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Price cap - Statutory consultation on changes to the wholesale 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 proposals regarding changes to the wholesale methodology within 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.

Executive Summary:

- **EDF accepts Ofgem's proposals to introduce quarterly updates of the price cap and reducing the notice period to 25 working days;**
- **EDF further supports Ofgem's proposal to introduce an allowance for backwardation costs. However, a deadband is no longer needed since the allowance is on an ex-ante basis and recovered over an annual period;**
- **Ofgem must closely monitor the impact that these proposals have for customers and suppliers and further address risks where necessary, in particular for the ability to hedge a quarterly price cap effectively;**
- **We are concerned that the current price cap legislation limits Ofgem's ability to support the most financially vulnerable customers. Therefore, Ofgem must continue to urge BEIS to reform the current legislation so that Ofgem can implement more targeted intervention;**

- **Ofgem must also continue to review other methodologies within the price cap that may no longer be fit-for-purpose, such as the margin and headroom allowances.**

Ofgem's Proposals

While we supported the implementation of the Price Cap Contracts option, we recognise the difficulties in transitioning promptly to such a framework, and we accept Ofgem's proposal to implement the Quarterly Price Cap option at this point in time. On balance, the 3-1.5-12 quarterly option proposed (3-month observation window, 1.5 month notice period and 12-month forward price setting period), with an additional allowance for backwardation costs, would reduce supplier's exposure to volume risks, while providing customers with a market comparable tariff to encourage competition and engagement. However, the risk of unexpected SVT volume costs is not removed entirely and Ofgem should therefore continue to monitor these costs going forward and make further adjustments if necessary.

We remain supportive of Ofgem's proposal to introduce a cost allowance for backwardation risk and we are pleased that Ofgem is proposing to calculate this on an ex-ante basis given that backwardation (and contango) costs can be calculated ahead of the price cap delivery period. We accept Ofgem's proposal that the backwardation costs will be recovered over a 12-month period, which will mitigate seasonal fluctuations in customer prices and is in line with how annualised fixed term tariffs are priced.

However, we do not support Ofgem's proposal to include a deadband. While we understood the rationale for a deadband when calculating an ex-post allowance or if recovering an ex-ante allowance over a quarterly period, we do not consider that a deadband is needed given the design Ofgem is proposing. In stable market conditions any backwardation or contango captured will be relatively small and will not lead to significant fluctuations in customers' bills, especially given the allowance is recovered over a 12-month period. Furthermore, the price cap should be aimed at fairly recovering the costs incurred for energy supply, and not force suppliers to take unnecessary risks.

On-going Monitoring of the Impacts

Ofgem has highlighted a number of potential impacts for customers, supplier wholesale costs and supplier operational costs. It is important that Ofgem closely monitors these risks through the transition period and on an on-going basis to ensure that it can quickly address any risks that create a significant detrimental impact for suppliers or customers.

Market liquidity is much lower for quarters than seasons. Liquidity should be monitored and reviewed with suppliers following any price cap change to ensure the quarterly cap can be efficiently hedged without significant detriment due to market liquidity (for example, incurring higher transactional costs due to risk management practises to manage limited wholesale liquidity).

Personal Projections will need to clearly communicate to customers that they are based on forecasts and that default tariff prices can move up or down on a quarterly basis. While there are existing licence obligations for suppliers to support customers with these projections, there are no such obligations for brokers, such as Price Comparison Websites. This could lead to significant customer detriment if these brokers do not act responsibly and we urge Ofgem to engage with BEIS on their review of third parties (TPIs) that operate in the energy retail market so that an appropriate TPI regulatory framework can be developed.

Operational Costs

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. Historically, the half yearly price cap changes have generated a large consumer response leading to significant peak demands on supplier customer service resources. Moving to more frequent price changes through quarterly updates, together with a shortened notification window, potentially could lead to a doubling of these peak demand events and a corresponding increase in operational workload and costs for suppliers. However, the impacts on customer service resourcing are unclear as we transition to quarterly cap updates and are further complicated by customer response to the Government's energy bill discount scheme that will be introduced at the same time. Given these uncertainties and the potential for increased supplier costs, Ofgem should continue to monitor the impact of moving to quarterly updates on supplier customer service costs and look to make allowance adjustments where appropriate.

We consider that key stakeholders, including BEIS and Ofgem, have a role in ensuring that industry wide communications around the price cap and changes to the cap levels are fit for purpose and improve customer engagement and confidence in the price cap. In addition, better signalling to suppliers as to when price cap announcements, including public statements on future cap projections, are to be made would allow suppliers to better manage their customer service resources and communications to customers.

Reform of Price Cap Legislation

Ofgem must continue to urge BEIS to review the role of price regulation in the future Retail Market, where a broader range of options for longer term reform can be considered. 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. For instance, as a result of the current price cap methodology, and which will continue to exist even with these proposed changes, the behaviour of engaged customers is directly increasing costs to less engaged customers, including vulnerable customers. This will continue to happen until such time there is a material change in the overall framework of price regulation (e.g. to separate out the default tariff where long-term disengaged customers are automatically put on, from the regulations around short term rollovers at the end of fixed term contracts or the regulated price a customer could directly opt in to at any point in time).

Vulnerable customers and those in financial difficulty should not be penalised by the price cap and Ofgem should be able to design price regulation that can be targeted. More targeted price regulation can provide price support to those who need it while allowing competition to develop for customers in the wider market. If the competitive market enables efficient suppliers to consistently make fair returns then there will be greater incentives for suppliers to invest, innovate and deliver great customer service.

Further Review of the Price Cap Methodologies

Ofgem must continue to review other methodologies within the price cap if it is to have regard to ensuring suppliers who operate efficiently are able to finance their activities. While Ofgem regularly reviews direct cost allowances within the cap it does not review whether indirect cost allowances are still fit-for-purpose.

For instance, the EBIT margin of 1.9% was decided by Ofgem in 2018 based on CMA analysis from 2016, implicitly maintaining the CMA's use of Return on Capital Employed (ROCE) approach, and its estimates for the Weighted Average Cost of Capital (WACC). While Ofgem's decision in 2018 was to maintain the same EBIT allowance for each cap period, we urge Ofgem to review whether this overall approach is still suitable given retail market conditions have changed significantly since the introduction of the cap.

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

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

Rebecca Beresford

Director of Net Zero Strategy & Policy