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Dear Dan

Energy Price Cap: Additional debt costs review 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 uncertainty and having to operate under the Default Tariff Cap (DTC). EDF remains committed to working constructively with both Ofgem and DESNZ 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.

We continue to support Ofgem's monitoring of the evolution of debt-related costs relative to price cap allowances over an extended period and consideration of the need for a temporary adjustment to reflect any material gap between supplier costs and the existing cap allowance. Our views on Ofgem's specific proposals in this respect are below. However, continuing to use the price cap as a means for suppliers to recover their efficient bad debt costs is flawed. EDF has previously called for consideration of a levy approach to 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 increased switching levels resume.

Consequently, while we are supportive of a temporary adjustment to the price cap, we urge Ofgem to make timely progress on a broader review and the development of an enduring solution to the recovery of debt-related costs that better protects the interests of both suppliers and all customers, and which is implemented in a period that immediately follows the ending of this temporary adjustment.

Adjustment to the price cap
Subject to our comments above on a long-term solution for debt cost recovery, EDF is supportive of Ofgem's proposal to introduce 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 analysis of the supplier data that has been provided through a series of RFIs (over the period April 2022 – September 2023) together with an estimate for the period October 2023 – March 2024, has demonstrated that there has been a material and systematic net under-allowance of costs under the DTC. On this basis an adjustment is important to ensure that suppliers can recover their efficiently incurred costs.

Benchmarking costs
EDF opposes Ofgem's proposal to use a lower quartile approach in setting an appropriate benchmark of bad debt costs as this will not appropriately address the divergence in costs and the allowance under the cap. Ofgem should continue with its original hybrid proposal and adopt an average benchmark approach for bad debt costs and a lower quartile for administration and working capital.

Ofgem has identified that there is a wide dispersion between the weighted average and lower quartile bad debt costs over the period April 2022 – September 2023 (i.e. £16 Typical Dual Fuel). Ofgem acknowledge that this divergence could partly reflect suppliers' different provisioning methodologies and differences in payment method mix between suppliers. We agree that it should be expected that there will be a range of provisioning approaches that are as a result of each individual supplier's interpretation of the financial responsibilities and as such provide no indication of a supplier's true efficiency. Therefore, it is clear that such a wide divergence is not due to suppliers' varying levels of efficiencies and so it would be more reasonable to take a weighted average on those supplier approaches to determine a benchmark for bad debt costs.

Ofgem's previous use of a lower quartile benchmarking approach for setting allowances under the DTC has predominantly been based around the assumption of targeting efficiency and ensuring that the overall cap level is set for a notional efficient supplier. However, in its proposal for bad debt costs it has failed to illustrate how efficiency is a significant and strong driving factor in the divergence in bad debt costs between suppliers, but rather justifies it on the basis of setting a stringent approach.

We agree that there is a need, in setting an appropriate adjustment, to balance a number of factors including: the level of protection for customers; allowing suppliers to recover efficient costs; ensuring incentives remain for suppliers to effectively manage debt; and supporting investment in the sector. However, Ofgem has failed to illustrate that adopting a lower quartile approach, as opposed to a weighted average for bad debt costs, provides a better balance of such factors and does not overly rely on an assumed efficiency factor as a driver for supplier debt cost differences.

Ofgem has also previously adopted a weighted average approach under the price cap for other allowances where there is a weak link between a supplier's efficiency and its costs and the presence other contributing factors such as customer base and other external factors (e.g. smart metering, COVID-19 and Additional Support Credit (ASC) bad debt costs). Without evidence to the contrary, we consider that the same reasoning should apply for setting a weighted average benchmark for bad debt costs. This would avoid the risk of continued under recovery by suppliers, while recognising that an 'efficient' benchmark used to set an adjustment needs to reflect non-efficiency factors and appropriately recognise the level of cost associated with delivering a good standard of service and the costs associated with managing debt effectively.

Time Period of Adjustment

While the proposed adjustment will cover the period up to end of March 2024 implementation of an enduring to solution to the recovery of debt related costs is currently not expected to be in place until 2025 at the earliest. There remains much uncertainty about the future level of debt-related costs and the potential for ongoing under recovery of debt costs by suppliers under the DTC. Further, there is significantly more risk that debt levels over the next 12 months will remain high, in part due to recent regulatory changes around debt recovery and the tools available to suppliers to manage debt levels efficiently.

It is, therefore, vital Ofgem continues to monitor debt-related costs in the interim period and make further adjustments where necessary. We would suggest that this would be best achieved by including debt related costs incurred by suppliers in the relevant cap periods post April 2024 in the true-up process for the temporary adjustment when updated cost information is available, so as to ensure that suppliers can recover their efficient costs. Ofgem should confirm that this will take place urgently.

Transparency

We remain concerned with the level of available data published by Ofgem and the ability of suppliers to validate Ofgem's decision and process, including the impact of the various benchmarking approaches. This is of particular concern given the significance of the apparent divergence in supplier costs and the spread of the adjustment value across the benchmark approach options. Further if Ofgem is to adopt a stringent approach suppliers need to have confidence and a better understanding of the underlying data that informs such an approach.

However, we recognise that providing some form of confidentiality ring to enable greater transparency would, at this stage of the review process, likely delay the implementation of this temporary adjustment beyond April 2024. On this basis we suggest that concerns around data transparency, including the possibility of data room, should be considered further as part of the later true-up exercise.

Adjustment Setting
We continue to consider that the original float should account for inflation. In not proposing to adopt such an approach, and potentially considering an inflation adjustment when carrying out the true-up, Ofgem previously argued that this would be consistent with the COVID-19 float allowance approach. 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 more significant impact on the level of any float set. Waiting for the true-up process, which is assumed to be in late 2024 at the earliest, to account for inflation is likely to result in a significant time lag between costs being incurred and recovery, even with under-recovery of debt being concentrated in the periods from April 2023 onwards. Under recovery of costs impacts customers and investment by suppliers, as such inflation should be accounted for in the original float**.**

In terms of the proposals to apply the adjustment to only DD and SC on a unit rate basis and allow for recovery of the allowance proportionately to the gas and electricity split of the dual fuel cap level, EDF is supportive of this overall approach in applying the adjustment.

Wider sectoral impacts and investability
More broadly, there continues to be the 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. 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 the impact of all adjustments on supplier profitability at a holistic level to ensure the overall cap level is sufficient to provide investor confidence in the sector.

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 wants 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.

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)