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By Email Only

OVO Energy Response to Default tariff cap working paper # 4 Treatment of environmental and social obligation costs under the default tariff cap and working paper #5 updated competitive reference price.

OVO Energy is the largest independent energy supplier in Britain. Founded in 2009 by entrepreneur Stephen Fitzpatrick, OVO Energy redesigned the energy experience to be fair, effortless, green and simple for all customers. Today, OVO Energy is a progressive energy company that serves more than 850,000 retail energy customers, striving to deliver more clean, affordable energy for everyone. Our core values encompass fair pricing, top customer service, clear and simple information, and innovative technology to make managing energy easier.

OVO Energy welcomes Ofgem's proposal to introduce an absolute default tariff cap to ensure disengaged customers are protected against overcharging, competition is promoted and gaming is reduced in the market.

To ensure the above policy aims are achieved we believe it is crucial that Ofgem complete a thorough analysis of costs and methodology applied ahead of implementing the cap. We believe a variety of considerations associated with the design of the cap should be considered with particular focus on Smart rollout, future Social and Environmental obligation costs and Green tariffs.

As both working papers pertain to design issues, OVO Energy has provided a more detailed response to each paper as part of this letter.

Working Paper #4 Treatment of environmental and social obligation costs under the default tariff cap

OVO Energy believes that Environmental and Social obligation costs must be included in any calculations of the cap as these are a large part of suppliers pricing. We agree that suppliers may have some material control over the costs of complying with the Energy

Company Obligation and – to a lesser extent – the Renewable Obligation scheme. Consequently, we would expect any costs relating to Environmental and Social obligations to be based on individual obligated supplier costs and to be reflective of actual costs. Our internal analysis highlights aspects of the obligations that can be reduced by operational efficiencies, for example, administrative costs, which can vary significantly among obligated suppliers.

OVO Energy would like to highlight the following areas of concern:

- **Renewable Obligation pricing** - We believe that due to prices for certificates being volatile and changing daily, Renewable Obligation pricing should be aligned with buyout pricing where possible. This will ensure less room for gaming in the market which would lead to a sustainable and fair price cap.

- **ECO 3 -** The Energy Company Obligation (ECO) is undergoing a policy focus change to a fully Affordable Warmth obligation. We would caution Ofgem regarding using historic information to forecast future obligations costs as these may not be fully reflective. Instead we would advise using BEIS impact assessments as per in Table 2 of Working paper #4. However, OVO Energy would suggest that the final stage impact assessment due in Summer 2018 be used as there are a number of concerns that have been raised with BEIS' consultation stage impact assessment. These concerns include:

    a) The impact on the obligation cost given the proposed removal of replacement and repair of oil and coal heating systems from the scheme.
    b) The impact on the obligation cost given from the proposed ban on co-funding renewable heating measures through both the Renewable Heat Incentive and ECO.
    c) The proposed changes to reduce the attributed energy savings to the installation of electric storage heaters and subsequent reduction in cost effectiveness.
    d) OVO Energy has concerns relating to the remaining technical potential of measures and the overlap of these homes with those occupied by eligible householders. The impact of this could be seen through significantly increased search costs.
    e) Finally, we are concerned that BEIS' consultation stage impact assessment does not include any increase in costs during the 3.5 years of the proposed ECO3 scheme.

- **Office for Budget Responsibility (OBR)** - the forecasting data used by the OBR is based on national statistics and is very dependent on weather and market conditions. The current prepayment methodology uses this approach and OVO Energy has found that If the costs deviate from forecasting there is very little scope to recover costs incurred due to incorrect forecasting data in subsequent periods. As a result, OVO Energy believes that OBR forecasting is not truly representative of each suppliers forecasts and cannot account for changes in the market. We believe this risk can be mitigated by using supplier based forecasting which would be more cost-reflective.

- **Assumptive Consumption Splits** - these do not reflect a customers actual usage. OVO Energy would suggest allowing suppliers to have the flexibility to use internal splits for all multi-rate customers. This would ensure the cap is price reflective.

Working Paper #5 Updated competitive reference price

OVO Energy believes that any methodology applied by Ofgem when assessing the cap should be reflective of all underlying costs. At present OVO Energy does not have a preferred view on which methodology (bottom -up cost or competitive reference price) should be used to set the cap. Our thinking is currently based on a principle that we would welcome either as long as the the cap is reflective of underlying supplier costs and is tweaked every six months so it moves with market conditions. This would allow headroom for efficient suppliers to operate profitably, stimulate innovation and promote efficiency. Once Ofgem have published more detail in its May consultation, OVO Energy endeavours to have a more detailed view on which approach we would favour.

If Ofgem did decide to use a competitive reference price methodology to set the cap OVO Energy would be concerned the cap may be set at an insufficient level unless a supplier that incurs all policy costs and is operationally efficient is used as a benchmark.

We would also would welcome further clarity on the below:

- **Default Tariffs-** there exists in the market currently a variety of default tariffs that are not cost -reflective, further to clause 1.6. in Ofgem's guidance in Working paper #5 ' *We would want to select suppliers whose average prices reflect the competitive segment of the market, helping to estimate what the efficient cost of supply is. In practice this means selecting suppliers with high levels of consumer engagement, and who have the lowest prices which are reflective of efficient costs of supply'.*[1] OVO Energy would urge Ofgem to proceed with caution when selecting suppliers' tariffs to introduce a benchmark. A particular concern is due to some suppliers using non-cost reflective (i.e. loss-making) Default tariffs as a business growth strategy. These should be excluded from all benchmarking calculations. We would welcome further detail on how Ofgem would differentiate between cost -reflective tariffs.
- **Smart meter costs -** OVO Energy is concerned that these costs have been omitted since appearing in the initial Open letter published by Ofgem ahead of working paper #1 Design of the Default Tariff Cap. Smart metering is a key mechanism for focus of ensuring customers who are disengaged do not suffer from high estimated bills. We are concerned that excluding these from analysis and the level of the cap may prove to disincentivize suppliers from maintaining high-levels of Smart rollout. Furthermore, failing to include these costs would mean the cap may is not cost reflective.
- **Green tariffs -** As mentioned above, OVO Energy has noticed Green tariffs have not been discussed as part of a competitive reference price. We would urge Ofgem to complete some more analysis and assess whether Default Green Tariffs are included in the cap. We believe excluding these from the cap will leave the

[1] Ofgem Working paper #5 Updated Competitive Reference Price (2018)

market susceptible to gaming unless Ofgem provide a strict framework on which Default Green tariffs may be excluded from the cap.

- **Customer Engagement** - OVO Energy would welcome additional detail on the definition of customer engagement *'4.2. One of our criteria could be a supplier's level of customer engagement.'*[2] If engagement was used as a proxy it cannot be based solely on tariff choice, for example the OVO Energy believes that some customers may prefer the flexibility of being on our default tariff 'Simpler' as this means they do not have to be tied in for 12 months or pay a Direct Debit. As a result it can be argued that the some engaged customers are choosing to stay on the variable tariff instead of fixing. Consequently, OVO Energy believes that the option outlined in 4.4. Of the Working paper looking '*at the proportion of a supplier's customers who have been on an SVT for more than three years, and include suppliers where this only represents a small fraction of their customer base"* [3]would be our preference when measuring customer engagement with their supplier.

- **Wholesale pricing** - the current prepayment methodology uses a model which does not align with OVO Energy's approach in setting cost reflective pricing. This is because a 12 month period of commodity prices is used to hedge for a season internally. As a result 'summer' and 'winter' prices are included in the cap throughout the year. If seasonal only prices will continue to be used for the wider price cap this may cause a detrimental impact to acquiring customers and continuing to have cost reflective pricing. Therefore, OVO Energy would welcome some more analysis from Ofgem on how these discrepancies can be mitigated.

- **Weighting** - OVO Energy would urge Ofgem to proceed with the weighting option outlined in 6.8. ' *One option would be to take a simple average, where each supplier included would have the same weight'.* Any weighting based on customer numbers may prove to add unnecessary complexity to the design of the cap and would lead to the Big 6 dominating the benchmark calculation.

Finally, OVO Energy would welcome more detail on the thinking of the design of the cap along with Ofgem's view on how any errors or oversights in the initial methodology may be mitigated once the cap is in place.

If you wish to discuss any points in detail OVO Energy would welcome any further questions by email policy@ovoenergy.com.

We look forward to hearing from you.

Kind regards,

The OVO Team

[2] Ofgem Working paper #5 Updated Competitive Reference Price (2018)
[3] Ofgem Working paper #5 Updated Competitive Reference Price (2018)