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Informal consultation on modification to the Electricity Distribution Licence to recover the costs associated with appointing a Supplier of Last Resort

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 does not support this change as proposed. Distribution Network Operators (DNO) should not be able to adjust network charges for the next regulatory year within the current 15 months notice period as established by Distribution Connection and Use of System Agreement (DCUSA) DCP 178 in 2015.

The proposed changes, in particular the provisions described in 38B.5 and 38B.6, will enable DNOs to increase network charges with far shorter notice (if the Materiality Threshold¹ is breached) than the 15 months normally required by DCUSA 19.1.1(B). As a result suppliers will bear the burden of mutualised costs stemming from Supplier of Last Resort (SoLR) claims. Suppliers will not be able to recover these costs via customer billing with comparable promptness. A significant proportion of customers (for most suppliers) are served by Fixed Term Supply Contracts, for which the Charges may not be varied within a fixed term contractual period (Supply Licence, Standard Condition 22C.9). Typically, such a period will be from one to three years (though this can vary across the market). As such, mutualised SoLR claim costs imposed via increased network charges, at the short notice enabled by this change, could not be factored into tariff pricing by suppliers for a significant proportion of their customer base.

From 1 January 2019, all Domestic Default and Evergreen Tariffs (excluding specific tariff types defined by Ofgem) will be subject to the default tariff cap. The defined methodology of the cap (Decision – Default tariff cap – Overview document, published 5 November 2018) provides for network costs as a fixed element (£258 as of

¹ Note: Analysis indicates that, when measured against Materiality Thresholds factored to 2020/21 prices, the cost distribution of Cooperative Energy's SoLR claim (stemming from the GB Energy Supply Limited SoLR event in 2016) across DNOs shows that a claim which breached materiality for one DNO, would likely breach the thresholds across all the other DNOs.

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implementation) based on DNO charging statements. In the accompanying Appendix 5 – Policy and Network Costs document (Table A5.3: Summary of our approach to estimating network charges), Ofgem noted the 15 month notice period for network charges, by which this element can be derived for the calculation of the cap. No headroom or risk allowance is afforded by the defined methodology, with regard to network costs (which is the second largest element of the total benchmark, after wholesale costs).

In the informal consultation letter (dated 20 November 2018) Ofgem acknowledges that: *'One of the consequences of these proposed changes would be that there could be multiple changes in charges within a charging year'*. Network cost increases would not correspond to the April and October cap review periods. As such, suppliers could be required to carry a proportion of SoLR claim costs for up to six months (the remainder of these costs would endure until the end of relevant fixed tariffs, or when new tariffs are launched which factor in the increased costs, as described above). Ofgem should not propose to change costs in a way which is inconsistent with the cap methodology. At a minimum, Ofgem should require 120 days notice of a change, either by the Distribution Licence or as part of a relevant derogation. This will enable these increases and accrued costs to be included in default tariff cap benchmark values at the periodic review points.

By allowing short notice changes to these costs, the cost burden will be transferred to suppliers, without recourse for them to recover these costs without including a risk premium in future pricing calculations. This is a reversal of Ofgem's determination for DCP 178, which stated the change from 40 days to 15 months notice *'will better facilitate the achievement of the DCUSA Charging Objectives'* and *'is consistent with our (Ofgem's) principal objective and statutory duties'*.

Introducing additional pricing volatility into the market by mutualising SoLR claim costs in this way, especially concurrently to the implementation of the default tariff cap, could have the perverse effect of pushing some suppliers closer to insolvency (if they lack the necessary capitalisation or budgetary flexibility to bear this additional cost for a period of six months between cap reviews, or until relevant Fixed Term Supply Contracts end). This could compound the number of SoLR claims and level of costs faced by DNOs, and will require further costs be spread across the remaining suppliers. Increased cost unpredictability and risk could increase the price of Fixed Term Supply Contracts. This risk was acknowledged by Ofgem in the 2012 *'Decision in relation to measures to mitigate network charging volatility arising from the price control settlement'* (Para 1.9). The impact on competition via reduced availability of cheaper tariffs and greater risk of SoLR events would be a poor outcome for customers.

Ofgem's 2012 decision included *'Restricting the frequency of intra-year charge changes'*. This decision referred to the basis; *'2.40. We consider that reducing the ability of a NWO to change charges intra-year will reduce the risk faced by suppliers and therefore reduce the cost imposed on consumers'*. In this context, Ofgem stated its *'principal criterion in assessing options to address network charging volatility was to consider which party is best placed to bear the cash-flow risk associated with changes to network companies (NWOs) allowed revenues'*. When applying this consideration to the proposed changes to

the Distribution Licence Condition, it is clear that DNOs are better placed to fund SoLR claims (and redeem costs via network charges on the basis of 15 months notice), than suppliers.

As it is currently drafted, this proposed change places the risk on suppliers. We note DNOs will be afforded the ability to pay SoLR claims to the appointed supplier via monthly instalments for up to 15 months, which will spread this cost. In most cases DNOs will have access to lower cost capital than suppliers (this was acknowledged by Ofgem in the 2012 decision, para 1.18). EDF Energy consider derogations as described in 38B.6 should only be accepted if a DNO can demonstrate that to finance the relevant SoLR claim cost (or aggregated value of multiple costs) would prevent it from maintaining an investment grade credit rating. It should be noted the cost of capital was a concern explored by DCUSA DCP 178 (see DCP 178 Change Report – published 20 June 2014) and that the majority of respondents did not foresee cost of capital for DNOs to be a significant issue with regards to the 15 months notice period. Further consultation or considered implementation of this change, in any form, should be thoroughly examined and supported by a robust financial impact assessment.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact Mark Hatton on 07875 110832 or myself.

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

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Paul Delamare'.

Paul Delamare
Head of Customers Policy and Regulation

EDF Energy
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