EDF ENERGY

Ofgem
9 Millbank
London
SW1P 3GE

Email to: retailpriceregulation@ofgem.gov.uk.

26 March 2018

Working paper #1: setting the default tariff cap

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, storage, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

Key points:

- **Ofgem's approach as to how it will test financeability needs to be clearly defined and should be the subject of a separate working paper as part of Ofgem's consultation process.**
- **It is essential that different cap levels are set in order to reflect the different costs imposed by various groups e.g. the cash/cheque to direct debit differential.**
- **Ofgem's periodic reviews need to look at the impact on the market as well as movements in suppliers' costs.**
- **Competitive price benchmarks are unreliable for a number of reasons and are therefore not a valid basis on which to set a cap.**
- **The existing safeguard tariff benchmark has many weaknesses already communicated by stakeholders to Ofgem.**
- **Resetting the reference price used under the existing safeguard tariffs may be a valid approach, but there is a need to ensure it represents sustainable costs levels.**
- **A bottom-up approach is the most appropriate method for estimating an efficient level of costs to set the initial level of the cap and would support an appropriate financeability test.**
- **The CMA's 1.25% margin should be revisited in order to meet the objectives of the default tariff cap, particularly in respect of enabling effective competition and ensuring efficient suppliers are able to finance their activities.**

EDF Energy
90 Whitfield Street
London W1T 4EZ
Tel +44 (0) 20 3219 6911

edfenergy.com

EDF Energy plc.
Registered in England and Wales.
Registered No. 2366852.
Registered office: 90 Whitfield Street
London W1T 4EZ

This correspondence is a corporate communication issued by EDF Energy plc on behalf of EDF Energy Holdings Limited, (Reg. No. 06930266) and its subsidiaries

Introduction

We are pleased to provide our comments on the working paper. Setting the cap in a relatively short space of time heightens the need for robust engagement with stakeholders. This first working paper is a welcome addition to meeting that need. We were also pleased to see Ofgem's 6 March paper setting out stakeholder responses to its paper on providing financial protection to more vulnerable consumers. Many of the matters raised are pertinent to the setting of wider tariff caps and we look forward to working with Ofgem to develop solutions to these.

Legislative framework

We are aware that following a recommendation from the BEIS Select Committee, revisions to the draft Bill were made that require Ofgem to review the level of the cap at least once every six months. The Committee believed this was necessary in order to keep up with changes in suppliers' costs and consumer engagement. As such Ofgem's review should quite rightly also look at the impact on the market and not just the movement in costs. Consequently, we believe Ofgem needs to set out what form of periodic review it will undertake in order to meet the requirements of the Bill.

Number of caps

We would welcome additional clarity from Ofgem regarding the status of the existing extended safeguard tariff (as provided for under SLC28AA) in the event that the default tariff cap is in place by the end of 2018. We are supportive of Ofgem setting a separate vulnerable cap to that of a default tariff cap as we believe this could better facilitate competition under a price cap environment, while at the same time ensure that there is appropriate price protection in place for vulnerable customers. We note through an amendment made to the original draft, a separate vulnerable cap imposed by Ofgem is allowed for under the Tariff Cap Bill ("the Bill") and we would welcome clarity on Ofgem's emerging thinking in this respect.

Financeability

The paper notes that the Bill sets out the factors Ofgem will need to take account of, and have regard to, when setting the level of the cap. While the focus of this paper is on setting the cap to reflect an efficient level of costs, there is no reference to how Ofgem will have regard to ensuring that efficient suppliers are able to finance their authorised activities. This "financeability" obligation goes beyond the scope of the costs that might be used to set the tariff cap, and requires Ofgem to consider the impact of the cap at the licensee level. That is, taking account of all of the other costs and revenues (of authorised activities) including in particular, those arising from fixed price contracts with consumers. The consideration of financeability will also need to assess the risks that a supplier takes (for example by operating in wholesale markets) and the returns needed to fund those risks. In order for Ofgem to have met its obligations arising from the Bill, we believe it is essential that Ofgem sets out how it will test financeability at the licensee level. This is a subject that warrants its own working paper and we encourage Ofgem to include one in its tariff cap programme.

Flexibility to price under the cap

In developing the cap, it is essential that the obligations placed on suppliers (i.e. by licence condition) allow them to price below that cap, for example in order to respond to competitive conditions. Such freedom is consistent with the requirement in the Bill to enable suppliers to compete effectively.

How the tariff cap varies with consumption

We agree that the cap should (a) have a standing charge and (b) linearly scale from nil consumption. Complex solutions should be avoided. In particular, complexity could result in costly IT builds and delayed implementation.

With regard to assumed consumption splits in respect of multi-register tariffs, we have previously noted that policy costs largely vary with consumption, but that the current (PPM and vulnerability caps) do not reflect this correctly. Ofgem makes reference to this issue in its 6 March paper.

Payment methods

We are pleased to see that Ofgem will consider whether to set different cap levels for customers with different payment methods. We believe that is essential that different cap levels are set in order to reflect the different costs imposed by various groups. In particular, customers paying by cash/cheque impose a significantly higher risk of a supplier incurring debt recovery and bad debt costs.

Not reflecting these differences would create a significant cross-subsidy between customer groups which would need justification; and by reducing incentives to pay by direct debit would raise costs for consumers overall (which would not be consistent with the over-arching objective in the Bill to protect the interests of consumers)

The fitting of a smart meter will not change the credit risk associated with the respective customer and is not relevant to this question. As discussed above, payment method price differentials are primarily related to credit risk and the associated recovery and bad debt costs, and not to the costs of the payment method itself.

Price versus cost benchmarks

We do not believe that reference prices provide a valid basis for setting the tariff cap for the following reasons:

- Prices may not reflect costs, including being set at or below marginal price, because a supplier may be pursing an acquisition/growth strategy, for example to attempt to rapidly reach a minimum efficient scale (and so recover its fixed costs). Prices can often also reflect regional growth strategies.
- As prices may not relate to costs, and suppliers may choose to have different margins on gas and electricity, it may lead to a methodology that has the effect of fixing a margin differential between gas and electricity.
- Non-large suppliers benefit from exemptions to various obligations, notably in respect of participation in the Warm Home Discount and Energy Companies Obligation. These advantages can be reflected in their prices.
- Different consumer groups impose different levels of costs and different suppliers have different cohorts of such customers. For example, smaller suppliers are likely to have relatively high proportions of direct debit customers (including customers paying in advance) and so have relatively low bad debt and debt recovery costs.
- The larger companies will have cohorts of deemed customers they are obligated to supply. Deemed customers are highly correlated with increased debt risk. These costs may not be reflected in the competitive and/or default prices of non-large suppliers.

- Prices reflect a supplier's particular wholesale market hedging choices and risk choices, which may in turn relate to a supplier's ability to fund trading collateral.
- The methodology is open to gaming by suppliers who, depending on how the methodology works, could price fixed tariffs upward or downwards to impact the level of the price cap.

Overall, we do not believe that Ofgem can satisfy its obligation to have regard to a suppliers' ability to finance its authorised activities using only a reference price approach. In particular, we note that a level of risk that could be tolerated in respect of the CMA's PPM cap which applies to a relatively small cohort of customers, becomes unacceptable if applied to a wider scope of customers.

Estimating an efficient level of costs to set the initial level of the cap

Our views on the four methods proposed are:

- **A basket of market tariffs** – we believe this is a wholly inappropriate method for setting default prices for the reasons set above.
- **The existing safeguard tariff benchmark** – The base year for the benchmark is now substantially out of date (2015) and not relevant, particularly in light of the issues raised in relation to the setting of the benchmark (for example the non-inclusion of current smart metering costs). Stakeholders have also raised issues with the way the benchmark is updated, indicating that it would not be an appropriate starting point for a wider cap (these are summarised in Ofgem's 6 March paper).
- **An updated competitive reference price** – this approach suffers from the weaknesses discussed above in respect of Ofgem relying on price benchmarks
- **A bottom-up cost assessment** – in our view this is the best approach to ensuring that suppliers can finance their respective activities in light of the (efficient) costs they face because it should explicitly take account of those costs (and an associated margin thereon).

Possible approaches to updating the allowance for efficient costs

Our views on the three approaches set out in the working paper are:

- **Basket of market tariffs** – we do not support updating the cap in relation to trends in a basket of market tariffs for the same reasons we do not believe the initial cap should be set by reference to such tariffs.
- **Periodic review of supplier's costs** – we support this approach. We note that the requirements of Ofgem arising from the Bill to ensure a supplier can finance its (efficient) activities are enduring. Periodic consideration of a supplier's costs is necessary to meet this obligation. Periodic collection of cost information could also facilitate improved comparability of cost reporting (as it has done for the network companies) and so make the process of reviewing and adjusting the cap more efficient.
- **Third party data** – our preference is for
    - Pass-through of wholesale and policy costs (setting an allowance with ex post correction). We note that setting an index for wholesale costs risks distorting wholesale markets as suppliers will be incentivised to buy to the index. This is likely to reduce liquidity for other products/time horizons.

EDF ENERGY

However, this may be hard to avoid if Ofgem is unable to implement a genuine pass through arrangement (i.e. allowing pass through of each supplier's efficiently incurred costs).
    - Pass through of policy costs (setting an allowance with error correction).
    - Use of an index for inflation.

Ofgem notes that use of external indices with their associated simplifications may cause assumed costs to materially diverge from true costs. We agree. Such risks, if imposed on suppliers, would need to be addressed either by some form of correction mechanism, or by being remunerated within the margin in order enable suppliers to finance their activities.

Bottom-up cost assessment

As we note above, we regard bottom-up assessment as an essential part of Ofgem meeting its obligation to have regard to ensuring suppliers can finance their activities.

In collecting costs from suppliers, a requirement to reconcile to the Consolidated Segmental Accounts (for the larger companies) should ensure all relevant costs are covered.

In carrying out a bottom-up benchmarking exercise costs are best categorised in relation to their driver.

Ofgem has recently issued for comment a draft request for information (RFI) in relation to the gathering of different cost and revenue information from suppliers, which is intended to help it design the methodology to be used for setting the cap level. We have noted that within the draft RFI, Ofgem is requesting extensive information about 'buckets' of costs at a very granular level. We believe that in meeting these requirements suppliers are highly likely to need to make a number of assumptions as to how its costs should be apportioned across the low-level cost categories. There is therefore the potential for differing assumptions to be used and a risk that unreliable benchmarks could be compiled using non-comparable buckets of costs. Given this risk, we would like to further understand how Ofgem will use the granular cost information it gathers and how in particular it will avoid the risks described above.

Direct fuel costs

We welcome Ofgem's intention to review in detail the design of the calculation for direct fuel costs and agree that this is particularly necessary if a bottom-up cost approach is used. The list of topics from paragraph 5.33 cover the primary issues and we provide our views on each below.

As a general point, we are concerned about the impact that using such a short period of price observation will have on the dynamics of wholesale energy markets, particularly in electricity. Suppliers of default tariff customers will have no incentive to hedge beyond eight months in advance of delivery and we have evidence to suggest that this is already reducing liquidity in longer-dated products. This will in turn make it more difficult for generators to hedge their output, increasing the risk profile of such businesses.

- **Shaping** – Although this is somewhat addressed by using quarterly products in gas and peak/baseload seasonal products in electricity, there remains a cost of shape which is not accounted for. The expected extra cost could be estimated using standard customer load profiles, combined with a shaped view of forward

prices – in electricity, this could use historic day-ahead auction outturn prices as a basis.

- **Transaction and trading costs** – Trading costs could be estimated by uplifting the underlying energy costs by a suitable percentage. The costs of funding credit/collateral should be explicitly included in an appropriate margin.
- **Forecast error and imbalance** – This is an important factor, particularly as volume deviations tend to be correlated with price. In the recent cold snap in February, suppliers had to manage increasing gas forecasts against within-day and day-ahead gas prices in the region of £2/therm. We recognise that the use of outturn values and a recovery factor could be complex to implement, and so would favour the simpler approach of a general allowance for forecast error, with a periodic review to ensure it is being set at an appropriate level.
- **Smoothing** – We do not favour making the adjustment period of the cap any less frequent than six-monthly due in part to the volume risk highlighted. Note that this volume risk adversely impacts suppliers in both directions; if wholesale prices rise rapidly during a cap period, customers may actively choose the capped tariff and suppliers would have to source extra energy at prices above those allowed for in the cap price. Conversely, if wholesale prices fall rapidly, customers may choose other tariffs, leaving suppliers with hedged energy to sell back at a loss. We suggest the inclusion of an allowance for this risk.
- **Seasonality** – The current model creates a basis risk for suppliers between their financial exposure (from how the cap is set – annual prices) and the physical exposure (purchasing energy for delivery for the six months) which we believe is unhedgeable. We recognise that the intent of using annual prices was to dampen seasonal variation in prices. However, we expect that any such seasonality would be dwarfed by movements in other costs (or in wholesale costs between the six-month observation periods). Therefore, we suggest using only the market prices for the cap period in question, i.e. one season or two quarters. If not, the methodology should include an allowance for this basis risk.
- **Transition** – – In paragraph 5.32, it is stated that Ofgem's current expectation is that it would use a version of the existing model for direct fuel costs, whether the overall approach is to adapt the current benchmark, or a more detailed bottom-up approach. It is likely that suppliers will start to base their hedging on this expectation and so we would urge that in the event you decide to follow a different approach that you provide an early indication of such intent, but also consider how this would affect suppliers who may already be building up costs for the initial cap periods.
- **Price data** – We support the use of a source that provides a robust assessment of wholesale prices and agree that ICIS Heren is one such supplier. However, there are other suppliers of market data and so we would suggest that the index should allow the flexibility to change the source.

<u>Environmental and social obligations</u>

We agree with the issues Ofgem has identified.

<u>Operating costs</u>

We agree with the issues identified in the Working Paper. We make the following comments and observations:

- In terms of identifying benchmark companies, a 'frontier' approach should not be used, particularly if doubts remain about differences in cost allocation and/or cost drivers etc.
- Comparisons between companies with large and smaller smart-metering rollout programmes should be made with care as the level/scale/maturity of their programmes is likely to be different
- As noted above, different customer groups impose different debt costs on suppliers; accounting for these is essential
- Suppliers that have only recently grown may not have the costs of sustainable levels of operations reflected in their historic accounting data
- Some suppliers have unavoidable costs of meeting historic pension obligations – such as those imposed by the Protected Persons regulations
- Suppliers are likely to experience different cost levels depending on their competitive strategies (e.g. charges from price comparison websites)

Transportation costs

We support Ofgem's approach.

Other direct costs

We agree.

Return on capital

We are pleased to see that Ofgem will consider the rate of return to be allowed under the cap. As a key part of meeting the financeability requirement, margin needs to be considered at the licensee level, as well as at the tariff cap level.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact me on 0203 219 6937.

I confirm that this letter may be published on Ofgem's website.

Yours sincerely,

Paul Delamare
Head of Customers Policy and Regulation