

Response to Working paper #1: setting the default tariff cap

Octopus Energy is a growing challenger energy supplier that supplies gas and electricity to domestic homes and businesses in Great Britain. Our largest investor is the Octopus Investments Group, which over the last decade has become the third largest investor into UK renewable generation in the UK and the largest in solar generation. We are the only energy supplier recommended by Which?, based on their analysis of industry metrics including complaints, pricing and customer surveys.

This document responds to Ofgem's working paper on setting the default tariff caps and makes the following recommendations:

- The basket of tariffs approach to defining the level of the cap should be adopted as the most responsive, reflective of real efficiency and least 'gameable'.
- To ensure competition is stimulated under the cap, thereby avoiding suppliers bunching at the level of the cap, a limit on the percentage difference between the lowest and highest tariffs offered by any given supplier should be integrated into the cap design or implemented alongside it.
- In recognition that the price cap will level the playing field those suppliers which are able to cross-subsidise their acquisition prices by overcharging large numbers of legacy customers and those which are not, policy cost exemptions such as for WHD and ECO should be lifted.
- Any cost data input to the final level should benchmark to the most efficient suppliers in the market to avoid the unintended consequence of institutionalising higher energy prices.

Options for estimating what is an efficient level of costs to set the initial level of the cap

Of the four options outlined, we support the approach of using a basket of tariffs to define the level of a cap.

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.

We believe that the use of a regularly updated index (such as monthly) would reduce the lag effect – both in terms of the window for the pricing being more recent and in terms of the implementation window being faster as the data could be published ongoing. Tariffs could be set with an annual cost at or below the cap at the date of renewal with the increasing adoption of fixed term default tariffs, or as variable tariffs with prices moved monthly, quarterly or annually.

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 (as long as the window is long enough and frequent enough) 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 measure.
- This concern assumes that suppliers want a cap to be set high. In fact, the majority of suppliers – those which run efficiently – have campaigned in favour of a cap, partly on the basis that it will disadvantage inefficient competitors. Any supplier that can offer low prices has an incentive to ensure that its rivals are put under pressure to do so.

Ensuring competition drives down prices under the cap

We believe that the cap will function more effectively with the inclusion of a simple ‘terms and conditions’ consumer protection rule to sit alongside the cap, limiting the percentage difference between the lowest and highest tariffs offered by a supplier.

While it is natural that a customer reaching the end of a fixed product might expect to see a change to reflect the cost differential of a variable product and any wholesale changes, this should be minimal and reflective of cost.

Without this measure, the rational behaviour for a supplier will be to “park” its SVT (and other default) prices at or near the level of the cap. It could still win new customers by offering cheap (loss-making) prices in comparison sites, knowing that most of them will end up on the default tariffs at the level of the cap.

Our analysis indicates that implementing this consumer protection will drive competition, delivering a thriving market in which companies which don’t offer lower prices to all customers will wither.

Harmonising policy costs across suppliers

As the working paper acknowledges, policy costs are borne unequally across suppliers. The original intention of this was to reflect ‘economies of scale’ for large suppliers in implementing social and environmental obligations. However, the evidence is now that smaller suppliers are able to operate more efficiently due to their more advanced digital technology and modern operating systems.

The price cap will go some way towards levelling the playing field between those suppliers which are able to cross-subsidise their acquisition prices by overcharging large numbers of legacy customers, and those which are not. Once the price cap is introduced it becomes untenable to narrow the tariff spread between different suppliers while maintaining a policy cost difference. Introducing cap therefore makes policy cost exemptions, such as for WHD and ECO, untenable.

Accurate reflection of 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 one – 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. We would be delighted to invite Ofgem to examine our low cost models.

Addendum: Modeling the level of the cap under a basket of tariffs approach

We have previously modeled various levels of the basket approach as part of our response in January to ‘Providing financial protection to more vulnerable customers’. This analysis showed that, beyond the cheapest 5 tariffs, the inclusion of more tariffs showed a similar shaped curve, just at different levels – probably reflecting some of the cost realities for different suppliers in the market:

Chart A shows that the cheapest tariff (blue line) and cheapest 5 tariffs (green line) are not very representative of the costs (the red line of Ofgem dual fuel cost calculation)

Chart A: cheapest 5 tariffs (insufficient for basket)

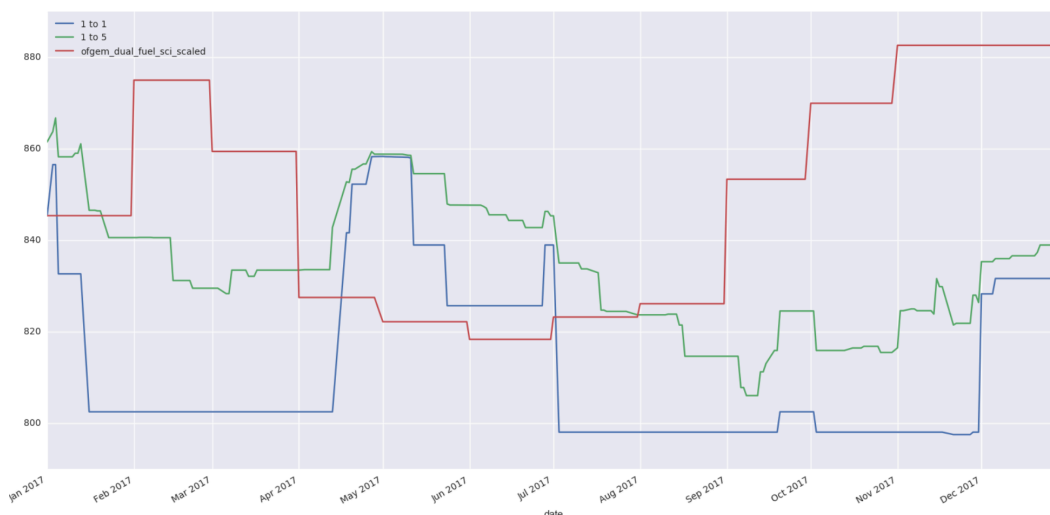
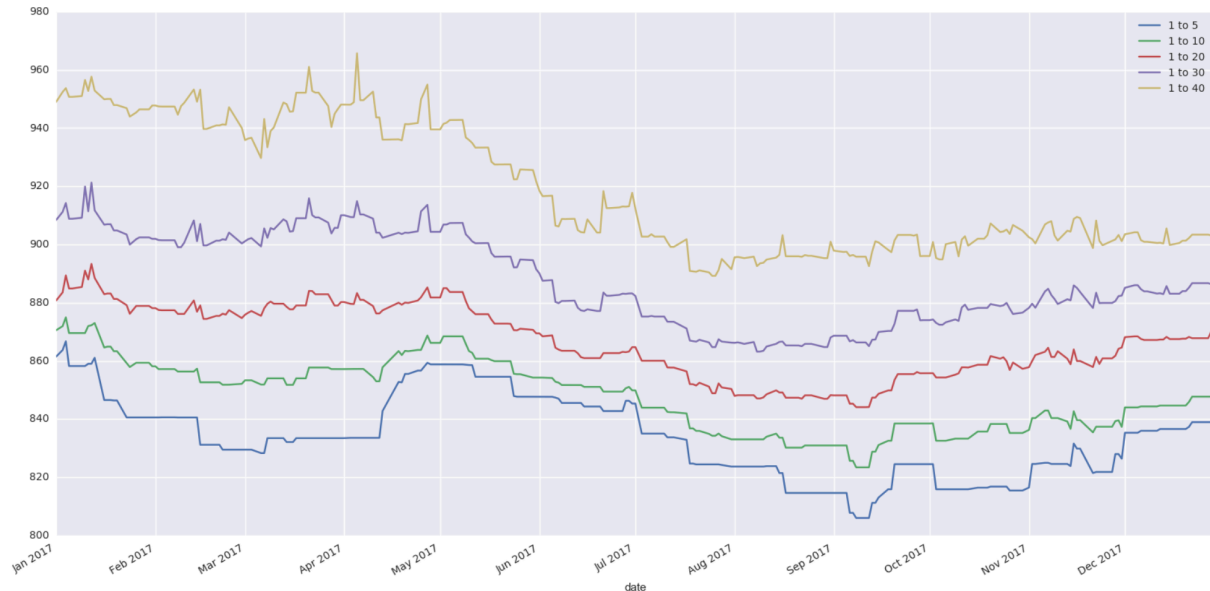


Chart B shows that beyond these cheapest 5 tariffs (blue line), larger baskets (with only the cheapest tariff per supplier) follow a consistent curve: cheapest 1 to 10 (green line), cheapest 1 to 20 (red line), cheapest 1 to 30 (purple line) and cheapest 1 to 40 (yellow line).

Chart B: Larger baskets provide high consistency suggesting a robust measure of market view on pricing and costs:



We also reviewed the impact of removing the cheapest 5 tariffs (as per the proposal in the paper) and looking at different slices of 10 tariffs. These made little/no difference to the shape of the curve – just the level. Likewise, only including suppliers over 50,000 customers made little/no difference to the shape of the curve – just the level.

So the question realistically becomes focused on level – which line is the most reflective of the cost position. Naturally there are a number of costs that kick-in with the 50,000 customer threshold and indeed many of the pricing strategies at this early stage of growth are not so cost-reflective, so one approach could be to take a basket of 10-20 of the cheapest tariffs of those suppliers over 50,000 customers. A multiplier, or a £-addition for the levies and obligations at over 250,000 accounts, could then be applied to this base line to get to the cap value.

One question posed is whether level of a basket may be pinned there by specific suppliers. Our analysis (shown in the graphs above and table 1 below) shows that with the 60+ suppliers in the market, the actual supplier taking any specific cheapest price position is dynamic, but the overall shape is driven by the annual wholesale costs cycle and variations – with the different levels of the curves driven by the fact that lower loss-making tariffs are off-set with the money made from the level and size of the Standard Variable Tariff (SVT) back-book, other revenue streams (eg meter rentals etc) and also that different suppliers have different costs in the areas of structural aspects of cost to supply: obligations, metering, segments served as well as the efficiency and effectiveness areas of cost to serve and hedging strategy. Newer suppliers with no back-book are not able to sustain loss-leading prices for long – so cannot pin the market down alone; whilst there are only a small number of larger suppliers, so any attempt by them to pin the market up or down is outweighed by the sheer number of competitors in the tariff. This is testament to the benefit of having brought so many companies into the market.

Table 1: Cheapest 25 tariffs (one per supplier) at 3 time-points across the past year (February, July and November 2017)

Position 1 is the cheapest in the market, 2 is the second cheapest

| date | 2017-02-01 | 2017-07-01 | 2017-11-01 |
|------|-----------------------|----------------------|----------------------------|
| rank | | | |
| 1.0 | IRESA Limited | One Select | Economy Energy |
| 2.0 | Toto Energy | Green Network Energy | IRESA Limited |
| 3.0 | Tonik Energy | Breeze Energy | Toto Energy |
| 4.0 | Economy Energy | Tonik Energy | Usio Energy Supply Limited |
| 5.0 | Avro Energy | Bristol Energy | Breeze Energy |
| 6.0 | Affect Energy | So Energy | Igloo Energy |
| 7.0 | Bristol Energy | Bulb | Bulb |
| 8.0 | PFP Energy | PFP Energy | Green Network Energy |
| 9.0 | So Energy | Together Energy | Tonik Energy |
| 10.0 | ScottishPower | Engie | One Select |
| 11.0 | Octopus Energy | Avro Energy | So Energy |
| 12.0 | Bulb | Toto Energy | Zebra Power |
| 13.0 | iSupplyEnergy | npower | Together Energy |
| 14.0 | Robin Hood Energy | Affect Energy | Nabuh Energy |
| 15.0 | Telecom Plus | Nabuh Energy | Affect Energy |
| 16.0 | GnERGY | Igloo Energy | E.ON |
| 17.0 | npower | Octopus Energy | Extra Energy |
| 18.0 | Flow Energy | Sainsbury's Energy | Pure Planet |
| 19.0 | Co-operative Energy | Co-operative Energy | Octopus Energy |
| 20.0 | LoCO2 Energy | GB Energy Supply | EBICo |
| 21.0 | Green Star Energy | iSupplyEnergy | iSupplyEnergy |
| 22.0 | Brighter World Energy | Flow Energy | Avro Energy |
| 23.0 | Go Effortless Energy | Robin Hood Energy | Bristol Energy |
| 24.0 | First Utility | Green Star Energy | Engie |
| 25.0 | SSE Southern Electric | First Utility | First Utility |

Finally, at a practical level for this basket approach, we note that it is key that there is a trusted source of the cheapest tariff by supplier across the market. This may require a licence condition to supply all tariffs to someone like Citizens Advice, so that the various exclusive and Price Comparison Website (PCW) tariffs are captured.