

Agenda

Advancing economics in business

The clock starts now: customer choice in the retail water market

What might the future retail water sector look like in England once competition is introduced in the non-household market in 2017? Alan Sutherland, Chief Executive, Water Industry Commission for Scotland, and Sonia Brown, Chief Regulation Officer, Ofwat, make the case that competition will lead to improved services that are administered effectively and efficiently, while tailored packages would enable a more sustainable use of precious water resources and improved resilience

Choice for business customers in the water market in England is finally on its way. As the government has stated,¹ all non-household water and sewerage customers in England will be able to switch their retail supplier from 2017. As a result, businesses, public sector organisations and charities, whatever their size and wherever they are located, will soon be able to renegotiate their existing arrangements.

This change will empower customers to demand services tailored to their needs and that are administered effectively and efficiently, as well as enabling a more sustainable use of precious water resources. Customer choice should also be good for the environment, helping the water and sewerage industry to become more resilient and encouraging suppliers to focus more on what happens to water at a customer's site.

However, before the market can open, there is a lot to do. The next price control by the water services regulation authority, Ofwat, covering the period 2015–20, is a major staging point. The final determination will underpin the relationship between retailers and wholesalers. There will also be important areas of work to ensure that:

- there is a level playing field (so that new entrants can compete with incumbent suppliers on fair terms);
- commercial relationships between market participants settle effectively;
- participants can access the information they need; and
- customers can switch supplier quickly and easily.

This article outlines the challenges that the retail market will help to address, and the benefits that could reasonably be expected to result for customers in England. Much of the analysis is based on the very positive experience in Scotland, where a competitive retail market has been in operation since 2008.²

The challenges

The UK government's 2011 Water White Paper set out the considerable challenges that lie ahead for the water and sewerage industry.³ It highlighted the pressures on the water service and sewerage systems, and the fact that supplies for abstraction are often limited across large parts of the country. As a result, prolonged periods of dry weather can mean restrictions for customers, while intense or prolonged rainfall places unacceptable pressures on drainage systems (this is felt even more acutely now that customers are less tolerant of sewer overflows into watercourses than they used to be).

We all want an industry that is more resilient—one that is fit for the future and is able to respond to the challenges of a changing climate. We also want the industry to be environmentally sustainable. Above all, and especially at a time when customers' budgets are stretched, the industry must be seen to be charging a fair price for a fair service, both now and in the future.

Regulation can play a meaningful role in this regard. Returns need to be seen to be reasonable, given the risks that water companies manage on behalf of customers. In other words, returns need to be fair to both investors and customers—ie, rewards for good

The views expressed in this article are those of the authors.

performance and innovation need to be balanced by the consequences if a company falls short of customers' expectations.

In our view, the introduction of choice for non-household customers should help to address these twin challenges of improving industry resilience and legitimacy.

Will competition deliver value for customers?

There is now clear evidence from Scotland that introducing competition reduces current costs and brings other customer benefits.⁴

In essence, competition in England can be expected to:

- bring reductions in the companies' current costs—thus keeping customers' bills lower than they would otherwise have been; and
- lead to improvements in the levels of service that retailers supply to customers (so that customers effectively get more for their money).

Experience also suggests that competition should lead to a more resilient industry. This, in itself, would ultimately lead to further relative improvements in the level of service experienced by customers, and further relative reductions in the costs that they would have to bear.

These cost reductions are possible because of the potential for efficiencies to be made within the activities of the existing incumbent water companies. With separate retail price controls, there is the opportunity for the retail part of the company to act as a profit centre in its own right for the first time. In this arrangement the costs of doubtful debts, working capital and meter reading are likely to be more closely scrutinised than ever before.

In Scotland, the water and sewerage company Business Stream has been able to improve its performance in a number of key areas, including:

- increasing its operating profit substantially (its EBITDA⁵ margin to sales increased from 2.4% to 5.1%);
- reducing bad debt by nearly a full percentage point to under 0.7%, and targeting 0.5% (worth more than £3m a year); and

- creating £138m worth of value today for its owner as a result of separation, and a further £195m if one accepts the potential for dynamic efficiency referred to in both supportive and negative reviews of the retail framework.⁶

Must we wait until 2017 before we see such benefits in England?

The short answer to this is 'no'. It will take time to establish the new governance arrangements but the benefits to customers are likely to begin to be seen before the market actually opens. If experience in Scotland (and in other utilities in England) is repeated, customers will start to find their suppliers being more attentive to their needs, in terms of both the services that are on offer and how the customer is billed, ahead of 2017. The water industry will have to start to become more focused on customers.

This will be no overnight transformation. Rather, it is likely to take place relatively gradually. This is because the water industry itself will need to start to change its own understanding of its customers. In Scotland, it was telling that, within the water industry, the words 'service/supply point', 'premises' and 'customer' were used interchangeably. Scottish Water has many more supply points than it has premises, and supplies many more premises than it has customers. This limited understanding on the part of the incumbent was a genuine—and avoidable—frustration in opening the market in Scotland.

We would expect the companies in England to learn from Scottish Water's experience and make significant improvements in understanding their customers and their relative profitability. For example, how many Marks & Spencer retail outlets are there in each company's area, and what services are they receiving? How much scope might there be to meet those same needs differently and at a lower cost? Such an understanding is, of course, critical to tailored customer services and we would expect there to be significant improvements in this area before the market opens.

Will there be big reductions in bills at market opening?

Certainly, in introducing retail competition in Scotland, the expectation was that price would be the key factor in deciding whether a company or public sector organisation chose to switch supplier. Reports from the market suggest that most new entrants seem initially to pursue price-based strategies.

That said, our observations of the retail market in Scotland suggest that retail competition is actually much more about tailored services. This includes offering different methods of charging and payment, aggregation and interpretation of bills, fitting loggers to meters,⁷ and providing advice to customers about how to improve their water efficiency or reduce their wastewater discharges. Customers say that the range of services provided and the focus on meeting their needs have improved considerably since the market was opened in 2008. So whereas Scottish Water traditionally paid only limited attention to what happened on a customer's site (usually only in line with its statutory responsibilities), attention is now firmly focused on that middle third of the industry value chain.

Importantly, customers also appear to be prepared to pay for these services. Many report that these services substantially reduce their administration costs so that they are willing to pay higher charges to access this benefit. Other customers have explained that they have forgone discounts that may otherwise have been available in order to access value-added services. In still other cases, we have heard of arrangements whereby the benefit of reduced consumption (and hence lower bills) is shared between the end-customer and the retail supplier.

Better levels of service, reduced bills and lower administration costs for end-customers will all help to improve the legitimacy of the industry from the customer's perspective. Perhaps less immediately obvious, however, are the potentially significant benefits to the industry's resilience that could result from working much more closely with customers, and by asking: 'How can I meet this customer's needs better and more cheaply?' In Scotland, water-harvesting solutions are becoming more common.⁸ Any such initiative that reduces potable water consumption and the amount of water being discharged to the sewerage system helps to build resilience.

How can the industry—and new entrants—test their readiness to grasp this opportunity? A start would be to consider the industry value chain, and think about all of the steps in the space between the delivery of water and the collection of wastewater. Each of those steps is an opportunity to build legitimacy and enhance the resilience that underpins a company's services.

How might the market develop?

Looking forward, we envisage that the commercial relationship that develops between the wholesalers and the retailers is likely to bring further benefits over time. This could involve challenges to what the wholesale business both is and *is not* doing, which in turn could drive further value for investors and for customers. In this regard, the differences in the wholesale services agreements and the different priorities that retailers have negotiated with Scottish Water are quite instructive.

It is also likely that customers' expectations will change over time, especially if carbon-reduction targets become harder to reach or the cost of not meeting these targets increases. There will be pressure for greater innovation, and retailers—working closely with customers—will provide an impetus to adopt new thinking and techniques.

Concluding thoughts

These thoughts about a future when retail competition is firmly established are necessarily speculative. They also depend on a satisfactory outcome to the UK government's proposed legislation (ie, the Water Bill). However, it is certain that the introduction of greater competition will bring real benefits to customers and, potentially, to investors by opening up new possibilities in water services. The new focus on the customer will build legitimacy and help to make the services of wholesale businesses more resilient.

From a regulatory standpoint, separate profit centres should make it easier for regulators to allow for targeted incentives for innovation or investment in improving efficiency. Such arrangements should allow a company to pursue both potentially net present value (NPV)-positive projects that do not pay back during a single regulatory period, and projects that involve greater risk (and therefore higher returns) but which could benefit customers and the environment.

We will address the mechanics of establishing a level playing field further in a second *Agenda* article, but for now, perhaps, water companies could start by asking themselves: 'Who are my customers?' and 'How can I meet this customer's needs even better and more cheaply?' How a company answers these questions will determine how successful it may be in the new retail market. The clock starts now!

Alan Sutherland and Sonia Brown

¹ HM Government (2013), 'Government Response to the EFRA Committee's Pre-legislative Scrutiny of the Draft Water Bill', June, p. 12. See also HM Government (2013), 'Water Bill', June 27th.

² See Water Industry Commission for Scotland (2011), 'Information Note 6: an Overview of the Competitive Retail Market', March.

³ Department for Environment, Food and Rural Affairs (2011), 'Water for Life', December 8th.

⁴ Water Industry Commission for Scotland (2011), 'Retail Competition in Scotland: an Audit Trail of the Costs Incurred and Savings Achieved', April.

⁵ Earnings before interest, tax, depreciation and amortisation.

⁶ Water Industry Commission for Scotland (2011), 'Retail Competition in Scotland: an Audit Trail of the Costs Incurred and Savings Achieved', April.

⁷ Data loggers collect information over time to show a consumer's water usage.

⁸ Water harvesting is when rainwater is collected and re-used as non-drinking water (such as for flushing toilets).

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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