

Darren Jones, *Chair of the Business, Energy and Industrial Strategy Committee*

Sent by email

5 July 2022

Dear Darren,

Thank you for inviting Octopus Energy to give further written evidence to the BEIS Select Committee inquiry into energy pricing and the future of the energy market. We are keen to continue supporting your work on this important topic.

Octopus Energy is by far the best financed energy company outside of the formerly nationalised incumbents, having raised over £1bn in equity finance – more than ten times the funding of Bulb and thousands of times more than Avro.

As such – we stand in a unique position – larger than some of the formerly nationalised incumbents, and backed by long-term investors including globally significant funds and energy giants (Canada Pension Plan, Al Gore's Generation Investment Management, Tokyo Gas, Origin Energy Pty).

We have detailed our views on credit balance protection below. Our key points are:

1. The major cause of supplier failure has been inadequate hedging and this risk needs to be addressed head on. Instead, Ofgem is tackling failures slowly and obliquely via ringfencing measures. These are neither necessary nor sufficient, and carry unfortunate side effects including higher energy bills and higher profits for suppliers.
2. The cost of honouring the credit balances of the customers of failed suppliers has been exaggerated by witnesses to the Committee. In fact it is expected to account for less than 10% of the total Supplier of Last Resort (SOLR) costs. The focus on this area of costs risks creating a distraction from addressing the underlying causes of failure
3. Ofgem's proposal to ring fence gross credit balances will have little if any effect in reducing the risk of supplier failure. As a measure to protect customer balances it is expensive. We estimate it will cost customers up to £15 every year. This annual cost is more than the £7.40 one off cost to customers for mutualising credit balances in this very unusual year. It will also damage competition and innovation and lead to higher supplier profits
4. Lower cost alternatives to ringfencing are available and used in other industries such as travel and banking to protect customer balances. We are disturbed that Ofgem has not assessed the impact of these or compared them with the proposal for ringfencing

5. Ofgem's impact assessment of its proposal to ringfence credit balances is fundamentally flawed. Among a catalogue of issues, it underestimates the cost of ringfencing 5-10 fold or more: (Ofgem assumes a cost of capital for a BBB rated company as 1.15% - whereas Bloomberg reports BBB yields at c. 6% and it is estimated that private companies pay 10-20%). Without any analytical rationale it attributes the proposal with being able to reduce the risk (and therefore the cost) of supplier failure by up to 95%. Under any realistic assumptions the analysis would reveal that this proposal is significantly against customer interests.

1. The major cause of supplier failure is inadequate buying of energy for their customers - this risk needs to be addressed head on.

It is clear that by far the biggest cause of supplier failure is insufficient hedging. This would have prevented virtually all failures and according to a recent report by NAO¹ who looked at administrator reports and identified that *'24 out of the 29 suppliers that have failed since July 2021 and found that 17 (71%) mention insufficient hedging'*. Addressing this issue directly - or making sure that companies without hedges are holding sufficient capital to manage the risk - would make a much bigger difference to customers than ringfencing credit balances.

As mentioned in the Committee hearings we are concerned that the focus on ring fencing the credit balances of all suppliers could detract from tackling the underlying issue which is thinly capitalised and poorly run retailers. Whilst we welcome Ofgem's initial thinking on introducing a Capital Adequacy regime in its recent publication² more should be done to directly improve financial resilience of the weakest companies in the sector, and this should be done as soon as possible.

Ofgem asserts that its proposal to ringfence customer credit balances will drive more responsible business behaviours and improve financial resilience. We can see that this approach may deter entry of companies with risky business practices - although measures Ofgem has introduced recently are intended to achieve the same. However, we cannot see how ringfencing credit balances will lead to a significantly reduced risk for companies already in the market and, as we discuss below, we are concerned this will simply drive up costs and profits for companies without commensurate benefits for customers.

¹ [NAO, The Energy Supplier Market report](#)

² [Consultation on Strengthening Financial Resilience](#)

Indeed, we have seen evidence from the CEO of a major incumbent which states clearly that Ofgem's proposals will increase risk and costs, which they state would require higher margins for energy suppliers.

2. The true cost of mutualising credit balances has been exaggerated, including statements to your Committee which were wrong by an order of magnitude.

Overall there is significant confusion on the cost of credit balance mutualisation associated with the recent spate of supplier failure. The recent NAO report³ confirmed that Ofgem expects the cost of honouring customer credit balances to account for less than 10% of the cost of Supplier of Last Resort (SOLR) arrangements.

We note that on Tuesday 19 April 2022 statements were made by witnesses that the significant increase in customer electricity standing charges in April was driven primarily by credit balance mutualisation. This is wrong – in reality, honouring credit balances accounted for about 1.6% of the recent increase in electricity standing charges .

Annual standing charges on electricity increased by £74.70 in the last price cap (April 2022). Of this, only £1.20 is related to credit balances of failed suppliers . It is expected that more costs from credit balance mutualisation will flow to the next price cap – at most, according to Ofgem, the amount for credit balances of failed suppliers would be expected to be around £3.70 – vastly less than the witnesses' claims of ⅓.

During the hearing on 19 April it was also asserted that *“The reason that electricity has gone up is that everybody has electricity; not everybody has gas. That is how we are recovering. It is the cost of supplier failures that is driving that”*. In actual fact, the total costs of supplier failures account for less than half the increase in standing charge – smaller than the increases due to fixed network costs from Ofgem (known as TCR) and increase in Warm Home Discount.

The focus on credit balances is misplaced. The incorrect information provided in the Committee hearing (described above) is an example of the confusion on this matter.

³ [NAO, The Energy Supplier Market](#)

3. Ofgem's proposals for every supplier to ringfence gross credit balances is poor value for money, and a blow to market competitiveness

We note that many well-run companies have higher debit balances than credit balances - for example, at Octopus, customer balances are net debit for 9 months of the year.

Ringfencing credit balances would mean that companies need additional capital to further finance debit-balances, which would add cost to all bills. It would be disproportionately expensive for large privately held companies and entirely prohibitive for smaller ones. The effect would be to increase bills for all customers, and to skew competition dramatically in favour of the formerly nationalised incumbents. With huge amounts of capital tied up to fund debit balances, companies would not be able to invest in innovation and technology - crucial for lowering customers costs and delivering net zero.

Moreover - ringfencing would be entirely tokenistic for large companies who serve around 85% of the market. As we saw with Bulb - when a large company fails it enters Special Administration and the credit and debit balances go together into the company under administration. In the event that the cost of administration is not covered fully by the proceeds from the company sale, the amount tax/bill payers have to honour will be credit balances net of debit balances. Thus, for the vast majority of the market, ring fencing the gross credit balances is an expensive and unnecessary measure: should the company fail, the Special Administration Regime means that customers will not be required to cover the full costs of gross credit balances.

Our estimates are that gross credit balance ringfencing as proposed by Ofgem (net of unbilled) would cost up to £15 every year at today's interest rates - set to rise significantly in a higher rate environment - perhaps to as much as £30 per year. Even at current rates the potential addition to annual customer bills is 2 x higher than the £7.40 expected cost of honouring credit balances of failed companies in the recent spate of failures. Indeed, over the last four years, credit balances of failed companies have added an average of £1.90 per year - meaning that Ofgem's proposals have a **negative** return on investment of around 8x.

Ofgem have been clear in discussions with companies that they understand investors expect a return on capital deployed and would allow for these extra costs in the price cap. This is a clear path to increasing bills in order to increase returns to investors - ie an increase in prices to increase profits.

Putting up bills with little in the way of improved supplier resilience would be unpalatable at the best of times - it's unacceptable during a crisis.

We are also concerned about the effects on competition- if ring fencing proposals were to be implemented in their current form it would dramatically skew competition in favour of the incumbents. This is primarily because incumbent suppliers have access to low cost of capital. This advantage is unearned and driven by historic corporate structures i.e. large incumbent suppliers have large parent companies that can be called upon to provide assurances/cheap credit lines. By contrast, both small and independent/private owned companies would need to access capital at market costs, which would be substantially more costly - there is a 2-4 fold range in WACC across the sector.

Whilst the distortion of market is noted by NERA in their impact assessment of the proposals⁴ it is not wholly assessed.

4. There are better, more cost effective and targeted alternatives that achieve the same outcomes - these have not been fully assessed by Ofgem.

We have explored better and lower cost alternatives to ringfencing customer credit balances. If the objective is to avoid relying on the generality of customers to refund the credit balances of the customers of failed suppliers, then an industry (or "pre mutualisation") fund would be significantly better value, as exists in the holiday industry (ATOL) and in banking with regard to customer deposits (Financial Services Compensation Scheme).

This would involve every company making a small annual contribution into a fund which would then be used to repay customer credit balances of failed suppliers in the (relatively rare) event that the incoming SOLR does not agree to honour them.

Our estimate is that an annual payment of around £2 a customer would be sufficient to build up this fund and allow it to cover the likely cost of credit balances on failed suppliers. This analysis is based on looking at the cost of mutualising credit balances over the past 5 years, including the cost associated with failures over the winter of 2021/22 and administration overheads of c. £3m per year.

In practice, it may be appropriate to increase the size of this annual contribution initially, to quickly build up sufficient reserves to protect customer balances of

⁴ [Proposed reforms on Credit Balances and Renewable Obligations Evaluating Cost and Benefits](#) - tariff differential reductions could lower the competitive pressure on large suppliers

failed suppliers. However, it is likely that this contribution could be scaled back over time and the cost of honouring credit balances met from returns on investments (as happens with the schemes above) when the fund is in surplus.

For completeness please see our analysis of potential solutions and its impacts per annum on costs to consumers in the table below.

	Bill increase	Increase in supplier profits
Ringfencing gross	£15 ⁵ (increasing in a high interest rate environment)	high
Ringfencing net	£5 per year	low
ATOL style insurance	£2 per year	nil

5. Ofgem’s impact assessment is fundamentally flawed and does not assess the true cost to consumers and impact on the market

It is a matter of great concern that the impact assessment (conducted by NERA) does not assess Ofgem’s preferred option against alternative options and so there is no evaluation of the most effective way of reducing the risk and cost of supplier failures. In particular, while there is some recognition that a capital adequacy regime plus an ATOL-like industry fund might be an effective combined remedy, the cost and benefit of this approach is not evaluated alongside the option of gross credit balance ringfencing.

The impact assessment is significantly flawed in that it both wildly overestimates the benefits of gross credit balance ringfencing and underestimates the cost and practical difficulty of ringfencing. We have many concerns about the analysis, but of particular note, the IA:

- Assumes ringfencing will reduce the risk of supplier failure by at least 80% and up to 95%. While ringfencing measures may result in better financed new entrants over time, it is not clear how the policy itself could have such a significant and immediate impact on risk of companies currently in the market. Indeed, we have seen correspondence from one incumbent CEO stating that Ofgem’s proposals will increase risk and costs. It follows that the assumption that ringfencing will have a drastic and immediate impact

⁵ Octopus analysis

on customer exposure to SOLR costs (including the costs associated with re-hedging) is highly questionable;

- Does not factor in the impact of the SAR regime (noted above) in which the credit balances of large companies are not mutualised but persist in the ongoing entity, alongside debit balances
- Assumes suppliers can raise the finance required for ringfencing gross credit balances at 1.12%, or at most for small suppliers, at 5.38%. Bloomberg currently reports that a BBB investment grade company will pay c. 6%, and our discussions with banks etc indicates that cost of capital for private companies is 10-20% if available at all. These figures are only set to rise in an increasing interest rate environment - see figure 1 of comparison between Ofgem and current (June 2022) market data on capital costs..
- The IA does not properly assess the impact on suppliers of implementing both renewable obligation and credit balance ring fencing requirements over a similar period nor does it assess potential costs passed to consumers if suppliers fail because of these policies. Requiring suppliers to simultaneously ringfence credit balances and renewable obligations could destabilise otherwise prudent suppliers - business models will need to be adjusted at pace, which, in some cases, may be impossible and lead to market exit.
- Does not factor in the negative impact on competition. As noted above, we observe a 2 to 4 fold spread in the cost of capital across the legacy and smallest new entrant suppliers. Given current market conditions, it is not apparent to us that all suppliers will be able to obtain the cash or letter of credit required for ringfencing; and
- Underestimates the likely value of gross credit balances in the coming years resulting from higher energy prices, again resulting in a further underestimate of the cost of ringfencing.

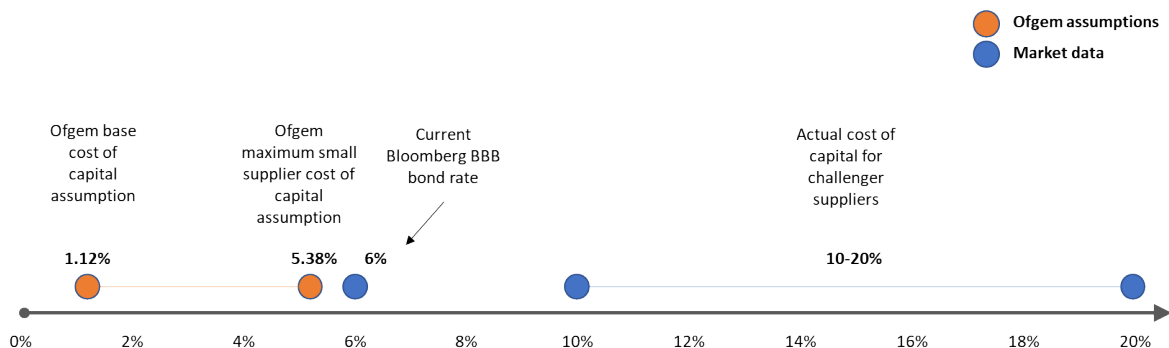


Figure 1: Market cost of capital data compared against Ofgem assumed cost of capital rates

We hope the above comments have been useful and we would be happy for these to be made public and to discuss our proposals in more detail.

Written submission from Octopus Energy (EPM0042)

Should you have any further questions please don't hesitate to get in touch.

Kind regards,
Greg Jackson
CEO, Octopus Energy