Consultation on the Prepayment Charge Restriction Order 2016 -

OVO's response to the CMA's public consultation

11th November 2016

1. Introduction

1.1. OVO supports the introduction of a price cap for all prepayment customers in Great Britain. We consider a restriction on pricing to be a proportionate remedy to the level of detriment the CMA has identified for prepayment customers.

1.2. In the sections below we outline a number of issues we believe remain with the current price cap proposal. We have raised all of the issues in this response previously with the CMA. The reason we have chosen to raise these issues once again – in spite of our understanding that the CMA is not willing to consider changing the design of the price cap at this stage – is our continued belief that the changes we are proposing would improve how the price cap functions and should therefore be considered if a review of the design of the CMA's price cap is conducted in future.

1.3. There are three issues we have with the proposed price cap, listed below. Each section of our response is dedicated to a specific issue and the solution we propose.

a). The lack of scope for Ofgem to provide suppliers with derogations from the price cap

b). The BSUoS cost forecast is not based on a customer profile

c). Policy costs have the potential to differ significantly from those forecast, with no ex – post mechanism to ensure suppliers do not under/over recover such policy costs

2. The lack of scope for Ofgem to provide suppliers with derogations from the price cap

2.1. OVO has consistently pointed to a lack of innovation as being one of the key reasons why engagement levels among domestic energy customers are so low. While we are confident that a price cap will reduce harm to disengaged customers we have some concerns that introducing a price cap may harm innovation in the prepayment market. We welcome the CMA's introduction of a derogations procedure for suppliers offering certain types of tariffs however we think that the proposed scope for derogations is too narrow.

2.2. Our suggestion is that the CMA provides Ofgem with the authority to consider offering derogations to any form of tariff or customer offering that Ofgem believes will be of benefit to prepayment customers. This would include, but not be limited to, derogations that would allow suppliers to offer appropriate time of use tariffs to prepayment customers, or tariffs that are tied to the installation of a particular technology into a customer's home such as a battery, or a heating device etc.

2.3. We are confident that a broad derogations procedure from the price cap will encourage suppliers to think outside of the box and will ultimately benefit all prepayment customers. We are also confident that Ofgem has the expertise necessary to rigorously assess whether new propositions from suppliers are ultimately to the benefit of prepayment customers and merit a derogation from the cap.

3. BSUoS cost forecast is not based on a standard customer profile

3.1. The CMA is proposing to calculate the allowance for BSUoS costs on the basis of using out-turn balancing costs from the preceding period. OVO has two concerns with this approach.

a). BSUoS is highly volatile, and

b). The CMA's proposed methodology does not reflect the half hourly shape of the cost of BSUoS for a domestic customer's profile

Volatile nature of BSUoS

3.2. The first concern we have is that BSUoS costs are highly volatile in nature and are therefore difficult for suppliers to forecast accurately. Under the proposed price cap suppliers will be limited in the amount of revenue they can recover from their prepayment customers. If the cost of BSUoS increases materially during a price cap period, it is likely that suppliers will incur costs they cannot recover.

3.3. We acknowledge that the CMA's proposal to calculate BSUoS costs on the basis of BSUoS costs for the preceding price cap period would provide suppliers with some ability to recover any revenue they may have under-recovered for BSUoS in the previous price cap period. However if BSUoS costs continue to increase over time, as is our prediction, suppliers would then continually under-recover the cost of BSUoS in each period of the entire price cap regime[1].

3.4. Our suggestion is that if BSUoS costs increase by more than 10% above the forecast level during a specific price cap period, then the subsequent allocation for BSUoS

[1] One example of the continued increase in the cost of BSUoS is National Grid's recent procurement of additional black start capacity for the coming winters.

costs in the next price cap period should equal 110% of the cost of BSUoS in the preceding period.

Shape of the cost of BSUoS

3.5. The second concern we have with regard to the CMA's proposal for forecasting BSUoS is that the proposed methodology does not reflect the true shape of BSUoS costs for domestic customers. Under the CMA's current proposals the allocation for BSUoS costs for prepayment customers is forecast on the basis of a blending of both non-domestic and domestic customer supply shapes. As the CMA will doubtless be aware non-domestic customers have quite a contrasting demand shape to domestic customers. Basing the BSUoS cost allocation on such a blend of customer supply shapes introduces the potential that the BSUoS cost allocation will not be cost reflective for domestic customers.

3.6. Our suggestion is to therefore base BSUoS costs on a deemed profile of domestic consumption for prepayment customers. This profile could be based on the existing non half hourly profile class for domestic customers.

4. Policy costs have the potential to differ significantly from those forecast

4.1. The CMA's proposal is to calculate policy costs for the price cap periods commencing in April and October on the basis of the Office for Budget Responsibility's (**OBR)** annual report which emerges at the start of each calendar year. The OBR's report is however only a forecast of policy costs for the coming year, based on assumptions around the price of wholesale energy.

4.2. As the CMA is aware a number of policy costs such as top up payments for the contracts for difference (**CfD**) and feed in tariff (**FiT**) schemes are closely linked to the price of wholesale energy. CFD and FiT top up payments **are not** capped by OBR's forecasts of "maximum allowed costs" which means that changes in the price of wholesale energy over the course of the coming year will not be reflected in the OBR's forecasts. OVO is therefore concerned that if wholesale prices decrease in the months following OBR's publication of its policy cost forecast, then suppliers will be liable for higher policy costs than they are capable of recovering from their prepayment customers[2].

4.3. OVO suggests that some form of ex post price cap period calculation of policy costs is undertaken which compares outturn policy costs against those originally forecasted by the OBR. Our suggestion is that if policy costs differ by more than 10% of the amount OBR had forecast for a given price cap period (**price cap $_0$**), then the policy cost for the price cap commencing six months after the conclusion of price cap $_0$ (**i.e. price cap $_2$**) could be altered by a percentage that reflected the difference between OBR's forecast and the outturn policy costs in price cap $_0$. We would envision that this

[2] An additional point we wish to make is the volatility of capacity market costs for suppliers. The cost of the Capacity Markets is forecast to amount to between £5 - £15 per customer each year. This expected cost is highly sensitive to issues such as grid constraints however and could therefore alter materially between OBR forecasts.

calculation and comparison could be undertaken during the six months between the conclusion of price cap $_0$ and the commencement of price cap $_2$, to ensure that suppliers receive sufficient notice of any adjustments the policy cost component of future price cap periods.