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Supplier Licencing Review: Reducing Credit Balance Mutualisation

Octopus Energy Response

12 May 2021

Nothing within our response is confidential and Ofgem may publish it in its entirety.

<u>Overview</u>

Octopus Energy is a leading, four times Which? recommended energy retailer serving over 2 million UK households. As a company committed to providing consumers with outrageously good service and excellent value, we share Ofgem's objectives to protect customers from the negative impact of retailers holding surplus credit balances.

Whilst we understand Ofgem's concerns about the practices of some suppliers, we consider any remedies should be proportionate - saving customers more than it costs them - and protect customer interests. They should also be non discriminatory in their impact on legacy vs challenger retailers and easy to enforce. Ofgem's proposals will not meet these criteria and we do not support them.

In particular we draw attention to:

- Our research which shows the vast majority of our customers are happy with how their balances are currently managed and do not want to find themselves in debt with their energy provider on a regular basis
- Recent experience that suggests Ofgem has greatly overestimated the scale of mutualisation costs that customers are likely to face in the coming decade and based this on out of date data
- Our estimate that implementation cost alone could cost around £65m across the industry over a five year period
- The market distortion and disruption these measures could bring about. Under these proposals even responsible retailers would need to find additional working capital and access to and cost of capital varies considerably between legacy and less established retailers. Ofgem's proposal to pursue these measures on a separate timeframe to BEIS' review of mutualisation arrangements for the Renewables Obligation means there could be multiple points of destabilisation and market exit.

In the light of this we ask Ofgem to consider, instead, stepping up measures to monitor and enforce compliance with the new Financial Responsibility Principle which was introduced only in January this year. This approach would allow Ofgem to take action against retailers that are behaving in an irresponsible manner, requiring them to improve performance which will reduce risk, improve customer outcomes or ensure a competitive SOLR process where winning bidders want to absorb costs. A targeted approach from Ofgem would avoid imposing

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additional costs and inconvenience on customers and the market instability and distortions that Ofgem's proposals will cause.

Should Ofgem wish, after a period of time, it could review the effect of its enhanced regulatory oversight and the Financial Responsibility Principle and assess the case for further prescription in the light of experience. This could be done in time for any changes to come into effect alongside the changes to the Renewable Obligation payments which BEIS is looking at. Not only would this be a targeted and proportionate approach, it would mean that should further protections be required, retailers would need to go to financial markets only once, to cover the combined effect of the RO and the credit balance changes.

Below we set out in more detail evidence to support our view that Ofgem's proposed measures are not proportionate; do not serve customer interests and discriminate against challenger businesses. We also comment on some of the design features of the measures proposed, including steps that could be taken to make them easier to implement and enforce. In preparation of our response to this consultation we have conducted research across 1600 of our direct debit customers.

Ensuring measures are proportionate

The proposals as set out are disproportionate and would cost customers significantly more than they would save in reduced mutualisation expenditure.

We disagree with Ofgem's assessment that retailers that are appropriately managing their customers' credit balances will be able to introduce the proposed measures without any additional costs. We estimate the cost to Octopus Energy of administering the proposed changes - *before including the cost of raising additional finance* - would amount to around £3.5m over a period of five years[1]. If this was scaled up across all retailers based on market share the cost of implementing and administering these proposals it could easily amount to over £40m. This is a conservative estimate as Octopus Energy is an efficient retailer and others' costs may be greater. A total market implementation figure of £65m is not unreasonable. These costs need to be factored into Ofgem's cost benefit analysis.

Ofgem considers that its proposals would benefit customers in the region of between £54m and £216m in avoided mutualisation costs over a ten year period. At the lower end of this range, we estimate the avoided costs to customers would be offset by the cost of implementation.

We suggest Ofgem reassess its estimated range of avoided cost of mutualisation as the scale of avoided costs do not appear plausible. The competitive bidding process that now exists allows Ofgem to seek evidence of financial stability (from the bidding party) and ensures mutualisation is only considered in the most exceptional of circumstances. Whilst Ofgem suggests that between 10 and 40 SoLRS may occur in the next 10 years we expect that the

[1] This includes the one off cost of building additional functionality in Kraken and the annual cost of tech maintenance, refund processing fees and handling additional customer queries.

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majority of these will undergo a competitive bidding process and as part of that costs will be absorbed by the winning party.

The impact assessment presumes that appointed SoLRs will claim the costs of honouring credit balances. In fact, in the last 12 months 99.6% of the SoLR portfolio has been transferred to a new licensed party through a competitive bidding process that includes the decision to absorb all or a majority of costs. Using the lower figure of only 'all' costs absorbed (88.8% of portfolios) and applying that to the upper figure of £216m in avoided costs, the result is a maximum mutualisation cost to customers of £24m over 10 years. This suggests the benefit to customers would be significantly less than the cost to implement prescriptive change.

The impact assessments within this consultation do not sufficiently take this recent evidence into consideration. As a result Ofgem risks implementing costly prescription that far outweighs the benefit to customers.

<u>Protecting customers interests</u>

In Octopus Energy we make sure that our approach to handling customer credit meets customer needs and preferences. Our research shows that Ofgem's proposals which will change these arrangements would not be in customer interests.

Kraken, our proprietary tech platform, has been designed to empower licenced parties to develop successful customer focussed business propositions and includes a payment adequacy function that balances customers accounts in an intuitive and non-intrusive way. This core function and our resultant business processes have been designed by energy specialists and continually improved through customer feedback. It therefore comes as no surprise that a survey we conducted in April 2021 of 1600 Octopus Energy customers shows that 78% of them are either satisfied or extremely satisfied with our current account management solutions.

Of relevance to Ofgem's proposals, our research also shows that nearly half (46%) of the customers we surveyed said they would prefer to never be in debt with us, with only a third "OK with occasionally going into debt". The Ofgem proposal to automatically refund credit balances at the end of 12 months would not meet the preferences of over 80% of the customers we surveyed. Less than 17% of these customers are happy being in debt half of the year, which is what would happen if the customer account was set to zero ahead of winter.

Furthermore, our research shows that where there is credit build up, 42% of customers want to be able to refund it when they choose. Only 13% of the customers we surveyed wanted the credit balance to be set to zero after 12 months. Similarly, when asked "how would you prefer to pay for your energy" less than 22% opted to make a fixed payment with a refund of any built up credit after 12 months.

Our automated payment adequacy combined with additional online account management tools protects our customers from extreme credit or debit positions whilst empowering them to manage their energy accounts, if they so wish. By mandating refunds to £0 or threshold limits

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determined by algorithm Ofgem would risk reducing the customer's ability to manage costs how they want to and therefore creating detrimental journeys for customers whose interests do not match prescriptive logic.

The energy industry is designed primarily around the fixed direct debit concept and indeed it is one that customers demand, having understood the benefits. As Ofgem recognise, the occurrence of a seasonal credit balance position is not in itself a problem, providing energy suppliers manage customers accounts effectively and do not encourage surplus credit. We are concerned about the unintended consequences of implementing credit balance prescription. With the fixed direct debit solution costing more and becoming more complicated for customers to understand there is risk that this might drive some suppliers away from the traditional payment offerings, significantly impacting customer experience and making switching more complicated for consumers to understand.

Not discriminating against less established retailers

We are deeply concerned that the measures currently proposed discriminate against less established retailers and could distort and destabilise the market.

Ofgem's proposals are highly prescriptive and while the final design is yet unclear, they will not match the arrangements applied by responsible retailers like Octopus Energy. This means that if they were implemented, retailers would need to raise additional working capital to fund their operations. This would have a differential impact across retailers in the market:

- Legacy suppliers have investment grade credit rating and would be able to easily and cheaply obtain debt funding for the additional working capital required or to protect any excess credit balances over Ofgem set thresholds.
- Most newer entrants will not be creditworthy enough to secure bank debt and these measures could trigger financial distress (see below).
- Some newer entrants, like Octopus Energy, who may have access to credit facilities via a parent company guarantee, will nonetheless face higher borrowing costs than legacy retailers and will need to impose higher margins in order to justify the use of equity capital to secure additional debt.[2]

We welcome Ofgem's acknowledgement that smaller retailers have a much higher cost of capital than legacy investment grade suppliers and that if new entrant suppliers are disadvantaged this will damage customer short and long term interests[3]. We are pleased that Ofgem has dropped its previous proposal for a retailer guarantee of customer credit balances on this basis. However, the need for additional working capital and the differential cost of

[2] Please refer to our 2019 SLR consultation response, provided in confidence to Ofgem, on Octopus Energy's cost of capital and financing arrangements.
[3] As well as being recognised in the credit balance consultation, Ofgem has recently recognised this dynamic in its decision on code modification DCP 349.

capital - and the fact that some retailers may not be able to raise finance at all - needs to be fully factored into the design and assessment of any revised measures.

We note and support Ofgem's desire to reduce the distortions in the market caused by some retailers using excess credit balances to fund below cost tariffs. We are nonetheless concerned that Ofgem has not considered the distortion that will occur if legacy retailers are given a further advantage through their lower cost of capital. This, along with their disproportionate share of inactive customers, will entrench their ability to price at below cost. These measures could therefore increase, rather than reduce the distortion in the market that we and Ofgem are concerned about.

As well as discriminating against challenger companies, we are concerned that these new measures could trigger market exits and create considerable market instability. The majority of retailers will need to go to the investor community for additional funds. This could inadvertently cause market exits either due to a run on confidence on an otherwise well run supplier or due to the competition for capital driving up cost. We are particularly concerned by Ofgem's proposal to implement these measures ahead of any clarity on BEIS' review of the Renewables Obligation funding arrangements. Introducing these measures separately would provide two points of potential instability and risk of retailer exit.

Assessing the options

Whilst our very strong recommendation is that Ofgem should be building and reinforcing the principles based framework, we acknowledge that this consultation is asking directly for feedback on the 2 measures in question - auto refund to customers and a credit balance threshold. If, despite the points we and others are making against these proposals, Ofgem decides to go ahead with market-wide measures, then we urge Ofgem to implement only one, not both of the proposals Ofgem has put forward.

Whilst Ofgem sees the threshold model as complementary to the autorefund, we recommend that the threshold model is the primary and only prescription that is required. With a sensibly set threshold Ofgem could drive more responsible retailer behaviour whilst allowing a retailers flexibility to manage the requirements of individual customers. It is therefore the only option debated here on in.

Given that market shares are changing, and rapidly in some cases, for a threshold approach to work effectively it would need to be applied on an annual and retrospective basis, in contrast with Ofgem's proposal to apply the threshold at several points during the year. Our suggestion would be that Ofgem release a model which suppliers can use to forecast their position. If then upon retrospective review a supplier exceeded their forecast, and a tolerance percentage, Ofgem would be justified in taking risk based action. Action could include a performance reporting process or an individual threshold for the relevant supplier that runs until the following year has been retrospectively reviewed.

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Protecting balances in this way is less intrusive for customers, easier to implement for suppliers and should be more simple to enforce for the regulator.

The auto refund measure would add costs and complexity as well as making monitoring and enforcement onerous and potentially impossible. With Ofgem having identified this as not solving the risk of surplus balances in isolation, we present the notion that this measure has no value in being considered further.