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Ofwat
Household retail project

By email to:

household.review@ofwat.gsi.gov.uk

Call for evidence - Review of household retail markets in the water and wastewater sector

Severn Trent is supportive of the introduction of competition where it makes sense for customers and the environment. We welcome Ofwat's approach to its review of the potential for household retail competition and are pleased to submit evidence into the process.

The call for evidence set out various areas where additional information or evidence could be helpful. Given the time constraints we have focused our response on one of these areas:

Market design, that may affect the analysis and your views on how these can best resolved;
Attached to this letter is a report we have commissioned from Economic Insight on evidence from other regulatory regimes where retail competition was introduced. The report sets out the findings from six regulatory regimes where retail competition was introduced and sets out seven specific issues that Ofwat would need to consider in determining the appropriate form of any household retail control. A summary of these findings are outlined in Annex 1 below.

We would welcome further dialogue on the issues raised in the report. Please contact in the first instance:

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Yours faithfully,

A J Ball

Dr Tony Ballance

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Annex 1: Key findings on market design

Key issue	Economics rationale	Regulatory precedent / other evidence
1) There is a relationship between regulated prices and competition (and the consumer welfare loss from prices that are "too high" is likely to be less than for prices that are "too low).	On the supply side, prices set by a regulator determine the amount of headroom available to entrants – and therefore, the incentives for competition. Where effective competition can develop, prices that are too high result in customers being temporarily overcharged, until entrants compete prices down. Prices that are too low mean that competition never develops, but regulatory and market implementation costs persist.	• The IPART's approach to regulating electricity and gas retail prices explicitly recognised the balance between customer protection and promoting competition and the persistent nature of the welfare loss associated with competition never occurring. • Offer's approach to electricity retail in England and Wales also acknowledged the need to balance these aims – and that regulation was not intended to mirror competition. • In relation to BT, Oftel and Ofcom recognised the risk that retail prices that were too low could give rise to margin squeeze. • In the Scottish water retail market, the WICS has allowed gross retail margins to increase – arguably to help foster competition. • Electricity retail in California provides an extreme example of the adverse consequences of setting retail prices that are 'too low.'
2) Consideration needs to be given to as to how customer acquisition and retention costs will be recovered.	For a competitive market to function, retailers will incur marketing costs in order to drive customer acquisition and retention. As these have not been allowed for historically in regulated prices for (monopoly) incumbents, economics suggests an allowance may be required to create appropriate entry signals.	• The IPART has explicitly allowed for customer acquisition and retention costs in its electricity retail controls. • Similarly, Stephen Littlechild's commentary on Offer's approach to electricity retail in England and Wales suggests that customer acquisition costs incurred by entrants are greater than the customer retention costs of incumbents (and that this matter was a consideration for Offer).
3) There is a need to consider whether any form of control should be 'national' or 'regional' in scope.	Because depending on the evidence regarding the efficient costs of supply, one could inadvertently: (i) provide 'too little' or 'too much' customer protection in certain geographies; and / or (ii) could provide 'too weak' or 'too strong' incentives for entry, undermining market development.	• Most retail service industries seem to be characterised by a small number of large, national, providers.

Key issue	Economics rationale	Regulatory precedent / other evidence
4) There is the need to balance pricing flexibility against customer bill incidence.	In a competitive retail market for household customers, we would expect pricing to develop in a way that revealed and reflected differences in demand and supply side factors. Prices could vary by differences in: (i) customer preferences and willingness to pay; (ii) the cost (including risk profile) of suppling different customer groups – which might be correlated with geography, even if geography itself is not the driver of the cost variation (e.g. bad debt).	• Our evidence suggests regulators generally opt for average / weighted controls on a basket of services, as opposed to setting individual prices at a detailed, or prescriptive, level. This gives retailers flexibility to price individual services accordingly.
5) Duration of any control needs to reflect the likely timing of market opening and the speed at which competition could develop.	Duration gives regulators flexibility to take into account new evidence that emerges before opening. The anticipated speed at which competition develops is also important, as the duration of control impacts a regulator's ability to remove or amend regulation as markets evolve, or to provide more certainty where market development is slower.	• Across the examples we have reviewed, regulators have often tied control duration to expected market development, often erring on the side of shorter controls. This includes: (i) the IPART setting 3 year controls for electricity and gas retail; (ii) Offer's electricity retail control being for just 2 years; and (iii) Oftel building in flexibility to move to RPI-0% within BT's 2002 fixed line control.
6) Importance of interactions with the non-household retail market.	Differing approaches to the form of controls across retail household and non-household markets may undermine the viability of business strategies and forms of competition that could be welfare enhancing.	• Evidence would suggest that the vast majority of non-household customers are low volume and therefore are likely to exhibit similar characteristics to household customers.
7) The demand side of the household retail market are the most critical to the development of competition.	There are generally few barriers to entry in retail markets; and therefore a range of existing firms/ suppliers could actively enter and participate. However, customer engagement is a concern, as customers have not been able to participate in the market to date.	• Regulators have recognised that their approach to the form of control (in terms of price 'levels', the number of price points and other aspects of regulatory design) can influence customer engagement. Therefore, regulators have given consideration to: (i) ensuring regulated prices aren't the cheapest on the market; (ii) limiting the number of regulated prices (but not the number of unregulated prices); and (iii) making use of non-price features, such as the use of price comparison websites.