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Dear Dan

Review of Additional Wholesale Costs in the Default Tariff Cap: update

EDF is the UK's largest producer of low carbon electricity. EDF operates low carbon nuclear power stations and is building the first of a new generation of nuclear plants. EDF also has a large and growing portfolio of renewable generation, including onshore, offshore wind and solar generation, and energy storage. We have around six million electricity and gas customer accounts, including residential and business users. EDF aims to help Britain achieve net zero by building a smarter energy future that will support delivery of net zero carbon emissions, including through digital innovations and new customer offerings that encourage the transition to low carbon electric transport and heating.

EDF welcomes the opportunity to provide comments on Ofgem's update regarding its review of additional wholesale costs in the default tariff cap (DTC), including a proposed framework for considering any adjustment. EDF understands Ofgem desire to review suppliers' wholesale costs for default tariff customers between October 2022 and September 2023. However, we nonetheless continue to have a number of concerns with Ofgem's proposed approach.

Timings

While we acknowledge that Ofgem has rescheduled its review timescales, we remain concerned with the timing of the review, together with Ofgem's earlier assertion that conditions in the retail market have now stabilised as wholesale prices have fallen.

While prices have currently stabilised, when compared to earlier parts of the ongoing energy crisis, they remain significantly higher and more volatile than the historic norm. For example, gas prices have increased significantly in percentage terms from what they were only four/five months ago, with a doubling of the price per therm (from c60p to c£1.20).

We are seeing further instability due to recent activities such as the pipeline sabotage and escalation of instability in the Middle East, in addition to the ongoing illegal invasion of Ukraine

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and high levels of inflation in the UK. Such issues drive uncertainty as to whether prices will experience further volatility this winter.

Consequently, we would urge Ofgem to delay any review until Spring 2024, when there should be evidence of the cost impacts of the coming winter and greater confidence in the stability of the retail market.

RFI Data and supplier put back

Ofgem's data assumptions on the impact of the areas under consideration within this Open Letter must be urgently updated and shared with suppliers. As previously discussed, Ofgem's initial data request resulted in suppliers providing data which understates potential losses and overstates any potential supplier benefit. This was due to the fact that Ofgem requested supplier data based on NBP volumes, but subsequently calculated the equivalent allowances using CT volume. Ofgem, acknowledging this risk, has since amended the data request, however, not in time for sufficient analysis to be carried out on the data in advance of the publication of this Open Letter. Ofgem should now, however, have the data it needs to arrive at a more accurate view, allowing any incorrect assumptions to be updated before a Statutory Consultation is published.

Therefore, it is essential that all data is corrected to ensure it is suitable for purpose and can accurately estimate each suppliers position accurately.

Systematic vs commercial benefit

In terms of determining both the need for and scale of any additional wholesale adjustment it is vital that Ofgem's approach (including through its RFIs) can robustly and clearly distinguish costs/benefits that arise because of systematic issues and those that result from the commercial actions of suppliers. Particularly given there were numerous elements interacting in the outturn energy costs during the period in question. We are, however, highly concerned that Ofgem's updated top-down approach will mean that making such vital distinctions is not possible.

EDF recognises that Ofgem should investigate and consider adjustments, both positive and negative, for systematic deviations from price cap allowances that arise through external market factors. However, suppliers must also be allowed to retain the commercial benefit they can achieve through successfully mitigating their risks in a manner different to the notional supplier. We have previously made suggestions to Ofgem to help refine and target RFIs as part of this workstream to assist Ofgem with such assessments.

Ofgem must also be highly conscious of the negative customer impacts of undermining suppliers' incentives and ability to innovate and drive efficiencies. If for example, commercial benefits achieved by suppliers are incorrectly clawed back by Ofgem as part of this or any review, it could blunt suppliers' future commercial and risk management approaches. This will likely result in suppliers being more risk averse and increasingly focussed on 'matching' the approach of the notional supplier in all instances.

Wider sectoral impacts and investability

More broadly, there is also a need to consider the profitability of the sector over an extended period, in addition to each individual cap period and review of each individual allowance. It is essential that we return to a sustainable, resilient and investable market capable of helping Britain achieve Net Zero. Ofgem must be careful not to over engineer any cap amendments due to short term impacts where these will be countered by longer term trends e.g., costs related to managing customer demand. The sector needs a period of stability after a traumatic few years. A resilient sector which has confidence in its ability to innovate and invest is what will bring the greatest consumer benefits in the medium to long term. To this end Ofgem must also ensure it is considering all adjustments impacts on supplier profitability at a holistic level to ensure the overall cap level is sufficient to provide investor confidence in the sector.

As previously discussed with Ofgem, if investors are not confident in the future of the UK domestic energy retail market, further market exits are likely and new entry will be discouraged. This will result in less competition, less innovation, less investment in new products and services that advance the Net Zero ambition, poorer customer service and, inevitably, costs to consumers. Restricting choice and increasing costs does not protect consumers.

EDF's key aim is to work constructively with Ofgem to develop and introduce measures that promote a healthy, well-functioning market. Such a market should allow efficient and sustainable businesses to attain a fair margin and enable continued innovation and investment to the benefit of consumers. The price cap, as Ofgem acknowledge is an imperfect instrument in this regard and one that drives additional risk for suppliers and costs for consumers. It is critical, therefore, that Ofgem, together with Government, urgently explore regulatory change that can provide confidence to responsible investors that an appropriate and fair return can be made in this market whilst at the same time the right consumer protections are in place.

Our response to the specific questions set out in the Ofgem update letter can be found in the appendix to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Steven Eyre or myself. I can confirm that this letter may be published on Ofgem's website.

Yours sincerely

John Mason
Senior Manager (Price Regulation and Market Dynamics)

Appendix
Review of Additional Wholesale Costs in the Default Tariff Cap: update

1. **To what extent do you agree or disagree with the overarching principles we have set out? Are there any additional principles you think we should consider when making a decision? Please fully explain your answer.**

At a high-level, EDF supports the Principles as presented.

However, we have concerns around how these Principles will be interpreted and implemented by Ofgem in relation to this review. How the Principles are interpreted and implemented is key to ensuring that suppliers remain incentivised to undertake risk mitigation strategies to reduce their costs and innovative approaches which could provide commercial benefit.

For example, in seeking *Principle 1: Protection of customers* if Ofgem take too broad an interpretation of any reduction in costs or increase in revenues then suppliers may no longer seek such benefits, as these will simply be claw backed at a later point by Ofgem. Whilst such a broad interpretation could benefit customers in the short term (by reducing allowances) it will not in the medium to long term as this will dilute the commercial impetus for suppliers to take actions which will ultimately benefit customers.

Also key is *Principle 2: Any adjustment should be appropriate across suppliers*. A key concern is how Ofgem will determine a fair industry view of any data provided. For example, the market currently has two very large retail suppliers and so utilising a simple weighted average across all suppliers could give an outsized impact from their approach which could distort any data that is aggregated at an industry level (potentially due to issues such as customer mix and scale advantages). Due to this it may be preferable, upon review to use a flat average approach instead to help better determine how suppliers in general have acted.

However, as Ofgem has not yet provided any insight on industry data collected via the various RFIs on this topic, EDF would recommend that Ofgem carry out such analysis using both, and any other approach that may be suitable (i.e., excluding certain supplier's data). Ofgem can then seek supplier feedback on these approaches and the potential positives and negatives each will hold as part of the statutory consultation stage. Ofgem can then make an informed decision on the most appropriate approach to take.

The most challenging principle to interpret will be *Principle 3: We would be more likely to adjust where costs or benefits were the result of external factors, rather than suppliers' commercial choices.* EDF fully supports such an approach but without a detailed analysis and understanding of each suppliers' commercial strategies and decision-making timelines this will be very difficult for Ofgem to determine. Currently, Ofgem's proposed approach is consistent with this principle. EDF would strongly recommend that in addition to the high-level data analysis Ofgem has agreed to undertake, that any outputs are fully tested with suppliers, both for individual suppliers own data and an aggregated industry data basis. This should allow sufficient time for each supplier to explain and evidence its commercial undertakings to ensure that only costs or benefits that were the result of external factors are included in any adjustment calculations.

2. **Given that Ofgem must exercise its functions under the Act with a view to protecting existing and future customers on standard variable and default tariffs, to what extent should suppliers be able to retain benefits or bear costs from (relating to principles 1 and 3):**
    a. **a) overall market movements (eg in SVT demand or price driven demand destruction), that are outside of their control?**

    b. **b) commercial decisions (eg hedging strategies), that deviate from the assumed behaviour in the price cap? Does your answer differ whether the impact is a cost or a benefit to suppliers? If so, why?**

EDF agrees that suppliers should not retain any costs or benefits that are directly accrued due to overall market movements outside of their control. However, this must be separated from any commercial actions which are taken by suppliers to mitigate such events. Whilst a reasonable action that all suppliers would be expected to undertake could be considered systematic, any action that goes above such expected reasonable actions should be excluded from a).

It is clear that any costs or benefits from commercial decisions should be retained by suppliers, as Ofgem confirmed under the previous allowance review when not all supplier losses were allowed to be recovered. A consistent approach must be taken whereby if any previous losses due to commercial actions were not allowed to be recovered then any commercial gains also are retained by suppliers.

However, if suppliers undertake actions that are reasonable in the circumstances in which these are made, if this results in further losses then these should be classified under a) and, therefore, be allowed to be recovered by suppliers. Differentiating between commercial vs systematic actions will not be possible without a detailed analysis and understanding of each suppliers' commercial strategies and decision-making timelines which will be very difficult to determine. Therefore, EDF would strongly recommend that in addition to the high-level data analysis Ofgem has agreed to undertake that any outputs are fully tested with suppliers, on an individual suppliers own data and an aggregated industry data basis.

3. **To what extent should we align to the approach taken for previous wholesale decisions? Has suppliers' ability to mitigate risks changed over time, or are there other relevant changes in circumstances which would impact suppliers' ability to mitigate risks?**

Ofgem should always seek to set fair Principles and ensure these are interpreted and implemented in a clear and consistent fashion. We do recognise that methodologies for allowances and true ups may need to change over time, but this should only be the case where it is based on robust evidence and where there are clear communications with suppliers on the intent and reasoning.

One overarching concern is the lack of clarity on the materiality threshold that Ofgem use to determine the need for an adjustment to an allowance to be implemented. Ofgem recently took the decision not to update the debt allowance in the Summer as there was insufficient evidence of a material or systematic gap between supplier costs and the allowance that warranted such an intervention. However, no further detail was provided and so it is unclear as to the level of variation that is required to warrant such actions.

As outlined in our response to Question 1, another key concern is how Ofgem will determine a fair industry view of any data provided. For example, the market currently has two very large retail suppliers and so utilising a simple weighted average across all suppliers could give an outsized impact from their approach.

As Ofgem has not yet provided any insight on industry data EDF would, therefore, recommend that Ofgem carry out such analysis using multiple approaches, rather than simply defaulting a weighted average approach. Ofgem can then seek supplier feedback on these approaches and the potential positives and negatives each will hold as part of the Statutory Consultation stage.

4. **Are there other considerations we should have when differentiating between an overall market movement (e.g. customers remaining on SVT tariffs), as opposed to an individual supplier's risk management strategy (ie between systemic and idiosyncratic risks)? To what extent should this include consideration of the number of suppliers who adopted a particular strategy?**

It is clear that any costs or benefits from commercial decisions should be retained by suppliers, as Ofgem confirmed under the previous allowance review when not all supplier losses were allowed to be recovered. A consistent approach must be taken whereby if any previous losses due to commercial actions were not allowed to be recovered then any commercial gains also are retained by suppliers.

However, we are concerned that differentiating between commercial vs systematic actions will not be possible without a detailed analysis and understanding of each suppliers' commercial strategies and decision-making timelines, which Ofgem is currently not planning to undertake. Therefore, EDF would strongly recommend that in addition to the high-level data analysis Ofgem has agreed to undertake that any outputs are fully tested with suppliers, on an individual suppliers own data and an aggregated industry data basis. This should allow sufficient time for each supplier to explain and evidence its commercial undertakings to ensure that <u>only</u> costs or benefits that were the result of external factors are included in any adjustment calculations.

We recognise that the number of suppliers who undertake an action does increase the likelihood that such an action is a reasonable response to market wide inputs rather than commercial actions, however, this is not universally true. This is why the individual actions of each supplier much be fairly considered, rather than relying on industry averages, especially if these could give outsized importance to particular suppliers' data.

5. Do you agree with our high-level approach to differentiating between impacts caused by commercial decisions and external events? Where we see discrepancies between costs and allowances, what evidence should be considered to distinguish between the impact of commercial choices versus the impact of market movements outside of a supplier's control?

No.

As discussed above, we have concerns with Ofgem using a weighted average approach, without undertaking further analysis to evidence that it will not result in misleading results, due to the over indexing of the actions of the two largest suppliers.

In addition, differentiating between commercial vs systematic actions will not be possible, and, therefore, such an approach is inconsistent with Ofgem's Principles, without a detailed analysis and understanding of each suppliers' commercial strategies and decision-making timelines. Therefore, EDF would strongly recommend that in addition to the high-level data analysis Ofgem has agreed to undertake that any outputs are fully tested with suppliers, on an individual suppliers own data and an aggregated industry data basis. This should allow sufficient time for each supplier to explain and evidence its commercial undertakings to ensure that <u>only</u> costs or benefits that were the result of external factors are included in any adjustment calculations. As Ofgem has already requested some information on specific areas of focus this data should be evaluated to help initially understand suppliers' specific strategies in relation to the numbers provided.

With regards to the impact of unexpected customer numbers specific consideration must also be given to cap periods 9a & 9b relating to Q4-22 and Q1-23. These cap periods were 'transitional' periods where the price cap methodology moved from the '6-2-12' methodology to the '3-1.5-12' methodology. During the 'observation window' forward prices reached unprecedented levels and suppliers faced significant exceptional risks and impacts from the uncertainty in customer numbers. Ofgem's methodology change was designed to help reduce the risk and impact of volume changes on suppliers, and specific consideration should be given to these periods prior to when Ofgem's changes came into full effect.

6. Given the variability in supplier approaches, and that Ofgem can only set one price cap level, how should we weight the commercial decisions made by some, but not

all, suppliers? For example, if all suppliers benefited from market movements outside their control but only some suppliers also took commercial decisions which created further benefit.

Any reasonable action taken due to external inputs would be expected to be undertaken by all, or nearly all supplies, anything over and above this is clearly commercial in nature. However, conversely a majority of suppliers taking a similar action is not sufficient on its own to evidence a systematic impact.

It is clear that any costs or benefits from commercial decisions should be retained by suppliers, as Ofgem confirmed under the previous allowance review when not all supplier losses were allowed to be recovered. A consistent approach must be taken whereby if any previous losses due to commercial actions were not allowed to be recovered then any commercial gains also are retained by suppliers.

However, if suppliers undertake actions that are reasonable in the circumstances in which these are made, if this results in further losses then these should be allowed to be recovered by suppliers.

7. What benchmark approaches should we consider and why? Should the approach differ based on the direction of a potential adjustment?

As outlined in our response to Question 1 a key concern is how Ofgem's benchmark will determine a fair industry view of any data provided. For example, the market currently has two very large retail suppliers and so utilising a simple weighted average across all suppliers could give an outsized impact from their approach. As Ofgem has yet to provide any insight on industry data, EDF would recommend that Ofgem carry out such analysis using multiple approaches, rather than simply defaulting a weighted average approach. Ofgem can then seek supplier feedback on these approaches and the potential positives and negatives each will hold as part of the Statutory Consultation stage.

Ofgem should always seek to set fair Principles and then ensure these are interpreted and implemented in a clear and consistent fashion, whether any variation is to increase or decrease any allowance.

8. Please also provide any additional views that may not be captured by the outlined questions.

There is also a need to consider the profitability of the sector over an extended period, in addition to each individual cap period, if we are to return to a sustainable, resilient and investable market capable of helping Britain achieve Net Zero. Ofgem must be careful not to over engineer any cap amendments due to short term impacts where these will be countered by longer term trends e.g., costs related to managing customer demand. The sector needs a period of stability after a traumatic few years. A resilient sector which has confidence in its ability to innovate and invest is what will bring the greatest consumer benefits in the medium to long term.

As previously discussed with Ofgem, if investors are not confident in the future of the UK domestic energy retail market, further market exits are likely and new entry will be discouraged. This will result in less competition, less innovation, less investment in new products and services that advance the Net Zero ambition, poorer customer service and, inevitably, costs to consumers. Restricting choice and increasing costs does not protect consumers.

EDF's key aim is to work constructively with Ofgem to develop and introduce measures that promote a healthy, well-functioning market. Such a market should allow efficient and sustainable businesses to attain a fair margin and enable continued innovation and investment to the benefit of consumers. The price cap, as Ofgem acknowledge is an imperfect instrument in this regard and one that drives additional risk for suppliers and costs for consumers. It is critical, therefore, that Ofgem, together with Government, urgently explore regulatory change that can provide confidence to responsible investors that an appropriate and fair return can be made in this market whilst at the same time appropriate consumer protections are in place.

EDF October 2023