Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

Email to: retailpriceregulation@ofgem.gov.uk.

13 April 2018

Working paper #2: market basket

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:

- **We agree with Ofgem's current thinking that a market basket approach is not suitable for setting the initial level of the cap.**
- **Using a basket approach to update the cap level would involve similar challenges and risks to that of setting the initial cap level and therefore is not supported.**
- **The more adjustments made to the basket to address the challenges and risks, the closer the approach becomes more of a benchmark.**
- **We believe a benchmark approach should be adopted from the beginning and is the best way to ensure all relevant costs have been duly considered.**

Introduction

We are pleased to provide comments on the working paper and welcome Ofgem's statement that it will issue further working papers discussing the options outlined in working paper #1. We noted in our response to that paper the importance of Ofgem setting out how it will assess the requirement placed on it by the Tariff Cap Bill to have regard to the ability of licensees to finance their authorised activities in the context of the cap, and we called for a separate working paper on this. This remains our firm view.

Design challenges with a market basket approach

We do not believe the market cheapest tariffs reflect the efficient costs of supplying energy to the customers that will be covered by the government's proposed cap for these reasons:

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

- Such prices will depend on a (large or small) supplier's pricing strategies, which may be short term (pricing at or below marginal cost in response to competitive conditions) or strategic (e.g. new entrants/small suppliers pricing low to win customers in order to achieve a minimum economic scale) and so not reflect the costs and reasonable margin of a sustainable supply company.
- Different companies face different costs, in particular those relating to meeting the requirements of the Warm Homes Discount (WHD) and the Energy Companies Obligation (ECO) - we note that BEIS' recent consultations on these do not include firm proposals to change the threshold at which small supplier exemptions from these obligations apply. It is important that the price cap takes account of the costs that suppliers with >250,000 customers face in meeting these obligations.
- Different cohorts of customers will impose different costs on suppliers. For example, deemed contract customers typically represent a higher debt risk than other domestic customers, imposing higher debt collection and bad debt costs on the relevant supplier. It is likely that new entrant suppliers will have relatively few deemed contract customers compared with the largest companies.
- Fixed tariffs have a different cost and risk profile compared to standard variable tariffs. For instance, fixed tariffs can be accompanied with exit fees and payment default arrangements that seek to de-risk such tariff offerings. Any comparison between fixed and SVT would need to reflect these differences and require adjustments to be made to the benchmark; however, to accurately value such risk measures would be difficult.
- Basing the cap on market prices may influence how those prices are set, and provide opportunities for suppliers to "game" the system - not just for suppliers with a large cohort of capped customers, but for other suppliers who strategically aspire to such cohorts in order to achieve a balanced portfolio of prices (recognising price dispersion as a natural feature of the energy supply market and enduring financeability) and so earn at least average returns.

The nature of competition in different market segments

Ofgem correctly identifies that prices charged to disengaged customers may be above the level of efficient costs and cheapest tariffs may be below. However, there is no discussion of the role (and economics) of price dispersion in retail energy markets (though this headroom paper). This concept is key to the operation of the market, and to setting the cap so that overall an efficient operator can finance its authorised activities.

Differences in supplier costs

We agree with the points Ofgem makes regarding the cost differences between suppliers:

- Subject to the WHD and ECO schemes and those who are not
- Operating in niche market segments
- Adopting different hedging horizons/approaches

We have already noted above, that different cohorts of customers can impose different costs, for example in relation to debt collection and debt write-off costs. While these costs can be recovered through different capped tariffs (cash/cheque versus direct debit price for example) they may not be observed in market cheapest prices where the customer is credit vetted and only offered direct debit prices.

Mitigating the issues through basket design

We note that Ofgem's list of potential parameters is a long one involving many arbitrary choices (such as excluding certain tariffs and not others). Such a list provides, in our view, ample reason as to why market cheapest prices cannot be used to set the price cap (and meet the requirements on Ofgem contained within the Tariff Cap Bill).

Evaluation

Ofgem state in paragraph 3.12 that using a basket based on fixed tariffs might reduce the risk of including the effects of consumer disengagement on the prices of variable tariffs, and might therefore be more reflective of the costs of an efficient supplier. However, to do so would simply involve a further 'distortion' as fixed prices are set at marginal levels that reflect the levels of engagement in fixed contracts. It would therefore not expose the true costs of supply as such marginal prices are set a level under average costs and are not sustainable for the customer base as a whole.

Basing a cap on fixed would therefore not allow suppliers to recover its costs and achieve a reasonable margin. We believe for Ofgem to meet is financeability obligations under the Bill it needs to test the impact of the cap at the licensee level and not just in supplying customers subject to the cap.

As we discuss above, we believe the nature of price dispersion in energy retail markets is a key feature which will need to be addressed in a future working paper.

Further discussion on risks of using cheapest tariffs

Adjusting for loss making tariffs would involve significant additional complexity, as Ofgem correctly notes. For instance, this would also require Ofgem in any adjustment to duly account for marginal cost tariffs which are not loss making, as they contribute to covering fixed costs that would otherwise be borne by the rest of the customer base, but are at a price level which is not sustainable for the customer base as a whole. Such complexities would bring with it the risk of inappropriate outcomes in our view.

Other differences in supplier costs: policy costs

We agree that the more adjustments needed to be made, the more the approach becomes like a benchmark – and so may as well be a benchmark approach from the beginning – i.e. as a cross-reference for a bottom up assessment of the efficient costs and reasonable margin or a sustainable supplier. EDF Energy believes a bottom-up assessment of costs plus margin is the best way to ensure that all of the relevant costs have been considered, with the market basket potentially being used as a benchmark or cross check.

Our current view on using the market basket to set the initial level of the cap

We agree with Ofgem's conclusion.

Our current view on using the market basket to update the cap over time

While changes across different market baskets may correlate over time, this does not mean that such changes will reflect the costs of supplying the relevant capped customers. For example:

- Market cheapest price persistently under-recover indirect costs and may not reflect marginal changes to those costs
- Likewise changes on costs not faced by all suppliers may not be represented or be under-represented in the basket – WHD, ECO and debt costs for example
- The risk of creating a gaming interaction between capped and non-capped prices remains
- Energy prices may be distorted by bundling, for example in relation to smart/digitally enable products and services.

We are not therefore supportive of using a market basket approach to update the cap over-time given similar concerns arise as with using the approach for setting the level of the initial cap.

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