ENERGY MARKET INVESTIGATION

Summary of hearing with Ovo Energy on 5 March 2015

Market rules and regulatory framework

1. Ovo did not consider there to be significant problems in the wholesale market. Any such problems were secondary, in terms of consumer harm, to that of the retail market. Reform ought to focus on getting more competition, entrants and expansion of existing entrants into the retail market. This would lead to a more liquid and efficient wholesale market. Any regulatory intervention that did not address this issue might lead to ineffective and short-term remedies.

2. Ovo approached cash-out prices in the balancing mechanism by investing in accurate demand forecasting. It felt its business had outperformed some of its competitors in this area.

3. Technological innovation, like smart-metering and live consumption data, would help address concerns regarding cash-out and wholesale markets. However the primary problems in the energy market remained in the retail sector.

4. Ovo understood the motivations underpinning the contract for difference (CfD) mechanism. However the way early CfDs had been allocated had led to customers paying too much for some technologies, such as offshore-wind and nuclear power. There was also evidence of overpayment and poor market design in the recent capacity market auction, and it appeared likely that customers might have overpaid.

5. Ovo said that whilst the capacity market was not a focus of its operation due to being a supply-only business, it nevertheless was concerned with double-paying in the capacity market. Falling overall demand in generation had undermined the need for a capacity market and it was not clear how the reforms worked with changes to the cash-out system.

Market power, vertical integration and liquidity

6. Ovo said there was not a problem with unilateral or any other kind of market power in the upstream sector of the energy market. Ovo had not perceived vertical integration as a barrier to growing its business. There was little benefit

to joining generation and retail arms with vertical integration and it did not consider it a great use of capital for shareholders.

Incentives to compete

7. Ovo felt there was no natural limit to the market share of independent suppliers, but that there were limitations on growth from the ability of big six suppliers to use their large bank of inactive customers to cross-subsidise cheap, protective tariffs in the market. This evidence of dual markets was shown in the widening price divergence of standard variable and fixed tariffs of the big six energy companies.

8. From October 2013 to October 2014 the larger energy companies had a high degree of price consistency and had withdrawn from the part of the retail market where tariffs were competitively priced. This had been a period of considerable growth for independent suppliers.

9. From October 2014 to March 2015 the pricing strategy of the large energy companies changed. This period saw a high degree of differentiation between standard-variable pricing, discounted pricing, and promotional pricing both across the big six suppliers, and between them and independent suppliers. From this date Ovo believed that the large energy suppliers had introduced loss-leading acquisition tariffs.

10. Since October 2014 independent suppliers had been winning less market share (and share of the switching market) than during the preceding year.

11. Ovo attributed the change in pricing strategy of the large suppliers, to the lack of impact of the Retail Market Review (RMR) and the announcement of the CMA market investigation in early 2014.

12. Ensuring compliance with the RMR was costly for Ovo and had a minimal effect on addressing market deficiencies. The regulation was well-intentioned, but ineffective, because sharing greater amounts of information with customers had no effect on inactive customers who were not engaged.

13. Cost reflectivity (when tariffs reflect costs to serve a customer) would lead to greater price consistency, incentivise a lowering of costs by suppliers, encourage innovation, and increase customer participation. Energy suppliers would then be responsible for demonstrating that differences in tariff pricing was reflected in the cost of serving those customers.

14. Ovo claimed that Ofgem lacked the ambition to use its regulatory powers to address transgressions made by energy companies, despite having the power to fine 10% of global revenue. Instead, principles-based regulation ought to

replace rules-based regulation, to aid in simplicity and to prevent energy companies circumventing regulation. This would require a cultural change both in the industry and by Ofgem.

Standard variable and fixed-term tariffs

15. Ovo noted that there was a significant price differential between standard-variable and fixed-term tariffs across the big energy companies, and that Ofgem placed the difference between tariffs in cost to serve at 6 to 7%. Ovo claimed that for consumers the difference in tariffs was 25% – a gap that could not be explained by additional costs to serve.

16. Ovo believed that the additional cost of serving a variable tariff portfolio would be between 2 and 4%, but that this could be reduced for the large incumbent suppliers due to their size and knowledge of customer history and the fact that customers were less likely to switch.

17. Ovo felt that although exit fees for customers on fixed-term contracts provided a higher degree of certainty for suppliers, almost all companies no longer charged exit fees. Instead they had chosen to focus on customer service, as a way of holding on to customers.

18. Ovo said that the difference in cost between its standard-variable tariff and its one-year-fixed tariff was £70–80 (based on an average customer). Ovo said that competitors' lower prices had not reflected costs and were unlikely to be the result of superior methods of hedging.

19. Ovo believed that lower wholesale prices were not passed on by the big six to inactive standard-variable customers, but instead used to subsidise cheaper acquisition tariffs for new customers. The majority of Ovo's customers were active online consumers with a low cost-to-serve, and 75 to 80% were on its cheapest tariff already.

20. The RMR's requirement that suppliers offered fewer tariffs meant that Ovo designed its standard-variable tariff as an out of contract catch-all tariff for those with bad debts or no customer history.

21. Ovo felt that the large energy companies operated an acquisition strategy that offered loss-leading acquisition tariffs financed by higher priced out-of-contract standard-variable tariffs once the original tariff expired. Similarly, the low tariff was also used as a retention tariff if a customer attempted to move supplier. Ovo believed this cycle was responsible for customers feeling powerless and creating a lack of trust in the energy sector.

22. Ovo noted that the large energy suppliers focused on average profitability because it hid the variance between its loss-leading tariffs and its expensive standard-variable customers, and that in its view each suppliers’ tariff should be examined individually.

23. Ovo felt that the lack of trust customers had in the market was exacerbated by falling wholesale prices not leading to correspondingly lower retail prices. This was due to the lack of competitive pressure in the standard-variable tariff market.

24. Ovo reported that 13% of its customers were on standard-variable tariffs and that it actively tried to get them onto fixed tariffs to maintain its customer base, as they saw standard variable tariffs as merely an attractively priced transitional default tariff.

25. Ovo considered acquisition costs to be higher for attracting sticky and inactive customers of rival suppliers. Ovo used a platform called Ovo Communities to overcome this barrier, in which it supplied energy to sticky consumers via local councils and housing associations – where prices were set by local authorities to attract those not traditionally engaged in the energy market.

26. Ovo suggested that all the big six energy firms had operated a hedging strategy that suggested there could be tacit co-ordination as no individual supplier risked losing customers by deviating from a common hedging practice.

Gas and electricity settlement

27. Ovo attributed low customer engagement in the market in part to the disconnect between customer behaviour and payment by quarterly estimated billing. It proposed that the advent of smart meter technology might increase customers’ sensitivity to the connection between usage and cost, provide the customer with more information, and lead to more competition through better engagement.

28. Ovo considered the current billing discrepancies between gas and electric to be unreasonable and outdated; that gas ought to be settled on actual daily usage. Project Nexus was thought to go some way to address this, but it still represented an outdated standard, whereas the industry needed real-time smart data. OVO added that slow progress on half-hourly settlement did not sit well with the mass roll-out of smart meters and risked undermining innovation in time of use tariffs.

Price comparison websites

29. Ovo did not have much trust in the Ofgem confidence code used by price comparison websites [✂]. For Ovo, the confidence code did not represent an impartial portrayal of a consumer's options.

Microbusinesses and small and medium-sized enterprises

30. Ovo had 2,300 customers it classed as micro-businesses or small and medium-sized enterprises (SMEs).

31. The microbusiness and SME market was different to that of domestic by being dominated by intermediary brokers. In this market, positive outcomes more frequently served the interest of intermediaries rather than customers. The lack of positive outcomes for consumers compelled Ovo [✂].

32. Ovo believed that the SME market focused on aggressive introductory tariffs with a high rollover onto deemed tariffs and that there was no standardisation of energy prices for businesses owing to the intermediaries' lack of transparency and the level of commission being rolled into tariffs. Ovo felt that the commission earned ought to be itemised on businesses' energy bills to incentivise better outcomes for customers.

33. Ovo noted that energy companies were prevented from direct-selling to SMEs due to the aggressive introductory tariffs offered through intermediaries and loss-leading retention tariffs offered by large energy suppliers. Ovo expressed that this undermined a sustainable competitive market and diminished incentive to participate in the market.

Industry codes

34. Ovo was pleased that the CMA had added a theory of harm concerning industry codes. Influencing and deriving benefit from industry codes was a significant barrier to entry as small suppliers did not have the resources of the large energy companies to affect change.

Profitability

35. Ovo believed it had achieved a fair gross margin and a steady rate of return. Profitability had been affected by its growth over the last 18 months and the prioritisation of investment in staff and technology – whilst also building trust in the Ovo brand.

36. Ovo's focus on profitability was forward-looking and expansionist, comparing its current size to how it intended to be in two to three years, rather than as a static company of its current size. Ovo aimed to be profitable on every customer at the full customer acquisition level that is, accounting for the acquisition cost of a growing customer base.

37. Ovo asserted that high profit margins did not correlate to efficient business practice or positive outcomes for customers. As a consequence, gross margins were a more meaningful statistic to assess market efficiency and competition, rather than profit margins.

38. Ovo achieved levels of growth in the preceding 18 months that, owing to its small size, could not be replicated by the large energy companies. Ovo reported that there were no barriers to expansion in its operating structure.

39. The only element that slowed down Ovo's growth was the power of the incumbent energy companies. Despite numerous accolades from consumer groups for superior pricing and service, Ovo only received [✂] of the switching market. Ovo attributed this to the brand recognition of the big six, and their subsidising loss-leading acquisition and retention tariffs.

40. Ovo suggested that its advantage over larger companies was in the more effective use of information technology; that despite being in the business of managing data, most of the large energy firms outsourced their information technology needs. As a consequence, the cost of outsourcing and consultancy raised prices for consumers. Larger companies were also slower to respond to regulatory and technological changes – such as smart metering, which might vastly increase the amount of data they need to process.

41. Ovo also believed that it had an advantage in personnel. It believed the big six lacked engagement with their customers and their staff, and did not promote the empowerment necessary for a more competitive market and were hiring strategists, data analysts and marketers, to maintain their expensive operations despite a diminishing market share.

42. Ovo highlighted that its own organisation's culture was inherently different owing to rapid growth during a period of recently increased competition; with the result being an investment in high-calibre individuals in technology.