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Dear Dan

### **Energy price cap operating cost review benchmarking working paper**

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, high prices, and operating under 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 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 in meeting their regulatory requirements and the needs of their customers forms a vital part of this work.

On this basis we are supportive of Ofgem performing a review of the operating costs allowance provided under the DTC. The major driver for such a review is the fact that the original baseline costs used to set the operating cost allowance are over six years old and are only subject to annual indexation. It is right, therefore, that Ofgem perform a review to determine whether in the current market suppliers can recover their efficient operating costs.

### **Benchmarking**

Ofgem must recognise that the market has evolved since the DTC was established and they should reflect this in their approach. For example, Ofgem must consider the correct balance in further incentivising efficiency from suppliers whilst ensuring that high and innovative customer service standards are taken forward. If Ofgem overly focus on efficiency, for

example by constantly favouring a lower quartile cost efficiency in different areas, this will make it challenging for suppliers to deliver the ever-increasing levels of customer service standards that customers expect and deserve.

It is vital that the level of allowance is set to one that allows all efficient and resilient suppliers, including small suppliers and those with innovative business models, to stay solvent and deliver high qualities of customer service for customers. On this basis 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. This would allow suppliers to have greater freedom to differentiate how they serve and create value for customers, leading to more choice, innovation and an active market.

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.

However, as all the data gathering has yet to be completed, EDF would recommend that Ofgem carry out their 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 future working papers and consultations.

In our previous response to the Call for Input we set out some high-level key messages that Ofgem needs to consider as part of its operating costs review. We consider these remain valid and are repeated below:

- Striking the right balance between having regard to efficiency and the investment necessary to enable the expected levels of customer service, particularly in light of the continued challenging conditions consumers face.
- The need to ensure that suppliers can recover their efficient smart metering costs reflecting the challenges facing suppliers at this point in the programme.
- How to further incentivise moves to smart through for example cost placement.
- Where cost could be placed on the unit rate, as opposed to the standing charge to better support low consumption consumers.
- The need for a methodology that is clear, simple, and updatable, as necessary, to reflect changing industry costs / to reflect market conditions.
- The creation of a new, separate allowance to cover industry costs that it is updated annually on a pass-through basis.

**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. 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 that impact 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 GB 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.

Our response to the detailed questions set out in the working paper 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

A handwritten signature in black ink, appearing to read "John Mason", with a stylized, flowing script.

John Mason  
**Senior Manager (Price Regulation and Market Dynamics)**

## **Appendix**

### **Energy price cap operating cost review benchmarking working paper**

#### **1. What is your view on how benchmarking options will lead to different outcomes?**

Ofgem must recognise that the market has evolved since the DTC was established and they should reflect this in their approach. For example, Ofgem must consider the correct balance in further incentivising efficiency from suppliers whilst ensuring that high and innovative customer service standards are taken forward. If Ofgem overly focus on efficiency, for example by constantly favouring a lower quartile cost efficiency in different areas, this will make it challenging for suppliers to deliver the ever-increasing levels of customer service standards that customers expect and deserve.

It is vital that the level of allowance is set to a level that allows all efficient and resilient suppliers, including small suppliers and those with innovative business models, to stay solvent and deliver high qualities of customer service for customers. On this basis 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.

#### **2. In terms of achieving these overarching objectives, what outcomes should we focus on through the operating cost review?**

Of the outcomes presented in the paper, Ofgem should focus on promoting sustainable competition, a cap that facilitates high customer service standards and at the same time improves suppliers' resilience to shocks or changes to competitive environment. Ofgem must also recognise that the market has evolved since the DTC was established and they should reflect this in their approach. For example, Ofgem must consider the correct balance in further incentivising efficiency from suppliers whilst ensuring that high and innovative customer service standards are taken forward. If Ofgem overly focus on efficiency, for example by constantly favouring a lower quartile cost efficiency in different areas, this will make it challenging for suppliers to deliver the ever-increasing levels of customer service standards that customers expect and deserve.

#### **3. Are there any other outcomes that we should consider achieving through the choice of benchmarking options?**

Ofgem should avoid perverse outcomes such as setting the allowance too low which could impact the resilience of suppliers and have a consequential detrimental effect on consumers, particularly at a time when the market is still subject to volatile conditions.

It is also important that the cap is set at a sufficient level that allows timely recovery of efficient costs. This would limit the risks of a supplier never being able to recover their full efficient costs over time given the inherent volume risks that suppliers face under the cap. It

would also help avoid the need for future adjustments and true-ups that are both time consuming and complex.

**4. Are there groups of costs captured within the operating cost review that are cross correlated and therefore those costs should be considered and benchmarked together?**

Where core operating costs are substantially fixed over time then these should be benchmarked and set with future adjustment limited to inflation. However, where costs significantly vary over time then these should be isolated and subject to future reviews and adjustments. These would for example include debt costs, smart metering costs and industry code charges and any other new and additional costs that arise from new or amended regulations.

**5. How should we treat costs (ie debt-related costs) that may be more uncertain than other costs?**

See answer to Q4.

**6. Are there any other costs that we should isolate from the total core operating costs? Benchmarking Parameters**

See answer to Q4.

**7. What are your views on setting separate core operating cost allowances for smart meter and traditional meter customers, given the risks we discussed in this section?**

While we accept the principle of separating core operating cost allowances for smart meter and traditional meter customers, we do not recommend that this is undertaken at this stage. Given the current stage of the smart metering programme and a need to better understand where benefits and saving are being achieved, there is clearly a need to look at this more comprehensively and separately to this operating costs review in order to ensure that the benefits of smart metering in terms of operating costs are not being misinterpreted. If this could evidence the operational cost savings that smart metering should bring then this is an opportunity to further the roll out of smart meters by making smart meters cheaper than legacy alternatives.

**8. What other benchmarking parameters do you think we should consider setting separate allowance for?**

See answer to Q4.

**9. What analysis do you think we should carry out in assessing the materiality of non-efficiency factors using the RFI data?**

We see some of the key factors being:

- Geographical presence, tenure, and associated staff costs.
- Investment to achieve key customer outcomes, especially in relation to smart installation, HH settlement, service levels.
- Market forces and demand / supply pressures in parts of our cost base, e.g., smart metering installation costs.
- Cost inflation. Variability is likely due to different contractual mechanisms across supply chain.
- Customer characteristics / demographics. Variability is caused by, for example, contact channel preferences, 'offline' costs (e.g., paper bills).
- Number and type of PSR customers and customers in vulnerable circumstances and associated higher cost of servicing these customers.
- Costs of servicing legacy prepayment.
- Levels of smart penetration.

We note that having a process to reflect these factors where possible within a benchmark metric is more appropriate than managing through periodic adjustments.

**10. What other approach do you think we should take in how we account for non-efficiency factors?**

EDF has no further suggestions at this time.

**11. What is your view on the proxy for suppliers' proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?**

In the event that a social tariff was introduced then this would be a good proxy for suppliers' proportion of high-cost-to-serve vulnerable customers. We agree that currently there is no perfect proxy and acknowledge that using the PSR as a proxy has its limitations. We would suggest therefore that in addition to PSR, Ofgem consider a combination of WHD and Do Not Install (DNI) customers.

**12. What level of stringency of the cap do you think we should consider?**

Ofgem must consider the correct balance in further incentivising efficiency from suppliers whilst ensuring that high and innovative customer service standards are taken forward. If Ofgem overly focus on efficiency, for example by constantly favouring a lower quartile cost efficiency in different areas, this will make it challenging for suppliers to invest and deliver the ever-increasing levels of customer service standards that customers expect and deserve.

**13. How should we account for the impact of the expected regulatory changes mentioned above?**

Ofgem needs to be confident that it is robustly capturing costs associated with regulatory change. It is also important that suppliers are able to recover their efficient costs in a timely manner and that the cap is not consistently under providing, creating a continual need for

future adjustments. Such an approach creates inherent risks for suppliers as this may lead to costs never being fully recovered by suppliers.

In terms of evolving industry charges, we note that Ofgem plan to set a separate cost component for these which we support.

**14. Which option of accounting for the uncertainties in costs driven by upcoming regulatory changes do you agree with? What other options do you think we should use to account for these costs?**

To account for uncertainties that arise from future regulatory changes not captured by the data currently collected, we recommend that Option 3, which would set a looser cap to account for uncertainties on additional efficient costs, is a sensible approach.

**15. How should we account for the limitations in our methodology and the associated uncertainty?**

It is beneficial that Ofgem recognise such limitations which are a facet of the DTC methodology. To account for this Ofgem must not take too aggressive an approach in choosing the lowest possible benchmarks, or combination of these, which would result in reducing the price cap to levels which would impact the resilience of the sector as a whole and its ability to appropriately serve and support its customers.

**16. What approach do you think we should take to set the benchmarks for different operating cost allowances?**

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.

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.

However, as all the data gathering has yet to be completed, EDF would recommend that Ofgem carry out their 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 future working papers and consultations.

We also note that, as per our response to the recent Ofgem call for input on debt related costs<sup>1</sup> 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 the call for input 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. It is essential that work on this is begun with urgency.

### **EDF November 2023**

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<sup>1</sup> Price Cap: Call for Input on the allowance for debt-related costs – EDF Response; 15 May 2023