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Adapting the Price Cap Methodology for Resilience in Volatile Markets

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.

We are pleased to have the opportunity to provide comments on Ofgem's developing thinking regarding medium term changes to the price cap. It is evident that the current methodology for the SVT cap is presenting unreasonable and unmanageable risks to suppliers, which in turn are damaging the stability of the retail market, increasing costs to consumers, and risk undermining the progress that is required to reach Net Zero. It is clear that reforms are needed.

The time available for Ofgem to consider amendments and introduce them before the Winter 2022 price cap is clearly very limited, particularly taking into consideration that **suppliers will begin purchasing for the October cap period on February 1st unless there is clarity about future changes**. To avoid unintended consequences, careful thought must be given to how transitions to a new methodology will be managed without negative impacts on customers or suppliers.

In addition, we expect that the role of price regulation in the future Retail Market will be included by BEIS in their review, where a broader range of options for longer term reform can be considered than Ofgem has included here. Given developments in the market since the introduction of the current cap, it will be important that BEIS reconsiders the objectives of any future price regulation in the context of its vision for a future competitive retail market.

Key Points:

- **Wholesale price volatility and the existing price cap methodology continue to expose suppliers to unmanageable volume risks. Wholesale volatility will always exist and if the price cap methodology is not changed there is a risk of further market exits and higher costs to consumers;**
- **Ofgem is constrained by the current legislation and the short timescales needed to address this issue by October 2022. The legislative framework must be**

reviewed in the long-term to build a more sustainable retail market that works for customers;

- **Ofgem will need to conduct an appropriate impact assessment prior to amending the price cap methodology to mitigate the transition risks for customers and suppliers;**
- **Based on Ofgem's current proposals, our preference is the Fixed Term Default Tariff and we are ready to work with Ofgem, and other industry participants, to further develop this proposal.**

Question 1: what is your view on the nature and scale of the volume risk facing suppliers, and the case for changing the current price cap methodology?

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. Due to the design of the current wholesale allowance methodology in the price cap, every supplier is exposed to volume risks that arise from increasing prices (more customers switch to SVT and suppliers have to buy additional volume at a higher price than they can recover through the price cap) and falling prices (more customers switch away from SVT and suppliers have to sell excess volume at a lower price than they procured it at).

As a result, we have seen over 25 suppliers exit the market, which has created a multi-billion-pound cost for consumers over the longer-term, despite many suppliers managing their risks prudently to minimise financial costs. Retaining the existing wholesale methodology will mean that financial losses continue to accumulate over the coming months, further increasing the risk of additional supplier exits. Due to the portfolio sizes for most of the remaining suppliers, another uncontrolled market exit would further increase costs to consumers by billions of pounds, which is not affordable for most households to absorb.

Question 2: what is the best way to tackle this issue whilst protecting consumer interests?

We recognise that Ofgem considers it is limited in the options that can be proposed to address this risk, by both the Tariff Cap Legislation and the timescale available to implement any change. On balance, two of the proposals within this Call for Input would be an improvement in allowing suppliers to recover a greater proportion of their efficient costs while also continuing to protect customers by retaining a cap on standard variable and default tariffs.

However, Ofgem has already had to rule out potential alternatives that could achieve a better outcome due to the constraints it considers exist as a result of the Tariff Cap Legislation. There are potentially other solutions that Ofgem has not considered within this publication, such as a cap on supplier profit margins rather than an absolute price cap. Ofgem must engage with BEIS to pursue a review of the legislative framework and policy objectives for the longer-term future of any price regulation and hold detailed discussions with suppliers on potential alternatives to the current default tariff cap that would deliver both value to customers and a more sustainable retail market.

Given the short timescales that Ofgem is working to we can understand why a detailed impact assessment of the proposed options has yet to be completed. As these proposals are developed there must be an appropriate impact assessment that considers the impact both on protecting customers and allowing efficient suppliers to recover their costs and to finance their activities. For

instance, any amendment to the price cap methodology must consider the current backwardation in the market and the hedging that suppliers may have already undertaken for the October 2022 price cap period.

Question 3: which adaptations to the price cap are preferred and why, including any additional options not set out in this paper? (Please provide an outline description of how any alternatives would work)

Status Quo with Re-opener

It is not clear how beneficial this would be compared to the current methodology since it lacks clarity on what Ofgem would consider an 'extreme circumstance' and what timescales are needed to achieve such as price change. The impact on customers could also be severe in a short period of time with limited alternatives potentially available in the market for those customers. Therefore, we do not support the development of this proposal.

Quarterly Cap

As Ofgem note, this would reduce the volume risk for suppliers from 8 months to 5 months and only partially addresses the risks for suppliers. There will also be more frequent price changes for customers that may prefer longer term stability. Therefore, we do not support the development of this proposal.

Fixed Term Default Tariff

Of the options presented by Ofgem, EDF considers that this is the one that should be further developed through industry collaboration. We consider the benefits of this proposal include:

- **Reduces volume risk while protecting customers:** as Ofgem note, this option will significantly reduce the volume risk for suppliers and allow suppliers to recover a greater proportion of their efficient costs while also continuing to protect customers by retaining a cap on standard variable and default tariffs;
- **Reduces price dispersion:** this approach is more aligned with the approach most suppliers will use for Fixed Priced Tariffs and will naturally reduce price dispersion within the market;
- **Retains market competition:** we do not believe switching levels will be negatively impacted by these proposals, especially if the fixed term default tariff is >12 months. In a falling market, customers would still be able to switch to a lower priced fixed tariff and suppliers would recover some of their efficient costs through an exit fee or upfront risk charge (please see below).

Aspects of the proposal we expect to discuss with Ofgem on this proposal include:

- **Delivering price security for customers by extending the tariff to 24 months:** Customers exposed to frequent price changes may be negatively impacted due to frequent changes in their spending. Longer-term price security would provide those customers with a security of supply and they would also be able to switch to lower fixed contracts if the market fell significantly. This option would increase longer term wholesale market liquidity and provide longer-term security for both suppliers and generators;

- **Reducing non-wholesale price risks:** Most non-wholesale costs within the price cap are known in advance and can easily be updated each month. Further price risks will arise if these non-wholesale costs are only updated every six months;
- **Mitigating transition risks:** Existing SVT customers could transition to this kind of structure in tranches, to allow SVT contract expiry to be spread over the year rather than concentrated in the initial month of implementation;
- **Reducing impacts on customer switching:** There needs to be consideration of the relative merits of the application of explicit exit fees versus the pricing in of equivalent risks in the level of the tariff.

Given the time available, our comments at this stage on Ofgem's proposals are high level. We look forward to substantial further engagement with Ofgem and other stakeholders, including consumer representatives, in the coming weeks and months. In the meantime, please contact Jon Cole or myself if you would like to discuss these proposals further.

Yours sincerely

A handwritten signature in black ink that reads 'R. Beresford'.

Rebecca Beresford
Head of Customers Policy and Regulation