



OVO Response to CMA Energy Market Investigation: Supplemental Notice of Possible Remedies

10 November 2015

A. RESPONSE TO BRITISH GAS AND SCOTTISH POWER PROPOSALS

1. INTRODUCTION

- 1.1 OVO considers that the removal of evergreen contracts may produce an overall positive outcome for customers and the wider energy market. However, we strongly disagree with this proposal as an alternative to the CMA's proposed safeguard tariff (Remedy 11).
- 1.2 In OVO's opinion the proposal to remove evergreen contracts has more in common with the CMA's proposed remedy 10; *"Measures to prompt customers on default tariffs to engage in the market"*. As such we would suggest that the proposal to remove evergreen tariffs be considered as an additional means of prompting customers to engage in the market and not as a means of providing *"direct protection to disengaged customers"*¹.
- 1.3 As per our response to the CMA's provisional findings and proposed remedies², we remain of the opinion that a full scale solution to the problems in the energy market must include a new measure that successfully protects customers from unfair pricing practices. The proposal to remove evergreen contracts fails to provide any additional level of protection to disengaged customers and is therefore not a full solution to the current problems in the energy market.

2. LACK OF PROTECTION FOR DISENGAGED CUSTOMERS

- 2.1 The safeguard tariff was introduced as a means of addressing the *"overarching feature of weak customer response"*, which the CMA reasons, grants; *"suppliers a position of unilateral market power concerning their inactive customer base and that suppliers have the ability to exploit such a position through their pricing policies"*³.
- 2.2 Removing evergreen contracts should theoretically improve customer response levels – the efficacy of which we discuss later – but it is clear that customer response levels would need to improve dramatically to remove certain suppliers' positions of unilateral market power over their inactive customer base.
- 2.3 Furthermore, removing evergreen contracts will not stop suppliers from exploiting their market power through pricing policies. -Section Removed-

¹ CMA (2015) Energy Market Investigation; Proposed Remedies

² OVO (2015) Response to the CMA's Propose Remedies

³ CMA (2015) Energy Market Investigation; Provisional Findings

- 2.4 For this reason, OVO is of the opinion that as long as customers remain disengaged, some level of protection in respect of pricing will always be necessary – i.e., prompting engagement is simply not enough. Proposing to remove evergreen contracts offers no such protection and is therefore only an incremental step in solving a far greater problem.

3. EVIDENCE CITED FOR IMPROVING ENGAGEMENT

- 3.1 As we have mentioned there is reason to suggest that removing evergreen tariffs would improve engagement levels amongst “disengaged customers”. The extent to which this proposal will be successful is not, in our opinion, sufficiently proven.
- 3.2 The evidence put forward by British Gas is based on their experience of how customers behave when coming to the end of a fixed term contract. Clearly, however, customers that are coming to the end of a fixed term contract are not a representative sample of the entire market. These customers are invariably those who have at some stage engaged with the energy market in order to sign up to a fixed term contract in the first place. This means that their propensity to respond to new information, messages or wider prompts is likely to be very different to that of a disengaged customer.
- 3.3 For this reason we reject the suggestion that the behaviour of engaged customers can be inferred as a proxy to how disengaged customers are likely to behave.

B. RESPONSE TO SPECIFIC CONSULTATION QUESTIONS

1. RESPONSE TO CONSULTATION QUESTION (N)

Are there any alternative remedies that would be as effective as the proposed remedy in addressing the provisional AEC and that would be less costly and/or intrusive?

- 1.1 In our response to the CMA’s provisional findings and proposed remedies, we outlined our conviction that introducing a regulatory principle of cost reflectivity would be the most cost effective solution to solving the current problems in the retail energy market. Our original response detailed the many reasons why we believe a cost reflective principle (CRP) would be a more effective solution to addressing the problems the CMA has found in the energy market associated with the ability of the six large energy incumbents to exploit their unilateral market power over their inactive customers.

1.2 Due to the short timespan afforded to us to respond to the CMA's provisional findings and proposed remedies, we were unable to outline how a cost reflective principle (CRP) would work in practice. Therefore this section will attempt to provide further evidence of how we think a CRP might be implemented, in addition to debunking some of the arguments we have heard against introducing such a principle. This response will therefore build on the prior arguments we have made by acting as a supplementary set of guidance as to how we envision a CRP might work in practice.

2. EXAMPLE OF HOW A COST REFLECTIVE PRINCIPLE WOULD OPERATE

- 2.1 One possible precedent for a cost reflective principle is supply licence condition 27.2A (although our suggestion is that a CRP would be drafted more in line with Ofgem's Standards of conduct). SLC 27.2A states that;
- "Any difference in terms and conditions as between payment methods for paying Charges for the Supply of Electricity shall reflect the costs to the supplier of the different payment methods."*
- 2.2 In practice, Ofgem have interpreted this condition - correctly in our view – as a means of protecting prepayment customers from being overcharged. As an example of this practice Ofgem's recent prepayment review⁴ states, *"We [Ofgem] do not intend to pursue discrepancies in pricing of payment types which result in lower charges for prepayment customers"*.
- 2.3 In support of this practice, Ofgem has undertaken a series of reviews to determine what justifies a fair difference in the price of different payment methods based on the cost of each method. Recently the CEO of Ofgem Dermot Nolan⁵ mentioned that in light of these reviews, Ofgem is of the opinion that a price uplift of £70 for prepayment customers is justified on the basis of current costs. Mr Nolan was however quick to point out that this £70 level is *"the absolute maximum that suppliers can go in terms of a differential"*.
- 2.4 To consolidate all of the above points, the introduction of the existing SLC 27.2A has given the regulator flexibility to protect a specific set of customers - i.e., prepayment customers. To achieve this the regulator has undertaken some analysis to calculate what a fair or justifiable cost should be, and issued guidance as to the boundaries of what it considers fair practice. This has given suppliers the freedom to set their own prices provided that

⁴ Ofgem (2015) Prepayment Review

⁵ Ofgem (2015) Evidence before the Energy Select Committee

they remain within clearly defined boundaries. The combined effect of this approach is that:

- a) Specific customers are afforded the required level of protection.
- b) Suppliers have a flexible regulatory regime in which to innovate, supported by clear guidance and precedent of what the regulator will consider to be fair or unfair.
- c) The rules and underlying principles are transparent, and the guidance around how to apply those rules and principles are clear.

2.5 In the next section we outline how the process for enforcing a CRP might operate, using the method by which Ofgem applies SLC 27.2A (as outlined in paragraph 2.4 above). -
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3. MODELLING THE IMPACT OF INTRODUCING A COST REFLECTIVE PRINCIPLE

3.1 -Section Removed-

-Graph Removed-

3.2 -Section Removed-

3.3 -Section Removed-

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3.4 -Section Removed-

3.5 -Section Removed-

4. THE IMPORTANCE OF OFGEM'S INTERPRETATION AND IMPLEMENTATION OF A CRP

4.1 As we stated in paragraph 2.4 we assume that Ofgem will interpret the CRP as a means of protecting customers from being overcharged. -Section Removed-

4.2 This is where Ofgem's interpretation of how it intends to operate a CRP in practice is so important. -Section Removed-

4.3 -Section Removed-

4.4 -Section Removed-

-Graph Removed-

4.5 -Section Removed-

4.6 As an aside, while we model this outcome as the effect of Ofgem placing pressure on suppliers to reduce their costs, the outcomes shown in this graph could equally be the result of the -Section Removed- having to react to competitive pressure in order to prevent themselves from seeing their market shares reduce.

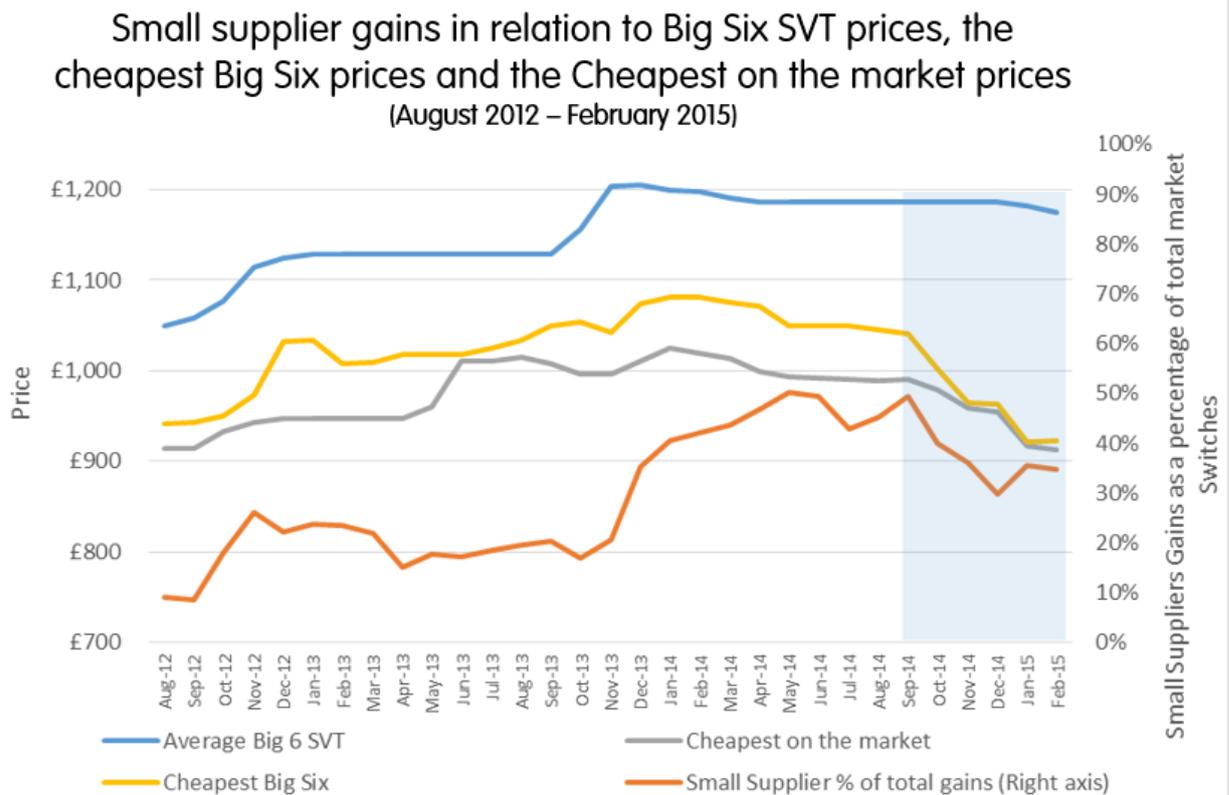
4.7 In summary, we can see that the clear advantage of a CRP is that it links a supplier's ability to compete in the active switching market to the SVTs it currently charges to its less active customers. This means that the competitive pressure of FTs – which is the key feature of the active switching market - is directly tethered to the market for SVT tariffs. When combined with a regulator who interprets and actively enforces such a principle as a means of preventing overcharging, the overall effect is that all suppliers are being continually compelled into trying to innovate and reduce their costs in order to maintain their market shares. In addition, there will perhaps always remain the threat of new entrants who enter the market with only one tariff and are unaffected by this principle. These new entrants will therefore always serve to provide continual competitive pressure on existing suppliers to reduce their costs in order to remain competitive.

5. FURTHER EVIDENCE ON THE ABILITY OF A CRP TO PROTECT CUSTOMERS

5.1 -Section Removed-

5.2 -Section Removed-

Figure 3



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) 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).

5.3 As can be seen in figure 3:

- (a) Following the highly publicised price rises of the Big Six's SVTs in autumn 2013, the small suppliers' gains as a percentage of total market switches increase from less than 20% in October 2013 to approximately 50% in May 2014.
- (b) Independent suppliers maintained this percentage gain until September 2014.
- (c) From September 2014 onwards (indicated by the shaded area) it can be seen that the cheapest Big Six tariff on offer largely tracked the cheapest tariff on the market.

5.4 -Section Removed-

5.5 -Section Removed-

6. FURTHER EVIDENCE ON THE ABILITY OF A CRP TO ENCOURAGE SWITCHING

- 6.1 One specific concern that we have been made aware of with regard to the introduction of a CRP is the potential for such a principle to have an adverse effect on switching rates.
- 6.2 While we recognise this as a potential concern, we would argue that:
- a) Introducing a safeguard tariff would directly impact customer's behaviour, whereas a CRP would simply impact the tariff prices available in the market. It would therefore appear that a CRP would be no less likely to inhibit switching than the proposed safeguard tariff – indeed there is reason to believe a CRP could have less of a detrimental impact on the rate of switching.
 - b) Analysis undertaken by Waddams⁶ shows that the propensity of customers to switch does not increase linearly with the potential gains from switching once those gains exceed a figure of approximately £120-£140. Clearly the intention of a CRP would be to reduce the differential between an individual suppliers tariff prices in the market, however as our modelling has illustrated there are still significant savings to be made for customers switching supplier. In Figure 3 the potential gain from switching could be as much as £251.
 - c) One could also argue that switching rates are indicative only of the level of dissatisfaction amongst customers with their current suppliers. While we would argue that a competitive market should exhibit a reasonable level of switching, it is far more important that a competitive market ensures that all customers are treated fairly and not overcharged. We therefore do not see the potential for a CRP to reduce switching rates as an issue in light of the greater positive impacts such a principle could achieve.

7. FURTHER EVIDENCE ON THE ABILITY OF A CRP TO ENCOURAGE INNOVATION

- 7.1 A further concern raised by the CMA in relation to CRP is that it may reduce the incentive for suppliers to innovate. We would argue that if anything our proposal to introduce a CRP would encourage greater levels of engagement.
- 7.2 Let us imagine that an innovative supplier discovers a unique means by which it can reduce its costs significantly by developing a new system. The benefit of developing this new system is that the supplier can reduce the price of its tariffs, potentially increasing its

⁶ Waddams (2015) "Options for the CMA" Energy Retail Markets: Evolution or Revolution Cornwall Energy 17 June 2015

market share and therefore its profitability. Thus the potential benefit of the new system would therefore be greater than the cost of developing it.

- a) In the current market, it is clear that incumbent suppliers do not price their tariffs in relation to cost. This means that they can respond to innovative firms not by investing themselves, but by lowering the price of one of their tariffs and making a small loss on a minority of their customers. For this reason we argue that an innovative supplier would decide not to develop a new system as it would be unlikely to acquire the additional market share needed to offset the cost of developing the new system.
- b) In a world with a CRP, we would argue that an innovative supplier is more likely to develop its new system. As before the incumbent suppliers would want to respond to the innovative firm by reducing their prices. Crucially however, the incumbent supplier would have to reduce the price of all of their tariffs, to maintain the cost reflective link between their tariff prices. The innovative supplier therefore knows that the incumbent supplier will be less likely to respond to its innovation by simply reducing its prices. For this reason we would argue that the innovative supplier would be more likely to decide to develop its new system in a world with a CRP.