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5 January 2023

Dear Marzia and Shai,

**Further 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.

We welcome the opportunity to respond to Ofgem's Further Consultation. It is particularly encouraging to see that Ofgem has listened to industry feedback and reconsidered its previous approach by not moving straight to a Statutory Consultation, as previously indicated. It is critical that before Ofgem moves to Statutory Consultation, Ofgem and industry identify the correct approach and economic model upon which any Statutory Consultation is ultimately based. EDF remains committed to working constructively with Ofgem to develop and introduce measures that promote a healthy, well-functioning market which is fair for consumers. In particular, we welcome Ofgem's ongoing work to review and improve the price cap arrangements that apply to default tariffs to reflect new evidence and the changing market context.

**Key points**

- Suppliers' ability to make a fair return is critical for a healthy, well-functioning and resilient energy retail market which delivers fair value for customers and supports our net zero future. The Default Tariff Cap (DTC) must, therefore, accurately reflect the returns that efficient

suppliers require to engage in purposeful and sustainable competition that benefits consumers.

- If there is evidence of suppliers having made excess profits, we agree that in the interest of consumers this should be addressed.
- However, we have seen no evidence of excess profits. Rather, the publicly available evidence from Ofgem clearly shows that suppliers have, on average, been loss-making since the DTC was introduced.
- In looking at the DTC EBIT Allowance in isolation, Ofgem risks making the current situation worse. Suppliers' inability to achieve a fair return only serves to undermine the resilience of Great Britain's (GB) retail market and its ability to attract the investment needed to deliver appropriate value and service for customers and achieve net zero.
- While it is welcome that Ofgem has already taken some steps to mitigate some of the increased costs and risks suppliers face, the underlying costs and level of systematic risk have nonetheless increased since 2018.
- Ofgem should, therefore, in the short-term:
  - Share its modelling, so that respondents can fully engage with and understand the model that Ofgem is basing its assumptions on.
  - Update its view of 'efficient theoretical supplier' and resulting capital employed figure, to ensure the allowance more accurately reflects actual suppliers and the higher costs they face.
  - Increase the equity beta estimation to reflect the higher risk suppliers face relative to the wider economy, which have not otherwise been addressed.
- Beyond this, Ofgem and BEIS must move forward with the long-delayed review on the future of the retail market, including the future of price regulation, to ensure we have a market that not only better protects consumers, but ensures efficient suppliers can make a fair return and support our net zero ambitions.

### **Introduction: Protecting Consumers**

EDF fully understands and agrees with Ofgem and the Government's focus on the short-term need to protect consumers from high and volatile energy prices, partly caused by Russia's unlawful invasion of Ukraine. This includes the actions the Government, supported by Ofgem, has taken in recent

months to mitigate the impact of high energy prices for consumers, including but not limited to the introduction of the Energy Price Guarantee and the Energy Bill Support Scheme. Indeed, EDF is working with Government and Ofgem to deliver and evolve these schemes, while continuing to advocate for further targeted support to mitigate the worst impacts of high energy costs on households and businesses.

That said, adjusting the level of the EBIT allowance will not help to address, or protect consumers from, volatile and high international energy prices. While Government interventions have been crucial to protect customers in the short term, such concerns are only properly addressed by reducing our reliance on volatile international fossil fuel prices. This is best achieved by a clear and meaningful focus on improving the energy efficiency of our building stock to reduce demand, investing in UK-based sources of low carbon-electricity (i.e. renewables and nuclear) and reforming the workings of our wholesale markets, as is currently being considered by BEIS through its Review of Electricity Market Arrangements (REMA).

If there were evidence that suppliers are making excess profits as a result of the ongoing gas crisis then we would of course agree that in the interest of consumers this should be addressed. However, we have not seen any evidence of excess profits made by energy suppliers. Rather, as we explore below, we have seen and experienced quite the opposite since the introduction of the DTC. Changing the current EBIT allowance, in the absence of wider and more holistic reform of the DTC, is insufficient in the face of the risk's energy suppliers face.

As part of a holistic review of the price cap methodology, we acknowledge that it is appropriate that Ofgem should include consideration of the EBIT allowance and domestic supplier risk exposure and profitability. However, in specifically looking at the DTC EBIT Allowance in isolation, Ofgem risks not considering the DTC as a whole and what it means for the actual financial outcomes achieved by suppliers. If Ofgem were to consider the DTC as a whole and what it means for actual financial outcomes, it would conclude that suppliers require a higher rate of return.

### **The need for a fair EBIT Allowance**

In the interests of current and future consumers facing high and volatile energy prices, Ofgem must ensure that GB has a healthy, well-functioning and resilient energy retail market. This means a market where a diverse range of efficient and sustainable businesses can attain a fair margin, attract investment and drive improvements in customer services, and supports innovation and net zero solutions that deliver value for consumers. A fair DTC EBIT allowance is critical in this regard. It is vital that the EBIT margin in the DTC accurately reflects the returns that efficient suppliers require to engage in purposeful and sustainable competition that benefits consumers.

If efficient suppliers are further prevented from making a fair margin by the proposed reform it is unclear why investors would support retail suppliers moving forward. If investors are not confident

in the future of the GB domestic energy retail market, further market exits are likely, while new entry will remain constrained. This will result in less competition, less innovation, less investment in new products and services that advance the Net Zero ambition, and result in poorer customer service and, missed opportunities to reduce costs for consumers. This includes major investors like EDF. Unless Ofgem can ensure that an efficient supplier can deliver a fair return, even organisations of the size and financial means of EDF will have to carefully consider future participation in the GB retail market.

GB does not currently have a healthy, well-functioning and resilient energy retail market. The failings were demonstrated last winter when volatile and high energy prices led to the collapse of over 30 suppliers, at a cost to consumers that current estimates place in excess of £6 billion<sup>1</sup>. In its inquiry into 'energy pricing and the future of the energy market' in July 2022, the BEIS Select Committee found that Ofgem had created a market environment that was not sustainable by allowing '*suppliers to enter the market without ensuring they had access to sufficient capital, acceptable business plans, and were run by individuals with relevant expertise.*'.

The failings of the market have been publicly acknowledged by BEIS and Ofgem. In December 2021, BEIS launched a call for evidence on the future of the energy retail market', noting a review was needed to ensure the market is '*resilient, sustainable, and continues to protect consumers as we move to a net zero energy system*'<sup>2</sup>. Meanwhile, over the past year, Ofgem has had to launch a major package of regulatory reform to address previous shortfalls and boost suppliers' financial resilience - as set out in their December 2021 action plan for financial resilience.<sup>3</sup>

### **Efficient suppliers cannot currently make a fair return**

The challenges outlined above have, in part, also been created by the introduction and structure of the DTC itself. The introduction of the DTC in 2019 has fundamentally impacted the functioning of the retail market, undermining suppliers' ability to manage or differentiate their approaches to pricing, financing or investment. Ultimately, for many efficient suppliers it has also made it impossible to make a fair return on their activity, even in 2022 when we have seen the near collapse of switching and, therefore, competition in the market.

While the DTC currently allows for a 1.9% EBIT allowance - and it is true that the absolute amount of money a supplier can make via this allowance is proportionate to revenue - this does not mean in reality that suppliers are indeed making sustainable returns or that the allowance is fair, let alone excessive. This is for several reasons, including:

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<sup>1</sup> £.27 billion estimate from <https://committees.parliament.uk/publications/31575/documents/177114/default/> plus estimated cost of Bulb sale as reported recently.

<sup>2</sup> <https://www.gov.uk/government/consultations/future-of-the-energy-retail-market-call-for-evidence>

<sup>3</sup> <https://www.ofgem.gov.uk/publications/action-plan-retail-financial-resilience>



- In reviewing the EBIT allowance in isolation, Ofgem is making the incorrect assumption that the rest of the DTC is set in a way that allows a supplier to recover their efficiently incurred costs – the existence of Ofgem’s own DTC Work Programme demonstrates this is currently not the case. In the absence of a holistic review of the DTC, its interaction with the market for fixed tariffs and suppliers’ actual financial outcomes, we do not understand how Ofgem can come to a rational and evidence-based determination that the EBIT allowance in the DTC is sufficient, let alone excessive.
- As shown by the failure of 30 suppliers last winter, as volatile prices increase, so do the vast majority of the risk’s suppliers face, often on an exponential basis. For example, if the sector experiences a sudden move towards a high and volatile wholesale cost position, the steps a supplier can and will need to take, such as raising capital, will become more expensive.

The publicly available evidence from Ofgem clearly shows that, since the DTC was introduced at the start of 2019, suppliers have on average been loss-making. Based on the Consolidated Segmental Statements that large, integrated suppliers are required to submit annually to Ofgem, the average profit margin across the retail supply market was -1.5% in 2019 and was -1% in 2020.

Aggregated CSS data is not available for 2021 or 2022. However, the individual company data from 2021 clearly shows that the three companies that provided Ofgem with CSS data made less than the DTC EBIT allowance in 2021, with two making significant losses (EDF -5.5%, Centrica 1.7% and Scottish Power -.1%). Ofgem should also be able to very easily determine that suppliers are not making excess profits, if any at all for many, through the extensive data gathering that it has undertaken this year<sup>4</sup> in response to supplier failures last winter. For example, EDF can clearly demonstrate through its financial accounts, which we have previously shared with Ofgem, that despite operating efficiently and continuing to deliver industry leading customer service - as evidenced by being in first place in the Citizens Advice League table of domestic retail supplier performance for the past three quarters in 2022 - we were not able to make a fair return in our domestic supply business last year (2022). **(REDACTED)**

### Issues with the EBIT allowances

Given the wider design of the DTC, we contend that the current EBIT allowance methodology is not sufficient, for two reasons:

- 1. A misunderstood systematic risk environment** - the risk environment that suppliers work within has changed considerably for the worse since the DTC’s EBIT allowance was set

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<sup>4</sup> This includes but is not limited to a) June’s Bad debt RFI; b) Monthly Financial Resilience and Gas Shipper RFIs; c) Quarterly stress testing and d) Ofgem’s Consolidated Segmental Accounts from EDF, Centrica and Scottish Power

in 2018 (when it was set based on the work of the Competition and Market Authority (CMA) 2016 review).

Since 2016, we have seen the significant impact on the economy of both COVID-19, a global gas crisis, and the introduction of the DTC - despite the fact that the majority of the CMA Panel did not recommend such an intervention. This change in risk is well documented in the detailed Energy UK sponsored paper produced by First Economics, which has been sent separately to Ofgem<sup>5</sup>, and by suppliers' financial accounts, which are available to Ofgem.

It is welcome that Ofgem has taken some steps to mitigate some of these risks, in particular those created as a result of the introduction of the DTC itself (e.g. moves to update the DTC quarterly, to introduce the Market Stabilisation Charge (MSC) and a temporary ban on exclusive tariffs). However, it would be wrong to conclude that such interventions have significantly offset the increased level of risk faced by suppliers. First Economics concludes that an enduring rebasing of the sector's risk profile vs pre 2016 perceptions is warranted, even when the present period of crisis comes to an end.

**2. An outdated 'theoretical efficient supplier' model** - The current EBIT methodology relies on an increasingly outdated set of characteristics to inform its construct of a 'efficient theoretical supplier'. Put simply, there are no at-scale suppliers left in the market who operate a domestic only company focussed on singularly providing default tariffs to customers, let alone who also have top quartile performance across each individual cost and the ability to hedge in line with the default tariff cap strategy. As such, the approach does not and cannot account for several risks and costs actual suppliers face, which the notional supplier does not.

This is important, as a supplier's ability to make a return and achieve the existing EBIT allowance is not only dependent on its efficiency and competitiveness, but also on its level of alignment with Ofgem's 'efficient theoretical supplier' model. In particular, because the model is based on a supplier with 100% SVT customers (an unrealistic assumption in a competitive market), it better allows suppliers with a high base of disengaged (default) customers to achieve a return, as they benefit more fully from those allowances designed to compensate the notional supplier for risks such as volume and backwardation.

## Transparency of modelling

Ofgem has still not provided suppliers with the opportunity to review the modelling informing its approach. In order to fully consider and answer the questions that Ofgem has proposed in this Further

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<sup>5</sup> <https://www.energy-uk.org.uk/index.php/publication.html?task=file.download&id=8391>

Consultation we need access to the working capital, collateral capital and risk capital model that Ofgem's forecasts are based upon. **(REDACTED)**

Describing a possible model is clearly not comparable with the benefits of being able to fully understand the model that Ofgem is basing its assumptions - and potentially its decisions - on, given the level of detail. While Ofgem may not have explicitly consulted on any outputs produced by its model, the very nature of the consultation means we are nonetheless being asked to comment on Ofgem considerations that could or will be informed by the model and its appropriateness. For example, without access to the model, we cannot determine:

- a. what costs and revenues are modelled, to ensure they are complete and accurate;
- b. what time lags are being built in to Ofgem's model for different costs and tariff payment types, which fundamentally impacts the working capital requirements;
- c. what opening balance sheet is assumed to validate its reasonableness and to be able to determine the working capital requirement split between the starting position and ongoing operations;
- d. how working capital assumptions adjust with wholesale prices to reflect increasing unaffordability of tariffs as they increase;
- e. information about the granularity the model is based on because, for example, EDF's working capital (by way of example) can vary by c£1 billion during a given month, so if the Ofgem Model just takes a month-end position, the assessment of the amount of working capital required would be misleading;
- f. whether the Ofgem Model assumes perfect market liquidity (like the CEPA Model). A reasonable model would reflect the inability to follow the SVT hedging strategy because it would show the real-world challenges with liquidity when trading Q+1 and Q+2 products versus S+1 and S+2, whereas the CEPA Model doesn't show this;
- g. what assumptions the high price and base price are based on; and
- h. whether the Ofgem Model would build in the volume and timing risk of customers switching tariffs. A reasonable model would account for these flows between tariff types and demonstrate the impact accurately, but it is unclear whether Ofgem's Model will ultimately account for fluctuating customers by tariff type.

**(REDACTED)**

We nevertheless note that, given Ofgem's self-imposed timeline to implement any changes to the EBIT allowance in time for the July – August 2023 DTC period, it is difficult to see how Ofgem will be able to give stakeholders the opportunity to meaningfully respond. To avoid any confusion, waiting until the statutory consultation stage to share the model is too late for EDF (and other market participants) to contribute or meaningfully engage with the Further Consultation as it removes EDF's ability to engage with Ofgem's full reasoning ahead of the statutory stage.

We would, therefore, urge Ofgem to, as soon as possible to share its model in its current format, even if it remains unfinished. Stakeholders, including EDF, should then be given appropriate time to meaningfully review and comment on the model. The length of time required will depend on the maturity of the model. Once received, EDF will be able to advise Ofgem of the length of time we consider is needed for suppliers to fully review the Ofgem Model and respond substantively to the questions posed.

### **Proposal and conclusion**

Given the above, it is simply incorrect for Ofgem's EBIT review to be driven by concerns that suppliers could be making excess profits (as per Paragraph 6.26 of the Further Consultation) under the current approach. Any adjustments to the DTC's EBIT allowance that further constrain a suppliers' ability to achieve a fair return will only serve to further undermine the resilience of the retail market and the appetite of investors and suppliers, including EDF, to continue to participate in this market.

Rather, if investors are to have confidence in the domestic market, Ofgem's focus must be on ensuring the EBIT allowance in the DTC adequately reflects the increased short and medium-term risks that suppliers face, and that efficient and responsible suppliers are able to make a fair return. To this end, Ofgem should, in the short-term:

- Share its modelling, so that respondents can fully engage with and understand the model that Ofgem is basing its assumptions on.
- Update its view of 'efficient theoretical supplier' and resulting capital employed figure to ensure the allowance more accurately reflects actual suppliers and the higher costs they face.
- Increase the equity beta estimation in its cost of capital calculation to reflect the higher risk suppliers face relative to the wider economy which have not otherwise been addressed.

Ofgem should then work with BEIS to progress its review of the future of the retail market, including consideration of whether the current approach to price regulation in the domestic retail market is fit for purpose. We contend that the past 18 months have clearly demonstrated that it is not, and that there is a need to replace the current failed approach with an alternative that not only better protects consumers, but also ensures suppliers are investable and encouraged to make a fair return – in line with the statutory framework. We note that the Government has already committed to implementing a *'new approach to consumer protection in energy markets, which will apply from April 2024 onwards ... as part of wider retail market reforms'* as part of this year's Autumn Statement<sup>6</sup>

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[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1118417/CCS102206544\\_0-001\\_SECURE\\_HMT\\_Autumn\\_Statement\\_November\\_2022\\_Web\\_accessible\\_1\\_.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1118417/CCS102206544_0-001_SECURE_HMT_Autumn_Statement_November_2022_Web_accessible_1_.pdf)

Without prejudice to the points made above, we have set out in the attached further detail on our specific views and concerns with Ofgem's proposals as part of our best efforts to respond to the questions in the consultation in the circumstances.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact me directly. Please note that this redacted version of the response may be published on the Ofgem website.

Yours sincerely

A handwritten signature in black ink, enclosed within a large, hand-drawn circle. The signature appears to be "Philippe Commaret".

**Philippe Commaret**  
**Managing Director, Customers**

## **Annex A: EDF Response to Further consultation on amending the methodology for setting Earnings Before Interest and Tax (EBIT) allowance**

### **Question 1: Are there any issues we should consider in relation to our proposed 1 July 2023 implementation?**

We disagree with Ofgem's approach in looking to make changes to the EBIT allowance for July 2023.

In particular, Ofgem has not allowed suppliers access to the model that is being used to inform decisions in this area. Describing models to a limited degree or detailing some of its inputs, but not all, is insufficient to enable Ofgem to properly and fully consult with stakeholders, because it prevents suppliers from being able to understand the exact model that Ofgem are basing its assumptions and potential decisions on. We have provided detail in the covering letter of why a simple description of the model is not sufficient to adequately consider and provide input.

Despite repeated requests, Ofgem has not provided a compelling reason why suppliers have not been able to review the current version of this model alongside this Further Consultation. Considering the centrality of the model to the conclusions that Ofgem hopes to reach through this consultation, the validity of the consultation is called into question through Ofgem's continued reluctance to share the model.

This consultation has also been published at the same time as five other consultations within the same policy area (finance regulation) which means there is insufficient time to comprehensively engage on these. Publishing an extensive suite of consultations, which span the holiday period, puts the limited number of employees who can consider the questions raised and respond in an impossible position. Despite cancelling annual leave employees have still had insufficient opportunity to consider all the issues raised in this suite of consultations, in a way that would have been most beneficial to the consultation process.

As a result of both, we contend that the ability of suppliers to fully engage in an EBIT review, including conducting extensive evidence gathering and analysis, is compromised at this time. Ofgem will not be able to gain a fully informed stakeholder view as part of the consultation process, undermining its ability to make a sound and robust final decision in time for July 2023.

Finally, it is also surprising that Ofgem is looking to reach a decision on the level of the EBIT margin at this time, given the volatile and dynamic nature of the domestic energy market and the extent to which risks, and business models are changing. This could mean there is a significant change in market conditions that will require the EBIT methodology to be further reviewed in the short-term.

### **Question 2: Do you agree with our assessment on the case for change?**

No. EDF does not agree with Ofgem's assessment on the case for change.

As set out in the covering letter to this response, it is fundamentally incorrect if Ofgem's EBIT review is being driven by concerns that suppliers could be making excess profits (as per Paragraph 6.26 of the Further Consultation) under the current approach. We have yet to see evidence that the current allowance overestimates a normal profit i.e. allows an excessive profit, and Ofgem should be able to clearly determine this by reviewing responses to the Consolidated Segmented Statements and stress testing RFLs.

In contrast to the perceived concern regarding suppliers making excessive returns as a result of volatile prices, Ofgem should be focusing on ensuring the EBIT allowance in the DTC adequately reflects the increased short and medium-term risks faced by suppliers, and on allowing efficient and responsible suppliers to make a fair return – which is currently not the case.

With this in mind, it is vitally important that Ofgem reconsider its approach in the following areas:

#### **a) Risk Profile**

Suppliers are supporting their customers during a period of significant volatility, falling consumer confidence and rising interest rates. Yet, Ofgem asserts that there is not sufficient data to amend the beta parameter from 0.8 (Further Consultation, Chapter 6) which was set in 2018. However, since 2016, we have seen the introduction of the DTC and the significant impacts on the economy of COVID-19, the gas crisis, the collapse of over 30 suppliers, and the extraordinary steps by governments and regulators in the UK and Europe to seek to mitigate their impacts on the energy market and consumers.

Energy UK has produced an informed report on the Cost of Capital with First Economics which clearly demonstrates that the beta parameter should be increased. The following excerpt from that report presents a clear case that Ofgem's own actions since the CMA investigation in 2016 has alone increased the risks that retail suppliers face:

*"One thing that particularly stands out is that the change in the sector's risk profile is partly a function of externally driven change in the upstream wholesale electricity and gas markets but also partly a consequence of regulatory intervention. In other sectors that we work in, economic regulation almost always reduces risk by giving companies greater certainty of cost recovery than they would get in a competitive market – e.g. by handing companies fixed revenue entitlements irrespective of volumes and by setting up Regulatory Asset Values (RAVs) to create legitimate expectations about the reimbursement of historical investments. By*



*contrast, in the energy retail sector, regulation looks to have created risks that would not have been present had suppliers been permitted to set their own cost-reflective tariffs.”<sup>7</sup>*

The report also notes that while, in the past, there may have been debate about whether some of the risks that affected a supplier's cost of capital under the Capital Asset Pricing Model (CAPM) framework were systematic, current circumstances have clearly shown that the risks are systematic in practice. The level of energy costs and prices have exerted, and continue to exert, a very sizeable influence on the inflation rate, household disposable income, interest rate policy, the government's fiscal position, the rate of change in GDP, the profits earned by firms in general, and the performance of the stock market. It follows that any risk which can impact suppliers' costs and prices, by virtue of its direct and indirect knock-on effects on the aforementioned measures, is relevant and matters to all firms in the wider economy and, hence, a systematic risk.

In exploring these risks that retail suppliers will face over the coming year, First Economics conclude that *'an enduring rebasing of the sector's risk profile vs pre-2016 perceptions are warranted even if the present period of crisis comes to an end.'* Therefore, while it is very welcome that Ofgem has taken some steps to mitigate some of these risks (e.g. moves to update the DTC quarterly, and introduce the Market Stabilisation Charge (MSC) and temporary ban on exclusive tariffs), any assertion in the Further Consultation that Ofgem has already addressed or fully mitigated the new increased level of systematic risks that retail suppliers face is incorrect based on both suppliers' recent experiences and independent economic analysis.

Given Ofgem has received detailed financial reports from all suppliers, it has evidence that it is not considering in this consultation that clearly demonstrates that the current beta parameter is no longer fit for purpose and must be increased.

#### ***b) The 'efficient theoretical supplier' model***

Given the level of recent supplier failures, there is a serious question as to how appropriate the set of characteristics used to inform the construct of a 'efficient theoretical supplier' are.

Ofgem is basing its considerations on a model of a 'efficient theoretical supplier' which has never been reflective of the reality of an actual efficient supplier in the domestic retail market, and the failings of which are particularly evident given the current market conditions. There are no at-scale suppliers left in the market who operate a domestic supply only company focussed on singly providing default tariffs to customers (and it has not been a policy goal of Ofgem to create one; quite the opposite given customer switching initiatives). Neither has there ever been suppliers who have also had top quartile performance across each individual cost and the ability to hedge in line with the default tariff cap strategy. As such, the approach cannot account for several risks and costs actual

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<sup>7</sup> <https://www.energy-uk.org.uk/index.php/publication.html?task=file.download&id=8391>

suppliers face, which the 'efficient theoretical supplier' does not, most notably associated with the volume risk and timing risk from customers switching to fixed tariffs and the free option value (and corresponding risk to suppliers) of the current deemed tariff.

While it is true the government's EPG has strongly encouraged domestic consumers on to Standard Variable Tariffs (SVTs) (because the EPG does not apply to new fixed rate tariff offers), a significant number of customers remain on pre-existing fixed tariffs, and the EPG is only a temporary intervention. In considering an appropriate EBIT margin, Ofgem must consider the market we want to have, not just the one we have today. Ofgem, BEIS, and suppliers all want to see a return to a market, where a variety of suppliers are competing for customers through a variety of fixed and variable product offers. BEIS is also already considering how it can adjust the EPG to facilitate a return to an active fixed tariff market in 2023.

This issue is further compounded by Ofgem proposing to inconsistently amend the characteristics of the 'efficient theoretical supplier' in areas where it is clear that the 'efficient theoretical supplier' diverges from the real world. For example, the proposed methodology used for collateral does not reflect that which would be taken by such a theoretical independent supplier, i.e. retaining collateral costs. Ofgem state that this is because most suppliers are now not independent, but part of larger company groups. Yet, Ofgem continues to ignore the reality of the market when it comes to considering average tariff type split.

### ***c) Collateral cost and interlinkages with Ofgem's FRC work programme***

On collateral costs, Ofgem recognises that different companies will use different approaches e.g. Letters of Credit (LoC), and Parent Company Guarantees (PCG). To adopt a rational approach Ofgem must, therefore, recognise in its modelling that such approaches will always impose relevant costs on any supplier as a legal entity or reflect an opportunity cost, as such financial support cannot be used for other non-retail or retail supply investments. Ofgem's proposals currently risk failing to consider the costs of these forms of credit support and, therefore, unfairly not considering the need for a return when there is a real cost for suppliers. This is true whether they are accounted for in relation to the aspect of the organisation that holds a supplier license or elsewhere in the organisation. No such financial instrument comes without cost.

Such concerns are particularly stark when Ofgem is concurrently consulting on placing minimum capital adequacy requirements on suppliers which are based on their actual and real financial position. Ofgem recognises that for any such requirements to have any credibility, they must be based on real financial positions. However, Ofgem is seeking to place additional and growing capital requirement costs on suppliers based on their actual financial positions (which will be informed by further Ofgem RFI, on top of the data Ofgem already has access to via its work on stress testing and

CSS) whilst potentially continuing to, or further, undermine suppliers' investability through the outcomes of this Further Consultation.

**Question 3: Do you agree with our proposal to include fixed assets as a component of capital employed and the suggested level?**

Overall, there is a logic in including fixed assets as a component of capital employed and a level of £85 per customer seems objectively reasonable. However, there is a lack of transparency in how Ofgem has calculated this number and, therefore, it is not possible to determine whether this is appropriate level for the 'efficient theoretical supplier' without access to Ofgem's model.

**Question 4: Do you agree that our estimate of fixed assets for a notional supplier is representative of current market conditions?**

As per our response to Question 3, there is a lack of transparency about why Ofgem has proposed £85 as the number and, therefore, it is not possible to determine whether this is an appropriate level for the 'efficient theoretical supplier' without access to Ofgem's model.

However, it should be recognised that a growing share of the market is utilising 'software as a service' models. **(REDACTED)**

Therefore, it appears that including IT cash costs in operating costs would be rational as this is increasingly how suppliers bear such costs. In the time allowed for this consultation we have not been able to explore such an alternative approach in any detail to determine whether this would be preferable. For example, a supplier moving from a capital employed approach to a software as a service approach does not necessarily reduce their overall costs of IT per customer.

**Question 5: What do you see as the minimum level of working capital required for a supplier to be able to operate and which method should we use to set it?**

Without being able to review Ofgem's detailed model of its 'efficient theoretical supplier' it is not possible to determine what would be a minimum level of working capital required. Allowing us to review the model would enable us to understand items such as the opening balance sheet, what frequency costs have been modelled over, how acquisition costs are treated and how Ofgem has modelled affordability assumptions in high price scenarios.

However, in determining the minimum level of working capital we would expect Ofgem to have at minimum considered the following areas:

- Seasonality – Ofgem recognises that working capital fluctuates over the year and so must ensure the minimal level is adequate to take account for this. One of the many flaws in the

current price cap methodology is that issues in relation to seasonality are not reflected. As the majority of customers pay on Direct Debit and energy consumption is highly seasonal, to not take seasonality into account is unreasonable;

- Energy costs – Suppliers pay energy costs in full each month. There is, therefore, a contractual lag compared to when suppliers receive such monies from their customers, following billing, which bears a credit risk which must be taken into account;
- Non-energy delivery costs – Suppliers must pay to deliver schemes such as the Feed in Tariff, which pays households for embedded renewable generation, and the Energy Company Obligation, which involves paying insulation companies to install measures in consumers' homes, before such monies can be claimed seasonally and infrequently;
- Non-energy policy costs – Suppliers must pay to cover cash flow risks for the Low Carbon Contracts Company, and as the Contracts for Difference policy continues to grow, provide the Contract for Difference (Total Reserve amount) funding, and in the future, the nuclear RAB regime.

Ofgem must also carefully consider the data provided in the accompanying RFI to obtain a view of the actual working capital requirements over the last two years for existing suppliers, adjusting the data for the impact of wholesale cost forecasts.

**Question 6: How can the relationship between wholesale prices and their volatility, and working capital be quantified?**

We would expect for this to be reflected in the model that Ofgem is utilising to inform its work in this area. However, as we have not been able to review this model, we are unable to determine whether this is the case or provide feedback on any of the assumptions used.

Although, working capital needs will scale with the level of wholesale prices, it must also be recognised that such working capital needs and risks will not uniformly scale with wholesale prices. Where wholesale costs are high and volatile, they can have an exponentially negative impact on suppliers and the level of working capital needed. For example, at a certain level, energy costs may become unaffordable for many customers, therefore having an exponential impact on debt levels. Volatility of prices can also make energy trading more expensive and increase collateral requirements at short notice.

When setting the EBIT allowance and quantifying the working capital required, we would propose Ofgem should consider the working capital requirement based on a base case of current wholesale prices. Any risk of prices increasing further beyond that which is observable in the market should be factored into the risk capital assessment via the higher case scenario.

**Question 7: Do you agree with our proposal to include wholesale cost volatility and unexpected demand shock as key drivers of volume risk when calculating suppliers' risk capital requirements?**

Yes, EDF agrees with this proposal as these are the key drivers of volume risk for which we would need to hold risk capital.

However, as per our response to Question 2, we would note that while developments like the move to quarterly price cap updates and the introduction of the Market Stabilisation Charge (MSC) have helped reduced the risk faced by suppliers, they have not been as impactful as Ofgem suggests in the Further Consultation. There remains a significant residual increase in the level of risk faced by suppliers, most notably associated with customers being able to move between fixed tariffs and the free option presented by the DTC. For example, in a rising market, this can, as we saw last winter, leave suppliers in a position where they are unable to recover their costs (while Ofgem did act to try and mitigate this via additional ad hoc allowances in the DTC, as previously discussed with Ofgem, these were ultimately not sufficient). Meanwhile, in a falling market, the MSC does not substantially, let alone completely, reimburse suppliers for the level of volumetric risk they face from customers moving to cheaper fixed tariffs as the market moved and energy costs reduce. Furthermore, as we have outlined in our response to the separate consultation on the MSC, it is only triggered by the relative movement of wholesale prices rather than when switching occurs, with suppliers required to absorb the costs of selling excess volume for customer losses in a falling market before the MSC is triggered. Therefore, it would be incorrect to assert that such risks have been significantly mitigated by Ofgem.

**Question 8: Do you agree with our assessment that backwardation, bad debt, and shaping and imbalances costs are accounted for in the existing cap allowances and that their inclusion within the EBIT allowance could lead to double counting?**

No, EDF does not agree that backwardation, bad debt and shaping and imbalances costs are fully accounted for in existing cap allowances and that their inclusion within the EBIT allowance would, therefore, lead to double counting.

Whilst these aspects are reflected in other cap allowances, this is in relation to expected costs on suppliers with an allowance provided on an ex-ante basis, for example on backwardation. Therefore, this does not cover the risk that actual outturn costs differ from those allowed, which should be included in the EBIT allowance.

Furthermore, the 'efficient theoretical supplier' model as described (based on a supplier with 100% default tariff customers) would also not account for a risk of unexpected under-recovery of deferred backwardation costs as a result of customer churn. Not only is this not realistic, but it goes against Ofgem's objective of introducing competition via the fixed tariff market, as it better compensates

suppliers with large disengaged default customer bases, who face a smaller risk from under-recovery of deferred costs. Therefore, Ofgem should either amend the cost allowances to consider possible under recovery, or the risk should be reflected in the EBIT percentage.

Reflecting the additional risk that suppliers *may* face is a separate financial risk aspect and, therefore, it is not double counting to include as part of the risk capital within the EBIT methodology. To take forward Ofgem's proposed approach would demonstrate a misunderstanding of the purpose of risk capital and how this must be reflected in any EBIT methodology change. Such risk capital is needed to ensure suppliers have sufficient liquid resources to manage any such issues.

**Question 9: Do you propose an alternative approach for measuring risk capital which is preferable to the approach we describe in this section and Appendix 1? In your approach, how do you model the relationship between wholesale price volatility and risk capital under stress test scenarios?**

In order to answer the questions that Ofgem has asked in this Further Consultation, we need access to the working capital, collateral capital, and risk capital model that Ofgem's forecasts are based upon. As it stands, EDF only has Appendix 1 in the Further Consultation, which describes an example modelling approach, developed by CEPA, that Ofgem *may* use.

We would note, however, the CEPA Model appears to make several assumptions in relation to the 'efficient theoretical supplier' that are not reasonable or correct. Based on the limited information available in Appendix 1 we would make the following points:

- In relation to A1.9 in Appendix 1, the CEPA model assumes an 'efficient theoretical supplier' with 100% standard variable tariff. It is unclear based in Appendix 1 how the model addresses the volume and timing risk from customers switching to fixed tariffs and the free option value (and corresponding risk to suppliers) of the current deemed tariff. A reasonable model would account for these flows between tariff types and demonstrate the impact accurately.

If this interaction with the fixed tariff market is not addressed within the model, or elsewhere in the DTC methodology on an ongoing basis, it risks continuing to encourage suppliers to migrate customers towards default tariffs to match the notional supplier profile in order to mitigate any risks suppliers face which are not modelled or encapsulated in Ofgem's current approach. This is at odds with the aims of Ofgem to protect consumers and promote competition.

- In relation to A.10 in Appendix 1, EDF would disagree that it is a conservative assumption to assume that a supplier's equity is stable. Indeed, this appears to highlight a flaw in the methodology. Our understanding is that the model solves the risk capital required calculation

by assuming zero EBIT in the Base Case and then calculating risk capital as the capital required to meet a variation in cash flows between a Base and High scenario over a future two-year period. This measure of risk capital will then be allowed a return in the EBIT allowance.

EDF notes that in the last two years the vast majority of suppliers have made substantial losses on default consumers in reality, and indeed over 30 have gone into administration. This reality means that investors are being required to put up more risk capital over time, however the method adopted will never provide a return on this increase to risk capital.

Therefore, this approach appears to be leading to require most, if not all, suppliers to bear a risk of stranded and irrecoverable sunk costs of investment. This is itself an incredibly strong signal to investors that Ofgem is not serious about creating a long-term sustainable market.

- With regards A1.12 in Appendix 1, there is an assumption that the notional supplier incurs efficient fuel costs. Suppliers are expected to trade Quarter+1 and Quarter+2 products in order to hedge in line with the DTC. These products have historically been, and continue to be, relatively illiquid as compared to the Season+1 and Season+2 products, meaning that suppliers are, as a result of the moving to quarterly cap updates, having to take on additional risk when trying to match the tariff cap hedging strategy. There is not a perfect energy market and suppliers will face additional costs over those estimated taking this approach.
- With regards Direct Debit customer payment profiles in A1.19 in Appendix 1, the assumption used by Ofgem is that all customers can afford their Direct Debits. Given high price scenarios, some customers will need to lower direct debits from the ideal amount and pay slightly less for longer, in order to manage their household budgets. Suppliers support vulnerable and lower-income households in this way, adversely impacting working capital to support customers, and the model should be updated to reflect this in High price scenarios. Indeed, many of these requirements are set by Ofgem in Licence Conditions which all retail suppliers must meet.

**Question 10: Do you have a view on a preferred approach with regards to the treatment of collateral under the cap?**

EDF supports including collateral in the capital employed calculation as this most closely reflects the correct approach to reflect the costs of an actual efficient supplier and best serves the development of a robust, competitive retail market.

As Ofgem has been clear that it wishes to continue to use a 'efficient theoretical supplier' to inform its approach to EBIT, the methodology used should reflect that which most closely resembles the approach that would be taken by an independent supplier – i.e. retaining the current approach where



collateral costs are included and recognising that these scale as wholesale prices increase. To not assume that an 'efficient notional supplier' is independent in this regard risks far-reaching unintended consequences for the future development of the retail market. Moving to allowing collateral as an operating cost allowance, will cause a significant challenge for independent suppliers, heavily restricting their ability to enter or grow in this market. This would detrimentally impact the competitive market and consumers, by in effect closing off retail supply to certain business models.

Furthermore, while Ofgem correctly recognises in the Further Consultation that different companies will use different approaches (e.g. Letters of Credit (LoC) and Parent Company Guarantees (PCG)), utilising LoCs and PCGs will always still put relevant costs on any supplier as a legal entity and reflect an opportunity cost, as such financial support cannot then be used for other non-retail or retail supply investments. To not include collateral, therefore, risks failing to consider the costs of these forms of credit support and, therefore, unfairly not considering the need for a return when there is a real cost for suppliers. This is true whether they are accounted in relation to the aspect of the organisation that holds a supplier license, or elsewhere in the organisation. No financial credit support is endless or comes at zero cost.

Such concerns are particularly stark when Ofgem is concurrently consulting on placing minimum capital adequacy requirements on suppliers which are based on their actual and real financial position. Ofgem recognises that for any such requirements to have any credence, they must be based on real financial positions. However, Ofgem is seeking to place additional and growing capital requirement costs on suppliers based on their actual financial positions (which will be informed by further Ofgem RFIs, on top of the data Ofgem already has access to via its work on stress testing and CSS) whilst potentially continuing to, or further, undermining suppliers' investability through the outcomes of this Further Consultation.

**Question 11: How are the collateral requirements calculated? Is it possible to quantify the relationship between collateral, wholesale prices and volatility?**

Yes, there is a relationship between collateral, wholesale prices and volatility. Suppliers must post collateral for several areas, including:

- Imbalance (e.g. Elexon/BCS and Xoserve)
- Trading/margining costs for energy purchases
- Non-energy costs e.g. CfD

Using Elexon/BSC collateral as an example, there is a clear link to wholesale prices via the "credit assessment price" (CAP) used by Elexon to determine the collateral requirements for a supplier. Elexon set the CAP with reference to wholesale prices using their stated methodology. Therefore, assuming the other components of the calculation remain static, if wholesale prices increase, the collateral requirements for a supplier also increase. During 2022, the CAP increased to a high of £415

/ MWh (the average Credit Assessment Price for 2018-2020, e.g. prior to the energy crisis, was c.£50 / MWh), which significantly increased EDF's collateral requirements with Elexon.

To further quantify the relationship between collateral, wholesale prices and volatility Ofgem should engage directly with the relevant scheme administrators to determine this relationship as they will be able to provide an overview of such collateral arrangements.

We provide more detail in relation to EDF on this issue in the linked Request for Information response we have submitted. However, trading and margining costs for energy purchases are bespoke to each supplier. Given Ofgem's use of a 'efficient theoretical supplier' model, not having access to the model itself makes it difficult to comment on the efficacy of Ofgem's approach.

**Question 12: Do the wholesale collateral requirements mechanisms differ for trading on exchange vs trading over-the-counter?**

Yes, but this will be bespoke to the individual contract for each supplier relationship and even within one supplier's portfolio there will be multiple bi-lateral arrangements which will vary between individual contracts. Arrangements are likely to cover an element of volatility, not just current mark-to-market and invoice exposure, and that volatility element could be set at a different rate e.g. if the arrangement is entered into in a time of higher volatility; this can mean higher collateral posting and higher costs.

**Question 13: Does posting collateral affect the level of risk capital employed?**

Yes, it is part of the resources that suppliers require to manage financial risk. It comes with an interest cost and is used to mitigate financial risk for counterparties.

**Question 14: Should the cost of capital allowance compensate for inflation risk? If so, how?**

Yes, the inflation risk should be included in the beta parameter as this underlines the risk basis that suppliers face. Increasing inflation increases all such financial risks and, therefore, including it in the beta will most fairly and simply reflect this additional risk to suppliers working market environment.

Suppliers are having to support their customers during a period of significant volatility, falling business and consumer confidence, rising prices, and rising interest rates. Therefore, it is incorrect that Ofgem suggests there is insufficient data to amend the beta parameter from 0.8 which was set in 2016, when there was far greater stability in the market (see response to Question 2). As a minimum, the additional risk that inflation brings to suppliers should be reflected here.

**Question 15: Do you have a strong preference between setting the risk-free rate using recent data, forward rates or recent data but with indexation?**

EDF supports a risk-free rate using recent data, but with accurate and timely indexation, so that any changes in the costs that suppliers face are quickly and accurately reflected within the price cap.

To achieve this Ofgem must urgently consult on its proposed approach, providing all relevant detail, giving suppliers sufficient opportunity to review and respond before any changes are brought into the EBIT allowance, to ensure this is implemented accurately.

**Question 16: Should the tax rate be updated? If yes, how frequently?**

Yes, it is essential that the tax rate is updated to reflect the latest legislative position.

As in our previous answer, it is essential that Ofgem urgently consult on its proposed approach, providing all relevant detail, giving suppliers sufficient opportunity to review and respond before any changes are brought into the EBIT allowance, to ensure this is implemented accurately.

**Question 17: Do you agree that a hybrid approach strikes an appropriate balance between cost reflectivity and simplicity? Do you agree that it is the most appropriate approach to implement in practice?**

Overall, EDF agrees that a hybrid approach strikes an appropriate balance between cost reflectivity and simplicity. We also agree that it is the most appropriate approach to implement in practice. There is a logic in that some fixed assets and renewable obligation costs do not scale with wholesale energy costs. However, there is no evidence that such an approach should be extended to other areas of the EBIT methodology which do scale with wholesale energy costs.

A fixed approach is not appropriate because most costs scale with wholesale prices. A cap or collar approach would lead to unrecovered costs or excess profits in extreme scenarios, neither of which is appropriate.

**Question 18: Do you agree that fixed assets and potentially RO ringfencing should be considered as part of the fixed components? Which other components may be fixed?**

Yes, EDF agrees that fixed assets and RO costs should be considered as part of the fixed components. However, there isn't any justifiable evidence to fix any other components as these will scale with energy costs.

**Question 19: Should the EBIT calculation include a component that adjusts based on market volatility? How could such an approach be quantified and implemented?**

Yes. Risk capital increases with market volatility and, therefore, the EBIT allowance needs to reflect this. We would welcome further industry consideration on this point to agree a way forward. However, in the short-term, a simple solution to reflect this risk would be to include consideration of it in a higher beta - such an approach has been considered and outlined by the Energy UK report from First Economics.

**Question 20: Do you agree that Ofgem should not schedule periodic reviews for the EBIT allowance methodology? If you disagree, how frequent should those reviews be?**

EDF agrees that Ofgem should not schedule periodic reviews for the EBIT allowance methodology. Instead, Ofgem should clearly set out what criteria would constitute significant changes to the environment in which suppliers operate, and then conduct reviews when these have been met.

**Question 21: Do you agree with the conditions we identified as constituting significant changes to the context in which suppliers operate? Are there any other conditions that should be included?**

Yes, EDF agrees with the conditions which Ofgem has identified as constituting significant changes to the context in which suppliers operate. We have not identified any other conditions that should be included.

However, Ofgem must provide more clarity on what evidence would be required to signify a 'significant change'. There could be a concern that Ofgem would not prioritise any such review where suppliers face more negative conditions, impacting on their investability. Therefore, we would welcome Ofgem providing assurances and specific clarity on what is considered significant and the types of evidence that suppliers could provide that would trigger such a review to take place.

**Question 22: Do you agree with our proposal to apply the EBIT allowance in a way that does not change the ratio of standing charges to unit charges?**

Yes, EDF agrees that the current ratio should be retained. This will ensure there aren't any demographical changes to how the EBIT allowance impacts on energy customers, whether low or high users, as any change to the ratio of standing charging to unit charges would entail.

**EDF Energy**  
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