Ofwat
Extending retail competition to the household sector - emerging findings

Response from Sustainability First
August 2015

Sustainability First

Sustainability First is a small environmental think tank and charity focussed on practical solutions for the energy and water sectors. We undertake research, publish policy and discussion papers and organise events to promote new thinking. Our focus includes: promoting the long-term public interest; innovation and how this can better serve sustainability policy and practice; and social aspects of sustainability. In particular, we work on issues of intra and inter generational equity, including fair treatment of customers in vulnerable situations, low-income consumers and citizens, and the broad agendas for affordability and efficiency.

Introduction

1. Due to the limited time given to respond to this consultation and the fact that it has taken place in mid summer, this is a high-level response. We are happy to discuss the content in more detail.

2. Sustainability First considers that there is further potential in the development of the domestic demand side in the water sector. The development of 'service' offers to households, for both water and energy, could in the future *potentially* play an important role in terms of furthering both long-term resilience and affordability. However, for this potential to be realized, it is vital that any changes that impact on households are implemented in such a way as to maintain trust and confidence in the sector.[1]

3. It will be important to think through the *practical* arrangements needed to ensure that any changes in retail activities really do have a positive impact on upstream activities – where the vast majority of costs arise and where issues of resilience and sustainability come to the fore. This may require additional market analysis to the economic modeling contained in the CBA and the more active involvement of a wider range of actors with expertise in environmental, social and quality issues.

4. Getting arrangements in place *in advance* of any change to ensure that low-income consumers and those in vulnerable circumstances are protected will also be key. Due to the size of bad debt in the sector, and the current legal restrictions around disconnections, this is not a 'side issue' but one that needs to be addressed head on in any plans. There is no such things as an 'average' consumer: the distributional impacts on specific groups and what can be done to protect them need to be spelt out.

5. Given the significant work that has been created by the European referendum, it may be difficult for Government and regulators to give adequate consideration to these complex issues at the current time. There could be a strong case to introduce transparent 'stage gates' into the reform process to allow adequate time for proper scrutiny of these key issues *before* fully committing to change. This would also

[1] See '*Trust and confidence: what does it mean for the different stakeholders in the energy and water sectors*' for a description of how getting the primary trust drivers for consumers wrong can lead to downward spirals of confidence (Sustainability First, New-Pin, 2016).

enable the results of the April 2017 opening of the non-household water market to be fed into deliberations, along with the energy experience of the role out of smart metering.

Detailed response

6. **Consumer outcomes** - The Cost Benefit Analysis (CBA) should have a stronger focus on consumer and public interest outcomes. In particular, the potential impacts of different approaches on outcomes, both short and long-term, that matter to customers, notably: affordability/value for money; customer service; reliability and quality of supply; convenience and control; environmental issues and safety. Whilst choice is clearly important, this is just one of the well known 'consumer principles.' Sustainability First notes that as water is largely an homogenous product, the extent for choice in the sector is somewhat limited.

7. **Long-term public interest** - Addressing long-term public interest concerns such as flooding and drought management require high levels of collaboration and cooperation. Consideration should be given as to how competition in the retail market, which by its nature may deter the sharing of information between companies, may impact existing and future action to address such issues. Whilst market approaches can give rise to flexible solutions, they tend to increase the number of 'interfaces' in the value chain that need to be managed. They can also lead to increased focus on short-term issues. These points can make achieving resilient services more challenging.[2]

8. **Distributional impact assessment** - We welcome the recognition that a full distributional analysis is needed. As noted, the aggregate analysis provides little insight into the reality of the impact of retail competition on the customer experience. It does not consider the likely impact on individuals or different consumer groups nor do stated cost savings represent the likely cost savings or increases to consumers. We support the list of characteristics and circumstances identified for consideration. Contrary to the view stated, we believe further work is needed to understand the likely winners and losers *before* a decision is made on whether to extend retail market competition to households. We understand the challenges this poses given the lack of appropriate available data and believe government should adjust its timescales for Ofwat's CBA submission, and introduce stage gates into the process, to allow for this necessary work. Government will be unable to understand the true costs, risks and benefits to consumers without this.

9. **Debt assumptions** – The analysis states that retailers operating in a competitive environment would have greater incentive and ability to reduce bad debt costs. We query the extent to which debt could be reduced without allowing water disconnection or compromising consumer protections:
    - 9.1 We understand from debt advice agencies that there have 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.
    - 9.2 There is arguably little to preclude existing water companies from having greater access to data on customers in financial difficulties, particularly given initiatives on data sharing being spearheaded by the UK Regulators Network and Ofgem's work on the Priority Services Register.

[2] See '*Long-run resilience in the energy and water sectors'* Sustainability First, New-Pin, July 2016

9.3 We consider it important to explore whether more targeted regulation might, as an alternative to competition, reduce bad debt. E.g. allowing less debt pass-through, enabling greater data sharing, or better use of water consumption data, so that companies are encouraged to take more preventative action to help customers manage their water use and reduce their bills.

9.4 The comparison with disconnection in the energy sector is a tenuous one. While there are low levels of disconnection in the energy sector (in 2014 there were only 192 electricity disconnections and 41 gas disconnections), it is widely recognized that customers in debt or who are financially insecure are moved/ encouraged onto prepayment meters where they can effectively self-disconnect. In 2014 around 17% of electricity customer accounts were paid by prepayment and 15% of gas[3]. As Citizens Advice noted in their report 'the number of PPM users is on the rise, on average 2,278 PPMs are installed every working day; largely driven by debt recovery arrangements'[4].

9.5 New retail entrants will need close monitoring to ensure that in the aggressive pursuit of debt they do not treat customers unfairly.

9.6 We understand that multi-utility operators are exploring whether or not they could offer water for 'free' as part of combined water, gas and electricity offer. This may enable them to effectively transfer water debt to an energy prepayment meter. We have concerns about the impact of such a move on fuel poverty and self-disconnection. These kinds of cross sector risks need to be captured and mitigated in collaboration with Ofgem. The robustness of such business models also needs to be carefully scrutinized.

10. **Costs** - We note that retail costs only account for 10% of average bills. We make the following additional comments on costs:

10.1 We query the degree to which retailers will realistically be able to assert a downward pressure on the cost of wholesale services such as water resources and treatment (which make up the bulk of the bill), as there is no national market in water, and services are likely to remain localised. The significant differences in resources, geography and assets between incumbent companies may make realising the projected benefits challenging. Understanding how the projected cost pressures may impact on Water Resource Management Plans will also be critical.

10.2 As noted, any cost impacts will not be felt equally across all customer segments. Even with an overarching net positive business case, there will be some consumers who are significantly worse off.

10.3 The greatest cost efficiencies in the retail side of the bill are likely to be achieved by retailers from other sectors entering the water retail market. Further analysis is needed to understand the opportunity here and the potential impact on the experience of customers in other sectors, particularly energy.

10.4 We welcome Ofwat attempting to capture the potential cost to the customer in terms of time lost when comparing deals (though the estimate seems somewhat conservative). Ofwat also needs to capture the costs to companies of customer churn at the scenario levels outlined.

11. **Customers in financial difficulties** -

[3] https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/annual_report_2014_final_0.pdf
[4] https://www.citizensadvice.org.uk/Global/Migrated_Documents/corporate/topping-up-or-dropping-out.pdf

11.1 Any move to unfettered retail competition risks unraveling the existing cross subsidies, which benefit many customers on low incomes. Without regulatory intervention, competition is likely to have a regressive impact and result in greater inequality across England.

11.2 Not all customers are equal in the eyes of the competitive market. There is a risk that companies will cherry-pick lower debt risk sticky customers and offer less attractive deals to those who cost more to serve.

11.3 There will need to be a systematic rethink as to how households in financial difficulties are supported. The current social tariff approach, for example, is unlikely to be appropriate and may well unravel in a competitive market. The experience of the Warm Home Discount in the energy sector, highlights that inconsistent availability of support between retailers can act as a barrier to customers switching to a better deal, either because they are concerned about loosing their social benefit, or because they don't realize they will loose it, so switch and end up worse off[5].

11.4 Incumbent suppliers are likely to have disproportionately higher numbers of customers in financial difficulties due to their relative 'stickiness'. The CMA investigation highlighted that '56% of the big six energy companies' consumers have never switched supplier, did not know it was possible or did not know if they had done so'[6]. This could distort competition, put incumbents at an advantage or disadvantage depending on how social support operates and how companies respond. It could result in higher prices for many least able to afford them. e.g. if customers are charged the true to cost serve them; if their cost to serve is socialized across fewer low cost able to pay customers; and/or, as has happened in other sectors, because companies exploit customers inability or unwillingness to move away.

12. **Customer engagement and switching** - Further clarity is needed on the switching and engagement definitions used in the analysis, the assumptions and evidence base. This includes the terms 'engaged', 'active', and what Ofwat understands as 'good competitive activity'.

12.1 We urge caution on switching expectations. The scenarios used appear to vary from 5% of customers annually switching with 5% engaging but not switching supplier, to 30% switching annually with 30% engaging. Even with a seamless 24 hour switching process, high levels of customer trust in water retail and high adoption of automation, a 60% engagement level seems unlikely.

12.2 Ofgem's 2015 Retail Market Review survey found that only 26% had 'ever switched tariff' [7] despite the prospect of significantly higher financial rewards than those likely to be available in water and reputational issues amongst incumbents. The report stated that 37% of consumers had 'engaged' in the energy market in the previous year, either by comparing tariffs, changing their tariff with their existing energy supplier (17%) or switching supplier (13%).

12.3 Ofcom's recent switching consultation highlights that in the12 months to July 2014, only 13% of customers switched at least one communication service. Switching rates for mobile, where there is arguably significant levels of customer interest, choice, and innovation fell from 9% to just 6% between 2013 and 2014[8].

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[5]https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/cvs_progress_report_for_website_final.pdf

[6] https://assets.publishing.service.gov.uk/media/5706757340f0b6038800003b/Provisional-decision-on-remedies-EMI.pdf . P.19. Para 89

[7]https://www.ofgem.gov.uk/sites/default/files/docs/ofgem_rmr_survey_2015_report_published.pdf

[8] http://stakeholders.ofcom.org.uk/binaries/consultations/mobile-switching/summary/consumer-switching.pdf

12.4 The estimated switching engagement time per customer of 10-30 minutes seems wildly optimistic even with automation.

12.5 The recognized likely increase in bundled products and services may hinder switching by effectively locking in customers to a particular retailer. Customers may sign up to a longer-term contract, to pay back the cost of a product over time (as with mobile phones) or face interoperability barriers.

13. **Choice** – We warn against Ofwat attempting to put an economic value on 'choice'. It is not an end in itself. Most customers support choice as they believe it will lead to cheaper bills, better service or products or services that better meet their needs. While 56% say they think greater choice is a good thing, the research does not demonstrate how they value this relative to other outcomes. For example, if you ask customers if they prefer a choice of three expensive water companies or one value for money one, the answer would probably be the latter.

14. **Bundling** – The analysis needs to recognize the dis-benefits of bundling:
    14.1 As the Harvard Business Review concludes 'a la carte pricing benefits the buyer and packaged or bundled deals give the advantage to the seller'[9].
    14.2 Consumer groups have expressed concerns that bundling means pricing is less transparent, can make it harder to compare deals, leads to greater customer confusion, and to customers paying over the odds for products and services they don't need.
    14.3 In the energy sector, dual fuel deals, are not always the cheapest option. It is sometimes better value for a customer to buy gas and electricity separately.
    14.4 Combined utility billing can reduce customer control and contrary to Ofwats' assertion hinder budgeting. E.g. a number of energy companies have trialed single wallet prepayment meters where customers pay for their gas and electricity together. Many customers complained it reduced their ability to budget as they had less flexibility to pay for and use different fuels at different times.
    14.5 Multi-utility bills may also hinder customers understanding of their water usage, and thus impact uptake of water efficiency and wider demand side initiatives.

15. **Trust and customer service** – We welcome the recognition that competition does not always lead to better customer service. While there is always room for improvement, levels of customer satisfaction and trust in water are on average relatively high. Complaints on the retail side are also comparatively low, compared to other utilities. The analysis needs to recognize this starting point as the counterfactual, and capture the potential dis-benefits of any move to competition. E.g.
    - New entrant issues – inexperienced companies' behavior results in falls in customer service – as witnessed in energy sector. Though arguably if existing utilities enter the water market this will be less of an issue.
    - It becomes harder for customers to identify who to speak to and how to get resolution and redress to their problems when things go wrong. In particular if there are not clear lines of responsibility between retailers, wholesalers and other parties, in the case of bundled products. Ensuring there is clarity for who is responsible for what in the end to end customer journey will be vital.

[9] https://hbr.org/2010/02/the-pros-and-cons-of-bundled-p

- As noted, there may be a decline in choice for some customers e.g. commercial drivers may result in fewer payment or hard copy communication options.
- Sharp commercial practices e.g. mis-selling, rollover contracts, unfair lock-in fees etc.
- Existing water companies withdrawing from the retail market may result in disruption.

- **Water efficiency** – we question if there are sufficient incentives for water retail companies to really encourage metered customers to reduce their water use, or water waste. As well as lower volumes leading to lower revenues, given that these customers may switch again, there may be little inducement for retailers to expend resources on water efficiency work. Introducing longer term customer contracts can of course get round this issue but may be perceived as a way of eroding choice.

16. **Timelines** – We urge caution on the speed of implementation, should retail competition for households go ahead. A phased approach with appropriate piloting (as happened in energy) and to allow time for feedback is clearly important. The use of transparent stage gates before any final commitment to change is made is recommended to allow effective scrutiny and ensure that the decision making process is seen as robust. Some of the implementation timescales scenarios outlined seem heroic. The introduction of retail competition in the household sector from a regulatory perspective will be more difficult and sensitive, not easier than the non-household sector.

17. **Protections** – As noted, the potential benefits depend on how any change would be implemented and designed. A full distributional analysis will identify the potential winners and losers from household retail competition. As a next step Ofwat must outline how it will develop the protections framework around this, to ensure all consumers benefit.

18. **Consultation process** – Given the significance of the reform programme envisaged, it is vital that future consultations take place in a more timely fashion. Whilst it is welcome that Ofwat has introduced new digital engagement mechanisms, in order to get a considered response, these need to be more carefully planned.