Octopus Energy response to the Default Tariff Cap: Policy Consultation

25 June 2018

Question 1: Which approach for setting a benchmark for efficient costs do you think would be most appropriate?

Option 1: A market basket of tariffs

We believe that to rule out using a market basket of competitive tariffs as a benchmark for efficient costs would be a mistake.

With so many different business models, trading strategies and customer propositions, it is no longer possible to define cost data. Furthermore, as a result of the work done by Ofgem to open up the retail energy market to new entrants, the ability of suppliers to bring cost savings into the market have exceeded expectations – including those of the CMA. Any approach that relies on cost data therefore runs the risk of institutionalising high energy costs.

By contrast, the basket of tariffs would give a very useful method of greater responsiveness to wholesale market movements, and better reflect increasing efficiency from energy suppliers, helping drive down costs for all rather than creating an artificial ceiling.

A basket is based on the activity of market participants, so concerns have been raised (by companies likely to be affected by a cap) about the possibility that companies could 'game' the cap by artificially keeping their prices higher to avoid a tighter cap being set. We believe such concerns do not stand up to scrutiny:

- With so many competing suppliers, basic design aspects can ensure that gaming is unfeasible.
- The fact that a basket is based on the prices companies actually charge real customers means it would not be viable for companies to set prices in order simply to influence the level of the cap because these prices are the ones which determine the profit or loss they make on their actual business – making it a much more meaningful measure than any abstract calculation.

If the market basket of tariffs method is to be discounted as the sole approach to setting a benchmark for efficient costs, we believe it should at the very least be used in conjunction with whichever option is chosen, in order to sense check against the other more 'gameable' methodologies.

Option 2: An adjusted version of the existing safeguard tariff

Of the remaining three options, Option 2 creates greatest efficiencies across Ofgem and suppliers in terms of avoiding multiple methodologies operating across the safeguard tariff and the price cap.

A further benefit of the CMA method is that the analysis that informed it was carried out before the price cap became policy, and as such before suppliers had an incentive to inflate their reported costs.

Option 3: The updated competitive price reference approach

The downside of Option 2 is that the market moved more quickly than the CMA anticipated, and the potential efficiencies that could be achieved by the newer suppliers in the market were therefore underestimated by the CMA, rendering the analysis very quickly out of date.

In the last few years there have emerged many far more efficient companies. 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. For example, efficient companies like Octopus Energy are operating with around three times lower operational headcount per customer than the benchmark suppliers identified in the CMA analysis. Any updated competitive price reference must therefore take the economics of these suppliers into account to estimate an efficient level.

As such, it is concerning therefore that only suppliers with more than 250,000 customers have been asked to respond to the Financials RFI issued 28 March 2018. Arbitrarily excluding suppliers below this level from the evidence gathering process for setting the cap means that an understanding of the financials of the most efficient suppliers in the market will not be gained, distorting the cap to reflect the operational inefficiencies of the incumbents.

Octopus has volunteered to respond to the RFI, to provide a view of truly efficient costs, and we urge Ofgem to seek supporting evidence from all other suppliers below 250,000 customers.

The only legitimate cost faced by larger suppliers extra to those of suppliers below the 250,000 customer threshold is that of the ECO and WHD policy obligation. These figures can be easily stripped out.

Furthermore, we believe that the tariff cap should be set at different levels for obligated and non-obligated suppliers, to remove the risk that inefficient suppliers below the 250,000 be allowed an artificial level of headroom.

Option 4: bottom-up cost approach

A ‘bottom up’ method would be the most easily ‘gamed’ by inefficient suppliers, who would have an incentive to inflate their costs.

While we strongly advocate the basket of tariffs option as the best way to provide the most reflective and responsive approach to costs, we acknowledge that some measure of costs estimation will take place in designing the cap. We therefore caution that the baseline for this estimation must be to the cost stack of efficient suppliers, not inefficient ones – as to be effective the price cap must act as a proxy for market pressure on inefficient suppliers to become efficient. The most modern

breed of suppliers are more efficient than those considered by the CMA, and it would be unacceptable for a cap to become mechanism to maintain high costs benchmarked to these suppliers, rather than bringing them down by benchmarking to the most efficient suppliers in the market.

Question 2: What are you views on the issues we should consider when setting the overall level of the cap, including the level of headroom?

In setting the overall level of the cap, Ofgem should be mindful of the huge incentive for suppliers to inflate their estimates for unavoidable costs.

Our experience in industry forums, Energy UK and the Ofgem workshop in preparation for this consultation has demonstrated that the large incumbent suppliers are arguing that they face 'efficient costs' that challenger suppliers do not, and that challenger suppliers with sustainably low SVTs are therefore not more efficient but have an advantage due to their size and customer base.

For example, we have observed incumbent suppliers pushing for elements such as pension liabilities, overhaul of operating systems, customers on paper bills and the smart meter rollout to be included in the calculation of efficient costs. These should be viewed with extreme caution, bearing in mind that the incumbent suppliers have enjoyed decades of excess profits without investing them in new systems, and do not face the far greater costs associated with starting a supply business from scratch - such as hiring and training a workforce, building technology systems and acquiring and on-boarding 100% of a customer base - compared with lower costs of relatively static disengaged customers enjoyed by larger suppliers.

Furthermore, newer suppliers, such as Octopus Energy inherit a diverse range of complex cost differentials when , almost all of our customers on smart meters are on meters inherited from another supplier, so we have a totally heterogeneous smarter base with high costs, eg: higher deemed and contract rentals – differentials of up to £70; low remote-read capability and high customer service requirements (explaining how to read, etc). Importantly, this is not due to pace of rollout of newer suppliers, but simply that by growing they inherently take on customers who've had smart meters installed by other suppliers at a far greater rate than shrinking or static companies.

We believe that once an efficient level of costs has been identified and an appropriate overall level of the cap has been calculated, including additional headroom over and above hypothecated additional policy costs would be unjustifiable.

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:

- Linking 'headroom' with 'competition' is mistaken – there is no historical evidence for any link.

- 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.
- It should be noted that 'switching rates' and 'engagement' are not the same thing. Any measure that seeks to increase switching actually discourages companies from investing in getting to know and engaging their customers.
- 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.

Question 3: Do you agree with our approach to accounting for different costs, in particular additional costs of serving consumers paying by standard credit?

We fully support Ofgem's position on this as laid out in this consultation. In particular, bad debt costs should be borne across a supplier's entire base, rather than split by payment type.

Question 4: Do you agree with our proposals for how we will use cost data to update the cap?

We have nothing to add to the discussion on this question.

Question 5: Do you agree with our assessments of whether an exemption for tariffs that appear to support renewable energy is necessary and workable?

We note that the derogation process could disadvantage smaller suppliers, as large suppliers tend to be better resourced in applying for derogations.

Any exemption should only apply where customers have explicitly chosen to be on a green tariff.

Question 6: Do you have any views on what information we should use to assess the conditions for competition?

As was noted during the most recent stage of the Tariff Cap Bill, switching rates are already high in the retail energy market. Levels of switching should not be confused with effective competition. It should also be noted that 'switching rates' and 'engagement' are not the same thing. We should be aiming for a market in which low levels of switching brings prices down for all customers

We are concerned that the factors outlined in 5.14 amounts to Ofgem effectively guessing what measures will affect market competitiveness. The only measure of market competition from the perspective of the consumer should be whether energy customers are getting good value, regardless of whether or not they switch.