability and/or incentive of customers to search and switch deals is likely to be low, irrespective of the behavior of customers.*
>
> *A key challenge to consider will be whether any customer protection safeguards could be designed in a manner that do not reduce the ability and incentive for suppliers to compete.*
>
> *In developing evidence, Ofwat should consider using a range of comparator retail markets.*

In addition to this initial response we intend to fully engage with the review process in the coming months. One aspect of this is a study we have commissioned, along with a number of other water companies, on the potential distributional impact of a retail household market on customers in vulnerable circumstances.

One concern which have highlighted in this response is that the impact on specific vulnerable customer groups may be lost in an aggregate customer market cost-benefit analysis. For example, it is conceivable that many customers could see a small benefit but with a large rebalanced cost causing significantly increased charges to a smaller group of customers in vulnerable circumstances. The impact on vulnerable customer groups should be given an appropriate weight in any consideration of costs and benefits.

An important source of evidence on the potential for retail household competition will be the operation of the non household retail market in England. This will reveal empirical evidence around market activity, rate of switching, delivery of efficiencies and benefits to customers. This revealed evidence will be more reliable than any theoretical forecast of market potential. In our view, the 2016 Ofwat study, whilst useful, is set too early to make a conclusive case and should instead be part of a longer term evidence gathering exercise that includes evidence discovered from the development of the non household retail market in England.

Will customers benefit from choice?

Customers should be at the heart of this review. Gathering evidence of customers views on retail competition is a critical part of this analysis. We note and welcome the fact that both CC Water and Ofwat intend to survey customer views on retail competition.

We support the intention that the review should be carried out with the aim of assessing potential customer benefits and costs, with as much evidence gathered as possible. It will also be important to ensure that all customer groups benefit, including those who have less propensity and opportunity to switch.

What is required to create a viable market?

For retail markets to succeed there must be active demand side and supply side participants and a clear regulatory framework that enables rather than frustrates competition. We make the following observations on each:

Demand side – will customers engage with the water market?

Ofwat will need to gather evidence on the likely level of customer engagement in the market.

Questions that need to be addressed include:

What level of switching might realistically be expected?

If, as is the case with energy, only around 10% of customers switch each year, and only 50% of customers can be considered active, is that sufficient for a market to work?

Will the behaviour of switchers protect non switchers?

To what extent are customers interested in the possibility of switching water retailer?

What scale of price saving / service improvement would be needed to encourage switching? (Energy market evidence suggests annual savings of over £100 are still not sufficient to motivate most customers to switch suppliers.)

There have been four energy market investigations over the last decade. Ofgem believe the market is not working efficiently as evidenced by the current referral to the CMA. The water industry must learn from experience in the energy sector.

The Energy Market – CMA Research into Customer views on the Energy Market

In February 2015, to understand customer behavior in the energy market, the CMA commissioned GfK NOP to produce a customer survey[1] report. It concluded the following:

> Whilst 89% of customers know they can switch suppliers, only 27% have done so in the last 3 years, with a further 17% in previous years.
>
> 83% of switchers do so to save money, with a mean saving of £174
>
> 34% of customers have not even considered switching.
>
> Barriers to switching include: cost reasons (46%) and the arduous process (27%)
>
> Access to the internet and to price comparison websites in particular were important factors, internet access customers were twice as likely to consider switching.

Similar factors are likely to apply for the water retail market. Indeed, it seems likely that customer's views on water retail will be coloured by their past experience in energy retail, although this should be tested in research. The water market could conceivably inherit the disillusionment that appears to have affected over a third of energy customers.

Supply Side – Will the water market attract new entrants?

In PR14, household retail had a 1% margin included in price limits. This will be insufficient to attract new entrants or to encourage switching. For non household retail, many new entrants suggest that the current 2.5% margin is insufficient. Creation of a household retail market would require an increase in retail margin that would need to be reflected in customer bills, to create a viable market which is attractive to entrants.

Regulatory involvement – getting the balance right

> What should be the balance between ex-ante and ex-post regulation?
> What role, if any, should Ofwat have in facilitating search and switching behaviour?
> Should Ofwat limit the number or type of tariffs available?
> To what extent will price discrimination (between regions and/or customers) be viewed as acceptable?

All these questions have been considered by Ofgem in the past and some are currently under debate in the CMA review. Ofgem has changed policy in these areas in the past, we suggest Ofwat should consider these lessons in any market review.

[1] https://assets.digital.cabinet-office.gov.uk/media/54e75c53ed915d0cf700000d/CMA_customer_survey_-_energy_investigation_-_GfK_Report.pdf

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Specific questions in the call for evidence:

What are the advantages and disadvantages of extending competition to retail services in the water and sewerage sector to household customers? How could this best be achieved?

Social Cross Subsidies and Customers in Vulnerable Circumstances

A key issue to be addressed in the assessment of any household retail market is the potential for unwinding the existing social cross subsidy between customers with low and high costs to serve.

Specifically, customers with good payment histories have significantly lower costs to serve than those who pay through more expensive payment routes or who have greater likelihood of non payment. At present, these costs are averaged over the customer base by applying a single household retail charge, creating a cross subsidy between the groups.

We recognise there are possible ways to mitigate the distributional impact of unwinding this cross subsidy, for instance, by restricting retailer behaviour or imposing a social insurance charge. However, these both have associated disadvantages, as we explain later.

If we assume no mitigation is in place the impact on vulnerable customers could be significant. Typically around 90% of NWL household customers have good payment history and could be judged as being at low risk of bad debt for retailers. A new retailer could offer those customers a cost reflective discount to the standard household retail tariff. This reduction might be around £18 per property (a reduction of 5% in the average household bill) as this is the typical bad debt component in the standard retail tariff.

It is sobering to note the implications if, assuming aggregate bad debt costs are unchanged, the unwinding of social cross subsidies is reflected in bills to higher cost to serve households. This would result in the standard household tariff increasing by over £160 for the remaining 10% of customers**:** an increase of 50% on a typical household bill for the most vulnerable household customers. These are extremely significant incidence effects which would appear to be contrary to Government guidance that customers in vulnerable circumstances should be protected.

We recognise that the above is a crude illustration and this is why we have joined with a number of other water companies to commission ICS Consulting to produce a report on the distributional impacts of retail competition, particularly in relation to customers in vulnerable circumstances. We hope that this will make a valuable contribution to the evidence base.

It is accepted that a social tariff could mitigate the impact of unwinding cross subsidies for some vulnerable customers. However, social tariffs currently require evidence of support for cross subsidy from the wider customer base. Experience suggests this support is often not forthcoming in areas with high social deprivation where the costs of support would be highest (this includes the North East of England).

Social de-averaging: Lessons from the Energy Market

The retail energy market has seen significant social de-averaging since market opening. This can be illustrated by reference to the case of prepayment meters. The proportion of prepayment meters in the market has doubled from 7% in 1996 to 15% in 2014. Prepayment meters are sometimes requested by customers as an aid to budgeting. However, prepayment meters are also installed by energy retailers as a way to minimise bad debt costs and can result in customer self disconnection[2] (this option is not allowed in the case of water under current legislation.)

The Competition and Markets Authority (CMA) estimates that prepayment meter users pay £80 more per year than the typical direct debit customer[3]. There is also little competition to provide retail services to prepayment customers. Thus, many customers in vulnerable circumstances in the energy market pay more than other customers and are excluded from the market through lack of choice.

This energy market experience suggests that, unless there are adequate safeguards, customers in vulnerable circumstances are unlikely to experience gains from a water household retail market.

In fairness we note that a number of such safeguards do exit in the retail energy market including licence clauses relating to the Winter Fuel Allowance and other vulnerable customer protection issues.

Evidence on the implications of household debt costs for a retail market – unwinding the social cross subsidy

The prevalence of debt management and bad debt costs in the household retail market should not be underestimated. They comprise 45% of retail costs.

Industry 2014/15 regulatory accounts show the aggregate household retail costs are as follows:

Household Retail: Industry Aggregated Data	Cost £m	% of total costs	£ Cost/property
Debt management	73	8%	3
Doubtful debts	338	37%	15
Other costs	496	55%	23
Total operating costs	**907**	**-**	**41**

[2] *https://www.citizensadvice.org.uk/about-us/how-citizens-advice-works/media/pressreleases/1-62-million-prepayment-energy-consumers-cuts-off-each-year/*
[3] *https://assets.digital.cabinet-office.gov.uk/media/559ad883e5274a155c00001b/EMI_PFs_Summary.pdf*

Clearly, a retailer will look to minimise the debt costs incurred, as this would allow a substantial margin on the retail charge. This creates a risk that as retailers target and collect their preferred 'good payers' as new customers, the incumbent is left with the ones with costly payment profiles.

As this process develops, there is a negative reinforcement cycle as the incumbent retailer average cost per customer increases as the social cross subsidy is unwound.

Mitigation of Social De-Averaging

There are two ways the social de-averaging issue might be mitigated; controls on retailer behaviour or compensation to the retailer for assuming increased bad debt risk.

<u>Behavioural controls</u>

Rules might be introduced that prohibit retailers from using certain criteria to set different prices for different customer groups. For instance, retailers might be obliged to set the same price regardless of payment mechanism and credit history.

We are concerned that retail price controls may not prove an effective way to prevent retailers exposing customers to differences in the costs that retailers incur in serving them. Even if intrusive and complex rules are in place to stop obvious forms of differentiation between customers, we would expect retailers to try to find ways to avoid attracting customers that pose higher risks of bad debt, without infringing these rules. This might be done, for example, through targeted advertising to customers profiles identified with low risks of bad debt, e.g. through internet retailing. Price differences may then emerge in the market between different segments of the market, which are served by different retailers.

<u>Compensation to retailer</u>

This could be through an insurance system or via a recharge to other retailers through wholesale charges. In both cases, the cost of bad debt will be spread across the whole customer base, as it is presently.

However, such an approach could make the retailer indifferent to the credit quality of each customer, as all increased bad debt costs will be 'costs passed through' to the customer base as a whole. It would remove the incentive for retailers to minimise debt costs under competitive pressures, introducing moral hazard. Indeed, retailers might offer inducements to customers to switch, while knowing that such customers would be unable to cover these costs over the long term.

The 2009 Reckon Report for Cave Review

The social cross subsidy issue was considered in the Reckon Report for the Cave & Walker Reviews: March 2009 Cross subsidies, price structures and competition in the England and Wales water industry[4]:

[4] http://webarchive.nationalarchives.gov.uk/20130402151656/http://archive.defra.gov.uk/environment/quality/water/industry/cavereview/documents/reckonreport090316.pdf

1.44 As far as we can tell, the only way to ensure that retailers would not differentiate between customers according to perceptions of customers' creditworthiness would be to create a scheme that insures retailers against the costs of late payment and bad debt.
This would create risks of moral hazard which could, in turn, increase costs across the industry. Such a scheme would also lose an opportunity to subject the management of bad debt to competitive pressures.

Impacts on water efficiency and meter take up

It seems likely that retailers would seek to gain customers by offering to reduce customer bills, particularly through water efficiency or the take up of meters. Promotion of water efficiency could be economically efficient, although studies have suggested that motivation for household water efficiency is often for non monetary reasons rather than bill reductions. Retailers may look to encourage water efficiency through non monetary rewards, financing this through the wholesale bill reductions.

For unmeasured properties, retailers would have little financial incentive to encourage customers to save water. Any reduction in demand for those customers would be to the benefit of the wholesalers costs. There would also be no way to measure customer water efficiency unless a meter were installed.

Retailers may focus on persuading high rateable value customers to switch to a meter. Whilst this may reduce the specific customer's bill, it does not reduce aggregate wholesale costs and so rebalances these on the remaining customer base.

Interaction with Wholesale

It is possible that creating a retail market would allow companies to focus more effectively on core areas (i.e. to specialise in either retail or wholesale). Retailers may be able to identify and challenge wholesaler costs in a way that a regulator cannot. Increased transparency of costs may allow companies to identify areas for greater efficiency challenge. For non household retail, experience from Scotland suggests that separation identified costs that both parties agreed were inefficient and were thus challenged and reduced. The developing English market has not yet shown such evidence, although it is too early to conclude on this.

On the other hand there are fears that the development of a household retail market could undermine the progress that has been made in the delivery of an integrated service to the satisfaction of the customer. Many water companies, partly in response to the Service Incentive Mechanism, have become effective in ensuring all customer contacts are dealt with by a customer facing representative, ensuring the customer does not feel they have been passed around the system or told another organisation is to blame. Critics of the energy and rail sectors often complain about the lack of accountability, or blame shifting between the parties.

Would retailers affect the upstream service?

It is not yet clear in the non household market whether retailers will focus on competing for market share with each other, or whether they will look to drive efficiencies in the wholesale service. The experience from Scotland suggests the former – there has been no take up of the Section 29E regulatory mechanism where retailers receive the benefit of lowering the wholesalers costs.

Unless a retailer contracts with an upstream resource provider, it is difficult to conceive of a way that they can receive a better price from the wholesaler than other retailers. The wholesaler has a general level playing field duty to ensure equal treatment of retailers.

For this reason, until the water resources and network access prices are better developed to allow retailers to pay different wholesale prices through contracts with resource providers, we do not anticipate any material impacts of household retail markets on upstream efficiencies or security of supply.

What scenarios for retail competition could be considered in Ofwat's analysis? What are the advantages and disadvantages of each for water and wastewater services for customers, the environment, wider society and investors?

We presume the thin market comprises the functions currently assigned to the household retail control; billing, payment handling and debt management and bad debt. This is currently around 8% of the total water & wastewater service. This would be the most appropriate scenario to align to the non household retail market and would allow non household retailers to gain economies of scale by merging household and non household customers in a single business. It would also align with the functions of other utility retailers such as energy, allowing integration where economies of scale justified.

In our view to minimise administration costs, there should be only one market operator, but with a clear system and code separation of the household and non household data given there are different legal characteristics. To preserve options for participants, there should be separate household and non household retail licences, as a company may wish to retain a household retail business whilst exiting the non household one or vice versa.

A thick retail market could include the local infrastructure areas currently delivered by incumbents or New Appointments and Variations. In our view, there may be a contradiction between the upfront NAV outlay for local infrastructure and the possibility for customers to switch retailers away from the NAV. If a retailer is to make longer term asset decisions, it will want to do so with the assurance of long term annual revenue to recover those costs. Adoption of a thick retail market would appear inconsistent with the continuation of the current NAV market.

It could be possible to include meter provision in the remit of retail competition. However, this was considered when the non household market was being defined and rejected as being contrary to the asset-light preference of retailers and was also difficult to reconcile with the objective that customers could switch retailers without changing meters. We note that licences do allow this decision to be revisited at a future date. In theory metering could be a separately contestable service, separate from wholesale or retail. However, our understanding is that in energy such separation has resulted in reduced incentives to innovate and invest in new technology as it reduces certainty of return on investment.

Similarly, we are not convinced that retailers wish to involve themselves in physically making new connections, beyond the desire to be the allocated retailer for new customers. We believe the self lay market already creates competition for services related to new development.

Essentially, the issue with a thick market is that it goes beyond what retailers traditionally view as their core competencies. By including extra 'non retail' services, Ofwat would risk deterring traditional retailers (particularly those involved in the thin non household retail market) from entering.

We note that Ofwat's thick market options include auctions for new developments or existing customers. This does seem to be contrary to the traditional retail format of encouraging individual customer choice, with the associated benefits and customer preferences. It would be interesting to see customer views on whether they would welcome being allocated a retailer rather than choosing one.

An auction of customers that are costly to serve may generate a competitive price, but will not prevent the social de-averaging referred to earlier.

In considering auctions, Ofwat should consider the costs of administration and of the bidding (for both successful and failed bidders). There would need to be an incentive for good customer service once the contract had been awarded.

We are not convinced that that creating a narrow market is a practicable proposition. Market segments will be much harder to define than the separation of households and non households. To open a market by regions could undermine the economies of scale obtained from a national approach which are key to a retail operating model.

Any retail model that does not align to the thin definition, as employed in retail non household and energy, risks losing the potential economies of scale and the ready pool of new retail entrants that are critical to expanding the value and opportunities of the market.

With respect to potential competition scenarios used to support the analysis, what additional risks or opportunities should be captured in Ofwat's analysis? How should these be assessed? What would be necessary for each of the scenarios to be implemented successfully? Over what time period could implementation take place?

Any delay between the costs of implementation and the economic benefits of competition arising would be significant in any time value cost benefit analysis. In any modelling, Ofwat should run scenarios that include the following sensitivities:

Slower take up of competitive opportunities
Higher cost of implementation than anticipated
The social costs of de-averaging falling on customers in vulnerable circumstances

The rate of customer take up of a water market is very uncertain. In the energy sector, despite an average bill level three times as high, a quarter of customers (27%) have switched supplier in the last three years, whilst just under a fifth (17%) had switched more than three years ago but a third (34%) have not even considered switching[5].

Implementation of the non household retail market in water took 5 years from the date of legislation. The household retail market is around 16 times larger than the non household one by numbers of customers so we do not foresee a timescale for implementation of less than this, despite the prior experience from the non household retail market.

The energy market has a history of 'false starts' and regulatory reversals of policy. Such delays have a cost that would be best avoided, but are a real possibility.

We recommend a relatively short timescale for the economic appraisal. Retail assets such as billing systems typically have short asset lives, so, an appraisal over their useful asset lives of around 10 years seems appropriate.

What are the interactions between household water retail and other markets in the water sector and beyond?

It is likely that some retailers would seek to offer a bundled utility package to household customers – combining water and energy retail. This creates a strong argument for ensuring the definition of water household retail services aligns with the energy markets (essentially a thin model) as well as with the current non household definition.

Some retailers are likely to offer value added services such as water softening and private pipe repairs to customers. As these services are already contestable, it is not clear whether this would be a significant change for customers, although they may be useful inducements to switching.

We are not convinced that retailers will have an impact on investment in infrastructure and upstream markets. The Water 2020 proposals for a market in providing new water resources appear much more likely to drive efficiencies than the suggestion that retailers could source more efficient water resources themselves.

A new upstream entrant with a low cost water resource is much more likely to wish to enter a long term stable contract with the incumbent wholesaler as a resource supplier than to try to contract with a competitive market retailer whose demand depends upon short term customer contracts.

In the absence of an effective upstream market there are limited opportunities for retailers to differentiate their purchasing strategy for wholesale services which further illustrates the importance of having a viable margin on 'pure' retail services if entry is to be incentivised.

[5] GKN CMA Report https://assets.digital.cabinet-office.gov.uk/media/54e75c53ed915d0cf700000d/CMA_customer_survey_-_energy_investigation_-_GfK_Report.pdf

Conclusion

The decision as to whether to create a retail market for household water services is of fundamental importance to the sector as a whole. Retail is the customer facing part of the service and any problems in delivery would undermine trust and confidence in the whole sector. The lessons learned from experience in the energy markets should be carefully considered.

In our view, the most relevant sources of evidence for the potential for a household retail market will be from the non household water retail market and from the household energy market. Whilst a study at this stage is useful, we believe no final cost benefit decision should be made until there is evidence that the non household retail market is successful. This would align with the recommendations of the Cave report, and of the evidence based, incremental approach taken by Defra and Ofwat to date.

Northumbrian Water Limited
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