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Consultation on amending the methodology for setting Earnings Before Interest and Tax (EBIT) allowance

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.

Suppliers continue to operate in a financially challenging environment and face increasing risks as a result of the continued period of market volatility and high prices, and operating under the existing default tariff cap. EDF remains committed to working constructively with both BEIS and Ofgem to develop and introduce measures that promote a healthy, well-functioning market. This should allow efficient and sustainable businesses to attain a fair margin and enable continued innovation and investment to benefit the interests of consumers. It is critical therefore that regulatory changes provide longer term confidence to responsible investors, with an improvement in the returns and therefore the confidence to invest in suppliers. Investor confidence has taken a significant dip since the implementation of the default tariff cap and in particular its suitability in the current environment.

In principle, we would welcome an appropriately constructed review of the EBIT allowance methodology, given at the time of its introduction we expressed reservations with the adopted approach. Many of the assumptions used to form the current 1.9% allowance were made by the Competition Markets Authority (CMA) over six years ago and at a time when market conditions were relatively benign. However, we are extremely disappointed with not only the commencement of this review at this time, but also the speed of the process Ofgem is undertaking to assess a key component of the current default tariff cap methodology.

It is unreasonable for Ofgem to expect suppliers to have the ability at this time to be able to fully engage and provide robust submissions accompanied by "thorough analysis" on this issue. The introduction of the Government's Energy Bill Support Scheme as well as the Energy Price Guarantee

and their impact on a changing market and the risks and costs supplier's face are highly uncertain and must be appropriately accounted for in any EBIT market review. Energy policy in terms of price protection for consumers this Winter and beyond is moving at pace and involving significant supplier resource in order to implement and deliver the new Prime Minister's ambitions in a timely manner.

Consequently, the ability of suppliers to fully engage in an EBIT review, including conducting extensive evidence gathering and analysis, is compromised at this time. This may bring in to question the extent to which Ofgem will gain an informed stakeholder view as part of the consultation process to contribute to a sound and robust final decision.

We are aware that Ofgem's EBIT review programme is being driven by concerns that suppliers could be making excess profits as a result of the volatility of the wholesale market. However, rather than launching a mistimed and rushed review, Ofgem should be able to address such concerns through its assessment of the supplier financial data it continually receives through its financial monitoring and stress testing of suppliers. We would urge Ofgem to utilise such already extant data sources, provided by suppliers through extensive activity and focussing our limited resources to ensure this was completed robustly.

Ongoing market risks

We are concerned about the principle of Ofgem looking to reach a decision on the level of the EBIT margin at this moment in time given the volatile and dynamic nature of the domestic energy market and the extent to which risks, and business models are changing. Since the start of the market crisis Ofgem, and subsequently Government, have implemented a number of positive changes to improve the resilience of the market and protect consumers. These include price cap adjustments, a market stabilisation charge (MSC), ban on exclusive tariffs and the Energy Price Guarantee. However, we do not agree with the assertion that these have reduced the risks that suppliers face over the last year, or moving forward, as high volatile wholesale markets remain. For instance, in terms of the current structure of the MSC it is unlikely to be triggered until well after a significant volume of customers will have switched and thereby putting at risk the financial resilience of some suppliers.

The current scope of proposed regulatory change is unlikely to be enough for a responsible investor to have long-term confidence in the retail supply market in Great Britain. Further regulatory developments will clearly be necessary to deliver a sustainable market where customers are protected and where market participants are able to invest and innovate. This includes progressing discussion on the future of price regulation in the residential market, including what is an appropriate margin in supply, where the current price cap runs to the end of 2023 and there has been little industry engagement so far on whether material changes are needed from 2024.

Notwithstanding the above, below we make some observations on the three key areas that Ofgem has identified in the current consultation:

Cost of Capital

The implementation of Capital Asset Pricing Model (CAPM) is appropriate to calculate a cost of capital, provided the input assumptions and implementation reflect the current and future uncertain environment that we operate in.

Given the time constraints, we have not conducted a detailed and thorough analysis of the CAPM components, however our initial desk top research suggests:

- A higher risk-free rate should be applied given recent and forecast interest rate rises and increased government “risk free” debt costs
- Higher equity risk premia should be used
- The short-term beta is more applicable given the aforementioned uncertainty and volatility in the energy supply industry

We are in a period of significant volatility, falling business and consumer confidence and rising interest rates; amongst many other drivers of the assumptions in CAPM, any outcome needs to reflect and recognise the current situation and the increased uncertainties faced by suppliers.

Capital employed (working/collateral/risk)

Ofgem reference the impact of RO and CCBs in the consultation, but the impact could be very significant dependent on a supplier’s access to finance or other credit support, which depends on their circumstances and the outcome of the consultation. The requirement on CCBs is likely to be materially different given future pricing levels and as such careful consideration needs to be given to the future scale and seasonality of the requirements.

We are entering into a period of record prices, those that have never been seen before that will have significant impact on consumers. The ability for consumers to pay at these price levels is completely untested and reference points are not available. Any assessment must include the heightened risk of more customers in default and not just the working capital effect, which will be significant, but also how any allowable return reflects additional bad debt losses.

As we have seen with the implementation of the default tariff cap and its interaction with the energy crisis, intervention creates unintended consequences, and this has driven significant losses across supply businesses with many failed suppliers. The current Government intervention, whilst welcome, also drives future uncertainty and risk in how a competitive market will operate both during and leading up to the intervention’s expiry. This should be suitably accounted for.

Overall capital employed needs a forward-looking focus and to be dynamic based on the changing market we operate in.

Methodology

In terms of methodology and implementation the core observation is that given the level of supplier failures under the previous model, there is a serious question as to how appropriate is the “Efficient

theoretical supplier” methodology approach. We have not had time to develop an alternative in the detail required by Ofgem’s consultation.

Overall, it is disappointing that such a fundamental topic is being rushed through without providing sufficient time to enable suppliers to engage meaningfully. The thorough stress testing undertaken by Ofgem should provide confidence over the level or return not being excessive over the next 12 months, which should then allow for a more robust and less rushed review.

Given the severely restricted engagement period allowed, we have not been able to answer your detailed questions as we have not had time to conduct robust analysis to inform this. This is very disappointing from our point of view and severely undermines any confidence with regards the rigour of Ofgem’s approach. Especially given the paramount importance of this topic - not just to suppliers desperate for a fair return but also to consumers keen to be reassured that energy supply companies are not profiteering in a period of high prices.

The design of the Default Tariff Cap (DTC), even with the recent introduction of amendments to the price cap arrangements, presents an unreasonable and unmanageable risk to suppliers. This in turn is damaging the stability of the retail market, increasing costs to consumers, and risks undermining the progress that is required to reach Net Zero. Consumer and supplier interests would be best served by both BEIS and Ofgem reviewing the role of price regulation in the future Retail Market, where a broader range of options for longer term reform can be considered, as opposed to continuing with piecemeal adjustments to the current price cap methodology and approach.

In terms of any extension to price protection beyond 2023, given developments in the retail 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. The introduction of the Government’s significant support measures reduces the impact on consumers from high wholesale energy prices and continued market volatility. This protection that will be in place for two years provides an opportunity for both BEIS and Ofgem to undertake a much broader and structured review of price regulation that provides better protection for consumers while at the same time promotes a healthy and sustainable competitive market.

Finally, in light of the above we call on Ofgem to reconsider its approach to conducting a review of EBIT. At the very least stakeholders should be provided with an appropriate timescale to be able to fully engage in the review and provide robust evidence-based analysis to support their submissions and fully inform Ofgem throughout its consultation process. Despite the current constraints on fully engaging with this consultation at this time, EDF remains committed to working with Ofgem on this issue. We therefore reserve the right to come back to Ofgem at a later date when we are in a position to provide a fully informed contribution to the highly complex issues at hand.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact John Mason or myself. I can 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 and Policy