HOUSE OF COMMONS

Business, Energy and Industrial Strategy Committee

Oral evidence: Energy pricing and the future of the energy market, HC 1130

Tuesday 22 March 2022

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Watch the meeting

Members present: Darren Jones (Chair); Tonia Antoniazzi; Alan Brown; Richard Fuller; Ms Nusrat Ghani; Paul Howell; Mark Jenkinson; Andy McDonald; Charlotte Nichols; Alexander Stafford

Questions 166 - 184

Witnesses

II: Rachel Fletcher, Director Regulation and Economics, Octopus Energy; Simon Oscroft; Co-Founder, So Energy.

Written evidence from witnesses:

– Rachel Fletcher, Director Regulation and Economics, Octopus Energy [EPM0010]

– Simon Oscroft, Co-Founder, So Energy [EPM0025]

Examination of Witnesses

Witnesses: Rachel Fletcher and Simon Oscroft.

Q166 **Chair:** We are now moving on to the second panel and we are delighted to welcome, on the screen, Rachel Fletcher, who is the director for regulation and economics at Octopus Energy and, in person, Simon Oscroft, who is the co-founder of So Energy. Good morning to both of you. Sorry that we are running slightly over.

Just to kick off this panel, could you explain to the Committee how the energy price cap, as well as the general crisis, has been affecting your business and what this might mean from your perspective in terms of the outlook for the rest of the year?

Rachel Fletcher: Octopus Energy is a very well-capitalised company. We have raised over $1 billion in terms of equity finance. We have very deep credit lines, so we are very well financed and stable. However, it is absolutely the case that the volatile wholesale market conditions are creating very considerable uncertainty about the costs that we all face going forward—not just us but all retailers.

What we see from Ofgem is a very concerted effort to revise the price cap, so that the costs that we are legitimately incurring in purchasing energy for our customers will be properly reflected in the price cap, but we wait to see the outcome of Ofgem's work. One of my key requests would be for us to see that sooner rather than later, just to reduce the uncertainty that retailers are facing.

Q167 **Chair:** How are you looking in terms of bad debt and customers not being able to pay their bills? Presumably, you are expecting this to go up over the course of this year. What is that going to mean from your perspective?

Rachel Fletcher: Ofgem has tools to reduce our exposure and to make sure that the price cap better reflects our costs. The thing that Ofgem can do very little about, if anything, is customers' ability to pay, and you just heard very eloquently from Gillian and Martin concerns that we share about how on earth customers are going to be able to afford an energy bill that could be £2,500 or £3,000, depending on your forecasts.

We already know that customers will be struggling when the price cap goes up in April, so that is a matter of really deep concern. We support the measures that the Chancellor announced in February to provide support to customers of around £200 from October, but, as Gillian and Martin have both said, that really is not going to touch the sides for the vast majority of customers. We need support that is very significantly higher than the £200 that has been announced.

Simon Oscroft: In terms of how we and our customers have been affected since the prices really started rising in Q3 last year, we have seen more customers than ever before contact us about tariff queries and payment queries. That has escalated into this year and we are seeing record contacts from customers day to day, managing their bills.

As we are getting into the new price cap period with the increase in prices that is going to take place as of 1 April, that is escalating even more. There are real concerns from customers, as you have heard from Citizens Advice, and we are seeing every day that customers just cannot afford to pay the increase that we are seeing. It is frightening to think what could happen in October, because we are already at what feels like the limits of what most people can afford to pay. That is the broad group of customers, not those who cannot afford to pay in the first place.

From a So Energy business perspective, we are seeing the challenges of managing the price cap in the same way that many suppliers are seeing it. From a country perspective, we had about 15 million customers on price cap rates at the beginning of last year. That number was 22 million or 23 million in January. By the end of summer, it is going to be significantly higher. All of that is unexpected and means that suppliers are picking up the tab for the delayed increases in costs, which puts massive pressure on funding and on the underlying supplier business model.

Q168 **Chair:** So you are having to raise funds in order to support your customers, and you are going to have to raise more funds if the Chancellor does not come forward to help customers more in order to pay their bills to you.

Simon Oscroft: Since September last year, every energy company—or every energy retailer, at least—will have been looking at additional funding resources. From a customer debt perspective, I would echo exactly what Rachel suggested. Where we are today, that package is going to need to be massively increased to alleviate the pain on customers.

There are a few ways in which you could go about it. One point that I would highlight is that, where we stand today on wholesale prices, they are forecast to come off at the back end of next year by about 60% to 70%. That would translate into a drop in bills of 50% or 60%, but it would translate into a drop in bills. So smoothing that increase over five or 10 years is a very reasonable solution that you should look to. It is not without potential knock-on impacts: what do we do if wholesale prices then increase again? But it is definitely a solution that we would look to as a good one that could help alleviate the pain that we are seeing.

Q169 **Chair:** Just to make sure that I understand that right, the Chancellor has announced this initial £200 loan, essentially, that goes on to bills, and the bill payers pay back a little bit over a period of time. The guarantee from the Treasury allows companies like yours to raise money to soften the blow of your wholesale costs. You are suggesting that the Chancellor should expand that and increase the years over which it is paid back.

Simon Oscroft: Yes. The devil is in the detail of exactly how it is going to be implemented, and we do have concerns from what we have seen so far. It needs to be backed by the Treasury, ultimately. It cannot go on to supplier balance sheets, which is really important, because supplier balance sheets are already stressed. Having said that, that mechanism is a very sensible one that could smooth out this cost over a long period. When wholesale prices recede, we are likely to see bills at sub £2,000 again, and you could have mitigated the jump up to £3,000 over 10 years. That is based on exactly where we are today on wholesale prices, and things can change.

Alan Brown: I have a minor declaration. I am a customer of Octopus at the moment.

Chair: Sorry, I should have said that as well. So am I.

Q170 **Alan Brown:** You heard Martin Lewis say that energy companies are disproportionately increasing direct debits over and above what the 50% increase would be relative to the cap. Is that something that would apply to your company?

Simon Oscroft: Absolutely not. In terms of the mechanism by which we do it, we look at what the customer's current balance is and at what expected costs will be over the next 12 months, based on the known price cap costs. We should be providing that calculation to every single customer when we do a direct debit review, so that they can see it for themselves and they have the transparency of how we have arrived at that figure.

Rachel Fletcher: I have very much the same answer. It is incumbent upon us, and we have supply licence requirements, to make sure that the direct debit arrangements that we have for our customers are accurate and reflect the customer's usage and the price cap charge. That is very much the approach that we take. We are currently going through that process for every single one of our customers.

Q171 **Alan Brown:** Rachel, did you find any evidence of rule breaking or mismanagement at companies whose customers Octopus has taken on through the supplier of last resort process?

Rachel Fletcher: We took on the customers of Avro, which is, after Bulb, the largest company to have failed over the last six months. We saw some evidence of that company not looking after its customers properly. For a start, the company was very far behind on its smart meter rollout programme, so there is a big gap to catch up there. The company had not been giving customers guaranteed standards of performance payments when they had failed to meet regulatory standards. They were not properly back billing for customers. When there is a back bill because the retailer has not read the meter, the retailer has to carry that cost, and we saw evidence of them not complying with that rule. Indeed, they were taking payments from a number of customers who had never actively switched to Avro. Those are just some illustrations of things that we saw when we took on those customers.

Q172 **Alan Brown:** Is that a regulatory failure in terms of Avro's performance?

Rachel Fletcher: It just contributes to the picture that Gillian was painting before of a company that was out of its depth and had grown well beyond its capability to look after customers.

Q173 **Alan Brown:** Is Octopus one of the companies that uses customers' credit balances as a cashflow mechanism? If not, can you detail how Octopus manages to protect customers' credit balances? Why is it that Octopus, in written evidence, stated its concern about Ofgem's proposals to protect credit balances?

Rachel Fletcher: About 90% of our customers choose to pay by direct debit and to have a standard monthly payment, because that helps them to budget. Of course, that is standard practice across the industry as a whole. On average, the customer balances that we hold are in the red—i.e. they are lower than we need to fund our purchases of energy for those customers. We absolutely refute allegations that we are using customer credit balances as a major source of working capital. As I said at the outset, we have very significant working capital lines and, indeed, pull working capital from other aspects of our business.

Q174 **Alan Brown:** So you could demonstrate that Octopus does not use customers' credit as a cashflow mechanism.

Rachel Fletcher: Customer credit balances arise through smoothing payments throughout the year, given that people use much more energy in the winter than they do in the summer. For three months of the year, our customer credit balances are positive to a very small amount. For the rest of the year, our balances are negative and we are having to use very significant working capital in order to pay for the energy for our customers.

I do want to raise something that is related to this. The alternative to providing customers with direct debit arrangements that we have just been talking about is to put customers on standard credit payment arrangements. Indeed, Ofgem authorises companies that do this to charge those customers an extra £130, on average, each year for those payment arrangements. This is why we are very concerned that the issue of credit balances, as responsibly applied by companies like ours, is not blown out of proportion, because the alternative is to charge customers extra, as is happening. Many of the big legacy customers have millions of customers on these standard credit arrangements, which are costing customers a huge amount of extra money.

We absolutely support Ofgem measures to take action where companies are poorly financed and do not have the capital structures or the capital adequacy that you would expect from a company that provides an essential service. We absolutely support that and, indeed, we would like to see Ofgem be given stronger powers than it already has, so that it could lock up hedging, which is accounting for about 90% of the cost of supplier failure. We are concerned that an over-focus on credit balances might miss sorting out the big problem here, which is thinly capitalised structures, and add cost to customer bills.

Q175 **Alan Brown:** Surely, in principle, you support a mechanism to support customers' credit balances.

Rachel Fletcher: We are saying that those credit balances are generally in the red. We are extending credit to our customers, and many retailers in our position are in a similar position. We are worried about a focus on credit balances. It is a bit like an insurance policy, where the cost of the policy far exceeds the value of the product that you are protecting. We are expecting the cost of honouring credit balances through this spate of supplier failures to amount to something perhaps no more than £20 per customer. The cost of removing credit balances, and tying up and neutralising that capital, could add up to £40 to customer bills, if you look at Ofgem's own calculations.

Q176 **Alan Brown:** I must admit that I am getting confused. You were saying that, as a company, you do not use credit balances as working capital, but now you are saying that if we protect credit balances, that will add cost to bills because it is increasing borrowing. The two there seem to be at odds with each other.

Rachel Fletcher: The alternative, which is that that money is neutralised, will add costs to customers' bills. Ofgem has sanctioned and authorised that. The real scandal here is that customers who pay on receipt of their bill are being charged £130 on average for that. That is a situation that we do not want to spread across the customer base as a whole.

Q177 **Alan Brown:** Simon, we know that Ofgem put forward proposals in December 2021, which came up earlier on. From your perspective, are there any outstanding issues that need to be resolved in terms of how these proposals are going to improve financial resilience in the market?

Simon Oscroft: On the topic of financial resilience, no retailer has made a profit over the last three or four years. It has not been a profitable market on the retail side. Regulating your way out of financial resilience by putting more controls in is potentially problematic. It is more about the wider market structure. We have seen a "switch, switch, switch" mantra, with cut-price energy deals continually competing and over-competing, and even moral hazard among some suppliers in terms of behaviours.

One thing that would particularly help would be changing the payment terms around the renewables obligation. This is a significant payment that we make every year, which suppliers either accrue for or make towards the end of the year. That has also gone into a large part of the cost of supplier failure. If you change that profile, it will mean that suppliers are not able to grow big businesses unprofitably. They would be able to achieve scale only through funding externally or being an underlying profitable company, which would be a good thing.

Changing that would remove some of the concerns around financial resilience and suppliers scaling very quickly but consistently unprofitably. You would need to do that over two or three years to give suppliers the time to adjust their working capital profiles, because it is a significant piece of the puzzle.

The other big concern that we have always been speaking to Ofgem about is around the loyalty penalty. In 2018, one of the CMA's recommendations was to allow exclusive tariffs and price comparison websites, so energy suppliers were able to offer cheap tariffs on price comparison websites, but offer different tariffs to their loyal renewing customers. We used to have the same price on both price comparison websites and loyal customers. It meant that, when you came to the end of your deal, you did not have to call up and haggle, or say you had seen a good deal on Martin Lewis's website.

That changed things and we saw bigger differentials, which meant that very savvy people got a better deal and those less digitally engaged paid more. It was a really bad thing for So Energy, bad for our staff when speaking to customers who think that we are trying to pull a fast one, and it is certainly bad for customers. Everyone pays more. Ofgem has put in place one of the measures temporarily to stop that practice, but that should be permanent. The FCA has done it, and it would be a good thing for the long-term health of the market.

Q178 **Andy McDonald:** Could I come back on the supplier of last resort process? Are any reforms required to rebalance the cost of failure between customers and investors?

Simon Oscroft: Sorry; reforms required for what, exactly?

Andy McDonald: The perverse outcome is that those who are protected are investors and not consumers in terms of the costs that are being borne. Are any reforms required to redress that balance?

Simon Oscroft: So Energy has not been particularly close to the process, but I do understand that there are big concerns around administrators chasing previous customers for debt. We heard earlier from Gillian, and I am sure that Rachel has some more views on how customers have been treated. One of the things from the supplier of last resort process is potentially the reclaiming of the levy. Over the last six months, you have seen suppliers going out of business because of an escalation in wholesale prices. That adds pressure, especially under a price cap regime.

The point at which you need the incoming supplier to recover its costs for picking up the tab for the new hedges is when we are trying to put it back on to customers through the existing supplier of last resort framework, so there should be a potential route there, where you can delay some of those costs over a longer period. We have seen supplier of last resort most commonly in 2018 and last year, when we had escalations in wholesale prices. Therefore, when you are recovering the costs, you are doing it at the point when bills are also the highest, which is not good for any customer.

Q179 **Andy McDonald:** Rachel, do you want to come in on that? Can I add to that whether those costs should be spread over a longer period? What would that mean for companies that have taken on the customers of failed suppliers and for their energy bills in the longer term?

Rachel Fletcher: In terms of reforms, the lion's share of the costs of supplier failure that customers are going to be facing is the cost of having to go in and hedge for the customers they have taken on. In our own supplier of last resort levy claim, for example, 96% of the costs that we are claiming are to do with having to hedge for the Avro customers. The reform that is greatly needed is Ofgem having the power to requisition the hedges that the failed supplier has made, or to require suppliers to make sure that, if they are not hedging, they are holding cash, and to requisition that cash.

More than anything else, that would massively slash the cost of supplier failure for customers, and it would remove the moral hazard issue that we see at the moment, where companies can sell their hedges, profit from those sales and leave their retail business to flounder and customers to pick up the tab. That is a really important reform. Ofgem needs powers from Government to do that, as well as structural reforms on retailers, which are probably best achieved through legislation rather than regulation.

When it comes to spreading the cost, you are probably aware that there was an attempt to take about £70 that is going to be in the April price cap and to spread that through an arrangement. Fundamentally, it all comes back to how we support customers over next winter with very high bills. However, ultimately, the cost of taking on those customers and the working capital cost are falling on the gaining supplier. If those costs are spread across a longer period for customers, something needs to be done to account for the additional working capital costs for the gaining supplier.

Just by way of illustration, in terms of the costs incurred in September for taking on the Avro customers, we will recover them in full only in May 2024, so they come through on a very long and protracted timeline already. However, that is not to detract from the fact that I absolutely understand the source of your question, and the concern to protect customers and to delay those costs for customers as far as possible.

Q180 **Andy McDonald:** Yours is a company that has taken over failed ones. What is your experience of dealing with the administrators in those circumstances? Can you say a little bit about what impact that has had on your customers and how the administration process might be improved?

Rachel Fletcher: It has already been touched on, but the fact that the administrator regime is set up with the administrators having no duty to customers is a big failure of the current arrangements. Their duty, of course, is to the failed company's creditors, which creates a massive imbalance. They can hold on to customers' cash, even if those are credit balances that the customer has paid in advance for energy. They can hold on to data, to systems and to the staff of the failed retailer, making the entire transition process less smooth for customers than it might otherwise be.

I was really pleased to hear Martin call out that our customers from Avro felt that, overall, they have had a positive customer experience. That is down to very considerable investment that we have made in technology and in training our people. That process of giving customers a smooth experience during a period that is, after all, quite unsettling is not made any easier by administrators' duties and by the behaviours of some administrators.

Q181 **Charlotte Nichols:** I am interested to hear from you about the lasting impact that the collapse of retailers will have on competition in the energy market. We have heard from other witnesses who have spoken this morning about how the price cap has, effectively, become a price floor rather than a price ceiling. What lessons need to be learned from previous policies introduced to stimulate competition within the retail market?

Simon Oscroft: Previous policies have generally designed a "switch, switch, switch" mantra. Generally, the lens through which Ofgem and BEIS have judged competition has been how many people are switching, which is slightly perverse. It is not necessarily in the customer's best interests to have to switch. Every customer would rather stay with their existing provider and know that they are getting a good deal. That would be better and save everyone time and hassle.

The bigger concern is around the price cap itself. It is there to ensure effective competition, and yet one of the outcomes has been that we have seen 40 supplier exits—and maybe 25 in the last six months alone—primarily from the price cap. We have also seen an increase in costs from those exits and in managing the risks associated with the price cap. The price cap is delaying price increases for customers in the short term but is adding cost overall to customers in the medium to long term, which is highly problematic. Where we stand, we see it not as promoting competition but as doing the opposite.

Q182 **Charlotte Nichols:** The Government said that they want to see a market where effective competition removes the need for a market-wide price cap. What policy and regulation would be needed to deliver this, from your perspective?

Simon Oscroft: The price cap itself is preventing that effective competition. If they want policies to ensure effective competition, it is the removal of the price cap, but it needs customer support in the short term. Right now, bills are going to record levels. We would still need customer support to alleviate that impact, but the price cap is preventing that effective competition.

If we were not to remove the price cap completely but move to a relative price cap, where customers were not penalised too much for loyalty or sticking on a default rate, that could be an approach that gives Government and others confidence that the market is moving towards a framework for effective competition.

Q183 **Charlotte Nichols:** In your first answer, you mentioned switching not necessarily being in customers' best interests. Do you have a view on what role intermediaries such as auto-switchers play in the market and how they should be regulated?

Simon Oscroft: Price comparison websites are a crucial part of the market. In So Energy's experience, for much of our lifetime up until the last six months, we were able to offer slightly cheaper tariffs on price comparison websites than some of the traditional energy providers. We did that through providing our service efficiently and in a better way, which meant that we were able to grow market share more organically. Price comparison websites gave us a great tool to advertise our services.

It also meant that, for a smaller supplier, you have more of a level playing field. We do not need to sponsor or to put TV adverts all over the country just to get our name out there. It means that we can compete with some of the larger companies, which is really important for the market and for competition.

In terms of regulation, Ofgem has a loose confidence code. It would make sense to move them more towards regulation. Certainly, the CMA is looking in greater detail at what the role of intermediaries is in general, and that should certainly play a role in the energy market, because they are a crucial part. Many customers engage with Martin Lewis more than they engage with their energy provider as the go-to.

On auto-switchers, we saw that they had only a very limited panel of energy suppliers. So Energy has never worked directly with auto-switchers. The underlying business model is designed to onboard a customer but to switch them away from you once they come to the end of their contract. In a world where we have cheap, exclusive tariffs, it never made financial sense to us. Why would you onboard a customer, lose a little bit of money in the first year and, hopefully, make a bit of money on them in years two, three, four and five, only for them to switch away? It never made sense, especially in a world of exclusive tariffs and cheaper deals on price comparison websites.

Q184 **Charlotte Nichols:** Rachel, coming to you with the same questions, could you give me some of your thoughts on the lasting impact that the collapse of retailers will have on competition in the energy market and on the lessons that need to be learned from previous policies introduced to stimulate competition within the market?

Rachel Fletcher: I agree with Simon that we are seeing fewer retailers in the market. Fundamentally, that is not a good thing for customers. It is only through competition that we are going to get better service for customers and, indeed, the innovation that is needed to help customers get to net zero, and to decarbonise their transport and heating, while keeping their overall energy bills low. We are massive supporters of competition. Through the recent spate of failures, many of the companies that failed were poorly run and poorly capitalised, but amongst them there were some that were genuinely innovating in service and products for customers.

We need to get back to a competitive market. I am hopeful that we will see wholesale markets revert to something like normal and competition resume. I also agree with Simon that the focus that there has been on customers switching is not a helpful one for the long term. We all need to be building trusted, lasting relationships with customers, so that we can help them understand how to decarbonise their energy use and to transition them on to time-of-use tariffs, for example, where they can use renewable energy when it is most plentiful and cheapest. That is something that Octopus is very much focused on, with about 60,000 of our customers on these smart tariffs.

We welcome BEIS's relook at its energy retail strategy in the light of the crisis, and the recognition that a focus on perpetual customer switching is not healthy or helpful. We hope that, once we come out of this wholesale market crisis, we have not closed the door to new entrants and that we can have vigorous and healthy competition.

I disagree with Simon in that, in peacetime, it has been perfectly possible to compete underneath the price cap. We certainly believe that there are sufficient margins baked into the price cap to allow for healthy competition between companies that are efficient. What Ofgem needs to focus on with the price cap is making it resilient to a volatile wholesale market situation, and that is what they are focusing on.

We will need price cap protection for customers for many years to come. We really welcome Government's recognition of this. Until we move away from a situation where the competition is on the price per unit, we will have the loyalty penalty in place, simply because the legacy retailers have so many customers who are not price sensitive, and we need a price cap to constrain what those customers are being charged, if we are not to revert to where we were before the price cap came in.

The way through all of this and the way to get a really healthy retail market that is helping the country get to net zero has very little to do with the retail market regulations and everything to do with wholesale market and system arrangements that will allow us to reward customers for using energy when it is green and cheap, and encourage us, as retailers, to give customers the tools to shift their energy consumption.

Chair: That brings panel two to an end, so thank you to Rachel Fletcher from Octopus Energy on the screen, and Simon Oscroft from So Energy in the room, for your contributions today. We are grateful to you both.