

Dame Meg Hillier MP  
Chair, Public Accounts Committee  
House of Commons  
London  
SW1A 0AA

CC

Darren Jones MP  
Chair, BEIS Select Committee

23 June 2022

Dear Dame Hillier,

I am writing to you further to the publication of the National Audit Office's report into the energy supply market. We will be submitting evidence to your Committee's forthcoming inquiry, however, I thought it might be helpful to write to you separately in light of the NAO report and the important points it raises.

**Executive summary:**

- 1. Ofgem's proposals to stabilise the energy retail market will have the opposite effect*
- 2. Ofgem's proposals will increase prices to consumers, and increase profits for energy suppliers*
- 3. Ofgem's Impact Assessment is fundamentally flawed with breathtakingly inaccurate assumptions*
- 4. Ofgem's proposals fail to address the cause of retail failures - the fact that poorly run suppliers had not hedged their energy purchases*

Octopus Energy was founded in 2016 and is now the largest and most innovative challenger in the energy retail sector. We serve over 3 million customers in the UK and our technology is transforming the way people use their energy to both lower their bills and decarbonise our economy. E.On, EDF and Good Energy have all chosen our platform to transform their business. We have received over £1bn of investment from very large and well respected energy companies and investment funds. We have won the Which? award for best energy retailer 4 years in a row.

In recent months, we have been corresponding with Ofgem and the BEIS Select Committee on the issue of supplier failures and the appropriate policy response from Ofgem. Given the relevance of the NAO report to the work of his Committee, I am copying Darren Jones into this letter.

In short, we are deeply concerned that Ofgem does not yet have a robust plan on the table to improve financial resilience in the retail sector.

Indeed, perversely, their proposals will drive up costs to consumers, damage competition and may introduce more risk to the sector. As the NAO report states, regulatory action must not come at the cost of competition. Challengers, like Octopus Energy, play an essential role within the energy market: improving customer service, driving innovation, accelerating decarbonisation, bringing down customers' bills and helping them to manage their energy use. It is vital that this is recognised by Government as it refreshes its retail strategy and that new measures designed to protect the market do not lock out new entrants that galvanise innovation and protect consumers from artificially high bills.

In the vernacular - the regulator failed to recognise the difference between fly by night chancers and serious challenger retailers. It allowed the former to thrive, creating an unsustainable market. It still hasn't learnt the difference and in its attempts to curtail the former, risks killing the latter, creating a moribund market of turgid incumbents.

I have set out further detail on these points below. Do please let me know if you have any questions or would like further information about any of the points raised below. I would be grateful to have the opportunity to meet with you to discuss the report and our suggestions for how its findings could be addressed.

### **Supplier resilience is not being addressed by Ofgem's proposals**

The NAO is absolutely correct to stress that Ofgem must act further and faster on supplier resilience.

As we have discussed with the BEIS Select Committee, we are concerned that there are still no concrete or credible plans in place to tackle the poor financial resilience and lack of sufficient hedging that was evident in all of the 29 failed suppliers.

An analysis of the administrator reports of the failed suppliers shows that insufficient (often no) hedging - and insufficient capital reserves to cover the associated exposure to wholesale price shocks - was the primary driver of supplier failure. Additional measures intended to improve supplier resilience will be meaningless without taking definitive action on this key issue. We are dismayed that the consultation Ofgem released on Monday contains only "early options" to introduce a capital adequacy regime.

### **Ringfencing credit balances would be costly and damage competition**

Instead of tackling poor financial resilience, Ofgem proposes to press forward with ringfencing customer credit balances. These proposals are not in customers' interests in either the short or longer term. We estimate that the impact of implementing this policy could

drive up the annual customer bill by around £15 - in contrast to the recent one off payment of £7.40 all customers incurred to repay the balances of those whose supplier has failed.

Ofgem asserts ringfencing would drive companies to adopt lower risk business strategies and reduce the probability of retailer failures, but they have provided no evidence to this effect. The positive case for credit balance ringfencing also rests on entirely unrealistic assumptions about cost of capital - they assume a cost of capital which is 5 to 20 times lower than realistic.

Ofgem's Impact Assessment takes no account of the fact that the vast majority of credit balances are reimbursed by acquiring suppliers rather than being mutualised, nor that for large suppliers, credit balances survive into Special Administration (as with Bulb) so are not mutualised at all. These flaws in their analysis further distorts the cost-benefit of ringfencing by hundreds of millions of pounds.

Both the overestimate of the benefit and the gross underestimate of the cost of ringfencing mean the impact analysis which Ofgem has produced is fundamentally flawed. Correcting these errors results in a completely different conclusion.

We would be happy to provide both Committees with our critique of the Impact Assessment in the near future.

### **Cheaper, less damaging alternatives are available and used in other industries**

Whilst the public appear largely uninterested in this detail, some stakeholders believe that the current mutualisation approach to protect customer balances is not sufficient. To summarise the current approach (which is not understood in Ofgem's Impact Assessment) - suppliers who "win" the bid to take on failed companies' customers take a share of the cost of safeguarding credit balances, with any remainder mutualised. Notably - this is very cost efficient. The NAO report confirms that the total mutualised amount is expected to account for less than 10% of total cost of supplier failures vs almost 85% for meeting the costs of unhedged fuel.

If credit balance mutualisation on supplier failure is no longer deemed acceptable, industry insurance funds are used in other industries and would be dramatically more cost effective, and less distorting to competition, than Ofgem's ringfencing proposals. We estimate that an arrangement similar to the ATOL scheme in the travel industry or the Financial Services Compensation Scheme, which protects customer bank balances, would cost customers around £2 a year compared to ringfencing which would cost 7-15 times more.

If implemented, Ofgem's approach will make it impossible for challenger brands to hold the incumbents accountable for their prices and accelerate the path to net zero through innovation. This is true even for well-established, well-hedged and well-capitalised

companies such as Octopus Energy. Ofgem's ringfencing proposals would disproportionately damage the position of challengers and reintroduce the oligopoly in the retail market that existed until 2016.

We are therefore very concerned that Ofgem is putting forward these proposals based on a fundamentally flawed Impact Assessment, whose assumptions are orders of magnitude inaccurate.

### **Other important points in the NAO report**

#### *Relative price cap*

Octopus Energy is in favour of the relative price cap model the NAO references as a possible alternative to the existing price cap. Under this model, a cap would be set on the difference between each supplier's best competitive price and their default tariff. This would create a more effective long-term guarantee of low prices while further protecting customers by managing the financial risk within the industry.

#### *The role of retailers*

The NAO report recommends that the Government provides clarity on its view of the role of retailers as part of its review of its retail strategy. Octopus Energy is clear that retailers are critical to the transition. We are in a pivotal position to build trust with customers and we have already shown that with this foundation we can innovate to give customers the tools they need to decarbonise heat, power and transport and keep control of their overall energy bills.

Ultimately, we believe that while the Government is considering its energy retail strategy, it is not appropriate for Ofgem to take misjudged and ill-informed steps which threaten to cut off competition, hinder innovation and ultimately drive up prices for consumers.

Do please let me know if there would be a suitable time for us to meet to discuss these points further.

Yours sincerely

Greg Jackson

CEO and Founder