

Ofwat consultation: Costs and benefits of introducing competition to residential customers in England – emerging findings (18 July 2016)

OVO Energy's response (24 August 2016)

1. Introduction

- 1.1. OVO is one of the UK's largest and fastest growing independent energy suppliers, with currently almost 700,000 domestic customers and over 1,000 employees.
- 1.2. OVO has participated actively in key competition and regulatory policy debates in the retail energy market, including the Competition and Markets Authority's recent investigation and Ofgem's ongoing regulatory reform.
- 1.3. On the basis that certain aspects of the retail energy market may be used as a template for introducing competition to the domestic water market, OVO is responding to this consultation in order to share with Ofwat what we see as the 'lessons learned' from the energy market. Specifically:
 - Being clear upfront about the vision and intended outcomes for customers in creating a competitive market, which in OVO's view should be to enable customers to use water more efficiently and sustainably
 - Designing the right model and incentives for market players to achieve the vision and outcomes, which in the case of water may involve clear separation between retail and infrastructure in the supply chain, and
 - Ensuring customers are protected against unfair pricing and suppliers are given sufficient flexibility to innovate, through cost reflective pricing and principles-based regulation.
- 1.4. We hope that our insight and views are useful to Ofwat in designing the future domestic water market and ensuring that competition delivers the best outcomes for domestic water customers.

2. **The vision and intended outcomes - what should competition achieve?**

- 2.1. In the context of essential utilities and commodities such as water and energy, wanting to give consumers more choice in suppliers and potentially better pricing, while important, are not enough. This is because many consumers are typically disengaged and inelastic - i.e., they will use what their needs dictate regardless of price.
- 2.2. We assume that the overarching vision for the consumption of essential utilities is to manage the cost and security of supply, and achieve environmental sustainability. Therefore, the specific outcome to achieve through introducing competition to the water market should be to encourage and enable customers to use water more efficiently and sustainably.

3. **How can the vision and outcomes be achieved?**

- 3.1. Suppliers need to be incentivised to innovate new ways in which to enable and encourage customers to consume water more efficiently and sustainably.
- 3.2. The challenge is that a traditional retail model is unlikely to incentivise investment in innovation in order to reduce demand. Broadly speaking, a retail model will rely on maximising consumption, and economies of scale, in order to generate sufficient financial gains.
- 3.3. In contrast, those responsible for the network and infrastructure for water supply are more likely to be incentivised to reduce demand because it is in their interests to reduce costly capital expenditure. Therefore, Ofwat may wish to consider how the retail and infrastructure aspects of the supply chain may be separated in order to create the right incentives for the relevant market players and therefore achieve the goal of reduced consumption.

4. **Engagement & pricing**

- 4.1. With the benefit of hindsight, the transition of the retail energy market from nationalisation to competition lead eventually to the two core problems we have in the market today: the **engagement problem** and the **pricing problem**. The emergence of these two problems can be traced back to the initial design of the retail energy market.

- 4.2. The starting point for opening the retail energy market to competition was that each supplier was dominant within its own region but could compete for customers in other regions. In theory, this would force the incumbent suppliers in other regions to respond by lowering prices in order to retain their customers in their incumbent region and/or offer competitive prices in other regions in a bid to gain more customers. It was assumed that the net effect of incumbent suppliers competing for customers both within and outside of their regions would be to reduce prices for all energy customers across the market and in so doing removing any market power regional monopolies retained within their incumbent regions.
- 4.3. Crucially however the design of the competitive energy market allowed suppliers free reign: (a) to price tariffs irrespective of their underlying cost, and (b) to create **different prices for different regions**. This in turn meant that suppliers could flex their pricing by discriminating between not only different regions but also different segments of customers (i.e., the engaged / active vs the disengaged / inactive).
- 4.4. Furthermore the energy market's initial rules and regulations did not encourage incumbent suppliers to compete on any elements other than price. This meant that suppliers were not incentivised to improve service levels or introduce new products that may have improved engagement levels amongst their customers.
- 4.5. The combination of the problems outlined above arguably incentivised suppliers to keep their customers disengaged. Once it became clear that the vast majority of customers were unresponsive to pricing alone, incumbent suppliers realised they could charge one set of prices to their inactive customers and another set of prices to those who were more engaged in the market. The CMA would subsequently describe this practice in their Final Report as incumbent suppliers *exerting unilateral market power* over their inactive customers.¹
- 4.6. As a result, an already disengaged customer base remained uninformed about the tariffs they were paying, receiving poor service, and not encouraged in any way to take advantage of competition and switch to better energy suppliers or better prices. Competition in the retail market was therefore ineffective at delivering

¹ [CMA Final Report](#), dated 24 June 2016, pg 3

substantive benefits to all energy customers, with few new suppliers entering the market - in fact, on reflection it may have increased prices substantially for some customers. It has taken substantial regulatory intervention in the last decade to further unwind the dominant positions enjoyed by the regional incumbents.

- 4.7. The same issues in relation to price discrimination and high levels of customer disengagement are likely to apply to a newly competitive water market unless it is designed to specifically address and mitigate these issues. In the remainder of this section, we outline OVO's cost reflective pricing principle which we proposed to the CMA to address the pricing problem in the energy market. In section 5 we outline the need to adopt principles-based regulations over prescriptive regulations to address the engagement problem.

Cost reflective pricing principle for the water market

- 4.8. In our formal responses to the CMA's energy market investigation, the primary measure we consistently proposed to address the pricing problem was the introduction of **cost reflectivity**. In light of the potential for some of the same problems to surface in the domestic water market Ofwat may wish to consider introducing a similar principle.
- 4.9. The proposal behind a cost reflective principle (**CRP**) is simple: a tariff that is not priced fairly in relation to underlying costs should not be allowed. This means that tariff prices that are priced at levels significantly below or above cost would trigger review by the regulator, with stringent penalties if they are found not to adhere to the principle. In this way, the CRP would prevent water suppliers from engaging in unfair pricing practices such as predatory pricing that have an adverse effect on competition
- 4.10. Forcing suppliers to price in line with underlying costs would mean that a supplier's ability to compete would be wholly dependent on how well they deliver efficiency savings and innovative products. The long term gain for the customer is clear - to remain competitive, a supplier would need to be both innovative and efficient, passing on the savings they make to try and acquire new customers whilst retaining existing customers by maintaining a high quality of service. An improvement in the

standard of service would also be expected to follow as the potential for cost based innovations are exhausted over time and the marginal benefit to customers becomes reorientated towards greater choice and other non price related values.

Potential for a social tariff for vulnerable customers

- 4.11. Another potential remedy we proposed to the CMA was a **mandatory social tariff for vulnerable customers** who met certain criteria.² We proposed this specific remedy based on evidence from the CMA's investigation which suggested that a disproportionate number of vulnerable customers were paying amongst the highest prices for their energy.
- 4.12. The social tariff was designed to work in tandem with the CRP and effectively acted as a cap on the price that energy suppliers could charge vulnerable customers. Furthermore, we recommended that the social tariff be funded out of general taxation, to avoid the costs of operating it being borne by non-vulnerable customers and therefore open to exploitation in tariff structuring practices of suppliers.
- 4.13. The primary purpose of the cap was therefore to reduce prices paid by vulnerable customers who were disengaged in the market. A secondary benefit of the social tariff we proposed was that it removed the ability of incumbent suppliers to exert their unilateral market power over their vulnerable customers.
- 4.14. We acknowledge that the case for a social tariff is an issue more for consideration in social policy rather than economic policy. However given that our particular social tariff was designed to serve a secondary purpose of reducing market power, we felt such a tariff merited consideration amongst other market mechanisms designed to reduce market power in a market transitioning to competition.

5. Delivering a framework that promotes innovation

- 5.1. OVO believes that the three primary purposes of rules and regulations in an essential service market should be to **protect** customers, to **engage** customers, and to **innovate** for customers.

² OVO [Proposed remedies](#) paper as a response to the CMA's Energy Market Investigation dated 10 June 2015

- Protection is especially important for vulnerable or economically disadvantaged customers.
 - Engagement of customers must be a key pillar of regulation in a competitive market, in order for customers to take full advantage of competition.
 - Innovation - and freedom for suppliers to achieve it - is vital. We strongly believe that innovating new products and services is key to unlocking disengagement amongst consumers.
- 5.2. Traditionally in our experience, regulators struggle to attain the right balance in designing market rules and regulations that protects customers while allowing suppliers the necessary flexibility to innovate and engage their customers. The main reason for this we believe is the continual reliance on prescriptive/detailed rules.

Limitations of prescriptive rules

- 5.3. The most fundamental failing of prescriptive/detailed rules is that success is determined by **formal - not substantive - compliance**. It typically involves a 'checkbox' approach, where both the regulator and the regulated are focussed solely on complying with the letter of the rules, instead of **taking responsibility for achieving the right outcomes for customers**. This misalignment between the rules and the outcomes they are intended to achieve results in not only those outcomes not actually being achieved, but a 'creative compliance' culture where the regulated manipulate their practices to fall within the letter of the rules while exploiting gaps or loopholes. Ultimately these practices invariably result in detriment to customers. In short, prescriptive rules in rapidly changing markets are particularly susceptible to 'creative compliance'.³
- 5.4. Furthermore, our experience of prescriptive/detailed rules in the energy market is an unnecessary level of complexity and an equal absence of flexibility to adapt to market developments and innovations. Prescriptive/detailed rules are incredibly difficult to future-proof. As a result, they are often out-of-date and highly re-active - that is, they are typically updated (rather hurriedly) after a change or development has happened in order to react to that specific change or development. In contrast,

³ Black, J [Making a success of Principles-based regulation](#), May 2007

particularly in order to deliver engagement and innovation in the market, rules need to be designed in a much more pro-active way.

- 5.5. In light of the limitations of prescriptive rules in the energy sector, OVO has continually advocated for the introduction to the energy market of **principles-based rules** that are designed to deliver clear, specific outcomes for customers. Ofwat may wish to consider introducing a similar regulatory framework as part of its transition to a competitive market.

Benefits of principle based rules supporting regulatory outcomes

- 5.6. In our opinion principles-based rules provide the best means of delivering better outcomes for customers because - in essence - the rules *are* the outcomes, as opposed to being specific steps to achieving them. And if the rules themselves represent the outcomes, then both the regulator and the regulated are responsible for delivering them, and are judged by their success in doing so - not in form but in substance. Principles-based rules also avoid the rigidity of prescriptive rules which enable businesses greater flexibility to innovate.
- 5.7. Many other regulated industries have adopted and successfully operate principles-based regulations, such as the Financial Conduct Authority (**FCA**), the Information Commissioner's Office and the Takeover Panel. The FCA regulate a complex market in which new products and innovations continually emerge. Rather than trying to update and adapt existing rules to keep up, the FCA decided to introduce a flexible regime that specifies what outcomes it expects suppliers to achieve with regard to their treatment of customers, without dictating how to achieve them.
- 5.8. We believe that a regulatory regime designed to deliver customer outcomes, supported by regulatory outcomes would be particularly appropriate for the domestic water market. New innovations and products made possible by technology are likely to provide the means for domestic water customers to take greater control of their water consumption than before. Suppliers competing to offer novel service types, perhaps completely at odds with the conventional consumption based pricing model, will compete for the best commercial offerings

to engage their customers. Once Ofwat is convinced of the overall outcomes it expects suppliers to achieve, suppliers can be left to uncover the best way of achieving them.