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Working paper #5: Updated competitive reference price

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 are unsure of the benefits of constructing a new benchmark compared with improving on the existing cap approach. Ofgem is right to continue to develop its Option 2 approach.**
- **It is not clear why a supplier should not maximise is profits, and so reduce costs to the efficient level, irrespective of whether or not they operate in the "more competitive segment".**
- **If Ofgem chooses a benchmark from suppliers operating "more in the competitive segment" in order to identify the efficient level of costs, there would be real risks of not capturing efficient costs that suppliers with less engaged customers face (such as a level of bad debt associated with deemed customers).**
- **Ofgem rightly notes that prices may not reflect costs, e.g. if a supplier is pricing for growth. It is important that the benchmark is set at sustainable levels.**
- **There would be an inconsistency in setting the benchmark at the frontier level of efficiency costs and applying a normal rate of return (which should reflect averagely efficient costs in the market).**
- **Suppliers may have chosen different accounting treatments (such as capitalising customer acquisition costs under IFRS15). The choice of benchmark should allow for such legitimate choices.**
- **It is important to understand whether the benchmark companies' wholesale costs reflect an appropriate starting point.**

- **Ofgem will not be able to identify all of the relevant cost drivers – and so its choice of efficient cost levels may not be valid for equally efficient companies (e.g. companies making equally valid choices about the level of customer service). Allowing for headroom can mitigate this risk.**

Reference price approaches

We note that Ofgem is continuing to consider an approach which would involve using the existing safeguard tariff as a basis, with then a number of methodological changes made in order to develop an improved benchmark that is appropriate for the larger scope of customers the cap would apply to. Ofgem assert that the advantage in adopting such an approach is that stakeholders (including Ofgem) will have experience in how the cap operates allowing parties to assess it and understand it fully.

We agree with this position and accept that such experience should allow for a proper assessment as to how the existing cap could be improved. Consequently, we are supportive of Ofgem's ongoing work in pursuing this approach and in particular Ofgem's consideration of appropriate changes that could be made in order to improve the accuracy of the cap calculation. We have, in responding to Ofgem's consultation in December 2017, suggested areas which we consider are most material to improve the cap and note a number of these are referenced in the working paper. Most notably, the treatment of smart costs is referenced and we would, along with the other material areas, welcome further clarity on Ofgem's thinking on these matters.

Below, we provide some specific comments on the updated competitive reference price approach set out in the working paper. However, in comparing the two reference price approaches it is important to acknowledge the additional risks and uncertainty involved with developing a recalculated benchmark. This would include, for instance, ensuring that it had duly considered the differences in efficient costs faced between suppliers operating in the market. Given this, Ofgem would need to establish the benefits of constructing a new benchmark compared with improving on the existing safeguard tariff approach, particularly in the context of the time constraints Ofgem is subject to.

The appropriateness of either reference price approaches in setting a cap level that allows suppliers to recover their efficient costs (and earn a normal rate of return) is highly dependent on the decisions made in respect of adjustments to the benchmark costs.

High level criteria for including suppliers in updated benchmark

We note Ofgem's objective for developing a recalculated price benchmark would be to select suppliers whose average costs are set by the market (i.e. which are "pricing competitively") in order to identify the efficient level of costs. We have two observations on this approach:

- It is not obvious why the level of customer engagement has any bearing on the incentive a supplier has to maximise returns; and

- Ofgem's proposed approach would replace one risk (benchmarking) with inefficient costs levels, for another, namely, missing key differences in costs drivers between target and incumbent suppliers (including the costs faced in supplying less engaged customers).

Ofgem should consider the cost of all suppliers (over a threshold size) making appropriate adjustments in order to duly reflect such differences, including the provision of an appropriate headroom that mitigates any inaccuracies or approximation.

Pricing competitively

One of the criteria Ofgem suggest it could use to identify suppliers who are a reasonable proxy for prices that would be seen in a competitive market would be to look at those suppliers with a high level of customer engagement. However, this would require a number of adjustments to be made in order to reflect the difference in efficient costs faced by suppliers and thereby avoid any inappropriate "apples and pears" comparisons. We have throughout our responses to the previous Working Papers highlighted a concern regarding adopting a frontier approach to identifying a benchmark, given the differences in cost allocation and/or cost drivers. For instance:

- 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. Ofgem refer to an option to focus on those suppliers predominantly having fixed-term tariff customers in selecting suppliers for the benchmark. To do so would be focussing on those suppliers who have probably relatively few deemed contract customers compared with the larger suppliers.
- Costs driven by growth/retention/shrinkage such as sales and marketing costs. Ofgem will need to establish an efficient level of sales and marketing costs to be used in the benchmark, accepting that there will be a divergence of supplier's business strategies across the sector.
- Ofgem will need to be cognisant when making costs comparisons of the potential for suppliers to make different choices (under IFRS15) regarding the manner in which they account for acquisition costs i.e. whether the costs are capitalised or treated as expenses.
- Incumbent suppliers have efficient capex costs that would need to be recovered. This includes IT expenditure, which in some instances would have been driven by regulatory change.
- Some suppliers have unavoidable costs of meeting historic obligations, such as those pension costs imposed by Protect Persons regulations.
- Fixed tariffs have a different cost and risk profile compared to standard variable/deemed 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/deemed 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.

We expressed concerns above about the rationale for excluding the costs of suppliers with cohorts of less active customers as this increases the risk of inappropriate cost comparisons. Use of the numbers of customers on fixed, or the number of customers on SVT for more than three years, would be part of this risk. However, if such proxies are used, Ofgem should avoid the extremes (e.g. suppliers with practically no SVT customers etc).

Relevance as a market-wide comparator

We welcome Ofgem's objective of identifying benchmark suppliers that are relevant as a market-wide comparator and therefore excluding those who are 'outliers' and have atypical business models. However, irrespective of the criteria used to identify the benchmark companies there will be a need for Ofgem to assess the impact of their pricing strategies and make adjustments to their prices in order for them to be more relevant as a market-wide comparator.

For instance, some suppliers may be seeking scale by competitively pricing on a marginal cost basis (i.e. with little contribution to fixed costs). While such pricing may promote growth it cannot be sustainable. This is likely to lead to the need for adjustments to ensure prices reflect sustainable costs. Adjusting for loss making tariffs would involve significant additional complexity, including taking due account for those 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 and undermines the value of using such prices to set the benchmark.

Main cost categories – adjustments/exclusions

Overall Ofgem's proposed costs categories for assessing potential adjustments or exclusions look sensible. We offer the following comments on specific categories:

- Wholesale costs; benchmark suppliers' prices may be a function of short-term movements in wholesale costs reflecting a suppliers inability to hedge further out due to collateral reasons. Ofgem will need to assess the extent to which the suppliers forming the benchmark are representative of a sensible hedging approach. For instance, a longer hedging period could potentially reduce the volatility of the cap for consumers over the cap term.

  We accept that under the cap that hedging across the market may shorten to reflect that the cap level will be updated every six months. However, it is important that in setting the initial level of the cap this reflects the starting position in terms of wholesale cost exposure and is reflective of the notional hedging position at that time.

- Environmental and social costs; we agree that there is a need to reflect the differences in exposure to such costs across suppliers and note that this is the subject of a separate working paper in which we will respond to in conjunction with this response.

- Operational costs; Ofgem's approach of selecting low prices and in particular as a means of excluding those suppliers who are less efficient would appear to be applying a frontier efficiency approach without any certainty that the costs drivers behind such prices are fully understood. Therefore its assessment of efficient cost levels may not be valid for equally efficient companies that have different cost drivers as a result of:

    - Customer type profile
    - Historic IT
    - Position in IT development cycle
    - Pensions
    - Choice of UK call centres
    - Self-service provision

  This risk could be mitigated by the inclusion of an appropriate headroom.

- Payment methods; we agree that Ofgem needs to account of different payment methods in setting cap levels. Applying a separate payment uplift outside the benchmark when calculating cap level is an essential adjustment that is needed. This would, for example, require Ofgem to look at debt costs as part of determining an appropriate uplift. It is currently unclear when and how it would perform this task.

Robustness

Ofgem is right to consider robustness throughout its process.

We agree that the number of suppliers included in the benchmark may be a means of influencing its robustness. It would also likely lead to the benchmark being more representative of the market as a whole. Ofgem are concerned that increasing the number in the benchmark may affect how close the benchmark was to an efficient level of costs. However, in ensuring robustness, there is balance to be made between adopting such a frontier efficiency approach and ensuring that the efficient costs levels are valid for equally efficient companies.

Weighting

We believe that whichever weighting policy is adopted it should ensure that no supplier dominates the benchmark calculation and depending on the criteria Ofgem adopt for including suppliers in the benchmark, this could be a risk under a customer weighting approach.

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

Paul Delamare
Head of Customers Policy and Regulation