



Response to the Competition and Markets Authority
Updated Issues Statement (12 May, 2015)

Summary of Key Points

1. The CMA's Updated Issues Statement (UIS) rightly focuses on the major problem in the energy market: the means by which incumbent suppliers are able to use their large base of inactive customers to segment the retail market. This has a detrimental effect on customers and competition in the market.
2. The effect of this large block of inactive customers has been to create two retail markets. One is competitive, comprising of active switchers putting downward pressure on costs. The second is passive, comprising of customers stuck on high standard variable tariffs. The second group, as the CMA shows, is more likely to include poorer and vulnerable customers. We believe it is important to distinguish between customers who are unable or less able to engage in the market because of their social or financial circumstances, from those who are well placed to engage but choose not to for various reasons.
3. Evidence from the UIS appears to show that average Big Six SVTs are moving away from underlying costs. This suggests that SVT prices do not seem to be responding to competitive pressures. We provide further evidence on this, and show that the trend may have got worse in the most recent six months.
4. The existence of inactive customers is damaging for both consumers and competition. In a market characterised by inactive customers you would expect worsening customer service, little downward pressure on costs, and little innovation. These are all evident in the GB supply market. The existence of inactive customers does not always imply harm to competition in a market. However, we argue it does in this case in the supply market not only because of the prejudicial approach the incumbent players take to this customer group, but also because these are to a large extent inherited or 'legacy' customers.
5. Moreover, the ability to gain high returns from SVT customers has allowed the Big Six to cross-subsidise protective tariffs that has damaged competition over the past five years. We think there is evidence that some of these tariffs have been loss-leading. Regulatory intervention has not stopped this practice by the incumbent suppliers.
6. Such protective tariffs certainly seem to be disconnected from underlying costs. The differential between the non-standard tariffs and SVTs for some large suppliers is very high. It is hard to see how this can be explained by differences in cost to serve.
7. The existence of these tariffs prevents innovative firms with higher standards of customer service from exploiting profitable opportunities in the market. It is worth noting that when these tariffs disappeared from the market for a 12-month period, the independents share of the market grew considerably.
8. This problem of incumbency has been made worse by poor regulatory and policy interventions. We think there is too much regulation in the energy sector, which acts as a barrier to entry and expansion. This includes the Industry Codes process, and we welcome the additional theory of harm presented by the CMA.
9. We think much of the regulatory intervention, in particular RMR, has damaged competition and stifled innovation. In particular, the four tariff rule and draconian controls over customer engagement and marketing has hindered innovation in providing a commercial, competitive answer to the problem of inactive customers.



10. Poorly designed policies and policy thresholds around social obligations have also acted as a barrier to growth for new entrants.
11. We think remedies to address these problems in the market could be relatively simple. They should combine the benefits of a liberalised market, while recognising that energy is a necessary good and vulnerable customers should enjoy specific protection:
 - a. A regulatory principle that tariffs must reflect costs, including prevention of loss-leading tariffs in the energy supply market.
 - b. The creation of a default social tariff for vulnerable customers. This would protect the part of the market that is currently not benefiting from competition, while still allowing a thriving, active competitive market.
 - c. A stripping back of regulation, including RMR. Ofgem should instead use a principles-based approach to regulation. Informational remedies will not be enough. Such an approach requires a more robust and proactive approach from the regulator to penalising companies that do break the rules.

We think other Theories of Harm like Vertical Integration, wholesale liquidity and rules are distractions. We are pleased to see the UIS recognises this.

Comments on specific Theories of Harm

Updated theory of harm 4: Energy suppliers face weak incentives to compete on price and non-price factors in retail markets, due in particular to inactive customers, supplier behaviours and/or regulatory interventions.

12. We believe, as we argued in our initial submission and in subsequent appearances before the CMA panel, that the major problem in the energy supply market is the means by which the Big Six incumbent suppliers use their stock of inactive customers to segment the retail market.
13. The effect has been to create two markets. One, for active switchers, is competitive. This market is driven by the innovation of independent suppliers and a downward pressure on cost to serve, partly due to better operational efficiencies of new entrants. The second is characterised by inactive customers on high Standard Variable Tariff (SVT) rates. As the survey commissioned on behalf of the CMA has shown, this group of inactive customers is more likely to include vulnerable customers such as the elderly and less affluent. Analysis undertaken by the UK Regulators Network¹ is consistent with the CMA survey's findings, with regard to customer vulnerability.
14. We agree that Figures 1 and 2 in the UIS support this two-market arguments. The Big Six's SVTs appear to have decoupled from underlying costs. The level of divergence does not appear to be the product of any change in the cost of supplying one group of customers over another. Rather,

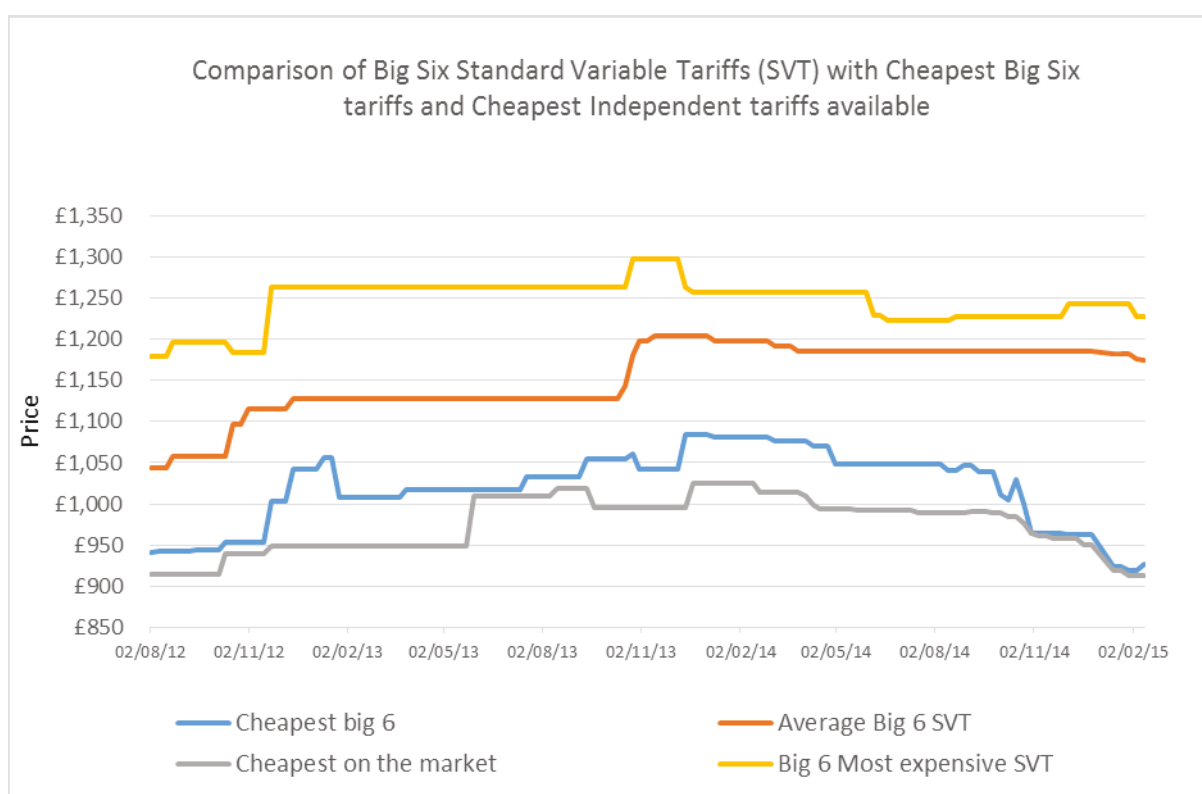
¹ UKRN Consumer Engagement and Switching Statement, 17 December 2014. This report found "in energy, consumers are less likely to switch if they: are from less affluent socio-economic grades; live in social or private rented accommodation; are older (i.e. 65+); have no or limited internet access.



it indicates weak competitive pressures in the SVT market. It indicates that at least some members of the Big Six are willing to price discriminate between their customers.

15. To reinforce this point, we have constructed similar data which goes up to February 2015 (rather than the data in the UIS which stops at early 2014). While our updated analysis does not include recent announced price drops on the Big Six SVTs, we do not think this would lead to significant changes in the pattern.

Figure 1



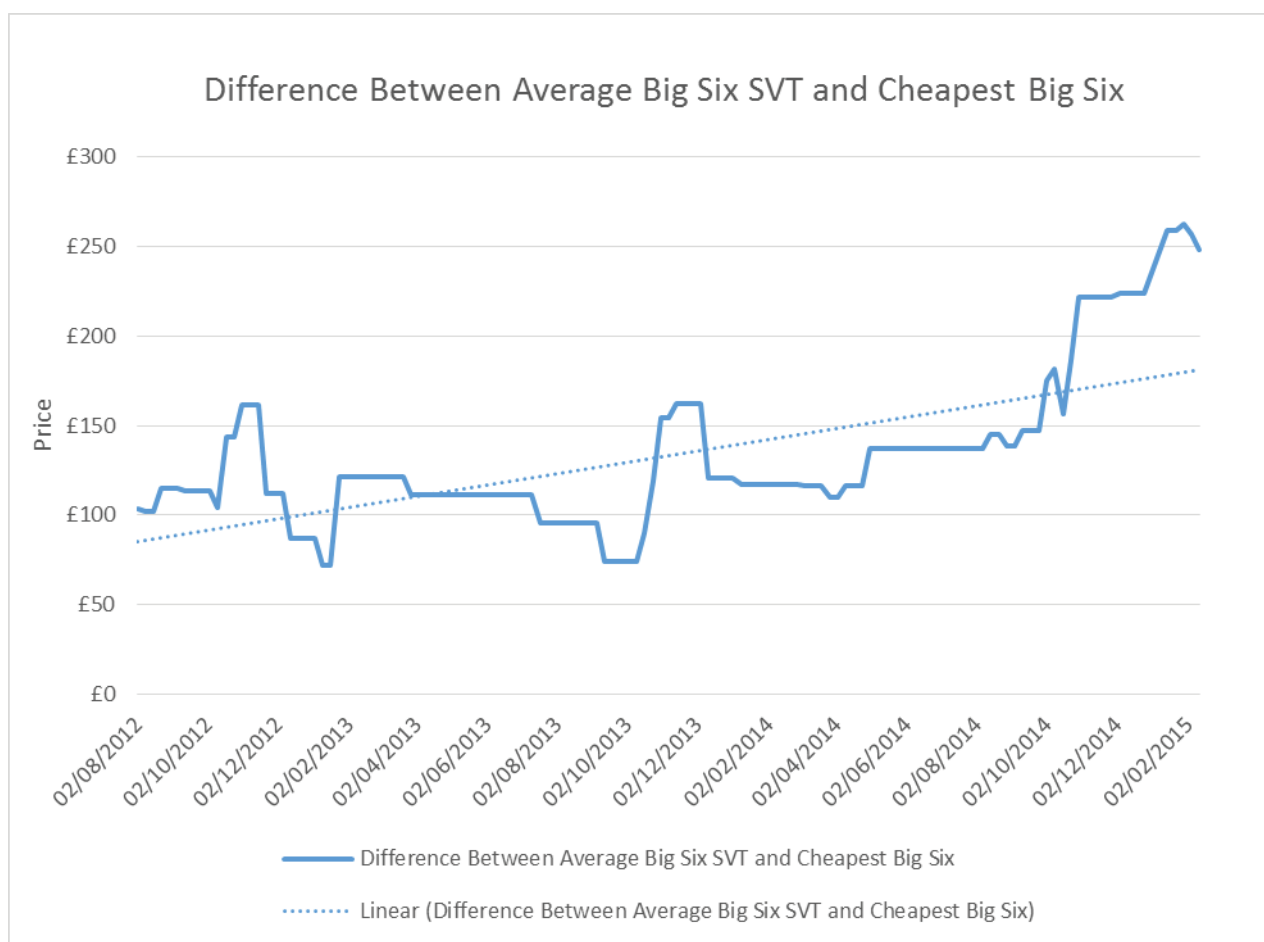
Source: *Energylinx.co.uk*, accessed 02/08/12 and every subsequent Thursday to the 12/02/2015. Data uses prices for Ofgem standard consumption (profile 1)2 for dual fuel users, averaged across all regions.

16. Figure 1 shows that the price of the average Big Six SVT and the price of the cheapest non-standard Big-6 tariffs (Red and Blue lines) has diverged in recent years. The original difference was £103 on the 02/08/12 and rose to £248 on the 12/02/2015, an increase of £145 (140%). This divergence can be seen in figure 2.

² Ofgem New typical domestic consumption values



Figure 2



Source: Energylinx.co.uk, accessed 02/08/12 and every subsequent Thursday to the 12/02/2015. Data uses prices for Ofgem standard consumption (profile 1)3 for dual fuel users, averaged across all regions.

17. The charts, alongside the CMA's findings, suggest that incumbent suppliers are capable of exercising market power and ignoring market signals, such as marginal cost. The introduction of RMR rules and tariff restrictions has done nothing to stop this trend and if anything, the pattern has worsened in recent months, despite falling wholesale costs.
18. Moreover, the chart shows that the price of the average Big Six SVT has trended towards the most expensive Big Six SVT (red line and green line). This could suggest a level of convergence amongst the Big Six Suppliers on pricing strategy, perhaps indicating that the dominant strategy for large suppliers is to incur losses on cheaper tariffs (that are typically introductory and time-limited by nature) and then recoup these losses by increasing the price of their SVT.

³ Ofgem New typical domestic consumption values



The effect of the two markets and why it matters for competition

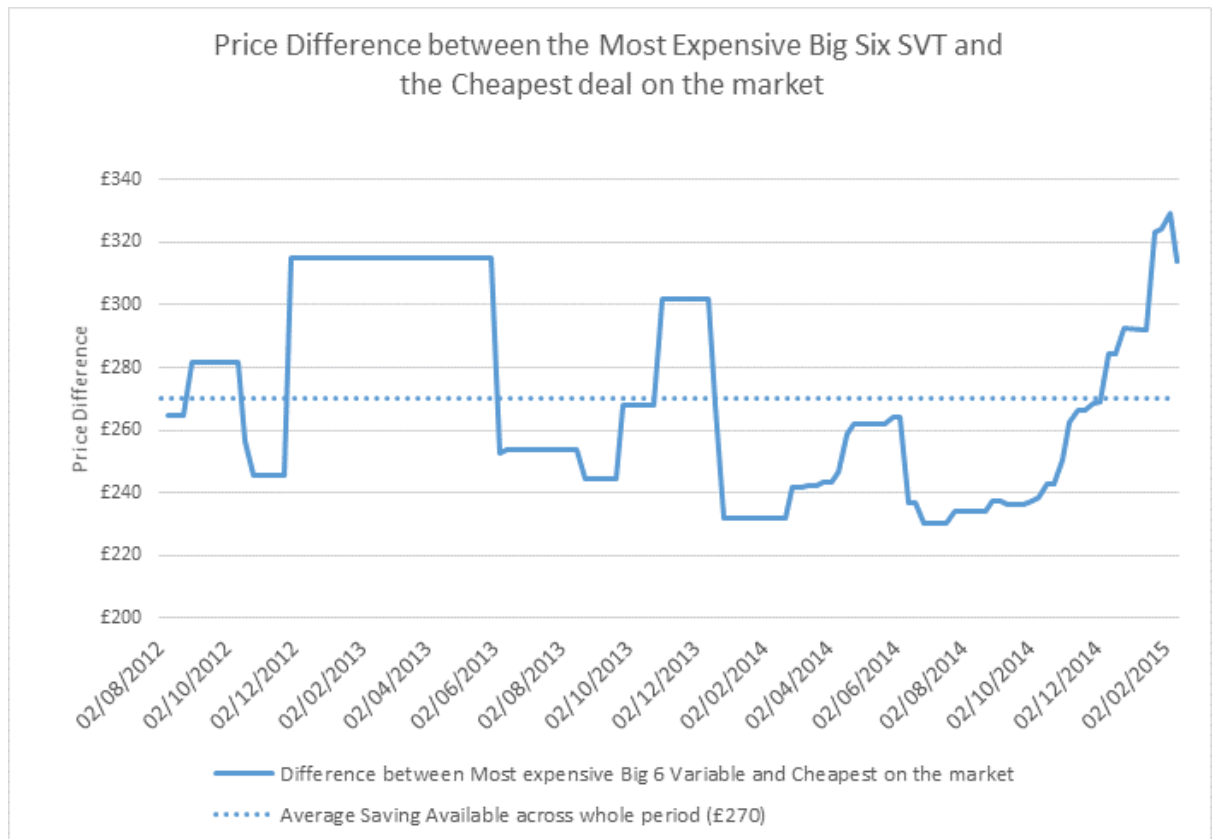
Customers paying higher prices

19. The current market sees many customers, particularly loyal customers (often inherited), paying more than they need to as evidenced by both Figures 1 and 2 and by the CMA "Analysis of the potential gains from switching"(CMA (2015b)). While this is a feature of many markets, it seems odd that in a market characterised by a largely undifferentiated product such large and widening differences in prices exist. One explanation is there is little risk of the Big Six losing significant market share from SVT customers due to their inactivity.
20. We think that the CMA analysis may even understate the gains from switching available to customers identified during the "relevant period" (31 March 2012 to 30 June 2014). We do not think that average savings gives the full picture. We think it is more telling to identify *maximum* savings, with perhaps average savings included as an additional consideration. Evidence such as Flores and Waddams 2013⁴ shows that energy customers are responsive to high price differentials. Conducting the analysis based upon an average tariff value (which has the effect of depressing the maximum savings available at the given time) rather than using the true extent of the potential gains of a significant number of customers risks underplaying the inactivity of many customers, even in the face of considerable savings.
21. OVO's analysis of the potential gains from switching during the same period showed that customers on SVT with Big Six suppliers could have saved a maximum of £315 by switching to the cheapest tariff in the market between 22/11/2012- 23/05/2013 (27 weeks). The average maximum savings would have been £270. The pattern of maximum savings can be seen in the chart below.

Figure 3

⁴ Flores, M. and Waddams Price, C (2013) "Consumer behaviour in the British retail electricity market" ESRC CCP Working Paper 13-10





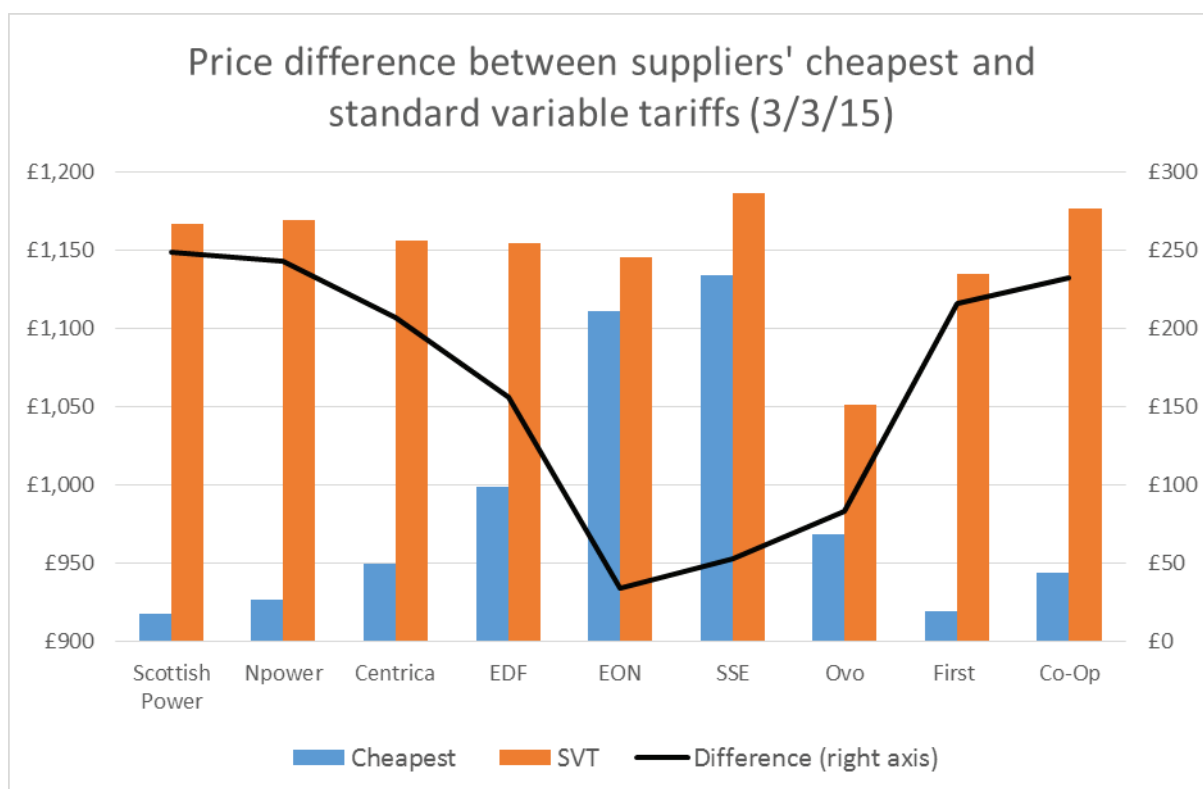
22. As an aside, it seems odd that the government mandates suppliers to pay £140 a year to their poorest customers through the Warm Home Discount where much higher levels of savings could be achieved by switching them.

Loss-leading

23. One of the most damaging aspects of the two markets problem is that it appears to allow incumbent suppliers to use revenues from their large group of inactive customers, to subsidise short-term, protective tariffs. In some cases, we think these tariffs may be loss-leading. The UIS analysis certainly suggests there are periods where non-standard tariffs are priced below expected costs (para 129). We think this has been a common feature of the market since OVO entered in 2009.
24. The chart below shows the cheapest and standard tariffs available from nine of the largest Energy Suppliers on a recent date (3/3/15).
25. The chart has several features. First it shows a significant discrepancy between some of the Big Six's SVTs and their cheapest tariffs. While there are genuine differences between costs to serve SVT customers and fixed tariff customers (debt, hedging strategy, churn, propensity to contact, for example), this cannot explain the large differentials from some suppliers.



Figure 3



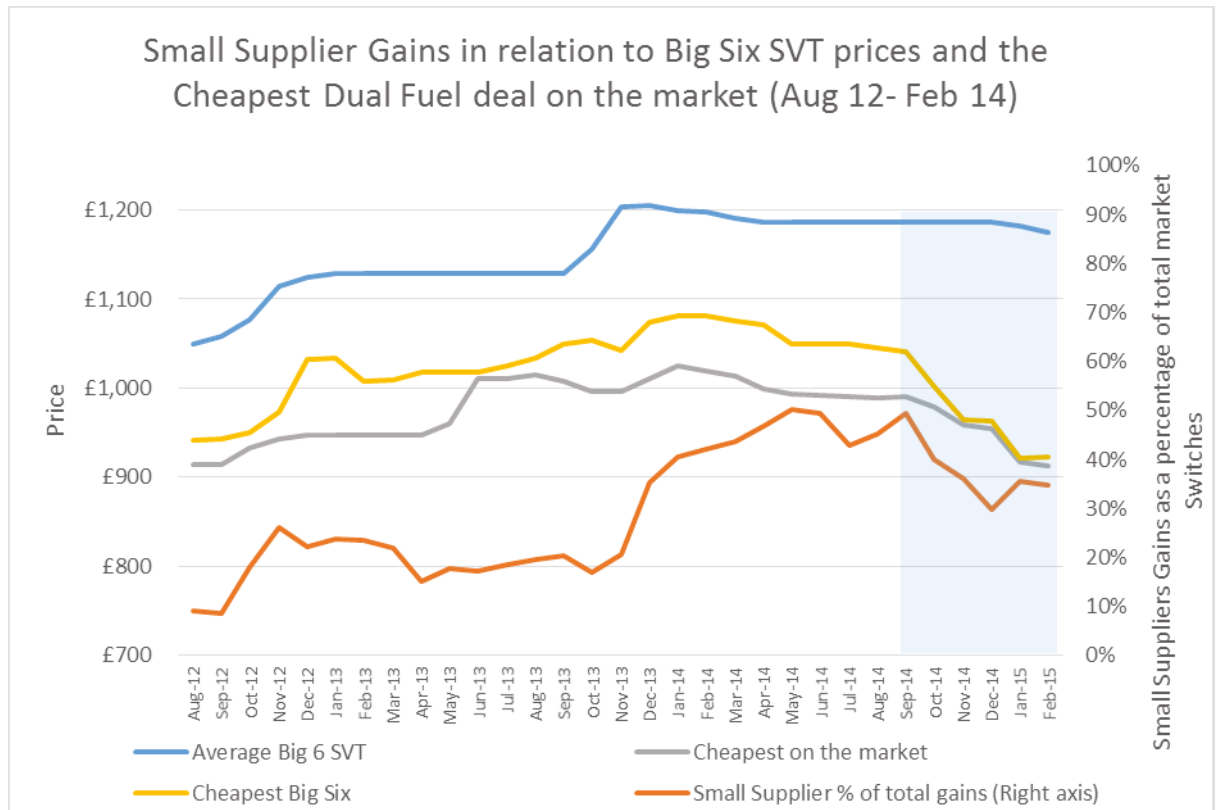
Source: Tariff data sourced from Uswitch both accessed on the 3/3/15. Data uses prices for Ofgem standard consumption (profile 1)5 for dual fuel users. All figures averaged across all regions. British Gas Figure includes their white label Sainsbury's tariff.

26. Further analysis on cost to serve, which we have provided to the CMA suggests that several suppliers' cheaper tariffs appear to be priced below what could be expected if the cheapest tariffs reflected underlying costs. There seems little likelihood that the large discounts observed from some of the suppliers reflect genuine differences in costs to serve. It therefore appears likely that the lower tariff is priced below cost and an example of loss-leading.
27. We believe this snapshot is typical of the market over the last few years. It is worth highlighting that while, on this particular snapshot, the differential for some suppliers is low, these suppliers have at other times both in recent months and over the past five years offered very aggressive tariffs. The pattern in recent years has seen incumbent suppliers periodically offer loss-leading tariffs, which are then withdrawn from the market after a few weeks.
28. The impact of these heavily-discounted tariffs in the market is profound. Figure 5 below shows this. The chart takes data from Figure 1 and includes the percentage of domestic market switches that are going to independent suppliers (red line).

⁵ Ofgem New typical domestic consumption values



Figure 4



Source: Energylinx.co.uk, accessed 02/08/12 and every subsequent Thursday to the 12/02/2015. Data uses prices for Ofgem standard consumption (profile 1)⁶ for dual fuel users, averaged across all regions. Energy UK Electricity Switching Figures February 2015 (Gains by small Suppliers as a percentage of total switching)

29. The chart shows that for a period of around 12 months (August 2013 to August 2014) the Big Six loss-leading tariffs largely disappeared from the market. This coincided with the percentage of switches going to independent supplier rising significantly (from 21% to 50%). When the protective tariffs returned in September 2014, the percentage of switches to independents fell (to 30%). This is perhaps not surprising and as you would expect from economic theory. However, it shows the important effect the protective tariffs have on the energy market and how they limit the ability of more cost-efficient suppliers to exploit profitable opportunities.

30. As stated above, it seems unlikely that the deep-discounting reflects a genuine difference in costs. More likely, it represents the ability of the incumbent suppliers to protect market share using revenues from sticky customers. It is not from any innovation or dramatic reduction in cost to serve.

⁶ Ofgem New typical domestic consumption values



31. It is worth highlighting there is a significant difference in the business model of independent suppliers compared to the Big Six. The vast majority of customers (in OVO's case, around 80%) with independent suppliers will be on the cheapest tariff. This is the reverse position to the Big Six, where the percentage on the SVT is between 50% and 90% (UIS, para 113).

Declining service quality.

32. In a market with weak customer activity, service quality could be expected to decline. That has clearly happened in the supply market. As the UIS shows complaints have increased, and there have been major problems in terms of customer service with some of the major suppliers. This supports findings elsewhere that customer satisfaction and trust in the energy market has decreased.

Innovation

33. Again, in a market characterised by weak consumer activity, you would expect limited innovation, as it is not needed to protect market share and profitability. The current energy supply market is also characterised by limited innovation. For example:
- a. Many of the Big Six, with some notable exemptions, have been very slow to introduce smart meters to their customers (and in some cases are using their slowness on smart to put off customers switching). In many ways, this is a way of keeping their customers disengaged from the market by restricting access to real-time information that would likely increase awareness of energy and the benefits of switching.
 - b. The codes system has failed to push forward half-hourly settlement with any urgency. This is despite it being central to the ability of the market to capture the benefits of smart meters for customers and for market efficiency.
 - c. Most market participants have also ignored segments of the market, such as prepayment customers, where there is very little competition and innovation and high margins. In fairness, some of the rules introduced by the regulator have also stifled competition and innovation in this area, including limits on new tariffs.
 - d. In short, the Big Six do not have to innovate to attract customers; the existence of a large base of inactive customers allows them simply to protect market share and stifle the growth of new suppliers by dominating the market with protective tariffs.

34. The UIS said the CMA had 'not yet taken a view on the strength of the arguments that the Six Large Energy Firms attempt to keep their SVT customers disengaged'. We think the use of White Label tariffs, confusing bills and statements (a problem which many of the RMR reforms have only compounded), poor customer service, announcing prices rises at similar times and the slow smart meter roll-out may all act as ways of keeping customers disengaged. One other way of keeping customers disengaged is to limit the number of changes to the SVT, where they have to alert customers to the change. Such a strategy is easier in a market with limited competitive pressure.

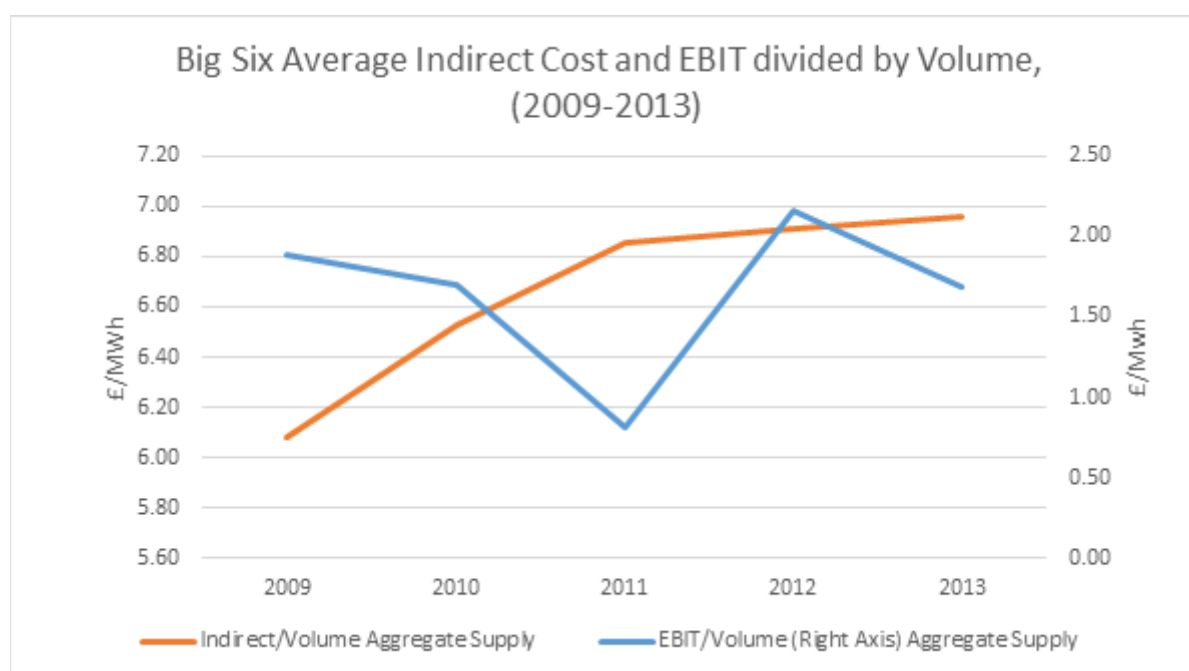
Costs

35. You would expect in a competitive market for indirect costs and gross margins to fall as competition from more cost-efficient rivals intensifies. It is not clear they have in the energy supply market.



36. The CMA has looked⁷ at indirect costs on a per customer basis and found no significant trend. While we think that while this is useful measures of whether costs are facing downward pressure, we are not sure it provides the full picture.
37. Evidence from the Consolidated Segmental Statements (CSS) shows that indirect costs on a per MW of energy supplied basis have increased from 2009-2013 (see Figure 6). The CSS also show that the profits of the supply arms of the Big Six on a per MW of energy supplied basis have remained steady. CMA analysis also suggests that gross margins for the large suppliers has remained steady. This suggests that the Big Six energy suppliers have been able to maintain profitability despite indirect costs rising as a proportion of energy supplied. Our argument would be they have been able to achieve this because of their large group of inactive, cost-insensitive customers.

Figure 6



Source: *Ofgem Consolidate Segmental Statements, 2009-2013 Annual Figures; EDF, Centrica, EON, Npower, Scottish Power and SSE* (SSE Figures are for their respective financial year)*

38. A possible counter argument to this analysis is that decreasing levels of energy consumption amongst the Big 6's consumers has increased indirect costs as a proportion of a suppliers' total costs. To remove this potential bias from our analysis we chose to weight the annual Volume of Energy Supply figures in the CSS by changes in annual demand figures for electricity and gas sourced from DECC⁸. We believe this is a useful measure when considering if competitive pressure has had an effect on indirect costs, as you would expect in a competitive market.
39. The chart shows that, with the exception of a downturn in 2011, suppliers have largely maintained their level of profitability (blue line). This suggests they are engaged in cost-plus

⁷ CMA; Profitability of Retail Energy Supply: Profit Margin Analysis, 16 March 2015

⁸ DECC: Digest of UK energy statistics (DUKES), 25 July 2013



pricing, thanks to their large bank of inactive customers. The suppliers appear to be simply passing on their costs to customers while increasing prices to ensure they make a steady profit.

40. Our analysis appears to be consistent with Table 2 on page 41 of the Profitability of Retail Energy Supply paper. That chart shows indirect costs plus profits have increased on a per MWh basis. **We could encourage the CMA to look at indirect costs and EBIT separately per volume supplied, as per our approach.**

Increased supplier profits and reasonable return

41. Since 2009 the profits of the Big Six companies have increased, as the CMA has noted, despite falling market share and a failure to cut indirect costs per volume of energy sold.
42. In para 149 of the UIS and the 'Analysis of cost of capital of energy firms' paper, the CMA explores the issue of the 'correct' measure of return for the supply sector. As we have stated in previous submissions, we are not convinced that ROCE is a useful measure by itself. We think it is much more important to look at ROCE alongside measures such as gross margins and cost to serve (see previous section).
43. We think the estimates of the correct level of WACC for a standalone supplier (9.3% - 11%) as identified in the 'Profitability' paper are too high. We do not believe that it would be difficult for a standalone supply business to get debt finance, even at the scale of some of the Big Six. A supply business characterised by a large number of low value debtors (customers) is likely to be a highly bankable proposition, due to the low risk of material default. It is unlikely that all of these customers would default at the same time on a large scale.
44. As a result, we think the WACC figures for a standalone supply business are too high. Putting a precise figure on this is not straightforward, but we think the figure should be lower than that considered by the CMA.
45. Moreover, OVO is not convinced that a standalone supplier needs high levels of collateral to support its business activities. We believe there are innovative solutions to the issue of collateral for independent suppliers and have provided evidence on this area.

Regulatory Burden

46. As noted in our initial statement, we consider that the prohibition of price discrimination (SLC 25A) reduced competitive pressure in the market. While the condition has now lapsed and Ofgem has clarified that it will no longer be enforced, it is likely that its influence still remains.
47. **Retail Market Review.** We consider that RMR has had a detrimental effect on both competition and innovation since it was introduced. It has done nothing to stop the major problems in the market, in terms of inactive customers and crucially the ability of incumbent suppliers to offer protective tariffs. Indeed, it may have made it harder for new entrants to target inactive customers with innovative products.
48. The four tariff rule has stifled innovation and customer choice. We have seen green tariffs, zero standing charge tariffs and tariffs designed specifically for elderly customers disappear from the market. From OVO's own experience, we have found that it has limited our ability to target underserved segments of the market, including prepayment customers and inactive customers in local communities. While Ofgem has granted us some derogations for tariffs, a move we welcome, it seems odd that we have to get permission for tariffs that we are hoping will help



customers⁹. The test of a tariff's success should come in the market, not in a supplier's ability to lobby the regulator successfully. Potential innovations around smart meters are similarly hampered. Too much of our internal discussions around new propositions for customers focus on whether a new idea would pass the four-tariff rule. Moreover, it is not clear that it has reduced complexity in the energy market.

49. RMR rules have also made key communications, including bills, more complicated. While we welcome giving customers information about cheaper available tariffs, we think some of the messaging around cheaper tariffs is not helpful. For example, prepayment customers have to be told about cheaper credit deals, even though they may not be eligible. This creates confusion for customers.
50. The requirements have provided customers with a lot more information, particularly on their bills, but it is not clear if it is useful, in the way that data from smart meters would be. This regulatory approach is based on a model of more information being better for customers, which misunderstands how customers engage in the energy market. Those likely to benefit from additional information are likely to be the customers who are already switching, rather than the disengaged, often vulnerable customers. Longer, more complicated bills risk making it even harder to engage inactive customers and suppliers should enjoy greater freedom to design bills that will appeal to particular groups of customers.
51. Implementing the rules has required a large amount of resource for suppliers, which is likely to favour larger suppliers. The underlying objective of some rules is not always clear and interpretation can be difficult due to a general lack of consolidated information or guidance available. This has a disproportionate impact on new entrants to the market, which may not have been as involved as other suppliers in the design of RMR from the beginning.
52. The overall regulatory burden is too high for the supply market. Even taking into account the critical importance of the energy market to the lives of customers and the need for sensible consumer protection, it is not clear that many of the regulations achieve that aim. The licence condition has ballooned to more than 430 pages, partly due to new regulations like RMR but also as a result of layers upon layers of intervention from both government (ECO, WHD, QR codes, smart meters) and regulators. On top of this, there are endless consultations, requests for information and working groups on a vast range of topics. In the past year, Ofgem has consulted on 164 issues, while DECC has consulted on 69 issues¹⁰. Rather frustratingly for energy companies trying to keep up with the slew of information, Ofgem does not hold a central database of ongoing consultations or requests for information. The Smart Energy Code is almost 800 pages long. This quantity of regulation is very difficult for smaller suppliers to keep up with and is an advantage to larger suppliers. Smaller suppliers are faced with a choice; dedicate greater resources to dealing with regulatory requirements or simply accept and implement the rules as they are designed. The first adds costs without much tangible benefit for customers and creates the risk a company becomes less focused on the consumer. The second choice risks being disenfranchised from the rule-making process, with the risk that incumbent suppliers can dominate the process to their own advantage.

⁹ Ofgem, to its credit, has speeded up the process considerably for our OVO Communities offer. While our initial application took more than 60 days, our recent applications have been approved in a matter of days.

¹⁰ Source: Ofgem and DECC website.



53. Policy thresholds for the Energy Company Obligation and the Warm Home Discount do act as barriers to expansion. Suppliers would be acting rationally if they delayed expansion until they could grow aggressively through these thresholds. These are large commitments, requiring considerable resources and different skills from those of an energy retailer. Attempts to stagger the threshold have not been helpful.
54. We were pleased to see the issue of half-hourly settlement raised in the UIS. It seems perverse that the government is driving a huge infrastructure programme rolling out smart meters, without putting in place systems that can take advantage of the benefits smart meters offer in terms of time of use pricing. This seems short-sighted. We would like to be able to test time-of-use tariffs which settle half-hourly, but face restrictions from Distribution Networks Operators (as well as RMR). There seems little industry urgency, including from Elexon, to move to half-hourly settlement.
55. We welcome some elements of the EBSCR, but are concerned about its interaction with the capacity market. We do not think this has been considered fully by policymakers. Our preference would be to have no capacity market and to monitor the impact of the SCR. However, we are concerned about the proposal that the PAR level should be set at 1MWh. We agree it should be reduced from its current position of 500MWh, but think 1MWh is too low and does not give a fair view of the marginal cost of individual imbalances over a half-hour period. We are concerned that too spiky a price signal will lead to excessive costs in the system and greater potential for generators to learn that they have become price-setters in the market. Therefore, we welcome the BSC's recent decision to reject P305 and approve P316.

Evidence and comments on other theories of harm

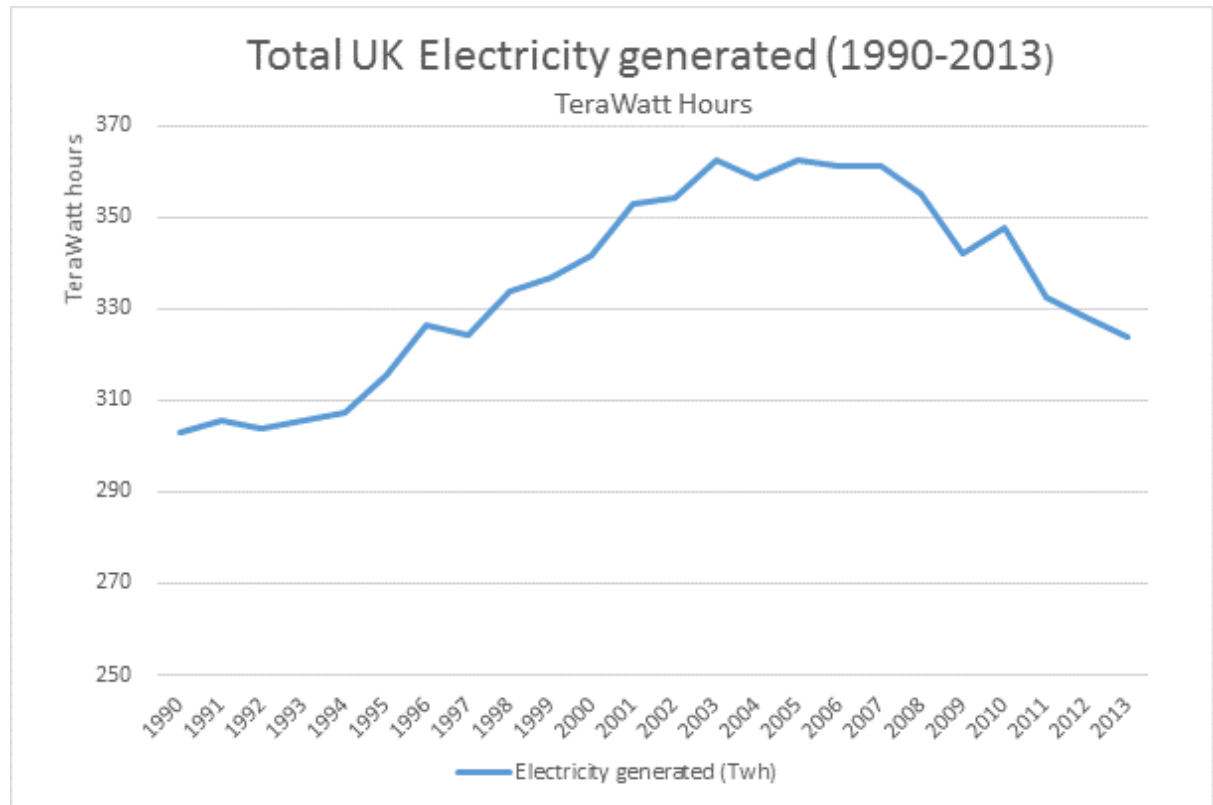
Theory of harm one: The market rules and regulatory framework distort competition and lead to inefficiencies in wholesale electricity markets.

56. We agree with the findings in the UIS that it is not clear that a pool wholesale market would be any better for competition than the current self-dispatch model under NETA. The current system has reasonable levels of transparency and efficiency.
57. We think the best way to achieve more liquidity and transparency in the wholesale market is to allow greater competition in the retail market. The experience of the Nordic market is that more liquidity in the day-ahead market has led to more liquidity in products further 'up the curve'. The Nordic market is a voluntary market and not a mandated pool. A richer retail market with more actors and activity in the publicly-traded markets would encourage a similar trend in the UK.
58. Capacity market. We are less convinced than the UIS findings of the need for a capacity market in the UK. We agree that the current model risks over-rewarding generation, particularly when tied to reforms of the balancing market. The UK's energy-only market has successfully incentivised new generation since 2001, including several GW of new CCGTs between 2006 and 2009.
59. At the same time, there are long-term trends of falling overall and peak demand since 2006. These are due to regulation on appliances and boilers, energy efficiency policy and wider trends in the economy, such as deindustrialisation. This demand does not seem to have risen in response to a higher macroeconomic growth since 2012 (see figure 7). In such a situation, combined with low carbon prices and low coal prices, it is not surprising the market is not encouraging new CCGTs to be built and it is not clear it needs to do so. Paying for coal to stay



open through capacity contracts in a context of trying to decarbonise the electricity market at some cost is nonsensical, particularly when the two contradictory measures will both be funded by consumers.

Figure 7



60. Even if it was decided that a capacity market was needed, it is not clear that the current design provides best value for customers, as the Technical Groups of Experts demonstrated. The failure to allow demand side response to compete is also a missed opportunity.
61. The introduction of the Contracts for Difference Model and the failure to inject competition into which technologies have been supported will lead to unnecessarily high costs for consumers. Success in gaining a CFD has been based on a company's ability to lobby, not on ability to compete in market. This favours larger generators.
62. It is not clear that Electricity Market Reform, and in particular the early CFDs awarded to expensive technologies at higher prices, have met two initial targets of the policy: to reduce cost of capital for projects; and attract new investors, including institutional investors. More competition should be injected into the model to protect consumers and early, expensive contracts for nuclear and offshore wind should be revisited. Technologies should not, where possible, compete against each other. The recent announcement of potential support for a tidal lagoon without adequate competitive pressure is not a promising sign. The success of recent auctions in driving down costs highlights the weakness of the original policy design.
63. A much simpler and better approach to reducing carbon emissions would be a clear carbon price.



Theory of Harm 2: Market power in electricity generation leads to higher prices

64. It is not clear there is market power in generation. There are eight major generators and a host of independent generators. It appears to us to be a competitive market.

Theory of Harm 3a: Opaque prices and low liquidity in wholesale electricity markets distort competition in retail and generation.

65. OVO has not had a problem buying power in the wholesale markets. We feel there is enough liquidity and transparency. We are not clear why this is a problem for other suppliers. Again, we believe that greater liquidity and a deeper market up the curve will follow from a more competitive retail market. This will only come as a result of a more competitive retail market.

66. We have found innovative ways to deal with the issue of collateral. We have discussed this at length with the CMA.

Theory of Harm 3b. Vertically integrated electricity companies act to harm the competitive position of non-integrated firms to the detriment of the consumer, either by increasing the costs of non-integrated energy suppliers or reducing the sales of non-integrated generating companies.

67. We have not found this a problem. There are advantages and disadvantages to being vertically integrated. If anything, OVO has found it beneficial to be a non-vertically integrated supplier, in particular in focusing on retail customers.

Theory of Harm 5: The Broader Regulatory Framework, including the current system of code governance, acts as a barrier to pro-competitive innovation and change.

68. The Industry Codes system does not appear to be working in the best interest of suppliers. It seems odd that contentious decisions such as reform of the balancing market are left to an industry code process, rather than driven by Ofgem. These processes take a long time and are opaque for many independent suppliers. The number of Code panels is high and it would take considerable resource to be able to usefully engage in the processes. We think this model should be revisited, with perhaps a greater role for Ofgem.

OVO's proposed remedies

69. As discussed above, there are two main problems in the energy market. The first is the legacy of inactive customers with Big Six suppliers. As we have shown, this market characteristic allows the incumbent suppliers to offer deep-discounted, probably loss-leading tariffs. The second issue is of overly-proscriptive legislation. We propose here remedies that would deal with these problems without damaging the advantages of a liberalised competitive market.

70. A clear regulatory principle of cost-reflectivity should be introduced to prevent loss-leading tariffs. Big Six suppliers should not be able to use their large base of incumbent customers to block the growth of new entrants, who offer lower cost to serve and better customer service. This should be part of a much-wider reform of regulation to focus on principles-based regulation.

71. Under the principle, suppliers must be able to justify shorter-term, deeply discounted tariffs on a costs basis. At present, it is not clear how the large differentials between Big Six SVT and the deep-discounted tariffs can be justified. Ofgem should be able to ask a supplier to justify such discounting at any time. As with all principle-based regulation, it is important that such a principle is backed up with strong regulatory powers to punish transgressors and a regulator



who is determined to act. This would mean quick and significant fines, banning from marketing tariffs for a period of time or losing their supply licence if they breached the principle. It is worth noting that for persistent failures of customer service, one of the Big Six suppliers was prevented from telesales for just 12 days. This appears likely too limited in scope to act as a real disincentive.

72. Second, the government or the regulator should set up a system of social default tariffs. The greatest concern over inactive customers stuck on high SVTs is that they may be vulnerable. As the evidence shows, customers who are vulnerable are more likely to be disengaged from the energy market and paying more than they need to. Government tries to compensate this by mandating suppliers to pay their poorest customers £140 a year through the Warm Home Discount. It seems odd that such a scheme does not cover the likely unnecessary payments per annum these customers are paying if they are on a high SVT.
73. Energy is not like many other markets. It is an essential service that is required to take part in society. As a result, those least able to deal with the outcomes of a liberalised market should be protected.
74. The government should recognise that it has a duty to protect those customers, without damaging wider competition.
75. Setting up such a system of default tariffs is not straightforward, but it is certainly possible and has worked elsewhere. Default tariffs operate in different guises in different markets. One possible system could work as follows:
 - a. The Government sets clear criteria for who should benefit from a social tariff. They should identify those customers who fit in the appropriate categories. Such identification has already happened in the Warm Home Discount scheme and ECO, and could be made even more straightforward. Such a system would not work without making it easy for suppliers to identify relevant customers.
 - b. Ofgem would then regulate a set tariff for such customers. This would be based on a simple hedging strategy plus costs. The government could decide that such tariffs had a very low or zero level of profit.
 - c. Suppliers would have to meet an obligation based on their market share and would have to buy-out if they did not meet the quota. Again, this works well for some government schemes. This would prevent suppliers actively trying to lose vulnerable customers.
 - d. These customers would be allowed to opt-out of the vulnerable tariff and take part in the active switching market, where they may be able to get even cheaper deals.
76. In effect, it would formalise the two markets that already exist in energy, but it would ensure that vulnerable customers are protected rather than exploited.
77. It need not stifle all innovation for vulnerable customers. Ofgem could allow innovative approach to dealing with fuel poverty, including rising block tariffs. It would also make it easier to target energy efficiency measures at the most vulnerable as you have a ready-identified group.
78. It would also allow restrictive rules to be relaxed in the non-vulnerable market. This would allow greater innovation.



79. The likely effect would also be to limit loss-leading (in addition to the principle identified above). The incumbent suppliers would have a smaller base of inactive customers that they were overcharging to subsidise cheaper deals (and excessive supplier profits).

We plan further work on these proposals.

For further information, please contact Guy Newey, Head of Policy. guy.newey@ovoenergy.com.

