Marzia Zafar
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

Email : priceprotectionpolicy@ofgem.gov.uk

28 June 2023

Dear Marzia,

Price Cap Statutory Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT)

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 price cap statutory consultation on amending the methodology for setting the EBIT allowance in the Default Tariff Cap (DTC). 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.

A healthy and resilient energy retail market

In the interests of current and future consumers, Great Britain needs a healthy, well-functioning and resilient energy retail market. As previously discussed with Ofgem, this means a market where a diverse range of efficient and sustainable businesses can attain a fair margin and attract investment to drive improvements in customer services, innovate and support net zero solutions that deliver value for consumers.

If this is not the case and investors are not confident in the future of the retail market, further market exits are likely, while new entry will be discouraged. This will result in less competition, less innovation, less investment in new products and services that advance the Net Zero ambition, poorer customer service and, inevitably, increased costs to consumers.

EDF Energy
90 Whitfield Street
London W1T 4EZ
Tel +44 (0) 00 0000 0000
Fax +44 (0) 00 0000 0000

It is, therefore, 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.

Views on Ofgem's approach and modelling

With this in mind, EDF welcomes many of the changes that have been made to Ofgem's December's 2022 proposals, namely acting on the need to reflect the increased systemic risk environment that suppliers are facing by updating the proposed asset beta. It is also welcome that Ofgem have shared their Working Capital model to help ensure Ofgem's methodology is finalised using the most rational and pragmatic of approaches and that evidence-based decisions are made.

However, in the limited time available, having reviewed Ofgem's proposed approach and model, it is clear that further changes are required if Ofgem's proposed approach is to correctly reflect the capital needs an independent notional supplier would face in a 1 in 20-year price shock environment.

EDF has worked in collaboration with Energy UK who have retained Charles River Associates (CRA) to produce an independent analysis of Ofgem's approach and model. The report identifies and focusses on two key areas where Ofgem must make changes to the assumptions within their model to ensure it produces a fair and reasonable EBIT allowance. These relate to Working Capital requirements and Ofgem's approach to estimating collateral capital.

EDF fully agrees with CRA that '*The average working capital maintained determined for the notionally efficient supplier (working capital contribution to the EBIT allowance) in the model, as well as the collateral contribution to the allowance, have been misrepresented*[1]'. We would urge Ofgem to urgently review the model based on CRA's well evidenced points and act on the clearly outlined actions suggested in Section 7 of the report.

In addition to the above, we have identified a number of further amendments to the model which are also required. These can be summarised as:

- **Scalable Percentage:** The 1.4% is proposed to remain static moving forward, after having been initially derived from a view of costs where prices are higher than has been seen or may be expected to be in future. It would be fairer and more accurate to use an average price over a longer measurement period to avoid distortion arising from the use of a very short measurement window.

- **RO ringfencing:** As these costs are only relevant for electricity accounts it is irrational and unfair to smear such costs across both the gas and electricity customers. Ofgem must urgently amend this, so all such costs are recovered from

[1] Charles River Associates (2023) A report on Ofgem's proposed changes to the EBIT margin Allowance, Section 7

electricity accounts only. EDF supports such costs being placed on gas in the medium term, to support Net Zero ambitions, but until this is implemented suppliers must be able to be reimbursed for costs they face on each fuel.

- **Zero cash:** The notional supplier model is built on the concept of perfect knowledge. Therefore, the model should provide for a theoretical return in all years – including the 1 in 20 price shock year, otherwise the level of return estimated is incorrect for the level of investment required under the model. Having this perfect ability to manage cash to zero means that suppliers must be able to pay a dividend. Alternatively, in an uncertain reality no financially responsible supplier would allow their cash position to go to zero (as is estimated in the model) and directors would have a duty to seek to exit the market or seek further investment (requiring greater return than allowed in the model) if they were expecting this to happen. At a zero cash position any further shock would result in insolvency and Directors have a duty to ensure this does not happen in an unplanned way. Either way, the opening working capital position is insufficient as it needs to either allow the returns to shareholders and cash to be managed to zero, or for the supplier to hold a cash buffer against uncertainty. The current methodology is an incorrect hybrid of the two where the notional supplier's returns are used to subsidise the working capital calculation.
  The model must provide an out-turn that allows for all suppliers to be able to stay solvent, including small suppliers. Therefore, Ofgem must not optimise the model to the degree that either dividends are not provided some years, or it is expected that a supplier can move to a zero cash position and not become insolvent.

- **Unrealistic assumptions:** The model assumes that all direct debit payments will be updated each quarter to reflect the latest price. This will not be possible for an independent notional supplier in all instances. Ofgem must allow for a more realistic lag for payments to be updated if the model is to accurately reflect the realities of being a supplier.

We provide more detail and evidence for each of these points in the attached appendix as part of our responses to the Statutory Consultation's questions.

We note that this work is also being carried out at the same time as reviews of related DTC allowances – to allow for the recovery of efficiently incurred OPEX costs and bad debt. It is key that Ofgem take a holistic approach to all such work to ensure that all costs are fairly reflected within the cap and that it considers the actual financial outcomes suppliers can achieve as a result. For example, Ofgem must recognise within the DTC that debt exponentially increases where prices increase beyond a certain point, due to increasing affordability issues for consumers. During a prolonged wholesale price spike, the working capital model assumes that supplier bad debt costs are sufficiently covered by the cost allowance. In reality they will increasingly worsen as prices rise. Whilst this will impact the debt allowance it also leads to greater working capital needs under the Working Capital model.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact Steven Eyre or myself. I can confirm that this letter and appendix may be published on Ofgem's website.

Yours sincerely

John Mason
Senior Manager (Price Regulation and Market Dynamics)

Appendix

EDF Response to Price Cap – Statutory Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT)

Question 1: Do you agree with our assessment for the case for change? Please explain your reasoning.

Whilst EDF agree that the EBIT methodology should reviewed there are a number of components of the Working Capital Model which must be updated before any changes are implemented. Having, in the limited time available, reviewed the model, it is clear that further changes are required to ensure that it is fit for purpose and accurately reflect the working capital needs an independent notional supplier would face in a 1 in 20-year price shock environment.

These are summarised in our covering letter and detailed below under the most relevant questions.

Question 2: Do you agree with our approach to estimating fixed assets? If not, why not? Please explain your reasoning.

No.

The approach taken to reflecting these costs within the model do not appear to be wholly rational. In particular, the 'Fixed' portion of EBIT allowance of £19.2/account in relation to the allowance from RO ringfencing. This is worth c. £8.2/account and is recovered through both electricity and gas accounts. For a supplier like EDF with three million electricity customers and two million gas customers on price cap prices, this would leave us in a situation of only being able to recover c. £20.5m of our c. £24.6m cost of RO ringfencing. To remedy this situation and ensure that an efficient supplier is able to recover their costs, ***Ofgem must ensure that all RO ringfencing costs are solely recovered through electricity rates***.

EDF supports such costs being placed on gas in the medium term, to support Net Zero ambitions, but until this is implemented suppliers must be able to be reimbursed for costs they face on each fuel. We would urge Ofgem to work with government to ensure policy costs are moved to gas from electricity and that the EBIT methodology then reflects that, once implemented.

Question 3: Do you agree with our approach to estimating working capital? If not, why not? Please explain your reasoning.

No.

The draft working capital model assumes that during the period of a price shock, cash representing previous profits will be used to build resilience rather than being distributed to shareholders. This is incorrect as the annual return to shareholders should be based on the capital employed, and not whether the liquidity associated with it has been used or not. Effectively this assumption means that prior returns are being used to artificially lower the working capital requirement in the model. The working capital model should set the amount of risk and working capital required consistent with the returns in the Price Cap, therefore it is outside the scope of the model to determine that a return to shareholders would be suspended, and this assumption must be corrected. This is because there is no reason in the notionally efficient supplier model for the supplier to not pay a return to its shareholders as it can perfectly manage its cash position.

Without removing this assumption this implies that the notional supplier cannot make a return in 1 in 20 years, as the return made is used to subsidise the working capital requirement. This means suppliers can only ever achieve 95% of the return (on average) that Ofgem have calculated as required for investment to be sustainable.

To address this problem, Ofgem must either build in a theoretical dividend based on previous 12-month period return, or alternatively increase the floor amount of cash above £nil (at all times) to represent the delayed future dividend that would be paid once the price shock was over.

This is essential to ensure that the model provides an out-turn that allows for all suppliers to be able to stay solvent, including small suppliers. Therefore, Ofgem must not optimise the model to the degree that either dividends are not provided some years, or it is expected that a supplier can move to a zero cash position and not become insolvent

This is a technical point of principle, but one that is necessary to ensure the consistency of the model and the returns that are made over time for the notional supplier.

In an uncertain reality no financially responsible supplier would allow their cash position to go to zero (as is estimated in the model) and Directors would have a duty to seek to exit the market or seek further investment (requiring greater return than allowed in the model) if they were expecting this to happen. At a zero cash position any further shock would result in insolvency and Directors have a duty to ensure this does not happen in an unplanned way.

Either way, the opening working capital position is insufficient as it needs to either allow the returns to shareholders and cash to be managed to zero, or for the supplier to hold a cash buffer against uncertainty. The current methodology is an incorrect hybrid of the two where the notional supplier's returns are used to subsidise the working capital calculation.

Furthermore, there is the unrealistic assumption of perfect operation made in the model for how quickly and comprehensively suppliers could update their direct debit payments to always accurately and immediately reflect the latest price cap level. This will not always be possible for an independent notional supplier in all instances. Ofgem must allow for a more realistic lag for payments to be updated if the model is to accurately reflect the realities of the market. For example, ***Ofgem could include a percentage of accounts where payments lag before being updated for a period of one or two months.*** This would be more realistic of the reality that a supplier would face e.g., a number of customers will not want to increase direct debit levels immediately, or there may be other constraints around how quickly and how often this can be implemented.

As outlined in our covering letter we would urge Ofgem to review the CRA report and those key aspects relating to working capital. These are set out in Section 7 and are[2]:

- Inconsistency in time periods used in the optimisation of the supplier's financial position (two years) and averaging of the working capital maintained (one year), and failure to recognise the working capital held by the notionally efficient supplier reaches £167 per customer under its model;

- Unrealistic zero minimum cash requirements for the supplier to continue operating during the price shock;

- Unrepresentative modelling, in magnitude and shape, of the 1-in-20 price shock that the notional supplier could experience.

To overcome these issues CRA outline potential solutions and we recommend that Ofgem take action in relation to the following:

- Extend the averaging period for working capital maintained from the period of the price shock (one year) to the full two-year period of the model;

- Introduce a cash constraint to the model to cover potential unforeseen operational expenditure requirements during the peak of the price shock;

- Re-run its SWPM model with a set of assumptions that is more representative of the price shock observed over 2021/2022.

Question 4: Do you agree with our approach to estimating collateral? If not, why not? Please explain your reasoning.

No, EDF does not support the approach to estimating collateral. ***CRA have produced an independent report which evidences the reasons for this with recommendations on how this should be updated.***

[2] Charles River Associates (2023) A report on Ofgem's proposed changes to the EBIT margin Allowance, Section 7

Within this report CRA outline that Ofgem's approach to calculating the collateral levels is misrepresentative of real-world capital requirements needed to cover supplier trading positions in that[3]:

- Direct observations of collateral costs are a more accurate estimate of other unobservable features of trading agreements between suppliers and trading companies.
- The averaging approach risk misses peak collateral requirements and conflicts with the more likely approach taken by suppliers to arrange sufficient funding to cover peak requirements, as opposed to the average.

Therefore, Ofgem needs to re-assess its assumption that a notionally efficient supplier would not be able to access the market itself but rather would always do so through an intermediary, as this creates a significant risk of under-funding actual collateral requirement under the cap.

Question 5: For suppliers trading via an intermediary, how has your wholesale collateral requirements changed since October 2022?

EDF's trading partner is EDF Trading Ltd. EDF Trading is the market-facing entity for EDF Group. It provides exclusive wholesale market access to power, gas, carbon and coal markets (with the exception of within-day continuous power and gas, and day-ahead power, where EDF Energy can transact on the Nord Pool Spot and EPEX Spot power markets and ICE OCM gas markets in its own right). EDF Trading does not require EDF Energy to lodge collateral.

Question 6: Do you agree with our proposals on cost of capital? Please explain your reasoning.

No, there are two areas where the model either does not appear to take a consistent approach or where more clarity is required.

Our analysis of Ofgem's model suggest that the 'Nominal UK Government gilt yield' uses a March average which has been used on an unrounded basis. However, for the 'Index-linked UK government gilt yields' figure is then rounded to two decimal places. This is an inconsistent approach and makes it more difficult for suppliers to estimate future price cap levels (to allow for timely planning to mitigate any customer impacts). Therefore, ***EDF request that Ofgem take a consistent approach to such rounding and clearly communicate their approach.***

Of even greater concern, however, is how Ofgem have calculated the CPI-RPI wedge figure as we have been unable to accurately replicate the approach that has been taken. Therefore, we ***request that Ofgem share the calculation methodology behind the CPI-RPI Wedge prior***

[3] Charles River Associates (2023) A report on Ofgem's proposed changes to the EBIT margin Allowance, Section 7

to any final decision. This is particularly impactful as it will not be updated ahead of the Q4-23 price cap period.

Question 7: Do you agree with our approach to setting and scaling the EBIT allowance? Please explain your reasoning.

No.

EDF does not support the approach taken as this is based on only using prices from Q4-23. As this scalable percentage is not proposed to be updated each quarter, it is irrational to use a such a short measurement window to set the scalable percentage. ***EDF would urge that the scalable percentage is calculated using a longer average period which would more accurately and fairly reflect energy costs faced by the notional supplier in the medium term.*** For example, an average of energy costs over a five-year period from the period when the price cap was introduced e.g., January 2019 – December 2023. It is essential that Ofgem move to using an average energy cost figure over a medium period or there could be perverse consequences e.g., if there is a spike in prices around the period which Ofgem are planning to use.

Similarly, it is essential that Ofgem always use the most up to date TDCV figure in their price cap methodology. ***Ofgem should confirm that they will always use the most up-to-date methodology to provide confidence to suppliers.***

Question 8: Do you agree with the conditions which may trigger revisiting the EBIT allowance parameters or its methodology? If not, why not? Please explain your reasoning.

It is welcome that Ofgem has recognised that conditions could require the EBIT allowance parameters or its methodology to be updated. However, ***EDF would request clarity and certainty on the conditions which would trigger a review to take place.***

It should also be noted the length of time that has been required for the current review. We would, therefore, welcome Ofgem clarifying that a more focussed review of any specific aspect of the model could take place and under what conditions such activity would take place.

EDF Energy
June 2023