



## Response to the Competition and Markets Authority Statement of Issues

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Dear Mr Kelly,

Please find below OVO Energy's response to the Competition and Markets Authority ('CMA') energy market investigation 'Statement of Issues'.

### Our goal

OVO's business has been built around what is best for our customers. We want to restore trust and help drive a simpler, fairer energy market. As a new entrant, we have consistently fought to deliver best value, innovation and customer experience, learning in the process a great deal about the barriers to entry and to growth. Despite what we have been able to achieve, some features of the market have undoubtedly prevented us from growing more rapidly and offering more effective competition.

### Where does the biggest problem lie?

In particular, we have serious concerns around the ability of the ex-monopoly companies to divide their customer base between those who have never switched and those who are switching all the time. The former group, which undoubtedly contains a larger proportion of vulnerable customers struggling with their bills, is not paying a fair price.

### Time for a change

We therefore welcome Ofgem's CMA referral. We believe competition between suppliers is the most effective way of ensuring customers get fair deal but today's market is failing consumers. It is also stifling innovation and the emergence and growth of smaller, independent businesses. Several (albeit well intentioned) regulatory interventions have not had the desired effect. In some cases they have arguably made the problem worse. Considerable changes are now needed to create a level playing field on which market forces can effectively drive the best outcomes for consumers.


### Working with you on behalf of our customers

We are by no means one of the largest suppliers in the market, but we consider this process extremely important and will make all efforts to participate fully in the investigation with the aim of securing for the best possible outcomes for our customers.

Your primary OVO contact going forward will be Jessica Lennard, Head Corporate Affairs. She can be contacted at [Jessica.Lennard@ovoenergy.com](mailto:Jessica.Lennard@ovoenergy.com).

We look forward to further engagement with you and colleagues over the coming months.

Yours,



Stephen Fitzpatrick  
CEO and Founder

## Introduction

1. OVO Energy ('OVO') entered the UK energy retail market in 2009 with the intention of offering a fairer, simpler and more competitively priced service to customers. OVO is now one of the UK's fastest growing independent suppliers, with over 360,000<sup>1</sup> customers and 500 staff. Whilst continuing to champion the core values on which the business was founded, OVO is focusing increasingly on improving customer experience and engagement through technology and innovation. Our goal is to reach one million customers by 2017 and to be the most trusted energy company in the UK.
2. OVO has grown rapidly in recent years;<sup>2</sup> however the current market structure has at times impeded, rather than facilitated, the growth of the business. Since our inception, we have observed and experienced several features acting as barriers to entry and/or expansion for independent suppliers. These features limit the ability of independents to challenge the ex-monopoly incumbents. The combined effect is to stifle competition, leading to poor outcomes for consumers who appear, in response, to be disengaging from the market.<sup>3</sup>
3. OVO has consequently advocated an investigation into competition in the market for several years. We welcomed Ofgem's decision to make a referral to the Competition and Markets Authority (the 'CMA'); and the identification of a number of key issues by the CMA in its 'Statement of Issues'.
4. OVO has regularly called for substantive changes to the current framework to create a level playing field on which competition between all retail suppliers (large and small) can thrive. However, the primary focus of OVO's business model is to start from a position of what is best for customers. Any attempt to reform the market which does not place consumers at its heart will be unsuccessful. It is therefore critical that the CMA's inquiry produces outcomes which will benefit not just businesses operating in the market, but also the customers they serve.
5. We believe our experience provides robust evidence as to the weaknesses of the current market arrangements. If you have any further questions or would like further evidence of our observations, please do not hesitate to contact us.

## Summary

6. The current problems in the energy market are partly the result of the initial conditions of the market following privatisation, after which the ex-monopoly companies inherited large, regional and, as it has become apparent, highly inelastic customer bases. They are also partly the result of the decisions and general approach taken by the regulator, Ofgem, in recent years.
7. In this submission, we have focused our attention on the features of the market that we believe are most damaging to competition. We understand that a discussion of potential remedies to the current situation is outside the scope of this initial response.

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<sup>1</sup> As of 12<sup>th</sup> August 2014

<sup>2</sup> In terms of customer numbers, OVO has grown over 240% in the last twelve months

<sup>3</sup> DECC (2014), *Quarterly Domestic Energy Switching Statistics*, 26<sup>th</sup> June 2014 shows a steady decline in the number of customers switching suppliers over recent years

8. Whilst we consider other 'Theories of Harm' included in the 'Statement of Issues' worthy of scrutiny, we do not believe they have led to such serious distortions of competition contrary to the interest of consumers as those upon which we have focused here.
9. In our experience, that the most credible and relevant 'Theories of Harm' are those under 'Theory of harm 4'. In particular, 4a (*Inactive customers reduce the incentives of energy suppliers to compete*) and 4c (*Regulatory interventions reduce the incentives for energy suppliers to compete*). These are discussed in more detail below.
10. However, we welcome the broad nature of the inquiry as suggested by the four 'Theories of Harm'. Our focus on 'Theory of harm 4' does not imply that we consider the other three 'Theories of Harm' impossible or even unlikely, merely that this is the area in which we believe our strongest evidence and most direct experience lies.

## Customer inactivity

11. Para 49-52 of the 'Statement of Issues'. Our experience indicates that the continued dominance of the incumbent suppliers, which each retain a large base of customers who have not changed energy supplier since the privatisation process began in 1989, is a significant barrier to competition.
12. Latest DECC figures show 33% of domestic electricity customers have never switched from their incumbent supplier, 25 years after the start of privatisation. For domestic gas customers, the figure is 37%.<sup>4</sup> Even these figures may overstate the extent of active switching when judged against the figures cited in para 15 below (for instance, changing accommodation or moving residence may be considered a 'switch'). This lack of activity was identified as a problem in Ofgem's 2008 'Energy Supply Probe'<sup>5</sup> and again in Ofgem's 'State of the Market Report'<sup>6</sup> earlier this year. Recent DECC figures show a general declining trend in switching rates since 2008 indicate less consumer engagement in the market, not more.<sup>7</sup> Many customers who do actively switch are, we believe, motivated more by a general sense of dissatisfaction, than by the existence of a genuinely competitive market place in which they trust.
13. The existence of large blocks of inactive consumers allows incumbent suppliers to segment the market between a small group of active, regular switchers); and those who do not switch. Most customers in this latter group are not on the best tariff offered by their supplier: by some estimates,<sup>8</sup> 75% of customers are on standard variable tariffs, which are typically the most expensive tariffs in the market. This suggests that even if customers are making an 'active' choice to remain with the same supplier, they are not making a rational choice.
14. We believe it is more likely that many of these customers have disengaged from the energy market altogether. Indeed, Ofgem has reported that 62% of customers could not recall ever having switched supplier.<sup>9</sup>
15. Evidence appears to suggest that these disengaged customers, those in the regions inherited by their ex-monopoly supplier and who have never switched, are being charged

<sup>4</sup> DECC (2014), *Quarterly Domestic Energy Customer Numbers*, 26<sup>th</sup> June 2014

<sup>5</sup> Ofgem (2008), *Energy Supply Probe – Initial Findings Report*, 6<sup>th</sup> October 2008

<sup>6</sup> Ofgem (2014), *State of the Market Assessment*, 27<sup>th</sup> March 2014

<sup>7</sup> DECC (2014), *Quarterly Domestic Energy Switching Statistics*, 26<sup>th</sup> June 2014

<sup>8</sup> Stephen Littlechild (2012), *Ofgem and the Philosopher's Stone*, International Energy Agency, 20<sup>th</sup> November 2012

<sup>9</sup> Ofgem (2014), *State of the Market Assessment*, 27<sup>th</sup> March 2014



disproportionately more (up to £250 according to Ofgem's 'State of the Market Report') for their energy.<sup>10</sup>

16. It is worth noting that as a new entrant, OVO's customers are necessarily switchers. An analysis of our customer base suggests, in contrast, that the most vulnerable category of consumers (for example, those in social housing and those who have prepayment meters) are much less likely to switch energy supplier. Special attention should be paid to the effectiveness of competition for this group of customers, which arguably suffers the most under the current arrangements.
17. It is also important to stress that many of those who have switched to Ovo are not simply motivated by price. We believe many are motivated by a general sense of dissatisfaction with their current supplier, rather than by the existence of a genuinely competitive market place in which they trust. Ofgem data seems to support this conclusion, with customer complaints having increased by more than 50% since the beginning of 2011 and a recent survey finding that 43% of customers did not trust energy suppliers to be open and transparent in their dealings with consumers.<sup>11</sup>
18. **We think it is imperative that the CMA inquiry examines the effect of incumbency and its continued impact on the market as a key priority.**
19. A further feature of the segmentation between inactive customers and the active customers has been to enable incumbent suppliers to offer short-term, introductory tariffs to the most regular switchers (see para 52 of the 'Statement of Issues'). In many cases, the tariff offered is substantially lower than the supplier's standard tariff, with little obvious explanation for such significant cost reductions to which the difference could be attributed. It is likely Ofgem reforms have made this problem worse (see below).
20. A key factor behind OVO's growth has been our ability to operate at extremely high levels of operational efficiency, allowing us to pass through cost savings to customers. We would be happy to provide further data on this. From the perspective of a nimble, efficient company buying in the market, we do not understand these introductory tariffs as explicable by reasonable assumptions on cost differentials. In many cases, it is unclear how they could generate more than a nominal margin for suppliers. In some cases, it appears possible that they may even be loss-leading.
21. These appear to be 'protective tariffs', specifically designed to maintain or boost market share at a particular moment in time. Given the data available on the price differential experienced by customers who have never switched,<sup>12</sup> there appears a strong possibility that they are effectively cross-subsidised by overcharging long term, inactive customers.
22. **We believe this approach is the one of most significant barriers to entry and expansion for independent suppliers.** Even if small suppliers are able to outperform incumbents on costs due to business model efficiencies, the ability of the incumbents to offer tariffs which appear disconnected from their actual costs necessarily restricts competition from these smaller players.

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<sup>10</sup> Ofgem *ibid.*

<sup>11</sup> Ofgem *ibid.* and Ipsos MORI (2013), *Customer Engagement with the Energy Market - Tracking Survey 2013*

<sup>12</sup> Ofgem *ibid.* and U-Switch who have also shared data with us from August 2014 which suggests a differential of £242, largely in line with Ofgem's finding of £250

23. OVO does not condone such a pricing strategy. Instead we advocate (and operate) a principle of cost reflectivity wherein all our tariffs reflect the real cost of doing business, plus a fair margin. On a market-wide level, this would result in the most efficient businesses providing effective competition, driving improved value and service for customers. However we have observed (and been effected by) the pricing strategy described above. Such an approach is made possible by the initial market conditions post-privatisation. In effect, new entrants are not competing on a level-playing field. **We strongly believe that the effect on competition of these initial market conditions, and of incumbency advantage more broadly, should be scrutinised.**

## Regulatory Intervention – Non-Discrimination Clause

24. Para 51, 58 of the ‘Statement of Issues’. Recognising these problems in the market, Ofgem has rightly made efforts to intervene to improve outcomes for consumers, particularly those not active in the market. These have been well-intentioned. However, they have led to unintended consequences, which we believe have been damaging to competition.
25. Ofgem’s 2008 intervention to introduce a new licence condition, 25A (which we refer to as the non-discrimination clause (NDC)) was designed to improve one outcome of the post-privatisation market structure - the regional dominance of the ex-monopoly companies. The NDC aimed to prevent companies charging higher mark-ups to customers in their ‘home’ regions. However, evidence suggests that this has in fact reduced competition with prices converging towards the higher end.<sup>13</sup> As discussed above, these tariffs have created a barrier to entry and expansion for independent suppliers. It is not clear they have benefited most consumers.
26. Following this intervention, incumbents have tended to retreat to their home regions and prices have risen overall and higher profits have been identified for incumbent suppliers.<sup>14</sup> Ofgem’s ‘State of the Market Assessment’ (along with other recent research) demonstrates that non-switching legacy customers in incumbent suppliers’ home regions tend to pay significantly higher prices.<sup>15</sup>
27. While this clause was not renewed in 2012, its on-going impact remains unclear. It is perfectly possible that as the NDC reduced competition in an oligopolistic market, its effects remain. **We believe the CMA should examine closely the impact of the NDC on competition and whether the withdrawal of the clause has improved the situation.**

## Retail Market Review (‘RMR’)

28. Para 51, 58 of the ‘Statement of Issues’. The RMR attempted to remedy problems that were, in part, an unintended consequence of the NDC decision. However, it is not clear that RMR will have the desired effect and may have created further unintended damage to competition.
29. As a general observation, we believe the direction of travel toward increasingly burdensome, over-complex regulatory intervention is particularly unhelpful for fledgling businesses.

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<sup>13</sup> Catherine Waddams Price, Minyan Zhu (2013), *Pricing in the UK retail energy market 2005-2013*, Centre for Competition Policy, CCP Working Paper 13-12

<sup>14</sup> Ofgem (2014), *Electricity and Gas Supply Market Indicators*, July 2014

<sup>15</sup> Ofgem *ibid*.

However, in particular, we believe the decision to limit the number of permitted tariffs is already having a detrimental impact on innovation in the market, a key source of competition.

30. We are concerned that RMR will stifle our ability to offer new products to potential customers. For example, we are currently developing a series of community-level tariffs and products with different groups across the UK (OVO Communities). While Ofgem staff have been extremely helpful in facilitating potential derogations and work-arounds to RMR rules, the fact that OVO's ability to create new products tailored to the needs of different communities is limited by permissions granted by the regulator creates unnecessary risks.
31. The success of OVO Communities (and similar product innovations) should be based on our ability to attract new customers to join it. It should not be dependent on our ability to persuade the regulator of its usefulness or desirability with reference to its own policy objectives and approach, which can sometimes be out of sync with the behaviour and attitudes we observe from our customers. Many of the customers we are targeting have not engaged in the energy market previously. It seems perverse that such an approach is limited by regulation aimed at improving the market for consumers.
32. Furthermore, current rapid changes in the energy market, in particular technological, make such restrictions inappropriately short-sighted. The smart meter roll-out to domestic customers offers huge potential for innovation in energy pricing (for example time of use tariffs) and the delivery of energy services. While RMR makes some accommodation this, it seems counter-productive to stifle the development of such a transformation by limiting the number of tariffs which could leverage these developments for the benefit of consumers.
33. Similarly, demand-side innovation is likely to become an increasingly important part of the energy market, as more intermittent supply comes onto the system and flexibility becomes more valuable. The current approach risks limiting innovation in this area and the development of an important market, identified as a priority by Government. Other potentially transformative market developments, such as distributed energy, also risk being impeded by such an approach.
34. **The CMA inquiry should investigate the potential damage to innovation from changes introduced in RMR.**
35. It should be made clear that we are not commenting here upon the willingness of Ofgem to consider derogations. Instead we disagree with the principle that innovation should be *prima facie* prohibited unless otherwise permitted via a process which, at this stage, remains largely untested in practice.
36. A more beneficial approach would allow for tariff innovation, but curtail the ability of incumbent suppliers to segment the market. This would reflect current licence conditions and competition law.