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**Consultation on Medium Tern Changes to the Price Cap Methodology**

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 default tariff 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 have already started to hedge for the October cap period. We know that Ofgem are fully aware of this and we expect any future statutory consultation to set out how these costs will be managed in the October cap.

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.

**Executive Summary:**

- **Based on the options put forward by Ofgem, the price cap contract option would be the most effective in addressing risks faced by suppliers;**
- **This option would also provide the largest benefit to customers. A 12-month price cap contract would provide customers with a market comparable tariff, which could lead to increased engagement;**
- **While we recognise the potential difficulties in transitioning to a new methodology, these challenges are not insurmountable, and we are ready to work with Ofgem and the industry to address these;**

- **If taken forward, a quarterly cap needs to balance the range of risks facing suppliers. The priority for the design of a quarterly cap should be to address the volume risk and for backwardation risk to be addressed via an additional cost allowance within the cap;**
- **A backwardation allowance should be calculated on an ex-ante basis since these costs are known in advance of the cap period;**
- **Moving to a 28-day notice period provides overall customer benefit, including by reducing supplier risks and therefore costs to customers.**

**Price Cap Contracts**

EDF continues to support in principle the concept of introducing a price cap contract. If introduced effectively it has potential to deliver a number of benefits and address some of the significant risks that suppliers face under the current price cap methodology. We consider the benefits of this option include:

- **Reduces volume risk while protecting customers**: 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;
- **Removes Backwardation risk**: if 12-month price cap contract is introduced then this would remove the significant backwardation risk that currently exists;
- **Retains market competition**: we do not believe switching levels will be negatively impacted by these proposals, especially if the price cap contract has a term of 12 months or more. A 12-month price cap contract would also make it easier for customers to compare with fixed term products in the market and likely reduce price dispersion for each cohort of customers.

However, we acknowledge that there are a few implementation challenges that would need to be resolved in order for a successful implementation of this option that meets the needs of both consumers and suppliers. We have set out, in the appendix, our response to the specific questions on these challenges set out in the consultation. While these are not insurmountable, there would be a need for Ofgem to work with suppliers to appropriately address these in a timely manner in the event that Ofgem decides to proceed with this option.

Specifically, it is clear that there is a need for Ofgem to take a pivotal role in devising suitable consumer communications that address the challenges of transitioning and operationalising a price cap contract approach. Consumers will need to understand how they will remain protected as we transition from the current six-month price cap approach and have confidence that they are being treated in a fair manner. This will be particularly important for a staggered transition where consumers will be allocated in monthly cohorts and where consumer concerns around fairness may arise. Ofgem will have an important role in ensuring consumers are communicated to in a clear and effective manner and that the benefits of moving to a price cap approach are clearly set out.

We also remain concerned that the primary price cap contract approach retains a customer's 'free option' to move on and off a price cap tariff and potentially between one-month price cap contract to a subsequent month price cap contract. This free ability to move between tariffs leaves suppliers with a volume risk that can lead to significant cost exposure, particularly at times of volatile

wholesale prices. Ofgem needs to reconsider the relative merits of the application of explicit exit fees that would apply to those who choose to exit the price cap tariff versus the pricing of equivalent risks in the level of the tariff that would apply to all default customers., including those that do not engage in the market. As an alternative to separate exit fees, Ofgem should consider the opportunity to extend the recently announced market stabilisation charge, albeit with an amended methodology to ensure it will achieve its intended objectives.

### Quarterly Price Cap Option

If Ofgem decides to implement the quarterly price cap, it must consider the hedging profile of any such quarterly cap to ensure the risks are fully understood and mitigations are in place. At a minimum, Ofgem must consider the risk balance for market liquidity, volume risk and backwardation risk.

On balance, the 3-1-12 quarterly option (3-month observation window, 1 month notice period and 12-month forward price setting period), with an additional allowance for backwardation costs, is the quarterly option variant that would be most effective at mitigating supplier exposure to these risks, while providing customers with a market comparable tariff to encourage engagement. That said, liquidity should be monitored and reviewed with suppliers following any price cap change to ensure the quarterly cap can be efficiently hedged without detriment due to market liquidity (for example, incurring higher transactional costs due to risk management practises to manage limited wholesale liquidity).

Our analysis of a quarterly 3-1-12 variant, with an ex-ante backwardation allowance, modelled over Winter 2021 concludes that:

- **A quarterly cap would have reduced the impacts of the energy crisis on suppliers, but it wouldn't have solved them:** given how fast prices rose, any indexing window would have resulted in the cap lagging the 'live' market and the 'free-option' risk would have remained leading to customers still choosing to default to SVT;
- **A 3-1-12 style cap with an ex-ante backwardation allowance would have further closed the differences to the 'live' market prices:** in particular, we would have seen a price cap broadly in line with the costs of a 'fixed' price product through Q1-22, reducing the number of customers choosing to default to SVT.

While both of these options would have meant earlier price rises for customers, those price rises would have reflected the rising wholesale costs, would have reduced the financial impact to suppliers and potentially reduced the number of market exits and overall cost to customers.

### Strengthened Status Quo

While Ofgem has already set a test framework with five criteria for making a mid-period adjustment, it is currently subjective as to whether these conditions have been met. This lack of certainty and potential for unexpected price changes have the potential to deter customer confidence in the market and can create additional risks for suppliers. As such, we would like Ofgem to not consider this as an enduring solution.

**Backwardation**

If Ofgem implements an option that still carries a backwardation risk, it must address this via an additional cost allowance within the price cap. Furthermore, this allowance must be calculated on an ex-ante basis since backwardation (and contango) costs can be calculated ahead of the price cap delivery period and an ex-ante allowance will mitigate cashflow issues for suppliers and incentivise more prudent management of supplier risks.

We consider the ex-post approach proposed by Ofgem to be inappropriate for a price cap that is set for all suppliers since it would introduce a bias for those who are the most successful (rewarded with an over-recovery of their costs) and those who are the least successful (penalised with an under-recovery of their costs), which is primarily based on the fortune of speculative deviations from the price cap methodology. While suppliers may still choose to deviate from the strategy with an ex-ante allowance, they would do so knowing exactly what financial risk they are holding and would not be able to recover any of their losses above the allowance.

**Reducing the Notice Period**

A reduction to the notice period will reduce volume risk for suppliers, and therefore costs for customers, and make the tariff more comparable with the wider competitive market, making it easier for customers to engage. In the statutory consultation for this proposal we are expecting Ofgem to provide further clarity of the impacts this change will have, including the licence conditions that would be impacted and the industry processes that would need to be adapted, such as some prepayment meter infrastructure services.

We look forward to continued industry engagement on these topics as we expect changes to be made ahead of October. 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**

## Appendix

### EDF Response to the Consultation on Medium Tern Changes to the Price Cap Methodology

**Q1. Are there any other costs and risks to consumers and suppliers that should be considered?**

We agree with Ofgem's assessment of the costs and risks to consumers and suppliers. Volatility has always existed in the market and historically suppliers have managed this through robust risk management. However, the tariff cap was not designed for this level of volatility and the current design has created significant costs for both consumers and suppliers.

Given developments in the market since the introduction of the current cap, it will be important that BEIS (and Ofgem) reconsiders the objectives of any future price regulation in the context of its vision for a future competitive retail market.

**Question 2: To what extent would a price cap contract without exit fees leave suppliers carrying volume risk in a falling prices scenario? How significant would this risk be? How might it be mitigated?**

A default tariff without an exit fee still provides customers with a 'free' option; in a falling market a customer can move freely to a fixed tariff and in a rising market a customer can default onto the protected default tariff. In a falling market, media or TPI marketing could create a scenario where the volume of customers switching away from the default tariff creates significant exposure for suppliers. The exact significance would ultimately depend on the risk management practice of the supplier, their capitalisation and their subsequent appetite and ability to compete in the fixed tariff market.

The possible solutions to address this risk include:

- **An exit fee**: applied specifically to those customers who decide to switch and determined by the mark-to-market value of the supplier's hedge position. It is likely that a customer deciding to switch while incurring an exit fee would still receive a financial benefit. This is our preferred solution as it is specifically targeted at those customers who are engaging in the market. However, we can understand why there are reservations and we see the Market Stabilisation Charge as an appropriate compromise, since the 'exit fee' would only apply when market conditions mean they are fully justified;
- **Risk premium**: charged to all customers on the tariff and determined by a forecast level of portfolio churn. A supplier would receive a financial benefit or loss dependent on the overall level of portfolio churn and market prices. Our concern with this solution is that the risk premium would apply to all customers including those who remain unengaged.
- **Market Stabilisation Charge**: applied when market prices reduce compared to the default tariff, ensuring suppliers mitigate some of their economic losses and remain financially stable. However, the current design of this charge, due to be implemented from April 2022, is not fit for purpose and needs to be amended. For instance, customers will

likely begin to switch as soon as fixed tariffs are priced below the default tariff and suppliers are required to absorb significant financial losses before the Market Stabilisation Charge is triggered, risking overall market stability.

**Question 3: Quarterly updates are a balance between the reduced volume risks and the increase backwardation risks. Please provide evidence and data on the relative costs and benefits of this.**

**Volume risk** can be managed by reducing the observation and notice period windows. The shorter these windows the more accurate a supplier's customer forecast is likely to be (and more comparable the tariff is to the competitive market to encourage customer engagement).

**Backwardation risk** can be mitigated by aligning forward price hedges with the delivery period, but this increases price volatility for customers, which will make market comparisons difficult, could drive churn and increase volume risk for suppliers. Furthermore, if the delivery period is shortened, a pre-payment customer will have to pay higher winter prices on their higher winter demand, compounding the impact on the most vulnerable customers.

A quarterly cap will increase the backwardation risks from the current price cap, and it is even more critical for Ofgem to ensure backwardation is addressed appropriately if this option is implemented. Our preferred approach is to use an ex-ante allowance with more details outlined in answer to Question 15.

**Market liquidity** is much lower for quarters than seasons. Increasing the observation window will reduce liquidity risk but will increase volume risk.

On balance, the 3-1-12 quarterly option (3-month observation window, 1 month notice period and 12-month forward price setting period), with an additional allowance for backwardation costs, is the quarterly option variant that would be most effective at mitigating supplier exposure to these risks, while providing customers with a market comparable tariff to encourage engagement. That said, liquidity should be monitored and reviewed with suppliers following any price cap change to ensure a quarterly cap can be efficiently hedged without detriment due to market liquidity (for example, suppliers incurring higher transactional costs due to risk management required to manage limited wholesale liquidity).

Our analysis of a quarterly 3-1-12 variant, with an ex-ante backwardation allowance, modelled over Winter 2021 concludes that:

- **A quarterly cap would have reduced the impacts of the energy crisis on suppliers, but it wouldn't have solved them:** given how fast prices rose, any indexing window would have resulted in the cap lagging the 'live' market and the 'free-option' risk would have remained leading to customers still choosing to default to SVT;
- **A 3-1-12 style cap with an ex-ante backwardation allowance would have further closed the differences to the 'live' market prices:** in particular, we would have seen a price cap broadly in line with the costs of a 'fixed' price product through Q1-22, reducing the number of customers choosing to default to SVT.

While both of these options would have meant earlier price rises for customers, those price rises would have reflected the rising wholesale costs, would have reduced the financial impact to suppliers and potentially reduced the number of market exits and overall cost to customers.

**Question 4: Please provide further evidence on the impact of quarterly updates and price cap contracts on households and their finances, and how these could be mitigated?**

If these options are priced in 12-month blocks and are cost reflective then these would have zero impact on household finances since Direct Debit levels would continue but supplier risk exposure would be reduced, which would create overall lower costs for customers. Without a 12-month weighted price then tariffs could become very seasonal and volatile, especially for pre-payment customers, and we encourage Ofgem to avoid these options when designing the new methodology.

**Question 5: Do you think it is unfair that consumers would sometimes have higher or lower prices depending on the wholesale cost at the time their cohort starts the price cap contract? Do you think over the longer run this would even out?**

We acknowledge that some customers may perceive a level of unfairness if they are placed in a cohort that has a higher price than the previous cohort. However, this challenge is not insurmountable and Ofgem has a pivotal role in ensuring consumers are communicated to in a clear and effective manner and that the benefits of moving to a price cap approach are clearly set out for consumers.

Furthermore, the 12-month price cap contract option would provide customers with a tariff that is comparable with the wider competitive market (of fixed price tariffs), which could lead to increased engagement by those customers who perceive the price cap contract to be unfair. This is also true for a price cap with a greater contract length (such as 24-months). If the contract is less than 12-months (such as 6-months) then customers may find it difficult to make compare against live market prices and may not have confidence that the price cap is market reflective.

Finally, if the price cap contract does not include an exit fee then customers will still have the free option to switch to a lower priced tariff in a falling market, whether that was a lower priced default tariff or, more likely, a lower priced fixed tariff.

**Question 6: What opportunity and impact could each proposal have on consumer engagement? Where there may be negative impacts, please provide options to address these. (Please provide evidence.)**

**Strengthened Status Quo:** there is minimal opportunity for this option to improve engagement since a customer would only notice a change in extreme circumstances, which can be very rare events. Furthermore, unexpected price changes have the potential to deter customer confidence in the market.

**Quarterly Price Cap:** customer engagement with a quarterly cap will depend on the hedge profile adopted. If the wholesale price is weighted on a forward looking 12-month period, it is likely to be comparable to live market tariffs. If the wholesale price is weighted on less than a forward looking

12-month period, it is unlikely to be comparable with competitive market tariffs, which would make it difficult for customers to engage in the market.

**Price cap Contract:** as set out in our response to the question above, a 12-month (or longer) price cap contract would provide consumers with a comparable tariff to those available in the competitive market, which would likely lead to an increase in overall engagement across the market.

**Question 7: What other operational impacts could a quarterly update or price cap contract have? Please provide data on the costs and benefits.**

Suppliers must ensure that customers are informed of price changes and are given appropriate time to consider their options and engage with their supplier if they have any questions. Both of these options will mean that suppliers need to inform customers more regularly, which will increase operational workload. However, this additional workload can be reduced over time through industry wide communications on price changes, potentially through Ofgem, which could improve customer engagement and lead to increased customer confidence in the default tariff.

**Question 8: Are there any challenges in transitioning to quarterly updates or the strengthened status quo? If so, please provide details.**

As set out in our cover letter, 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 have already started to hedge for the October cap period. We know that Ofgem is fully aware of this and we expect any future statutory consultation to set out how these costs will be managed in the October cap.

**Quarterly Price Cap:** depending on the length of the observation window and the forward price setting period, this may increase liquidity risks for suppliers.

**Strengthened Status Quo:** while Ofgem has already set a test framework with five criteria for making a mid-period adjustment, it is currently subjective as to whether these conditions have been met. This lack of certainty and potential for unexpected price changes have the potential to deter customer confidence in the market and can create additional risks for suppliers.

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**Question 9: What would the impact be if suppliers tried to buy the energy requirements for all their customers on price cap contracts in August (for 12-month contracts) or August and February (for 6-month contracts) of each year? Do stakeholders agree there would be liquidity challenges in the wholesale markets? How damaging would this be? Are there any ways to avoid this issue?**

Since the current price cap was introduced, we have seen liquidity move towards the near term with the shorter hedging window for default tariffs. Moving the entire default customer base to a four to six week hedging window, once (or twice) per year, will significantly compound buying requirements into a very narrow and predictable window. Moving to this structure will inherently drive liquidity into this window but it will be very challenging given the size of volumes across the industry. It will also likely drive a price reaction. If a large amount of buying activity all enters the

market at the same predictable point (with a disproportionate amount of buying versus selling activity), prices are very likely to be driven up during each window. This would create challenges to hedging, and potentially have adverse impacts to customers if market prices trend higher during the windows. This would impact all retail markets including I&C and SME customers.

However, we may see more generators come to the market and be willing to sell in that period if they think that there's going to be increased demand for power over that period, but this could lead to higher prices. It is important to note that this isn't the case for CfD generators, who would still either target day-ahead or gradual hedging across the entire Season+1 window to match their reference price.

**Question 10: If we were to implement the price cap contract, how should we implement it - with an immediate start and single cohort on a price cap, or with a staggered start and six or twelve different cohorts?**

Our view is that an immediate transition with a single cohort is not feasible. A staggered approach with twelve different cohorts would present much lower operational risk for suppliers and mitigate the market liquidity issues referenced in question 9.

**Question 11: What is a fair and practical way to allocate consumers to different cohorts?**

There are various ways that this could be done, including through a random allocation, inviting customers to move each month with a specified backstop or by moving customers based on the month that they joined their supplier. In any allocation that is decided upon, Ofgem will have an important role in ensuring consumers are communicated to in a clear and effective manner and that the benefits of moving to a price cap approach are clearly set out for consumers.

**Question 12: Should we consider any of these variations further? If so, which one(s) and on what basis? (Please provide evidence).**

**6-1-6 profile:** while this would address the backwardation risk, the volume risk would remain albeit at a lower level than the current method. If Ofgem moved to Jan-Jun and Jul-Dec periods (to minimise seasonal pricing) there is a risk that some of the periods do not have market liquidity during the observation window, making indexation and price forecasting almost impossible. This approach would also be very difficult to explain to customers.

**Price cap contracts:** longer-term price security (tariffs >12 months) 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. A high proportion of the competitive market already offers these tariffs, which will make price comparisons easier and could lead to an increase in engagement amongst customers.

**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.

Furthermore, it is important that any variations consulted on or taken-forward are sensible, appropriate and workable. It is inefficient for suppliers to continue to comment on variants that are not feasible or will not deliver the intended benefits.

**Question 13: Do you have any evidence or data that supports or challenges our assessment of the benefits of this (shorter notice period)? What are the practical considerations for price changes over winter and Christmas?**

A reduction to the notice period will reduce volume risk for suppliers, and therefore costs for customers, and make the tariff more comparable with the wider competitive market, making it easier for customers to engage. In the statutory consultation for this proposal we are expecting Ofgem to provide further clarity of the impacts this change will have, including the licence conditions that would be impacted and the industry processes that would need to be adapted, such as some prepayment meter infrastructure services.

**Question 14: Do you have evidence or data to support a move to a shorter implementation window – such as 14 days? What are the potential risks to consumers of a shorter notice period? And what are the operational considerations?**

When a more detailed industry assessment of reducing the notice period to 28 days is available then it may become clear whether a further reduction is feasible. There will be a minimum number of days required for suppliers to update their systems, for the prepayment infrastructure to be updated and for clear communications to be made to customers. Improvements to industry wide customer communications can reduce the burden on suppliers so that they only need to update their systems, which would enable a shorter notice period.

Furthermore, reviewing and reducing the time required to successfully update prices and inform customers will become more vital in the transition to a low-carbon energy system, especially in developing appropriate Time of Use tariffs.

**Question 15: Given the changes in the wholesale market since summer 2021, how should these be reflected in the deadband (i.e. BAU backwardation) calculation?**

Any deadband must exclude extreme market conditions to avoid skewing the results and to ensure size of the deadband is one that a suppler should expect to manage through 'normal' markets.

Furthermore, the deadband should be centred around zero and not historical average costs/benefits. If the deadband is centred around an average it will create an implicit cost or benefit to either consumers or the supplier. The standard deviation can still be calculated by using historical data but would be applied against zero to create the 'deadband'.

**Question 16: Do you have any views on the challenge of collecting backwardation costs from suppliers via RFI?**

We consider the ex-post approach proposed by Ofgem to be inappropriate for a price cap that is set for all suppliers since it would introduce a bias for those who are the most successful (rewarded

with an over-recovery of their costs) and those who are the least successful (penalised with an under-recovery of their costs), which is primarily based on the fortune of speculation. While suppliers may still choose to deviate from the strategy with an ex-ante allowance, they would do so knowing exactly what financial risk they are holding and would not be able to recover any of their losses above the allowance.

**Question 17: Are there additional costs or benefits of taking an ex-post approach in this instance? If so, please provide details or evidence of these.**

Please see our response to question 16.

**EDF**
**March 2022**