Written evidence submitted by Octopus Energy (EPM0010)

BEIS Select Committee Consultation: Energy pricing and the future of the Energy Market
Octopus Energy submission – 31 January 2022

Introduction to Octopus Energy

Octopus Energy welcomes the opportunity to respond to the BEIS Select Committee's Call for Evidence into Energy pricing and the future of the Energy Market.

Octopus Energy Group is a global energy tech pioneer, launched in 2016 to use technology to unlock a customer focused and affordable green energy revolution. We have operations in 13 countries. Octopus's domestic energy arm already serves 3.1 million customers. Octopus Electric Vehicles is helping make clean transport cheaper and easier, and Octopus Energy Services is bringing smart meters, EV chargers and soon heat pumps to thousands of homes. Octopus Energy Generation is one of Europe's largest investors in renewable energy, managing a £3.4 billion portfolio of renewable energy assets throughout the continent.

All of these are made possible by Octopus's tech arm, Kraken Technologies, which offers a proprietary, in-house platform based on advanced data and machine learning capabilities. Kraken automates much of the energy supply chain to allow outstanding service and efficiency as the world transitions to a decentralised, decarbonised energy system. This technology has been licensed to support over 20 million customer accounts worldwide, through deals with EDF Energy, Good Energy, E.ON energy, Tokyo Gas and Origin Energy. We are using this technology to provide smart, time of use tariffs to over 50 thousand customers in the UK.

In December 2021, Octopus Energy Group was valued at approximately $5 billion following a $600 million investment from Al Gore's Generation Investment Management and a $300 million investment from Canada Pensions Plan Investments Board. Both investors back businesses that drive sustainability, promote green energy and tackle climate change. It was the company's third major investment round since launching to the market.

For more information, please see our website

Executive summary

The key points we would like to make to the Committee as it considers the issue of energy prices are as follows:

- **Urgent action is required ahead of April.** Without urgent action in the next few days, energy bills will reach around £2000 for a typical customer in April this year. This will make energy unaffordable for all but those on above average incomes and have a significant inflationary impact on the economy. We hope there is substance to the media reports that Government is formulating a plan to mitigate the impact on customers. Any Government support to alleviate the impact of rising prices is only likely to be a temporary fix and sustainable measures are needed to prevent a reoccurrence of this situation.

- **Review of wholesale market arrangements is vital.** The key underlying cause of the energy price crisis is escalation of wholesale energy prices and general wholesale market instability. There is much evidence to suggest we should expect continued energy price spikes during the transition to a zero carbon energy system and for as long as we rely on global gas prices to set our wholesale energy prices. There is a growing imperative for Government to commit to reviewing the wholesale market arrangements in Great Britain and to design alternative arrangements that would better serve us during this transition. So far we have seen no commitment from Government to this effect. It would also be good to see support for measures which will help us decarbonise and reduce our dependence on global fossil fuel markets more quickly.

- **Stronger regulation on retailer financial viability is needed but must not choke off innovation and competition.** The spike in wholesale energy prices has exposed significant financial weaknesses in many energy retailers, leading to a spate of failures in recent months, and placing yet more costs onto consumers. Ofgem has important work underway now to improve retailer financial resilience and to reduce the risk that retailer failure places on customers and tax payers. We support this work but caution against an over correction that would choke off innovation and competition, just as the retail market needs it. We have set out ideas on how to reach this balance in section 1 below.

- **Price regulation will be required for some time to come - but other tools are needed to resolve the affordability challenge**. Price regulation has been highly successful in protecting customers from unfair prices and placing an efficiency imperative on retailers. It will be needed for many years to come until we can rely on competition to deliver fair prices to all customers. Ofgem needs to revise the design of the cap so it does not expose retailers to wholesale market volatility, and work is under way. But this work should not loosen the pressure on retailers to improve their efficiency. A more streamlined and effective approach would be a relative price cap but this will require Government action and cannot be introduced by Ofgem. We would like Government to recognise that as long as wholesale prices are rising, a price cap is unlikely to resolve the affordability challenge that many households face. Work is needed to design lasting measures to address this issue.

- **Looking beyond this crisis, a new approach to retail market regulation - and system wide reform - are needed to achieve a customer focused transition to net zero.** Retailers have huge potential to help customers to flex when they use energy to make most of power when it is cheap and green, and Octopus Energy already has over 50 thousand customers on such arrangements. Not only are they making a contribution to decarbonising the grid, but smart tariffs give customers another point of control over their energy bills and strengthen the investment case for electric vehicles, heat pumps and other low carbon technologies. A less prescriptive approach to retail regulation, focused on creating a level playing field and vigorous competition between market participants would help to encourage the necessary innovation. More than anything, though, it is the wholesale and network charging arrangements which reduce the incentive on retailers to offer smart tariffs which could save the country billions of pounds a year and help bring customers on the net zero journey. As Government reassesses its approach to retail market regulation we would like to see a recognition of the need for these wider system reforms and a holistic approach to achieving net zero.

Consultation response

1. The regulatory requirements companies must meet in order to trade as a regulated entity in the retail energy market

Octopus supports Ofgem in taking action to strengthen retailer financial resilience. While volatile wholesale market conditions have contributed to the recent spate of retailer failure, most companies that have exited the market were not adequately capitalised, had poor (or no) hedging strategies or exhibited other weaknesses in their business strategy. In current market conditions, it has been necessary to mutualise the cost of supplying customers of the failed retailers. Before accounting for the cost of the Bulb Special Administration, these failures are expected to add around £70 to customer bills from April 2022, with more costs to come. Ofgem introduced financial resilience licence principles over a year ago, but these were not robustly enforced. Further action is needed to ensure that suppliers are diligent, well run and financially sound and to reduce the cost to customers of retailer failure in the future.

Nonetheless, Ofgem must not create a regime where poorly performing retailers are never allowed to fail, and regulations must still enable new entry and much needed innovation and competition. We are keen to ensure that new requirements are proportionate to the likelihood and impact of retailer failure, and that an over correction does not create "fortress retail".

We have a couple of specific suggestions on how to achieve this balance:

- we would like to see Ofgem focusing on arrangements which incentivise retailers to be properly capitalised and prudently run. Arrangements which require owners to have capital at risk, effectively exposing investors to the cost of retailer failure, should be the first line of defence. They should mean that prescriptive regulations and tests by Ofgem can be more light touch. We welcome the recent moves Ofgem has made in this regard
- We would like to see the design of financial resilience tests recognise that the cost of failure to customers (or taxpayers) rises as the size of the retailer grows. Regulations should also be designed so that well capitalised and prudently run businesses are not overly burdened with information requests, with tests tightening up for those companies which have failed to provide the necessary assurances
- We understand the focus on retailer practices around customer credit balances. Any new prescriptions on the holding of customer credit balances (beyond the current requirement on suppliers to refund these balances on request and to regularly review direct debit levels) need to be carefully designed. Poorly designed arrangements could harm customers by leading retailers to remove fixed direct debit arrangements, and distort competition between retailers which have investment grade credit ratings and those which don't.
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2. The performance of previous policies introduced to stimulate effective competition within the retail energy market, and an assessment of the impact on competition of proposed future regulatory frameworks

Octopus is passionate about the need for vigorous competition within the energy retail market as a route to stimulating efficiency and low cost for customers. Competition should also stimulate innovation, including in the products and services needed to help customers make the steps they need to decarbonise their energy use as we reach net zero. Significant work is needed to achieve a regulatory framework to achieve these goals.

We welcome Government's recent decision to take another look at its energy retail strategy. Beyond the measures underway to improve the stability of the retail market. there are four features we consider are vital for a successful policy and regulatory framework:

a. Continued price protection for inactive customers until it is clear there is sufficient competition between providers to ensure all customers receive fair prices;
b. Measures to create a level playing field and vigorous competition between licensed retailers and other consumer facing businesses in the energy industry (known as third party intermediaries). We need to ensure customers are properly treated who ever they are engaging with as they buy energy and take the steps needed to decarbonise their energy use

c. More principles based, innovation-friendly, flexible regulation, fit for the energy transition
d. Serious attention to removing the system wide barriers which at present inhibit retailers from playing a full role in the energy transition.

We set out more details on each of these below. We cover the wider policy and regulatory features which need reform if retailers are to make a significant contribution to reaching net zero in section 5 below.

Price protection

Octopus campaigned hard for the price cap, and we are pleased that since its introduction customers have benefited from a more competitive retail market. Specifically, it has done three things:

- Driven a strong focus on cost cutting across the industry (more than achieved in many years of "free" competition
- Given customer confidence they are paying a fair price - including by providing transparency through a "reference price" for those customers that regularly shop around
- Preserved continued competition for active customers and - until the current wholesale market instability - the availability of good deals for those willing to switch supplier

We firmly believe that the price cap should remain in place at least until there is more confidence that there is sufficient competitive pressure on retailers to prevent the old practice of "tease and squeeze" where loyal customers paid a sizeable premium over regular switchers. We welcome the recent commitment from Government that it will extend the price cap beyond 2023 when the price cap legislation comes to an end. We would like to see Government take steps in this direction soon. We make further comments on the design of the cap in section 3 below.

Level playing field

We welcome the additional competitive pressure that can be provided by new business models (such as aggregators and those looking to provide "energy as a service"). We also note the assistance that other businesses (like switching services) can provide to the competitive market. We expect these new models to proliferate as low carbon technology such as electric vehicles and low carbon heat expands. It is important these business types are properly regulated both to protect customers and, where they provide the same services as retailers, to ensure a level playing field. We welcome Government's review of third party intermediary regulation which is aiming to plug an important gap in the current suite of regulations. We see this as the first step in ongoing work to enable vigorous competition between businesses in serving customers on the route to net zero.

Principle based regulation

Regulations and policy interventions are more likely to enable competition, innovation and great customer outcomes if they are principle based. Principle based approaches are also more likely to stand the test of time and remain relevant to changing circumstances than highly detailed and prescriptive rules.

Ofgem has, in the past, tried to strip away unhelpful prescriptive regulation which only adds cost and is often full of loopholes. There remains considerable scope to continue this work so that retailers are encouraged to direct their energies on delivering for customers instead of complying with overly restrictive and sometimes confusing or outmoded regulations. As noted above, we are concerned that work under way to improve the financial resilience of retailers may end up being disproportionately prescriptive and burdensome.

As we transition to net zero, new regulations will be needed to protect customers (including how their data is used and the interoperability of new assets they might buy). As well adopting principles, we would like to see Ofgem and Government taking a speedier, agile, co-development approach with the industry. The exact challenges we will face cannot be predicted with certainty.

3. The functioning and performance of the Energy Price Cap and an assessment of its use in the future, and an assessment of the role of auto-switching.

Energy Price Cap - performance to date

As noted above we consider the current price cap arrangements have performed well to protect customers from unfair prices and to allow continued competition - until the recent period of wholesale price volatility. The issue with the current methodology is that it is not designed for periods of wholesale market volatility and places a financial strain on retailers in these conditions. In normal wholesale market conditions, we have been able to make decent margins on price-capped customers. We do not agree with retailers who claim that the price cap means it is not possible to make money in this market.

Energy Price Cap - future design

Ofgem has work under way now to redesign the cap so that it does not expose retailers to the risk of failing to recover the cost of supplying customers on the cap when wholesale prices are very volatile. We welcome this work and consider that many of the alternative methodologies Ofgem is considering would represent an improvement on the current arrangements. We are keen, however, to ensure the design of price controls continues to drive retailers to improve their efficiency. Reforms to price control should be focused on reducing risks associated with swings in the wholesale market, not making it easier for retailers to make a margin in stable conditions.

We continue to favour a relative price cap (based on the gap between each individual supplier's acquisition tariffs and the price they charge for default tariffs) and believe it is considerably better than an absolute price cap in addressing the risk of wholesale volatility while protecting customer interests. We understand that Ofgem considers the current legislation does not allow them to introduce a relative cap and we would urge Government to lend its support for this evolution of the cap.

What price caps cannot achieve

Finally on price caps - the current arrangements are designed to protect customers from unfair prices - not to protect them from high costs when underlying wholesale market costs are rising, as they are at present. There is evidence to suggest that energy prices will be high and volatile for many years to come if we continue to rely on gas as the marginal fuel in our market.

As the committee considers the important matter of energy prices we would ask you to:

- Seek clarity on the role of the price cap. It is not the right instrument to protect customers from wholesale price increases and to keep energy affordable in those circumstances. If this is Government's objective, other interventions will be needed for this purpose;

- Call for wholesale market reform and measures to bring about a more rapid move to a low carbon energy mix and efficient buildings, so we can start to address the underlying causes of rising energy bills. Measures which make it easier and quicker to obtain the planning and other permissions to build wind and solar farms and which would encourage greater demand side response would help to insulate us from the impact of volatile international gas prices. Work to supercharge improvements to the fabric of homes - particularly amongst the poorest in society - would go a long way to mitigate the impact of rising prices on fuel poverty and help us reduce our carbon footprint.

Auto switching

We welcome Government's decision to put its proposals for opt in/opt out switching on a back burner. We would like to see these taken off the table altogether. Measures to intervene to "force" customers to switch supplier would be very intrusive and reinforce a focus on customer switching rather than on providing customers with long term sustainable and good value products. Auto switching trials undertaken by Ofgem suggest that such measures are unlikely to be effective in shifting the behaviour of millions of customers who remain on default tariffs and who have hardly, if ever, switched supplier.

4. The future of Bulb and the recovery of public funds and the cost to consumers of other energy supplier failures

Over the last few months, the Supplier of Last Resort (SOLR) process has been successful in providing the customers of many failed retailers with continuity of supply and retail services. In current wholesale market conditions and with a below market price cap in place, it is inevitable that retailers providing last resort services have called on the mutualised levy to help recover the cost of serving these customers. Without the levy - or some other form of support - it would have been impossible for Ofgem to assign these customers to another retailer. However, in normal wholesale market conditions, customer bases of failing suppliers are attractive and retailers normally compete for the opportunity to take on these customers without need for much or any levy support. If Ofgem is successful in reforming the price cap then the need to rely on levy payments when taking on customers through the SOLR process should be reduced.

Mutualisation costs associated with the recent spate of retailer failures are now significant, as noted above. The default is that these costs will be recovered from customers, beginning in April this year, at the same time that the price cap is due to rise to reflect the recent rise in wholesale costs. We strongly recommend that action is taken to protect customers from this step change in prices. The estimated £2000 annual energy bill will be unaffordable for all but above average income households and will have a significant inflationary impact on the economy - possibly adding 2 percentage points to CPI-H. If Government does not intervene to protect customers from the recent wholesale price spikes, we strongly recommend that as a minimum, the measures which Ofgem is enabling are introduced to at least delay the c£70 uplift to bills associated with retailer failure.

The Government has a choice on how and when to recover the estimated £1.7bn cost of the Bulb Special Administration. The most progressive approach is to recover these costs through general taxation and not through energy bills.

5. The role of retail market reform in the context of the UK's net zero transition and domestic energy security requirements

It is essential that beyond the measures noted above to stabilise and increase competition in the retail market, steps are taken so that the retail market can support a customer focused transition to net zero. To achieve this, alongside the changes to the retail market framework (discussed above) urgent reforms are needed upstream - in the wholesale market and in network charging arrangements.

The role of retailers in harnessing demand side response

Octopus Energy's mission is to provide the products and services to help customers decarbonise and manage their energy bills by using power when it is cheapest and greenest. We already have several years of experience in providing smart tariffs that make it easy and rewarding for 50 thousand customers of all types to flex their energy patterns to save money and support a cost effective decarbonised energy system.

Academics have estimated that if widely adopted, this demand side response could reduce the need for investment in generation and grids, saving the country around £5bn a year by 2050. Smart, time of use tariffs also make it more attractive and affordable for people to invest in electric vehicles, heat pumps, domestic storage and other forms of low carbon technology (LCT) needed to decarbonise domestic power, heat and transport.

System arrangements need urgent reform

Currently, wholesale market and network charging arrangements mean that smart tariffs are loss making for retailers. While we provides these tariffs for thousands of our customers, there is no incentive for us to make the investment needed for these to become mass market products. Millions of customers are losing out on the opportunity to support the transition to net zero and to benefit from new ways of managing their energy costs.

Key barriers within the current system arrangements include:

- **Wholesale market arrangements** provide neither a sufficiently strong time of use signal to reward domestic scale flexibility nor an effective route to market for it. National Grid ESO's procurement of balancing and ancillary services are still biased against demand-side flexibility. At distribution level, flexibility markets are still very immature and provide a poor basis for investment in flexibility services
- **Network charging arrangements** provide only weak dynamic time of use signals, with recent changes having diluted rather than strengthening those that were in place
- **Customers with flexible load still attract unavoidable charges** - for example balancing service charges (which are escalating), network "standing charges" and environmental levies even where through flexing their energy use, they are helping to balance and decarbonise the system
- **Environmental levies** on electricity skew the incentives and reduce the domestic business case to switch from gas to electric heating

Consequences of doing nothing

Without wider reforms, unnecessary costs will be added to the entire low carbon energy system, putting public and political support for the net zero agenda at risk. We therefore ask the Government to give urgent attention to making the wholesale and other system reforms that will harness demand side and other forms of flexibility, and help to control the cost of the transition for customers.

We also ask that serious consideration is given to how time of use tariffs can be supported while the necessary system reforms are being carried out. These reforms are likely to take several years. In the meantime, there is a risk that smart tariffs which Octopus and others are offering will stagnate, just as customers with EVs and other LCTs and demanding them, and just as the grid needs the demand side response to help accommodate the additional load from EVs, heat pumps etc.

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