

Severn Trent response to Ofwat questionnaire on spillover effects

The introduction of non-household retail competition was an important milestone for the water and wastewater sectors. It has the potential to deliver benefits to non-household customers through greater choice and also can help promote greater legitimacy.

We recognise that the Cave Review and subsequent studies identified the scope for spillover benefits into the household retail and wholesale services. Although some of the proposed benefits were quite large, we do not consider that the success, or not, of the retail non-household market depends on the realisation of these outcomes. That said, we think it is very sensible for Ofwat to consider the extent to which these benefits have been delivered so that future reforms can be improved to deliver better results for customers.

With the market less than 12 months old however, we believe it is rather early to try and assess the benefits and trying to assess this now runs the risk of creating a misleading position. Since market opening, we believe entrants have been focused on establishing their operations and position in the market. As a result we have not yet seen any significant spill-over benefits. This does not mean such benefits will not arise in due course. Indeed, we expect that as the market develops we might see some of the benefits identified in the Cave Review and Impact Assessment take shape.

To support the development of the market we have introduced a number of changes. For example, we are offering retailers an alternative credit arrangement. The scheme gives participating retailers a discount on the current credit requirement, up to a total of approximately £125k. It's quick to implement via a straightforward agreement, simple to administer and available to all. All retailers have already been notified and can contact their account manager for more details.

The move has been welcomed by many retailers and demonstrates that we have been listening to their feedback. This was confirmed by one smaller retailer who told us that they can now sign up larger non household customers therefore allowing them to grow their business, as previously they couldn't afford credit arrangements so had to prepay. This meant they could only attract customers who were also prepaying.

In the note below we address each of the points raised in the questionnaire you sent us.

Wholesale cost efficiencies

Prior to the introduction of competition, we already operated functionally separate retail and wholesale business units. Therefore we have not observed retail competition delivering the types of benefits being described in the questionnaire.

We have, however, delivered substantial wholesale efficiencies through other means. These are not related to retail competition but rather through greater innovation that is incentivised under the design of the wholesale controls. We will cover this in our PR19 submission.

Retail cost efficiencies

There are two important points to consider about retail efficiencies: the availability of other comparators; and the impact of the PR14 retail control.

We are increasingly benchmarking our performance against companies outside of the water sector. Therefore, whilst water retail competition is a useful comparator, we are already looking outside the sector to identify efficiency opportunities. For example, we introduced new technology that allows

customers to track their jobs; and we are challenging our own costs against other sectors, for example in relation to bad debt.

In terms of water-retail as a specific comparator, to date we have not seen any evidence suggesting higher levels of performance. For example we have not observed retailers devoting any significant effort to promoting the benefits of water efficiency to their customers or making available actual resources to enable these businesses to save water.

The second point to note is that we separated our household and non-household retail businesses at the start of AMP6. This occurred against the backdrop of a new regulatory regime which included the use of the “Average Cost to Serve” and a tough efficiency challenge in the form of no allowance for input price pressure. This created very strong incentives to deliver efficiencies, with savings being retained until the reset of prices in 2020. Therefore whilst we have delivered efficiencies in the retail business, it is difficult to disentangle those relating to PR14 and those relating to the separation of retail household and non-household activities.

Additional points - void properties

One impact of retail competition is that the number of void properties in the non household sector is increasing. This is arguably because there is no real incentive for retailers to try and find the owners of these properties and bill them. For example, if the retailer discovers there is a tenant at a void property and suspects there is no real chance of getting any payment from them, the retailer will wish to keep them in a void state because if they’re brought into chargeable status and they don’t pay, the retailer bears 100% of the bad debt – but if they do pay, the retailer only gets 5-10% of the billed revenue.

To help address this disincentive we will be proposing a new outcome delivery incentive in our PR19 submission. This will promote a reduction in voids which will deliver lower bills for all customers.

Conclusion

We support the desire of Ofwat to consider the extent to which reforms are delivering the expected benefits. As we noted in the introduction we think it is rather early to effectively assess spillover benefits from the competitive market to the non-competitive services. We would welcome reviewing this once the PR19 process has been concluded where we should be better able to evidence some of the points you raised.