Economic Insight

NON-HOUSEHOLD WATER RETAIL MARKET STUDY

Summary of our Final Report

April 2021

Since the non-household (NHH) water retail market opened in April 2017, some customers have benefitted from lower prices, improved quality, and / or a greater variety in service offerings. However, there are concerns that the market is not working as well as it could for all customers. Our market study, which was commissioned by a number of retailers through the UK Water Retailer Council (UKWRC), identifies why sub-optimal outcomes may be arising and makes recommendations as to how the market could be improved.

Based on the evidence:

- **Our primary concern is that the regulated default tariffs for the lowest usage customers are below the efficient level**. We estimate that the average allowed cost to serve for customers with 0-0.5Ml usage is £78 per annum, whereas industry-average actually incurred cost to serve is £121 per annum (excluding the effects of COVID-19). We do not find evidence that this difference is due to inefficiency. This mismatch can result in customer harm because: retailers may have insufficient incentives to engage with customers; retailers may not be able to provide the efficient level of service in the long-run; and there may be a risk of systemic retailer failure.
- We are also concerned that the **crystallisation of bad debt risk**, due to COVID-19, is increasing the likelihood of systemic retailer failure in the short-term. The industry as a whole has been loss making, and the pandemic is expected to significantly reduce profitability further. As a result, we consider that there is a material risk of systemic retailer failure, and that some customers may become ‘stranded’ for a period of time. This is risk is unlikely to be in customers’ interests.
- In relation to the demand-side, we have further concerns that **some customers do not have access to the information needed to engage effectively in the market**. This may prevent some customers from fully benefitting from the market.

We believe that it is important to address these concerns as a matter of priority, to ensure the survival and development of the NHH water retail market. We make a series of recommendations to remedy our concerns.

The NHH water retail market has been open for competition since April 2017. This means that businesses, charities and public sector organisations can choose which retail supplier to purchase water and wastewater services from. However, various stakeholders (including Ofwat, MOSL, and CCWater) have concerns that the market is not working as well as it could for customers. In relation to the current outcomes that customers are experiencing, we observe the following.

- Overall, there are low levels of awareness, engagement and switching in the market (especially among lower usage customers)
- A proportion of customers report low satisfaction with their current retailer, and the number of complaints has increased since market opening
- The level of innovation in the market has been lower than anticipated at market opening
- There are concerns that there is a risk of systemic firm failure that is not in the interests of customers

We have developed a set of theories of harm (TOHs) to assess why customers may be experiencing sub-optimal outcomes, in line with how a competition authority would undertake a market study. Each TOH specifies a hypothesis that explains why a particular sub-optimal outcome may be arising. We have focused on the TOHs that we consider may be most material in terms of customer detriment.

We have assessed each TOH against the available evidence, including: publicly available sources; a detailed request for information (RFI) to retailers; and a structured series of stakeholder engagements (including with Ofwat, Defra, MOSL, CCWater, customers, TPIs, wholesalers and retailers). The study's conclusions and recommendations are nevertheless our own views.

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The table below sets out each TOH that we have assessed along with our rating of the level of concern given the available evidence. The subsequent slides provide details on the TOHs that we have 'significant' or 'some' concerns about.

	Sub-theory	Level of concern
TOH 1: The market is not working for smaller customers due to low customer engagement and weak supply-side incentives	TOH 1a: The costs of switching outweigh the benefits for smaller customers	Some
	TOH 1b: Smaller customers are subject to misconceptions and behavioural factors	Limited / no
	TOH 1c: Prices and costs are misaligned	Significant
TOH 2: Customer access to quality and innovation is constrained	TOH 2a: Customers are willing to pay for higher quality and more innovative services, but cannot identify this before choosing a supplier	Some
	TOH 2b: Dominance of price competition at the expense of quality and innovation arises because of path dependency in the market	Significant
TOH 3: Market frictions reduce service quality and drive-up prices	TOH 3: Market frictions reduce service quality and drive-up prices	Some
TOH 4: There is a risk of systemic firm failure	TOH 4a: Margins are not sufficient to compensate for undiversifiable bad debt risk	Significant
	TOH 4b: There is a risk of stranded customers if a firm fails	Significant
	TOH 4c: Self-supply has negative impacts on overall financial sustainability and customer welfare	Limited / no

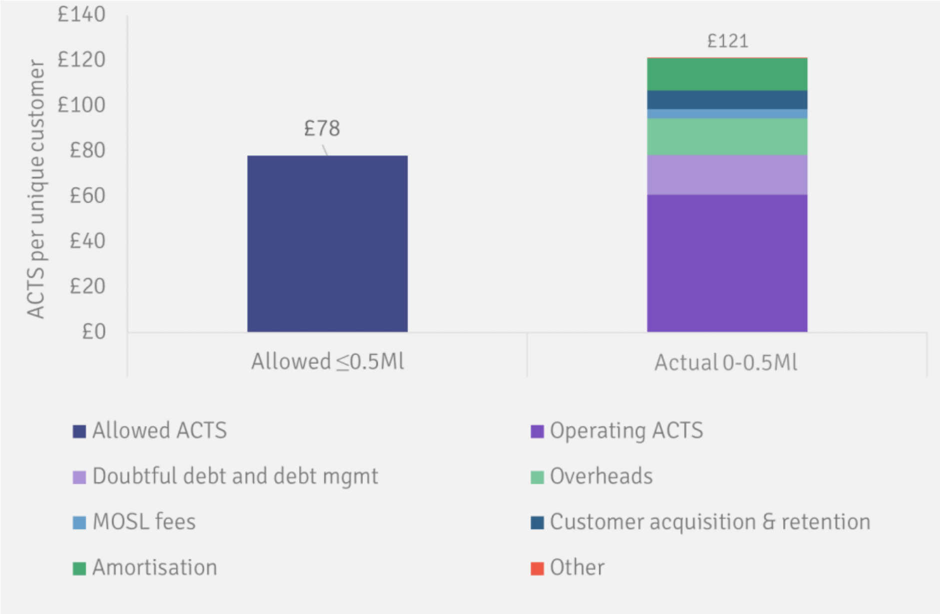
SIGNIFICANT CONCERN: PRICES AND COSTS ARE MISALIGNED FOR THE LOWEST USAGE CUSTOMERS (TOH 1c)

Our analysis suggests that the default tariffs for customers in the 0-0.5Ml usage band are below the efficient level. More specifically, the average cost to serve (ACTS) component of the default tariffs is below the cost that an efficient company could achieve.

As shown opposite, we estimate that under the current Retail Exit Code (REC) the average allowed ACTS for a unique customer with 0-0.5Ml usage is £78 per annum; whereas the industry-average actually incurred ACTS over the first three years of the market being open was £121 per annum (excluding the effects of COVID-19).

We define unique customers as the organisation that has, or would, engage in the market. Some businesses operate multiple premises, but engage with retailers as a single entity, e.g. a chain of shops. Therefore, unique customers can have multiple premises.

Figure: Actual vs allowed ACTS per unique customer with 0-0.5Ml usage per annum, excluding COVID-19 effects



Note: (i) PR16 data on premises was used for weighting the allowed ACTS by the number of premises before converting these to the allowed ACTS per customer; (ii) the actual ACTS figures include 5 NHH water retailers, a mix of incumbents and new entrants; (iii) the data presented is the industry-average across the first three years of market operation; (iv) adjustments have been made to bad debt costs in 2019/20 to strip out the effects of COVID-19; and (v) operating ACTS include billing, contacts, meter reading and depreciation costs.

WE DO NOT FIND EVIDENCE THAT THE DIFFERENCE BETWEEN ACTUAL AND ALLOWED COSTS IS DUE TO INEFFICIENCY IN THE MARKET

The finding that actual costs exceed allowed costs does not appear sensitive to accounting assumptions (e.g. how overhead costs have been allocated to different customer segments).

Furthermore, **we do not find evidence that the difference between actual and allowed costs is due to inefficiency in the market**.

- Although we find evidence of significant market friction costs, we do not consider that they are sufficient to explain the gap between actual and allowed costs. At the total industry level (including all usage bands), we estimate that friction costs could account for 4% to 15% of the ACTS. This equates to between £4 and £18 of the ACTS for 0-0.5Ml unique customers.
- There is some variation in actual ACTS between retailers, but we do not find evidence that the industry ACTS is inflated because of some relatively inefficient companies.
- The actual industry ACTS is within the range of other sectors.

Customer harm

Although the default tariffs are intended as a backstop protection for customers by capping prices, we are concerned that the significant mismatch between regulated default tariffs and the efficient cost level is giving rise to customer harm.

- Retailers may not have a sufficient incentive to engage with lower usage customers, since they are not able to earn a sufficient return for their efforts. This may reduce levels of engagement and prevent customers experiencing the benefits of switching / renegotiating their contract.
- In the long run, retailers may not be able to provide the efficient level of service. Without cross-subsidisation, retailers will be unable to provide the efficient level of service for a price that is below the efficient level. Retailers may also lack the incentive to invest in innovation.

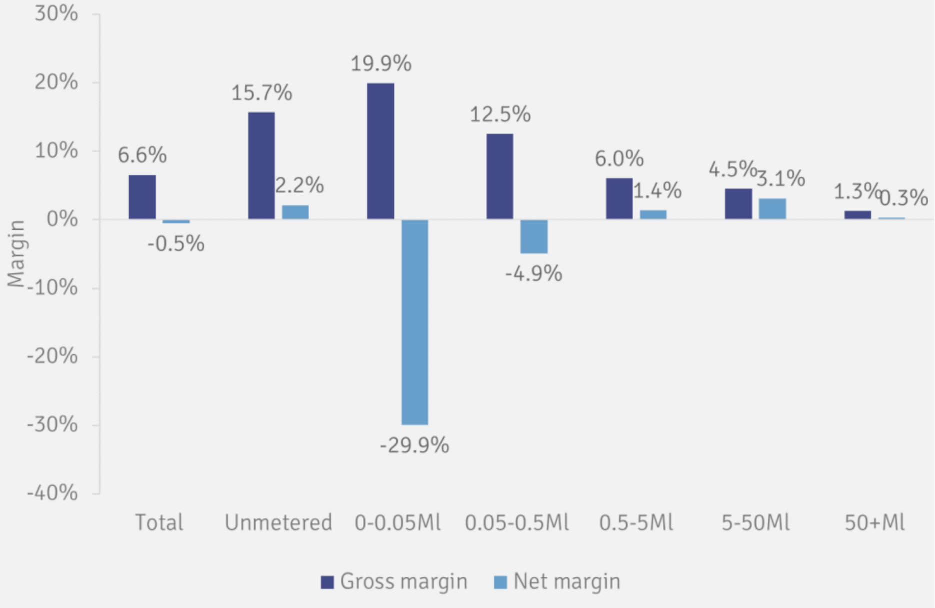
SIGNIFICANT CONCERN: DOMINANCE OF PRICE COMPETITION AT THE EXPENSE OF QUALITY AND INNOVATION ARISES BECAUSE OF PATH DEPENDENCY IN THE MARKET (TOH 2b)

At the aggregate level, **the industry has been loss making over the first three years of the market being open**, even when the effects of COVID-19 are removed. This appears to be a direct result of the mismatch between prices and costs for lower usage customers.

As can be seen opposite, customers with 0-0.5Ml usage have had negative EBIT margins, and this is even more pronounced at the lowest level of consumption (i.e. for customers with 0-0.05Ml usage).

We have not found evidence to suggest that the industry is loss making because of inefficiency.

Figure: Actual gross margin and net margin per unique customer segment, excluding COVID-19 effects



Note: (i) the figures include 5 NHH water retailers, a mix of incumbents and new entrants; (ii) the data presented is the industry-average across the three first years of market operation; and (iii) adjustments have been made to bad debt costs in 2019/20 to strip out the effects of COVID-19.

THE EVIDENCE SUGGESTS THAT, FROM THE RETAILERS' PERSPECTIVE, THERE IS NOT ENOUGH VALUE IN THE MARKET TO COMPETE ON QUALITY

We have not identified strong evidence to suggest whether the net margin component of regulated default tariffs has been set at the efficient level or not.

- However, we have not assessed the net margins in detail, not least because retailers have been making negative net margins. We do have certain methodological issues with how the margin was set, along with further complexities that have been revealed since market opening. The efficient level of allowed net margins may therefore warrant further analysis.
- Similarly, we have not identified strong evidence to suggest whether the gross margins for 0.5-50Ml usage premises are set at the efficient level or not.

Customer harm

Overall, the evidence suggests that, from the retailers' perspective, there is not enough value in the market to compete on quality. This means that the market may be stuck in a 'low quality' equilibrium, where there is a focus on price rather than quality. As such, customers may be being harmed through sub-optimal quality.

SIGNIFICANT CONCERN: MARGINS ARE NOT SUFFICIENT TO COMPENSATE FOR UNDIVERSIFIABLE BAD DEBT RISK (TOH 4a)

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We are concerned that there is a risk of systemic retailer failure, because margins are not sufficient to compensate retailers for undiversifiable bad debt risk. This is a particularly pertinent concern, given the significant increase in bad debt costs that are expected due to COVID-19. The underlying risk that retailers face has not necessarily changed, but the pandemic has revealed what level of risk retailers are exposed to.

Two factors contribute to our concern about systemic failure:

- As shown opposite, overall retailers have been lossmaking, even before COVID-19. This is not sustainable and therefore this alone raises concerns about retailer failures.
- Bad debt costs are expected to increase significantly as a result of COVID-19. Each percentage point increase in bad debt will reduce EBIT margins by one percentage point, without any mitigating actions.

Table: Industry profit margins

	2017/18	2018/19	2019/20*
Gross profit margin	7.34%	7.30%	5.61%
EBIT margin	0.78%	0.60%	-5.47%
PBT margin	-0.06%	-0.35%	-6.24%

*Source: analysis of the statutory accounts of nine retailers from Companies House. *Based on seven retailers for which 2019/20 accounts are available.*

Average annual industry bad debt provision (pre-COVID): 1.1% of revenue

Industry bad debt costs increased to about 3.4% in 2019/20

Retailers generally expect bad debt costs to be between 3% and 5% in 2020/21

Source: analysis RFI data

FIRMS WILL STILL BE EXPOSED TO SIGNIFICANT LOSSES EVEN WITH OFWAT'S BAD DEBT COST RECOVERY MECHANISM

Recognising that COVID-19 presents a risk of systemic retailer failure, Ofwat is intending to implement a bad debt cost sharing mechanism that will allow retailers to recoup some of the additional bad debt costs from 1st April 2022. However, firms will still be exposed to significant losses. Assuming bad debt of those on default tariffs increased from 1% to 3.5%, an average retailer could be expected to face a reduction in EBIT margins on default tariff customers of 1.4 percentage points.

Notably, Ofwat's approach exposes NHH water retailers to significantly more COVID-19 bad debt costs than Ofgem's current approach to reflecting additional bad debt costs in the domestic energy retail price cap.

Customer harm

The risk of systemic retailer failure can result in customer harm through interruptions to retail services, confusion caused by the interim supply process, and the time incurred by the customer through engaging with a new supplier.

SIGNIFICANT CONCERN: THERE IS A RISK OF STRANDED CUSTOMERS IF A FIRM FAILS (TOH 4b)

We also have significant concerns that if a firm (or multiple firms) were to fail, no other retailer would be willing and / or able to act as an interim supplier, under the current conditions. Although a solution would ultimately have to be found, there is a risk that customers would be 'stranded' without a retailer for a period of time.

Our finding is based on the following.

- There does not appear to be an appropriate risk-return balance at the industry level at the moment, e.g. we observe negative EBIT margins. COVID-19 is likely to increase the probability of retailer failures.
- Acting as an interim supplier will involve incurring costs associated with customer transfer along with working capital requirements. Our financial modelling finds that the cashflow and profitability impacts of these can be significant.
- If a large retailer were to fail, there would likely not be a legally obliged backstop retailer for a large proportion of its customers. This is because acquiring licensees are the backstop suppliers to many of their own customers.

Customer harm

We are concerned that there is a risk that there would be a non-negligible amount of time that customers would be without a retailer – and that this would result in significant customer harm, along with undermining the integrity of the market.

Furthermore, there may be a risk that the supply points of multi-site customers would not all be allocated to the same firm (e.g. if sites were allocated to wholesalers), which would contradict one of the benefits of the open market.

FURTHERMORE, WE ALSO HAVE SOME CONCERNS REGARDING THE OTHER TOHs THAT WE HAVE ASSESSED.

The costs of switching outweigh the benefits for smaller customers (TOH 1a)

- On the demand-side, we have some concerns that customers may not be fully engaging in the market, partly because the costs (largely in terms of time) outweigh the benefits.
- Given an average annual bill for microbusinesses of around £350, a 5% price reduction would only equate to £17.50. There can be quality benefits to switching.
- We recognise that price and non-price protections are currently in place to protect customers because there is low engagement among lower usage customers.

Customers are willing to pay for higher quality and more innovative services, but cannot identify this before choosing a supplier (TOH 2a)

- We have some concerns that customers are not able to identify the quality of the service provided by different retailers before choosing a supplier.
- We do not, however, find evidence that ‘in general’ customers would be willing to pay significantly more for higher quality or more innovative services.

Market frictions reduce service quality and drive-up prices (TOH 3)

- We have some concerns regarding the quality of market data and, in some specific cases, inadequate retailer-wholesaler interactions.
- We find that issues with market data may have led to annual friction costs of between about £6 and £24m for retailers as a whole.
- We understand that the market operator and all market participants are already taking active steps to address these issues, which suggests that these costs should reduce going forward.

GIVEN OUR CONCERNS, WE HAVE IDENTIFIED A PACKAGE OF REMEDIES FOR CONSIDERATION BY STAKEHOLDERS – TO ENSURE THE SURVIVAL AND DEVELOPMENT OF THE NHH WATER RETAIL MARKET.

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R1

The allowed ACTS for the 0-0.5Ml band should be increased

The efficient level of cost to serve the customers with the lowest usage appears to be above that allowed in the default tariffs. As such, to remedy the potential harm, the allowed costs should be increased. We recommend that this remedy is considered to take effect from April 2022.

R2

The bad debt cost recovery mechanism should be strengthened

The current risk-return balance is not sufficient to compensate retailers for the risk, and there is a very current risk of systemic retailer failure that would not be in customers' interests. We recommend that this remedy is implemented as a matter of urgency.

R3

Price caps should be applied on a unique customer basis to reflect customer behaviour

Price caps are currently defined for usage bands on a premises basis, thus engaged customers with relatively high overall usage but with multiple 'small usage' premises will be subject to the price caps (i.e. may be 'overprotected').

R4

Companies should synchronise efforts to reduce the market friction costs

We recommend that the costs of addressing market frictions (and particularly those related to data issues) could be reduced if the individual companies undertaking these activities pooled their efforts.

WE HAVE ALSO DEVELOPED A SET OF OTHER REMEDIES AND GENERAL RECOMMENDATIONS FOR OFWAT AND OTHER STAKEHOLDERS TO CONSIDER.

Other remedies	A reliable and accessible comparison tool should be developed to address information asymmetry
	Participation of TPIs likely used by small businesses should be facilitated
	The interim supply arrangements should be reviewed to limit the risk that customers are 'stranded'
	Allowing change to payment terms for customers on deemed contracts should be considered
General recommendations	Ofwat should set out a vision for how the regulation of the NHH water retail market should develop, and under what conditions price caps will be removed or loosened
	Ofwat should develop its evidence and understanding of how both engagement and costs vary between customer segments

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