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Reviewing the potential impact of increased wholesale volatility on the default tariff cap: November 2021 policy consultation

EDF is the UK's largest producer of low carbon electricity. EDF operates low carbon nuclear power stations and is building the first of a new generation of nuclear plants. EDF also has a large and growing portfolio of renewable generation, including onshore, offshore wind and solar generation, and energy storage. We have around six million electricity and gas customer accounts, including residential and business users. EDF aims to help Britain achieve net zero by building a smarter energy future that will support delivery of net zero carbon emissions, including through digital innovations and new customer offerings that encourage the transition to low carbon electric transport and heating.

As required by the Domestic Gas and Electricity (Tariff Cap) Act 2018 (Act), Ofgem must have regard to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence. In the current market, suppliers are not recovering their efficient costs and as a result we have seen over 25 suppliers exit the market, which is going to create a multi-billion-pound cost for consumers over the longer-term. Despite many suppliers managing their risks prudently to minimise financial costs, the default tariff cap is acting as a constraint for suppliers and financial losses will continue to accumulate over the coming months. Ofgem need to address this situation urgently to mitigate the risk of further supplier exits that lead to increased costs for consumers.

The market crisis we are experiencing for Winter-2021 should not be viewed as a one-off situation that will not be repeated. Wholesale markets have always been, and will continue to be, volatile. We are already seeing Summer-2022 prices slowly increase, which could again mean that the wholesale allowance provided for under the default tariff cap is insufficient for suppliers to recover their efficient costs. The volatile nature of prices and the impact these will have on tariffs over the coming months is making it impossible for suppliers to accurately forecast the customer accounts that will remain on the default tariff or switch to a fixed term tariff.

For now, Ofgem's number one priority should be to ensure suppliers remain financially resilient by making the necessary adjustments to the April tariff cap to recognise the losses incurred in Winter 2021 and the substantial risks that exist in the Summer 2022 period (through this consultation) and by implementing further medium term interventions to manage market volatility risks (through the recently published statutory consultation on addressing market volatility risks). If Ofgem do not take appropriate action, further market exits should be expected at significant a cost to consumers.

Executive Summary:

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- **We agree with Ofgem's proposal to use the wholesale risk allowance to make an interim adjustment, given the short timescales available prior to the April tariff cap announcement.**
- **The costs we are experiencing are materially higher than the allowance provided under the tariff cap, despite taking a prudent and reasonable approach to managing our risks.**
- **To mitigate any comparability risks Ofgem should adopt an average view of supplier costs rather than any alternative benchmark. Ofgem must take a holistic view of the costs and benefits being incurred by all suppliers and not show bias towards those suppliers whose costs are no more prudent or reasonable but may result in a lower adjustment.**
- **Even where an appropriate adjustment for the losses in Winter 2021 is made for the next cap period, the ability for suppliers to recover their costs will be significantly impacted by changes in default tariff customer numbers in H1 2022. This risk needs to be reflected in any adjustment.**

Assessment of Supplier Actions

We have set out in the attached appendix how, as a prudent and responsible supplier, our hedging strategy evolved throughout 2021 in response to our market observations and revised forecasts. We have also provided Ofgem, through a series of RFIs, data on how our default portfolio forecasts have evolved during 2021. We are confident that we have continued to make reasonable and prudent decisions throughout the year that reflected the market conditions and forecasts at each point in time.

It is possible that other suppliers adopted different strategies which may, with the benefit of perfect hindsight, have led to a better overall result in terms of mitigating wholesale costs. However, that does not dictate which supplier has or has not made reasonable attempts to mitigate the wholesale risks that they face. It is important that Ofgem's assessment and comparability of the additional wholesale costs faced across all suppliers is not subject to any hindsight bias.

In setting any revision to the wholesale risk allowance to reflect the material additional wholesale costs suppliers are facing, Ofgem should adopt a cost benchmark based on an average supplier position as opposed to, for example, a lower quartile approach, which could be overly influenced by those suppliers whose strategies led to a lower costs overall but which were not necessarily any more prudent or reasonable than other suppliers at that point in time.

Similarly, any cost where Ofgem considers that suppliers may have made a saving relative to the price cap allowance should be carefully analysed as in some cases it may not in practice be the case that a supplier's costs have fallen, due to adopting robust risk management processes. We have provided further context to this point in our appendix.

Recovering Losses and Default Tariff Customer Number Changes

We acknowledge the need to ensure the tariff cap continues to protect default customers as required by the legislation that introduced it. A fundamental part of this is to ensure that suppliers who operate efficiently can finance their activities and are able to recover their efficient costs and an appropriate margin under the cap allowance. On this basis, Ofgem not only needs to look at the overall level of additional efficient wholesale costs in setting any adjustment but also at the ability of suppliers to be able to recover that additional cost in a future cap period where default tariff customer portfolios may have significantly changed.

In a scenario where in early 2022 wholesale costs fall and fixed term contract prices start to fall below the next tariff cap period allowance, there is the potential for a substantial shift in customers moving from a default tariff to new fixed term products. Any sizeable shift would not only remove the ability for suppliers to recover those additional wholesale costs already incurred but would also have concerning distributional impacts by allowing switching customers to avoid the costs that they have contributed to.

In addition, based on current forward curves it is possible that we see a repeat of Winter 2021 where the default tariff cap remains below fixed prices and we see similar market crisis impacts.

Any adjustment decided upon during this consultation must consider all these scenarios.

Wholesale Risk Allowance vs Other Mechanisms

Ofgem's minded to position is to make an adjustment using the wholesale additional risk allowance as an interim solution. We agree with this approach given the limited time available to introduce any adjustment prior to the next cap period and on the basis that this is only a time limited adjustment.

We are aware that Ofgem has commenced a broader review[1] of the price cap and that a more enduring approach to reflecting the wholesale costs faced by suppliers forms part of that review. We look forward to working with Ofgem during this review and in developing alternative approaches that preserve appropriate protections for customers but where risks and costs to suppliers are better reflected.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact Jon Cole or myself. I confirm that this letter may be published on Ofgem's website.

Yours sincerely

R. Beresford

Rebecca Beresford
Head of Customers Policy and Regulation

[1] Call for input: Adaptation the price cap methodology for resilience in volatile markets; 15 December 2022