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Octopus Energy response to Working Paper #3: approach to headroom

The role of headroom in setting the default tariff cap

We reject the assumption that, in a price cap design in which efficient costs – including a normal rate of return – have already been accounted for, further (artificial) headroom is required to enable suppliers to compete and provide an incentive to shop around:

- It is unconscionable that suppliers, in order to deliver on a metric to increase switching rates, should be encouraged to overcharge customers. The correct rate of overcharging in any consumer market should be zero.
- Any headroom would reduce the incentive on suppliers to innovate and drive efficiencies, and would have the effect of institutionalising overcharging.
- Market evidence, such as that provided by Citizens Advice, demonstrates that there is very little correlation between price differentials and switching rates. Headroom is therefore not a factor in providing incentives to shop around.
- Any headroom would reduce protection for disengaged customers.
- Any headroom would distort market competition by allowing suppliers with higher numbers of 'legacy', disengaged, customers to cross-subsidise tariffs in the switching market, .

The analysis plan to inform thinking on headroom

Noting that Ofgem has received little evidence to better inform its thinking on the headroom, we would be delighted to give Ofgem full access to our P&L and pricing models, and urge other suppliers to do the same.

a) Impact on consumer bills

We agree that this is an important factor in informing the design and level of the tariff cap, and invite Ofgem to make use of the data we have collected over the past 18 months showing all prices in the market daily.

b) Impact on revenues and profitability

We believe it is outside the role of Ofgem to guard supplier revenues and profitability via a headroom. The wide differential in efficiency between suppliers is, and should be, the reason for differential in profit.

The recent experience of challenger energy suppliers demonstrates that under price pressure 50%+ efficiency gains are possible while maintaining good long term good value prices for all customers, both new and loyal.
If suppliers are not able to make a profit under a tariff level that reflects the cost of supply of an efficient supplier they should become more efficient – not be given a headroom allowance.

Regarding the most proportionate way to engage and look at small suppliers, we reject the suggestion that it would be appropriate to take as a benchmark those suppliers that have a large differential between their default tariff and cheapest fixed tariffs. Growth and acquisition should not be predicated on large differentials between default and fixed tariffs for either large or small suppliers:

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- For large, inefficient suppliers with a legacy base of profitable loyal customers, large price differentials enable the cross-subsidisation of tariffs to appear competitive in the switching market, leading to the majority of customers being overcharged.
- For small suppliers, advertising below-cost prices can mean that relatively small market shocks can cause small suppliers to collapse, leading to the SOLR issues we have experienced recently.
- In both cases, the dynamic is self-reinforcing as it incentivises suppliers simply to compete on the basis of misleading, loss-leading first-year ‘discounts’ to new customers, rather than on providing value or quality of service for all customers – thereby removing the market incentive to innovate and become more efficient.

It is vitally important that Ofgem doesn't simply ossify these existing, detrimental business models through implementation of the default tariff cap when there is an opportunity to incentivise better ones that serve the interests of consumers.

Instead, Ofgem should seek to understand the economics and incentivise the business models of suppliers that deliver good consumer outcomes. Some of the fastest growing challengers are able to offer good value prices without large differentials between default and fixed tariffs, and have some of the best records in the market on complaints, customer service and customer satisfaction.

Octopus Energy is one such supplier and we would welcome the chance to give Ofgem full access to our pricing models.

c) Consumer incentives to engage

While we support all measures that make switching as quick and easy as possible, and have consistently made the case for a more ambitious rate of progress on faster switching, switching rates are a flawed metric upon which to base a judgement of the health of a consumer market or the success of the price cap.

In other consumer markets, loyalty is an indicator of high quality service, and if a typical retailer in another sector experienced 20% loss in a given year it would be considered highly negative.

Evidence to date demonstrates that there is no correlation between price differentials and switching rates. Indeed, the most successful and fast-growing challenger suppliers, including Octopus Energy, have built up their customer base from zero (relying entirely on switching behaviour) and yet have favoured narrow differentials in consultations.

d) Impact on supplier incentives

We agree that it is important to model how suppliers might behave under the default tariff cap, and urge Ofgem to also examine the impact on supplier behaviour of a limit on price differentials between default and fixed tariffs. We believe that this simple enhancement to the implementation of the cap would bring real competitive tension, based on transparency and efficiency, to bear on the retail energy market. This would drive prices down far below the expected level of the cap and would make both the ongoing setting of the cap, and the decision of when to lift it, much less burdensome for Ofgem.

Next steps

Alternative sources of evidence or analysis

Much of the behaviour that drives poor outcomes for consumers in the retail energy market is explored in Xavier Gabaix’s and David Laibson’s 2006 paper, ‘Shrouded attributes, consumer myopia, and information suppression in competitive markets’. We recommend Ofgem examine their work.

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We would welcome Ofgem make us of our market-leading pricing data and modelling, which gives an unrivalled view of the pricing behaviour in the retail energy market.

We would be happy for Ofgem to look depth at Octopus Energy’s costs and pricing, and urge all suppliers to open their books to Ofgem in the same way.