ENERGY MARKET INVESTIGATION

Summary of hearing with OVO Energy on 29 October 2015

Interaction with the wholesale energy market

1. OVO Energy (OVO) considered that it was not necessary for large energy supply businesses to own their own generation businesses. OVO considered that the large suppliers in the GB energy market were ‘quasi-vertically integrated’ as most of them did not have sufficient generation capacity to cover the whole of their customers’ needs, and so had to purchase the energy they sold as well as generate it themselves.

2. OVO discussed the fee arrangement that it had with a trading intermediary. It said it was the most capital-efficient way of obtaining the credit its retail business needed, and allowed it to avoid posting collateral.

3. OVO explained that the trading intermediary was also in a better position than other lenders to understand the risks involved in the market. It said it might consider other ways of accessing capital if they proved more efficient than their current arrangements.

4. If the volatility of the wholesale energy market increased, then OVO’s costs to its trading intermediary would also increase and it would need to pay more for access to credit. OVO said the alternative route of purchasing a power station in a volatile market was less suitable to their business model and had higher capital costs than its current arrangements with a trading intermediary.

5. OVO’s retail business sold energy to customers on a ‘one-month running contract’ which had no fixed term. In order to ensure it had enough energy to meet its customers’ needs, it would estimate how many customers it would have and their likely demand over a certain period.

6. OVO said its relationship with its trading intermediary was positive and that it routinely reported to it regarding its business and overall strategy. The arrangement, however, was flexible enough for it to introduce new and innovative products provided a business case could be justified.

7. The vast majority of OVO’s customers paid by direct debit. Its arrangements with its trading intermediary ensured that there were no cash flow issues and that its business model would support further growth. A decision on the

viability of the model going forward would also be assessed as the company grew.

The retail energy market

8. From a commercial point of view, there was relatively little difference between the amount of energy used by a 'larger' domestic user and a 'smaller' one. The domestic retail energy market was not like, for example, financial services, where there would be very large differences in the amount of money customers could afford to invest. OVO's energy supply business was therefore not particularly sensitive to individual customer demand.

9. However, OVO did seek to attract customers with particular characteristics. As well as looking to obtain customers who could pay their bills, it also wanted to attract those it considered to be 'conscientious', ie who had thought about more than just price when choosing their supplier, and had also considered issues such as how environmentally-friendly the energy they were buying was and whether their energy supplier was a good corporate citizen. OVO considered that it ran its business in a responsible way and that 'conscientious' customers who recognised this would be more likely to stay with it long-term than if they were only interested in the cheapest price they could get. It also noted that it was cheaper for it to service customers who were happy to manage their accounts online, although it also provided customer services for those who preferred to do so via phone or e-mail. OVO was also actively engaged in the prepayment or pay-as-you-go market where it considered that it could provide a better and more convenient service for these customers.

10. OVO did not encourage its customers to keep their costs down or to behave in particular ways. OVO said that suppliers with more accurate and billing systems and fewer customer complaints were likely to have less bad debt. If a supplier wanted its customers to behave in a particular way, it needed to provide them with an easy way to do so. OVO considered that improving its online offering and making it as convenient as possible was the best way to achieve this.

11. OVO considered that the only additional factor (beyond payment methods and benchmarking costs) that the CMA should consider when comparing the businesses of the six large energy suppliers and those of the mid-tier suppliers (of which OVO was one) was looking at the average price paid by customers since their last switch of supplier. This would enable the CMA to compare prices for engaged and disengaged customers.

12. A certain proportion of OVO's customers were currently on its SVT, and the vast majority of these had joined as fixed tariff customers and then moved onto the SVT. OVO preferred to use fixed tariffs to attract customers because that way new customers would have a fixed price for a known period, whereas if they were to join on a cheap variable tariff, their price could potentially be raised a short time after they had joined, which could make them unhappy. OVO wanted to avoid the practice of having cheaper tariffs which could only be accessed by new customers.

13. OVO discussed the role that costs play in determining the price it charges for fixed and SVT tariffs. It said that it believed in cost-reflective pricing, and that it tried to price competitively to attract new customers. It said typically there were unique features of the SVT customer base that increased costs for suppliers, such as a different debt profile.

14. OVO supported continuing to offer a competitive SVT tariff to consumers, but also advocated any measure that protects customers from unfair pricing practices.

15. Other suppliers could have loss-making acquisition tariffs because there were effectively two different markets for energy customers; one market was for those who regularly switched, and the other consisted of those who only switched rarely, if ever. This meant that a strategy of trying to acquire as many customers as possible on fixed tariffs was feasible as many of these customers would not switch away when they moved onto more expensive SVTs. OVO did not agree with this strategy.

16. OVO considered that all tariffs should reflect a supplier's costs. This would prevent suppliers having low prices for one set of their customers and high prices for another. OVO proposed that there should be a limit on the difference between a supplier's lowest and highest prices. When suppliers introduced new tariffs, they would have to explain how the price reflected their costs to serve their customers. This would make it difficult for suppliers to justify 25 to 30% differences between their highest and lowest tariffs where service costs were around 4 to 5% for the average customer.

17. OVO noted that despite recent intense competition for new customers between suppliers via fixed tariffs and large falls in wholesale prices, there had been no downward pressure on existing customers' variable tariffs. This was because there was no link between the prices suppliers charged to new and existing customers. If suppliers had to adhere to a principle of cost-reflectivity when setting their prices, this problem would be solved without having to introduce price caps or other interventions. It would also allow suppliers to operate different business models reflecting their respective cost

bases and efficiencies. What suppliers would not be able to do would be to pass all their inefficiencies onto a group of disengaged customers while at the same time aggressively pricing to acquire new customers. OVO said this was a practice that had made entry harder for some new suppliers.

18. OVO did not consider that the big six suppliers really did operate different hedging strategies for their fixed and variable tariff customers. In reality, what they probably did was allocate their expensive trades to their variable customers and their profitable ones to their fixed term customers.

19. If tariffs were cost-reflective they would not only take into account the costs of supplying energy, but also the costs of any other services bundled with energy. Cost-reflectivity had been introduced via EU legislation, which meant that any extra charges suppliers wanted to charge customers who did not pay by direct debit had to actually reflect the extra costs involved and not be punitive. OVO's view was that the only reason there should be differences between suppliers' retail energy prices was costs, rather than the ability of consumers to engage with the market.

20. OVO would be content with the regulation required to ensure that suppliers were adhering to a cost-reflectivity principle. It considered this was a better way of assessing suppliers' performance in respect of consumers than profitability because it was possible to operate an energy company in a way that allowed for substantial losses for some customers which were then recouped by charging other customers more. If prices reflected costs, then the most efficient businesses would have a competitive advantage.

21. OVO noted that despite publicity and actions by Ofgem, large suppliers were able to maintain overly large price differentials between their cheapest and more expensive tariffs because consumers did not switch. If cost-reflectivity was required, more consumers would pay less for their energy and companies which wanted to attract new customers by lowering their prices would need to find efficiencies or innovate to do so. The link created by cost-reflectively between suppliers' highest and lowest tariffs would lead to lower prices for the majority of consumers.

22. OVO said that the CMA did not need to worry about the 20 to 25% of consumers who were engaged. If it was concerned about the rest, then in OVO's view it had one of two options. It could regulate the prices suppliers charged, which OVO considered to be difficult and dangerous, or it could ensure there was a link between suppliers' cheapest and highest or average prices. If a principle of cost-reflectivity could be successfully applied for payment methods it could be applied to other aspects of tariffs.

23. OVO did not consider that the proposals from Centrica and Scottish Power to do away with evergreen SVTs were viable. Suppliers were currently required to notify customers if cheaper deals were available so the benefit of further notification was unproven. Disengaged customers who already ignored prompts to switch would continue to do so no matter what a tariff was called. For that reason it was unclear what benefit disengaged customers would receive from Centrica and Scottish Power's proposal. OVO was also concerned that without any controls on the price of a default fixed tariff, that much of the issues around overcharging would remain. A fairly priced evergreen tariff was not a bad outcome for customers. If customers were treated fairly, they should not have to switch tariffs every year.

24. OVO considered that principles-based regulation could be made to work as long as everyone in the retail energy market understood that they had to abide by the principles, and the regulator was well-informed, proactive, and had sufficient power to take action. It was important that there was always an element of doubt as to when a principle might be breached, so that companies would make sure they were always operating on the correct side of the rules. The regulator should not be pulled into supplying too much guidance to suppliers. The presence of detailed rules tended to lead to people trying to get as close to breaking them as possible or to try to find loopholes. Principles-based regulation would lead to suppliers making sure they were actually acting in line with principles that would benefit consumers. Principles-based regulation had been able to work in financial markets which were much more complicated than energy.

25. Given the experience of the energy market since privatisation and deregulation, OVO's view was that it was unlikely that simply encouraging consumer engagement would be enough to solve the problems with the retail energy market. Solving these problems would require removing the ability of suppliers to charge based on what they considered customers could bear instead of the actual costs of supplying energy.

26. OVO had been in communication with Ofgem about obtaining slots for prepayment tariffs. OVO had said the process whereby slots were allocated was not entirely transparent; it was concerned that there was a wider issue about how this process worked. It said it had requested Ofgem to look into the matter.

27. There were a number of other technical issues around the operation of prepayment meters, including the reallocation of misdirected payments, which might deter suppliers from entering this part of the market. OVO said that the introduction of smart prepayment meters should address most of these problems.

28. OVO noted that currently it could only access half-hourly data from its customers who had smart meters if they had agreed that OVO could access this information. OVO suggested that one potential way of addressing this might be to change the licence conditions so that suppliers automatically had access to this information, but advocated that further consideration on the subject was required. Another way would be to give customers financial incentives to opt-in. OVO considered that a more gradual, elective, process might be the better way to proceed rather than mandating 100% half-hourly settlement. Once the Smart Data Communications Company (Smart DCC) body was operating it should become easier to switch customers to elective half-hourly settlement and manage its operation. OVO was currently targeting its prepayment customers for installation of smart meters.

29. As far as the safeguard tariff was concerned, the main issue was to which group or groups of customers it should apply. For example, there may be some customers who have chosen green tariffs which would be expensive by safeguard tariff standards, and be very happy with their choice. If these customers choose not to respond to encouragements to switch would they be classed as disengaged and moved onto the safeguard tariff? Applying a one-size-fits-all price cap to the whole of the market appeared disproportionate, so OVO had proposed a social tariff which would protect those disengaged customers who could not properly engage with the market. It had also proposed a social tariff because this could potentially take over a number of the goals of measures such as the Energy Company Obligation (ECO) and the Warm Home Discount (WHD), which were complex and costly to manage.

30. As to how to work out which customers the social tariff should apply to, OVO said it was very difficult for suppliers to determine the vulnerability of customers, who would not for example want to discuss the particulars of any disabilities they might have with their energy suppliers. OVO had been discussing with Ofgem some way of taking this responsibility away from suppliers by using information from the DWP or by having a national vulnerability register run by Citizens Advice, who would be better able to determine an individual customer’s vulnerability level. A supplier would simply have to check whether a customer was on this register to determine their eligibility for the social tariff. Whilst setting up such a register would involve considerable work, OVO said that in the long run it would be more efficient for suppliers and consumers.

31. In some cases suppliers had been allocated funds to be distributed to various groups of customers, and suppliers had had to try find them within their customer base, often at a cost that would be greater in some cases than the benefit the customer would receive. Also the design of the scheme meant that

some customers might, because of their demographic characteristics, be better off with one supplier than another.

32. A mix of cost-reflective tariffs, a social tariff and more education about switching would provide the best way of ensuring that energy was more affordable for the vast majority of customers. OVO noted that prior to the introduction of the Retail Market Review (RMR) its bills had been much simpler and, it considered, straightforward for customers to understand than they were currently. Bills simply needed to tell customers what they needed to pay and whether they could pay less. If this was what the regulations required then it would be possible for suppliers to design bills accordingly and allow the regulator to judge whether they met the required standard.

33. OVO was uncertain about how well requiring suppliers to provide other suppliers with the details of their customers on SVTs who had not switched for five years would work. Some customers might not be happy about having to share this information and it may be the case that it would be better if a neutral party, such as Ofgem, were to approach customers instead rather than suppliers.

34. OVO had grown significantly in 2014. It was comparably easier to grow in this period prior to the increase in the level of competition in the market, which was consistent with the increase in the number of active suppliers from around 10 in 2014 to 25 now. OVO said that there were around another 25 potential entrants to the market who were applying for licences. There were no real barriers to entry present in the market. The question was whether the new entrants would be able to create sustainable long-term business models.

35. OVO noted that when, prior to the 2015 general election, the Labour Party had announced its policy of freezing retail energy prices, several of the six large energy suppliers had effectively stopped offering large discounts. This had enabled OVO and suppliers that did not heavily discount acquisition tariffs to grow. However, the large energy suppliers could not afford to continue losing large numbers of customers and had to re-engage with the switching market at some point. OVO argued that they did so by heavily discounting their acquisition tariffs, reducing the ability of OVO and suppliers with a similar approach to cost reflective pricing, to continue to gain market share at their prior rates.

36. As far as other aspects of RMR were concerned, OVO's view was that the prohibition on cash discounts was too prescriptive and limited suppliers' ability to offer discounts to customers. Discounts were a feature of many other markets, and the requirement on energy suppliers to seek derogations from the RMR rules before offering them was overly restrictive.

Market regulation and governance

37. OVO favoured a system of principles-based regulation over the current set of detailed rules. While it recognised that some specific rules were necessary, it considered that if the majority of rules were replaced by simple standards of conduct then it would become relatively straightforward to work out whether a bill was sufficiently clear or not. Currently, every time a rule changed, suppliers had to spend significant time, money and resources adapting to that change. OVO noted two instances where it felt the RMR rules were particularly unhelpful. These were: *(a)* that suppliers could not provide information about fixed tariffs in the Tariff Information Label even though these might be cheaper than a supplier's cheapest variable tariff; and *(b)* the requirement to give cheaper tariff messaging to fixed tariff customers during the term of their contract. OVO also considered that to allay concerns about the removal of the four-tariff rule, a change could be made to allow for a larger number of tariffs, but suppliers could be required to ensure each of its tariffs was clearly different.

38. OVO suspected that many of the customers who had switched to it were in the habit of switching regularly. OVO considered that while cost-reflectivity would benefit the market, it would need to be introduced alongside other measures, such as better communication with consumers about the benefits of switching. OVO did not think that cost-reflectivity would necessarily inhibit switching as differences between suppliers' efficiency levels would still lead to significant enough differences in their tariffs. Cost-reflectivity would however prevent suppliers subsidising their acquisition tariffs by charging their incumbent customers more.

39. OVO agreed that monitoring cost-reflectivity would have costs, but it considered that these costs would be worth it if consumers were protected. The CMA's current remedies options, such as price regulation, would also involve costs for industry and the regulator.