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8 October 2018

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Default Tariff Cap – Statutory Consultation

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.

EDF Energy welcomes the opportunity to respond to Ofgem's default tariff cap proposals. This is a fundamental intervention in the market which will have multiple repercussions for both customers and market participants for the long term if the cap is not set at the right level and due regard to the matters set out in the Act has not been achieved.

It is recognised that Ofgem has a difficult task in balancing the contradictory requirements placed on it by the Tariff Cap Act, in particular, the challenge of balancing the overarching requirement to protect domestic consumers, while having regard to the ability of suppliers to compete and finance themselves.

We believe that much has been achieved in developing an appropriate balance, but there are key areas where further work is required. We set out our views on the changes needed in this response.

A summary of key changes needed to achieve the Act's objectives:

1. Financeability

A broader range of suppliers should be financeable – not just those with unrepresentative features (lowest cost consumers/very large scale/very high proportion of default customers). Specifically, there are two key changes that need to be made:

- Ofgem should ensure that suppliers with cost levels at the benchmark level can finance their activities. Ofgem's acceptance that under the cap (para 4.93 of the impact assessment) some suppliers operating at the most efficient large supplier benchmark would, with limited ability to raise their fixed prices, be unfinanceable is not consistent with the financeability test.
- While it would not seem possible to set the cap so that a supplier with any mix of fixed (engaged) and default customers is financeable, Ofgem should ensure the suppliers with around the market (weighted) average mix of fuel, tariff

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type, payment type and regional mix are financeable. This would ensure that typical, rather than outlier, suppliers are financeable.

In assessing financeability, changes in fixed prices after the introduction of the cap can make a substantial difference to the outcomes (as Ofgem recognises in the draft IA). However, in current market conditions the floor price is low and is set by suppliers investing in growth and therefore the ability of suppliers to raise fixed prices in current market conditions is limited. In particular, it is clear that some suppliers are offering very low prices, which at times do not, in our estimation, cover the marginal costs of supply, let alone any contribution to fixed costs and EBIT. It is not possible for suppliers to acquire customers at prices materially above the floor, suggesting that assuming any increase in fixed prices in the financeability test is inappropriate.

The primary focus of the Act is on customer protection. However, we do not believe that customers are protected by denying the ability of efficient suppliers to recover their costs. The consequences of unfinanceable suppliers are far ranging and may include supplier failure and/or consolidation, withdrawal from serving high cost customers, pressure to reduce customer service to statutory minimum and cost reduction programmes through for example offshoring leading to UK job losses.

In terms of any resulting supplier failure this could well increase customer bills through the recovery of costs via the SoLR and Energy Administration arrangements and undermine competition in the longer term. We note that while occasional suppler failure has little systematic impact, widespread failure could have material detrimental impact on consumers.

The level of market uncertainty over time, including the future path of fixed prices, means that Ofgem should continually monitor the impact of the cap on suppliers and be prepared to make adjustments if such suppliers cannot finance their activities despite having efficient cost levels.

2. Operating Costs

The inclusion of a £5 (per dual fuel customer) additional efficiency factor is without a robust basis and comes on top of a cap that does not fund the efficient costs of suppliers in all circumstances. In this context it appears unnecessarily demanding (worsening non-finaceability) and should be dropped.

3. Wholesale costs

Ofgem's changing approach to wholesale market hedging assumptions for the first period of the cap (combined with rising wholesale prices) has resulted in costs that will not be recoverable under Ofgem's proposal. EDF Energy believes its hedging decisions were prudent in the context of a cap being set under constrained timescales and so any indication of proposals that were to become effective in less than seven months' time had to be acted on. Allowance needs to be made to allow suppliers to recover these costs.

4. Unidentified Gas

The proposed allowance for unidentified gas (UIG) of 0.96% is unrealistic. Post Nexus, UIG levels have been volatile and are subject to extensive investigation. Over the period of the cap UIG levels are expected to change. Ofgem should include a "soft" variable for UIG so that it can be updated in line with Xoserve's expectations.

5. Smart Metering

We have identified a number of issues with the smart metering allowance. The BEIS CBA model, overlaid with Ofgem adjustments appears to be overly complex, opaque and lacks robustness. We therefore question the reliability of the current allowance which we believe is likely to understate suppliers' true deployment costs. As a result, we are concerned about the lack of a correction mechanism in the suggested cap implementation.

Our detailed response that explores these changes further is set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Toby Allen on 07875 114310 or myself on 01483 489576.

I confirm that this letter and attachment may be published on Ofgem's website. However, the annex should be treated as confidential.

Yours sincerely,

Paul Delamare
Head of Customers Policy and Regulation

Attachment

Default Tariff Cap: Statutory Consultation

EDF Energy Detailed Response

1. Meeting the requirements of the Act

While the objective of the Act is to protect customers on SVT/default prices it requires Ofgem to have regard to a range of matters, specifically:

- the need to create incentives for holders of supply licences to improve their efficiency;
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

In setting that cap, Ofgem is required to balance a set of requirements that are inherently contradictory for example, protecting customers though lower regulated prices can reduce competition and make it harder for suppliers to finance their activities. EDF Energy recognises that to achieve the best balance is a difficult task.

We think it is possible to set a coherent framework which Ofgem can use to achieve an appropriate balance, but that this has not yet been achieved.

Incentives to improve efficiency

Under the proposed cap, it is clear that only certain suppliers will be able to achieve normal levels of profit. In particular:

- Suppliers with very high proportions of default customers (assuming fixed prices do not increase – see below)
- The very largest suppliers that can spread their fixed costs – we assume the single legacy supplier who can earn positive returns under the cap is also the largest
- Suppliers with atypically low costs (e.g. suppliers with few or no vulnerable customers, suppliers with little bad debt, suppliers with no legacy pension obligations etc) – these suppliers will benefit from the difference between the frontier and lower quartile companies and the headroom allowance.

- Small suppliers benefiting from policy cost exemptions (ECO, WHD) – worth around £38 per dual fuel customer

Large suppliers will not achieve normal levels of profit in 2019 and so will have very strong incentives to reduce costs. In this context, the proposal to apply a £5 (per dual fuel customer) efficient improvement assumption looks unnecessarily harsh. It is adding an additional efficiency factor over and above that already built in to a methodology that sets a cap that underfunds the efficient costs of suppliers with non-extreme business models. The £5 efficiency incentive also appears to be arbitrary and without evidence as to whether it is achievable and over what period.

Furthermore, it takes no account of the material implementation costs suppliers will face given the manner in which the cap has been constructed. For instance, changes to IT systems will be required in order to facilitate the adoption of different standing charges that will apply across the different payment methods.

EDF Energy believes this additional efficiency factor should be removed.

Frontier/lower quartile cost levels

Based on analysis of costs of ten large and medium suppliers in 2017, Ofgem sets allowances for operating costs in relation to the lower quartile supplier (which is also the lowest cost legacy supplier). Ofgem does not base an operating cost allowance on the two lowest cost suppliers because of uncertainty and variation in suppliers' efficient costs.

Ofgem presents the difference between frontier and lower quartile costs as additional allowances to cover uncertainty and variation in efficient costs. An alternative and better approach would have been to exclude the frontier companies from the benchmarking analysis on the grounds that they did not provide a robust comparator for other suppliers given their different customer base and atypical low costs.

In setting allowances for operating costs, Ofgem uses the lowest cost legacy supplier. In doing so, Ofgem has effectively chosen the lowest cost "frontier" supplier from the pool of comparable suppliers (i.e. those suppliers with a range of customers and circumstances).

Ofgem says in its impact assessment that under the cap it is possible for an efficient supplier to achieve normal profits (the level at which it can remain in the market). Given that the frontier supplier does not represent the cost of supply to a range of customers, testing their financeability is, by definition, not representative of suppliers facing different levels of efficient costs (e.g. because of the needs of their customer cohorts). Ofgem should always test financeability at the benchmark cost level.

2. Enabling suppliers to compete

Throughout Ofgem's proposals, reference is made to the possibility for suppliers to raise their fixed prices (e.g. to recover some revenues lost as a result of the cap).

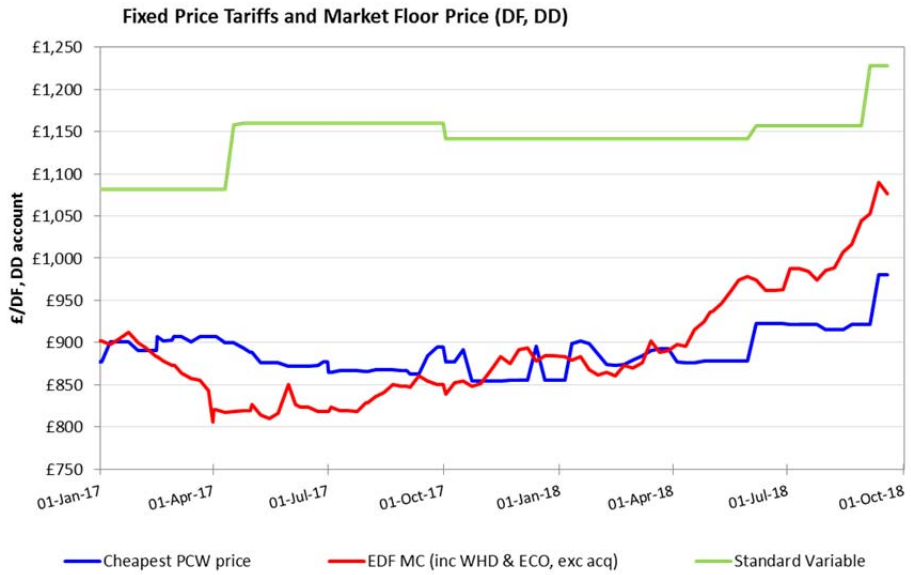
The ability of suppliers to raise fixed prices in current market conditions is limited. In particular, it is clear that some suppliers are offering very low prices, which at times do not, in our estimation, cover the marginal costs of supply, let alone any contribution to fixed costs and EBIT. It is likely that such suppliers are pricing below cost in order to grow and achieve scale.

Such prices set the market floor, and the price customers see on the opening page on price comparison websites. Prices materially above these levels do not attract, or materially retain, consumers. Therefore, the ability of suppliers to raise their fixed prices is very significantly constrained by the market floor. Given the market floor is effectively set by small suppliers' ability and willingness to price below cost in order to grow, it is not clear whether and when this level will rise once the cap is introduced.

In the Draft Impact Assessment, Ofgem appear to argue that between 0% - 75% of the revenue reduction from the cap might be offset by increases in revenues from fixed tariffs. Not only is this a huge range of uncertainty within the proposals, Ofgem also seem to believe that a range of outcomes is equally possible (at one point, Ofgem say that the outcome may be somewhere in the middle).

Such an approach seems fundamentally flawed in ignoring the presence and effect of the market floor in preventing suppliers from raising fixed prices.

The chart below shows the cheapest prices on price comparison websites (PCWs). Also shown is our estimate of prices based on variable costs plus a small (10%) contribution to overheads (in red). EDF Energy standard variable tariffs are shown in green. As can be seen the cheapest prices have been below costs since spring 2018, but tended not to be so in earlier periods.



If suppliers cannot raise their fixed prices, they will not be able to finance their activities unless the cap provides more revenues.

3. Incentives to switch

While under the proposed cap, we agree that some incentives to switch will remain; we believe it is important to understand how those incentives are funded.

There will clearly be some scope to outperform the benchmark costs, by being more efficient, choosing lower cost to serve customers, or by being small enough not to incur social and environmental levies. However, the amount of savings that can be plausibly achieved through these routes is small compared with current market differentials, which appear to be driven by suppliers pricing below cost in order to grow and achieve scale.

It is highly uncertain whether this will persist – and it is not sustainable for any individual supplier in the long term. The cap should be set on a sustainable basis that does not rely (in terms of meeting the requirements of the cap) on suppliers continuing to price below cost in order to deliver competition in the market.

4. Financeability

Under the current proposals, it is clear that many suppliers will not be able to make a normal profit under the cap. The outcome partly depends on whether fixed prices increase – which we think is highly uncertain as we describe above.

Ofgem also appear to assert that movement on operating costs to be on/at the efficiency frontier can offset the potential adverse impacts that might come from starting with various combinations of customers by fuel, tariff type, payment type, and regional mix.

We understand that it would not be possible to meet the customer protection objective in the Act, while ensuring that normal levels of profit can be achieved with any combination of these things. So, the question is what is the right balance to strike?

We do not believe that reductions in operating costs can make up the difference for the majority of suppliers. In particular, it will not be possible for a supplier to service a wide range of customers (such as one of the six legacy suppliers) to achieve the cost level of the frontier companies (which are simply not robust comparators).

The scale of the impact of a supplier's mix of tariff types etc. is typically far greater than any operating cost reductions achievable below the benchmark level. The following analysis illustrates the point:

SVT prices £1000
Non-SVT Prices £990

Supplier A	SVT Customers	Non-SVT Customers	Total
Customers	250,000	750,000	1,000,000
Allowed SVT Profit at benchmark level	4,750,000		
Fixed Customers profit		6,682,500	
Overall EBIT %			1.15

Supplier B	SVT Customers	Non-SVT	Total
Customers	750,000	250,000	1,000,000
Allowed SVT Profit at benchmark level	14,250,000		
Fixed Customers profit		2,250,000	
Overall EBIT %			1.65

In the table above Supplier A and Supplier B both have 1 million customers, have costs at the benchmark level and prices exactly the same at £1000 for SVT customers and £990 for non-SVT customers, just £10 less. The profit made on SVT customers is £19 in line with the allowed 1.9% and so non-SVT customers earn just a 0.9% profit given the lower price.

The only difference between the two suppliers is that Supplier A has 75% non-SVT customers and 25% SVT customers and Supplier B has 75% SVT customers and 25% non-SVT customers. This difference in customer mix results in Supplier A making 30% less profit than Supplier B. Both suppliers are below the normal level of profit that Ofgem and the CMA have said is 1.9%, but the supplier who has more engaged customers is very substantially below that level.

What this demonstrates is Ofgem's current approach would incentivise suppliers to not engage customers and would therefore penalise those who have actively engaged

customers and possess a lower proportion of default customers. Furthermore, it is questionable that with the existence of such incentives how the 'effective competition' conditions for exiting the cap will be met.

We believe a sensible approach would be to set the cap at a level in which the benchmark supplier can earn a normal level of profit at the (weighted) market average mix of fuel, tariff type, payment type and regional mix.

5. Wholesale costs

Setting the first cap allowance

In the May consultation, Ofgem proposed a transitional arrangement, where direct fuel allowance for the first cap period would be set using a different observation window from the one it normally uses to analyse forward contracts. Specifically, Ofgem proposed using an April to September observation period.

Given that the most efficient approach is for a supplier to match the index used by the cap, EDF Energy began hedging using Ofgem's preferred approach.

Ofgem now proposes to revert back to its standard approach for a winter cap period, observing prices offered between February and July 2018 for contracts that would be delivered between October 2018 and September 2019.

Because wholesale energy costs have risen, Ofgem will now be assuming price levels that are no longer accessible and which are lower than those resulting from the signal it gave in May. This needs to be corrected, by either Ofgem reverting back to its May proposals, or by including a bespoke adjustment to the initial level of the cap. We believe that either of these approaches can be achieved by adapting the Wholesale Cost Allowance Model (Annex 2) and would not therefore require a change to the proposed licence condition wording.

EDF Energy believes its hedging decisions were prudent in the context of a cap being set under constrained timescales and so any indication of proposals that were to become effective in less than seven months' time had to be acted on.

As stated by Ofgem, moving the observation window back to February to July, from the previous proposal of April to September, results in a significant reduction of 'more than £30 for a dual fuel SVT customer in annualised terms'. This is a substantial change to make in hindsight after the observation window was over and opportunities to hedge in line with the cap have passed, resulting in a large cost for suppliers to bear.

Additional direct fuel cost allowances

We agree with Ofgem's assessment to include additional allowances for shaping, forecast error, imbalance cost, transaction cost and losses and UIG.

In the case of forecast error, we have two concerns with how the allowance has been calculated.

Forecast error – treatment of customer numbers

The forecast error around customer numbers has not been addressed. The model treats forecast error for a single profile due to weather, etc. As we have highlighted in our previous response, this is both a significant factor and one where wholesale cost movements in both directions will raise costs in a manner that efficient suppliers cannot risk manage or hedge against.

To provide a worked example, suppose that wholesale prices rise such that prevailing prices are 20% higher than prices from the cap observation window for the cap (which is less than the rise recently observed). In this case, fixed tariffs will rise relative to the cap price and lead to greater take-up of the default tariff from renewing customers. We could expect this to increase our volume of customers on the default tariff by 5%, leading to an increase in overall costs of 1% (we must buy for this 5% increase in volume at 20% higher prices).

In the opposite case, if wholesale prices fall by 20%, we would expect fixed tariffs to be more attractive and so could see 5% of customers we expected to be on the default tariff to opt for fixed tariffs. In this instance, we would need to sell back 5% of our volume at 20% lower prices than originally paid, leading to an increase in overall costs of 1%.

This element is not enumerated in the factors you considered in setting the allowance for additional risk and uncertainty (paragraph 3.51 of Appendix 4) and so is another factor of a similar magnitude to the proposed risk and certainty allowance. Thus, we suggest that this allowance is increased by an amount up to 1%.

Forecast error – capture of hourly error

Secondly, we have two concerns relating to your model of forecast error as described in Table A4.3 of Appendix 4 and which we reviewed in the disclosure room.

In calculating the price component of the forecast error for electricity, you first average hourly N2EX prices to a single daily value, then compute the absolute difference to a monthly forward price, and take a further average of those differences. This does not capture the full effect of hourly forecast variability and so we believe it would be more appropriate not to calculate a daily average, but rather to take absolute differences at hourly granularity and then perform the averaging.

In addition, when calculating the monthly forward price, you use the baseload contract price. This is not consistent with the rest of your modelling, e.g. of the shape component and in the forward prices where you use 70% baseload and 30% peak. We believe that it would be more appropriate to use this same mix of baseload and peak prices in calculating the monthly forward price for the forecast error.

Both of these would be a relatively simple change to your existing model.

6. Allowance for unidentified gas (UIG)

Ofgem set out in Appendix 4 that it has made an allowance of 0.96 to cover the costs of unidentified gas.

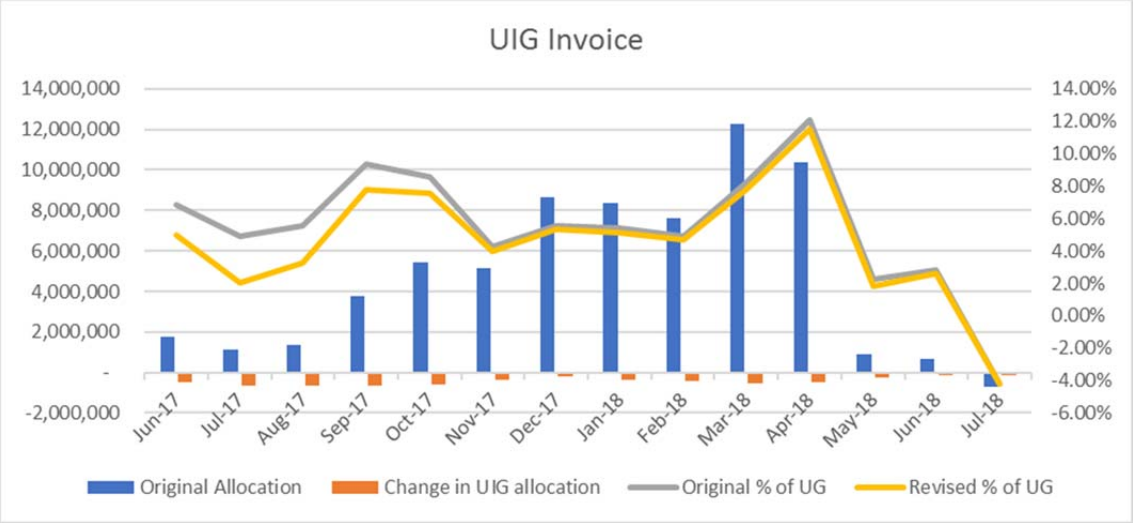
While a 1% allowance would have made sense prior to Nexus (UNC432) under the reconciliation by difference approach, it is not relevant to current arrangements.

Prior to the implementation of UNC432, the industry had become accustomed to permanent UIG of around 1% of throughput. This figure represents the residual amount of gas still unaccounted for at the UNC cut-off date, i.e. after 3-4 years of reconciliation. However, the daily UIG figures since 1 June 2017 have generally been in excess of this and have shown considerable volatility. This unpredictability makes it difficult for gas shippers to determine how much gas they should purchase in order to balance their daily positions. The issue is compounded by uncertainty over how much of the variance between allocated gas and actual consumption will be resolved through subsequent reconciliation, and when this will occur.

Ofgem has recently approved the commissioning of a UIG taskforce, led by Xoserve. The primary objective of the taskforce, as set out in UNC658, is to reduce levels of UIG to less than 4% by 31 December 2018. Ofgem acknowledge, in their decision document, that work needs to be carried out in order to address the root causes of UIG. While we support this approach, Ofgem has itself identified the need to allow more recent changes to the gas settlement arrangements time to fully take effect, for example changes to require more frequent submission of readings. While it is currently uncertain what the eventual level of post Nexus UIG will be, we agree with Ofgem's determination that reducing UIG to 4% would represent a positive step and demonstrate achievement of the UNC objectives. The Taskforce will focus on recommending changes that could be made in order to address UIG. However, industry will then have to consider whether these changes should be made. Any changes will then need to follow the industry change procedures, making it difficult to identify when changes/correction etc will be introduced. What is clear, based on the output from the Taskforce to date, is that UIG will remain volatile and above historic levels for some time.

While we understand Ofgem's view that a number of the current issues around UIG stem from poor data, it is important to note that not all of this data is within the control of suppliers. For example, Xoserve has identified some significant issues relating to the accuracy and reliability of information provided for Daily Metered sites in Class 2. Those Shippers with supply points in Class 2 will be contributing to the issues with UIG, but will not be subject to the Tariff Cap and will therefore be able to make more agile pricing decisions in relation to UIG volatility. Furthermore, in addition to the issues identified by Xoserve in its role as Taskforce lead, industry is still encountering significant issues in relation to reliability of AQ values post Nexus. As of the 27 September, Xoserve is still actively tracking 13 live AQ issues, which will be adversely impacting the reliability of AQs and subsequently the volatility of UIG.

Based on current expert views, EDF Energy is forecasting a UIG value of between three and five percent for 2019. We acknowledge that due to the gas settlement process a proportion of the current UIG volumes will be returned to us via subsequent reconciliation over the coming weeks and years. However, to date we have not seen evidence of significant changes to the UIG volumes through subsequent reconciliation. The issues identified by Xoserve to date suggest systemic problems with various inputs to the UIG calculations. Not all of these issues can be addressed by the submission of extra readings e.g. weather factors. Therefore we would question Ofgem's current thinking that suppliers, with the right behaviours, can eventually recover the costs associated with UIG.



Given the materiality of current annualised UIG levels and the high levels of uncertainty as to where it will end up, we propose that the initial allowance for UIG should be 4% which should be included as an updatable variable within the cap. Ofgem could use forecasts from Xoserve which are based on the modelled impacts of the improvements we expect it to bring forward.

Ofgem should also ensure that any allowance is appropriately reflected in the Wholesale Cost Allowance Model (as set out in Annex 2). Currently, the UIG allowance is applied within the Direct Fuel Cost Component WorkSheet and specifically under Section 2 in row 26. However, it would appear that it was Ofgem's intention to apply it under Section 3 "Apply Regional electricity losses and unidentified gas uplift" in row 56. On this basis, we believe Ofgem should remove the UIG allowance from row 26 and apply it to the formula used across row 56.

7. Allowances for Smart Metering

Our detailed points on the allowances for smart metering can be found in the confidential annex to this response. These views have been informed in part by the access our advisors

gained to Ofgem's Disclosure Room and their Final Report which was approved for removal from the Room by Ofgem.

8. Typical Consumption Values

Ofgem needs to be mindful of the impact of any future change in the typical domestic consumption values over the period of the cap, particularly given the likely trend of such values falling. For instance, where some categories of costs move with consumption changes, operating costs do not. Ofgem's model therefore needs to appropriately factor in the impact of any change in TDCV.

9. SMETS2 - Prepayment

We are concerned with the potential consequences of Ofgem's proposal for default customers who upgrade to SMETs2 PPM to be subject to the DD cap. For instance, it is possible for individual customers to become subject to a price change at the time a SMETs2 meter is installed, depending on the extent to which there is a price divergence between the prepayment safeguard tariff and the DD Default tariff cap. This could have detrimental implications for the customer journey around smart meter installs and involve operational issues around price changes for suppliers. Ofgem should engage with the industry to explore how such issues can be mitigated.

10. Standard Licence Condition amendments

The proposed licence condition currently distinguishes three separate payment type pots, namely "Standard Credit", "Fully Interoperable Smart Prepayment" or "Other Payment". Each payment method offered to customers will fall within one of these pots and the relevant Benchmark Maximum Charges will apply.

We are concerned that the current definition for "Standard Credit" may unintentionally exclude certain payment types that should naturally fall within the Standard Credit pot and that a suitable amendment to the definition will provide certainty and clarity. As currently drafted, Standard Credit is defined as:

'Standard Credit' means a Payment Method whereby a Domestic Customer pays the licensee directly for Charges for Supply Activities ***after receiving a Bill,*** *such payment not drawn automatically from a Domestic Customer's bank account by reason of a direct debit authorisation or otherwise;*

Through the inclusion of the words highlighted in bold, the definition would exclude the payment types listed below on the basis that such payments do not necessarily follow the customer receiving a Bill. These descriptions are contained within the most recent Ofgem Social Obligations Reporting Guidance published on 12 August 2016:

- budget payment schemes whereby customers pay by weekly/fortnightly/twice monthly payment schemes

- flexible payment methods such as using a payment card/book to make frequent cash payments.
- monthly standing order, monthly payment schemes (cash or cheque)

We believe these payment types should fall within the "Standard Credit" pot and that such an approach would be consistent with the Ofgem guidance (repeated below) that accompanied its request for information to suppliers as part of its tariff cap development.

'Standard credit (SC)' refers to tariffs which apply to customers that pay quarterly on receipt of their bill. This should also include any payment types (for example fuel direct or monthly/weekly/fortnightly payment schemes) where the customer is paying the same tariff as a customer that pays quarterly on receipt of their bill. Customers may be paying at any frequency (quarterly/monthly/fortnightly).

We propose that Ofgem amend the definition of "Standard Credit" by removing the words highlighted in bold above; or alternatively provide clarity that the definition should be interpreted in such way that would result in the payment types listed above being within the scope of the definition. Ofgem should consider aligning the various definitions of payment methods to ensure clarity amongst suppliers.

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October 2018