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Dear Dan

Price Cap: Additional debt-related costs allowance policy consultation

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 because of continued market volatility and high prices, and operating under the 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 that allows efficient and sustainable businesses to attain a fair margin and enable continued innovation and investment to the benefit of consumers. The ability of suppliers to recover their efficient operating costs, including those associated with increasing levels of debt, in meeting their regulatory requirements and the needs of their customers forms a vital part of this work.

On this basis we welcome Ofgem's monitoring of the evolution of debt-related costs relative to price cap allowances for an extended period and consideration of the need for an adjustment to reflect any material gap between supplier costs and the existing cap allowance.

Adjustment to the price cap

EDF is supportive of Ofgem initially introducing a temporary adjustment to the price cap to account for additional debt related costs from April 2024 for an initial 12-month period. Ofgem's own analysis of the supplier data that has been provided through RFIs has shown that there has been a divergence between debt-related costs (on a weighted average basis) and the existing price cap allowances across periods April 2022 – Jun 2023.

Further, Ofgem considers that this divergence is material, and unlikely to be offset by any over allowance in the medium term. On this basis, the case for an adjustment to the price cap against Ofgem's test of whether a change in the costs facing suppliers is material and systematic, considering the market as a whole has been met and an adjustment should be made accordingly.

We are also supportive of Ofgem extending the scope of its analysis to another quarter of costs (i.e., Q3 2023) within any adjustment. It is in the interest of customers to allow suppliers as a whole to recover efficiently incurred costs, as it ensures that that they are adequately funded for the services they provide and reduces the risks of supplier exits and mutualised costs.

However, the indicative data used is, in our view, misleading and could lead to sub-optimum decisions. It is important that Ofgem avoid back loading the true-up by underestimating the scale of the issue at the outset. Specifically, Ofgem appears to have disproportionately relied on the first two RFIs which were likely heavily impacted by Energy Price Guarantee (EPG) and Energy Bill Support Scheme (EBSS) payments to show no material deviation from the allowance. The third RFI did show a need for an additional allowance and a further fourth RFI for Q3 2023 is likely to show a greater deviation. Ofgem need to ensure that they have fully considered the impact of latest RFI data and provide aggregated views of impact of different benchmarking approaches so stakeholders can consider and engage with them productively.

More broadly, while welcoming this intervention further work is needed to ensure that the cost and impact of debt levels can be minimised whilst supporting customers, for example through the provision of smart meters and ensuring they are on the most effective payment method, such as PAYG, to support customers in managing their energy costs.

A holistic approach is required where a balance is developed to minimise the debt costs that all households contribute towards whilst providing appropriate support to those who struggle to pay for energy. Based on Ofgem's own estimates households on the default tariff cap and cash/ cheque payment terms are paying c£115 towards recovering debt costs (c£18 for DD and Prepayment)[1].

Ofgem must consider how such costs can be minimised whilst also protecting financially vulnerable customers. Sensible suppliers will take an integrated approach where debt paths are appropriate to each customers individual circumstances to support customers staying out of debt. This may require more efficient focus and funding for debt paths, adequately reflected in the price cap recovery, but which could ultimately reduce overall debt levels. Ofgem must work with suppliers to ensure that this is a key focus so that a sustainable model can be developed which is recognised by all customers as appropriate and proportionate and to ensure that consumers support the steps taken by suppliers to minimise debt overall.

[1] [1] Standard meters, typical domestic consumption value and including VAT.

Benchmarking
In terms of an appropriate benchmark of bad debt costs Ofgem should move away from using a lower quartile approach and adopt an average benchmark approach. Ofgem has already adopted such an approach under the price cap for other allowances such as smart metering, COVID-19 and additional support credit (ASC) bad debt costs. Ofgem's previous reasoning for a weighted average approach as opposed to a lower quartile approach have included a weak link between a supplier's efficiency and its costs and other contributing factors such as customer base and other external factors. We consider that the same reasoning should apply for setting a benchmark for additional bad debt costs. A further risk of using a lower quartile approach could be the inclusion of supplier costs that while lower are associated with poor standards of service, including around debt. An 'efficient' benchmark used to set an adjustment needs to appropriately recognise the level of cost associated with delivering a good standard of service and the costs associated with managing debt effectively.

In determining what form of average benchmark (i.e. weighted or flat etc) should be adopted, it is important that Ofgem also takes a fair industry view of any data provided. For example, the market currently has two very large retail suppliers and so utilising a simple weighted average across all suppliers could give an outsized impact from their approach which could distort any data that is aggregated at an industry level (potentially due to issues such as customer mix and scale advantages). Due to this it may be preferable to use a flat average approach instead. This is because Ofgem is trying to determine how suppliers in general have been impacted and so giving each suppliers actions equal weighting could achieve this more accurately.

However, as the data gathering has yet to be completed, EDF would recommend that Ofgem carry out such analysis using both, and any other approach that may be suitable. Ofgem can then seek supplier feedback on these approaches and the potential positives and negatives each will hold as part of the statutory consultation stage.

Implementation of an adjustment
In considering how to make any adjustment in order to address the uncertainty around actual costs and timely recovery by suppliers of its efficient costs, we are supportive of Ofgem introducing an adjustment from April 2024 using a float and true-up approach. There remains significant uncertainty as to how actual debt-related costs will evolve this winter and beyond. Providing an allowance through an initial float and adjusting this at a later stage as and when more accurate data on outturn debt-related costs materialise is a sensible approach.

While supportive of a true-up approach for a temporary adjustment, we recognise that it can be timely and complex, as demonstrated through the COVID-19 true-up process. Therefore, Ofgem should work with suppliers to ensure any such process is efficient and timely.

Alternative approach to cost recovery
In the short term, it is important that any changes needed to ensure efficient suppliers can fairly recover additional debt costs they have or are likely to face are quickly and effectively undertaken. However, continuing to use the price cap as a means for suppliers to recover their efficient bad debt costs is flawed. EDF in its response to Ofgem's earlier call for input on

allowance for debt-related costs[2] called for consideration of a levy approach that would address two key moral hazards (i.e., customers moving to fixed tariffs and avoiding costs or suppliers unable to fully recover costs through customers moving to other suppliers) that could be realised as the market reopens and more competitive tariffs and switching levels resume.

Consequently, while we are supportive of a temporary adjustment to the price cap, we continue to urge Ofgem to concurrently undertake a much broader review of the need for an enduring solution to the recovery of debt-related costs that better protects the interests of both suppliers and all customers.

Wider sectoral impacts and investability

More broadly, there is also a need to consider the profitability of the sector over an extended period, in addition to each individual cap period and review of each individual allowance. It is essential that we return to a sustainable, resilient and investable market capable of helping Britain achieve Net Zero. Ofgem must be careful not to over engineer any cap amendments due to short term impacts where these will be countered by longer term trends e.g., costs related to managing customer demand. The sector needs a period of stability after a traumatic few years. A resilient sector which has confidence in its ability to innovate and invest is what will bring the greatest consumer benefits in the medium to long term. To this end Ofgem must also ensure it is considering all adjustments impacts on supplier profitability at a holistic level to ensure the overall cap level is sufficient to provide investor confidence in the sector.

As previously discussed with Ofgem, if investors are not confident in the future of the UK domestic energy retail market, further market exits are likely and 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, costs to consumers. Restricting choice and increasing costs does not protect consumers.

EDF's key aim is to work constructively with Ofgem to develop and introduce measures that promote a healthy, well-functioning market. Such a market should allow efficient and sustainable businesses to attain a fair margin and enable continued innovation and investment to the benefit of consumers. The price cap, as Ofgem acknowledge is an imperfect instrument in this regard and one that drives additional risk for suppliers and costs for consumers. It is critical, therefore, that Ofgem, together with Government, also urgently explore regulatory change that can provide confidence to responsible investors that an appropriate and fair return can be made in this market whilst at the same time the right consumer protections are in place.

[2] Price Cap: Call for Input on the allowance for debt-related costs – EDF Response; 15 May 2023

Our response to the detailed questions set out in the policy consultation can be found in the attached appendix.

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 may be published on Ofgem's website.

Yours sincerely

John Mason
Senior Manager (Price Regulation and Market Dynamics)

Appendix
Price Cap: Additional debt-related costs allowance policy consultation

1 Do you consider that we should make a temporary adjustment to the price cap to account for additional debt-related costs?

Yes. Ofgem's own analysis of the supplier data that has been provided through RFIs has shown that there has been a divergence between debt-related costs (on a weighted average basis) and the existing price cap allowances across periods April 2022 – Jun 2023.

Further, Ofgem considers that this divergence is material, and unlikely to be offset by any over allowance in the medium term. On this basis, the case for an adjustment to the price cap against Ofgem's test of whether a change in the costs facing suppliers is material and systematic, considering the market as a whole has been met and an adjustment should be made accordingly.

While supportive of a temporary adjustment for additional debt-related costs, it is important that Ofgem as part of its broader operating costs review and allowance adjustments, also consider the more enduring impacts on both the cost to collect debt and suppliers' ability to collect debt, including for example as a result of the new involuntary PPM supply licence condition changes.

2 Do you think that suppliers cost due to the moratorium on involuntary PPM installation should be included in the adjustment?

Yes. We see no reason why any additional costs associated with suppliers complying with the moratorium on involuntary PPM installations should be excluded. We note that Ofgem comment that "*a supplier who has been in breach of standard licence conditions historically may see a larger increase in debt-related costs due to the moratorium, compared to other suppliers. Such a supplier may have made greater use of involuntary PPM installation, and the moratorium could lead to upward reassessments of previous provisions. In this case, using the suppliers' data could lead to us overstating efficient debt-related costs in the cap periods following the moratorium".* While in theory this may true, Ofgem could account for this in any benchmark by excluding data from suppliers who had been found in breach of the relevant standard licence conditions (NB – we are not currently aware of Ofgem actually having found any supplier in breach of the previous rules). It would not be fair to artificially reduce all suppliers' additional costs as a result of a theoretical assumption that some non-compliant suppliers could have a larger increase in debt-related costs due to the moratorium.

3 Do you agree that any adjustment should be made using the existing price cap mechanism, rather than a bespoke levy or other new mechanism?

In the short-term we are supportive of a temporary adjustment to the existing price cap mechanism to reflect any additional debt-related costs. As this is likely to allow for a timelier recovery of such costs compared to any other new mechanism. However, continuing to use the price cap as a means for suppliers to recover their efficient bad debt costs is utliamtly flawed. We continue to urge Ofgem to concurrently consider a better enduring approach (such as a levy) for market-wide debt related costs that would address two key moral hazards (i.e., customers moving to fixed tariffs and avoiding costs or suppliers unable to fully recover costs through customers moving to other suppliers) that could be realised as the market reopens and more competitive tariffs and switching levels resume.

4 Do you have any views on whether it would be appropriate to explore a specific levy mechanism for DNI ('do not install') customers? This would be separate to any adjustment for additional debt-related costs.

As set out in our answer to Q3 above, we are calling for Ofgem to consider a levy approach for market-wide debt related costs. On this basis, our preference would be for this to be broad in scope and as such include costs associated with DNI customers, as opposed to the development of a specific levy mechanism for DNI customers only.

5 Do you agree that we should make an initial float adjustment in April 2024, followed by a later true-up? Do you agree it should be included within the cap for a 12-month period? Do you agree that this allowance should be temporary only?

In considering how to make any adjustment in order to address the uncertainty around actual costs and timely recovery by suppliers of its efficient costs, we are supportive of Ofgem introducing any adjustment from April 2024 using a float and true-up approach. There remains significant uncertainty as to how actual debt-related costs will evolve this winter and beyond. Providing an allowance for a 12-month period through an initial float and adjusting this at a later stage as and when more accurate data on outturn debt-related costs materialise is a sensible approach.

We agree that this allowance should be temporary subject to Ofgem developing a more enduring market wide solution that addresses the two moral hazards as described above in answer to Q3 and Ofgem addressing the enduring increases in supplier debt-related costs (e.g. as a result of the new rules around involuntary PPM) through its ongoing review of operating costs.

6 Should the debt-related costs allowance, if introduced for the April 2024 price cap, be subject to a later true-up, and if so, when should this adjustment occur?

Yes, see answer to Q5 above. As Ofgem state there is a potential trade-off between timeliness of any true-up, and its accuracy at reflecting efficient costs only. We consider a prudent approach would be to commence a true-up process when there is sufficient confidence in the data that will be available at that time. On that basis we consider the process should commence towards the end of 2024, particularly if Ofgem are to adopt a single wider true-up approach that covers both this allowance and the allowance for an additional support credit (ASC) bad debt costs.

7 Do you agree that we should carry out only one wider debt-related costs true-up?

We agree subject to Ofgem's decision as to when such a wider debt-related costs true-up would take place. Ofgem has previously stated that a true-up process for ASC bad debt costs would commence in 2024, we do not believe that by combining the two true-ups into one review should lead to this timeline being extended.

8 Should the float allowance be uprated to account for inflation, or should we make no additional adjustments?

Yes, the original float should account for inflation. Ofgem argue that not up-rating the float allowance to account for inflation would be consistent with the COVID-19 float allowance. However, inflation levels are far more material now than at the time the COVID-19 float was set and so not accounting for inflation is likely to have a far significant impact on the level of any float set. Waiting for the true-up process, which is assumed to be in later 2024 at the earliest, to account for inflation is likely to result in a significant time lag between costs being incurred and recovery. Under recovery of costs impacts customers and investment by suppliers, as such inflation should be accounted for in the original float.

9 Do you agree with the proposed overarching methodological approach for estimating the existing debt-related costs allowance, and using it to determine whether there has been an over or under-allowance for debt-related costs in 2022/23?

Yes. For the purposes of this temporary adjustment, we agree that where Ofgem need to use 2018 data to apportion allowances, that it will use the best (most precise) data from 2018 where available. When apportioning allowances without precise 2018 data Ofgem should ideally maintain as much consistency as possible between the approach to different allowances that contain an element of debt-related costs. However, we would like to see an alternative approach adopted as part of an enduring solution developed under the current broader operating costs review.

10 Do you have any other suggestions of alterative methodologies or other factors we should consider for how to calculate the debt-related costs over or under-allowance in 2022/23?

No.

11 Do you agree that we should consider each debt-related cost (bad debt, debt-administrative costs, and working capital costs) in scope of this review?

Yes. All elements of debt-related costs are relevant and should be within the scope of this review.

12 Which, if any, of the benchmarking options do you favour?

In terms of an appropriate benchmark of bad debt costs Ofgem should move away from using a lower quartile approach and adopt an average benchmark approach. Ofgem has already adopted such an approach under the price cap for other allowances such as smart metering, COVID-19 and additional support credit (ASC) bad debt costs. Ofgem's previous reasoning for a weighted average approach as opposed to a lower quartile approach have included a weak link between a supplier's efficiency and its costs and other contributing factors such as customer base and other external factors. We consider that the same reasoning should apply for setting a benchmark for additional bad debt costs.

In determining what form of average benchmark (i.e., weighted or flat etc) should be adopted, it is important that Ofgem takes a fair industry view of any data provided. For example, the market currently has two very large retail suppliers and so utilising a simple weighted average across all suppliers could give an outsized impact from their approach. Due to this it may be preferable to use a flat average approach instead. This is because Ofgem is trying to determine how suppliers in general have been impacted and so giving each suppliers actions equal weighting will achieve this more accurately.

However, as the data gathering has yet to be completed, EDF would recommend that Ofgem carry out such analysis using both, and any other approach that may be suitable. Ofgem can then seek supplier feedback on these approaches and the potential positives and negatives each will hold as part of the statutory consultation stage.

13 Do you have any views on which payment method allocation option would be preferable?

In terms of this temporary one-off adjustment, Option 1 which follows the payment method allocation split used for the COVID-19 adjustment, would appear the most appropriate.

14 Do you agree with us allocating other debt-related costs (debt-related administrative and working capital costs) uniformly across payment method?

Yes. Given the constraints on providing data on debt-related administrative costs by payment method and separating non-customer working capital costs by payment method, allocating these costs uniformly across payment method is a sensible approach.

15 How should we apportion any debt-related costs allowance over the unit rate and standing charge elements of the cap only?

For electricity we have a preference of Option 1 which allocates any allowance between the standing charge and unit rate elements of the cap in the same proportions as total costs are currently recovered under the cap. However, for gas Ofgem should consider weighting more of the recovery to the standing charge due to the fact that gas consumption is more uncertain and heavily dependent on temperature and related heating demand.

16 How should we apportion any debt-related costs allowance between fuel and meter types?

Given this is planned to be a one-off temporary adjustment, we suggest that for both fuel and meter type that Ofgem apply an equal allocation. However, this should not necessarily set a precedent for any enduring solution that forms part of the current operating cost allowance review. Due to the more seasonal nature of gas consumption, there is a compelling argument that more debt recovery being carried out via electricity would bring a number of benefits, by spreading such costs more evenly over the year for all customers and giving more confidence for suppliers that their costs will be recovered. EDF would welcome further discussion and consideration of this by Ofgem.

EDF
November 2023