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Dear Dan

Price Cap: Call for Input on the Operating Cost Allowances Review

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.

Suppliers continue to operate in a financially challenging environment and face increasing risks because of continued market volatility and high prices, and operating under the Default Tariff Cap. EDF remains committed to working constructively with both BEIS and Ofgem to develop and introduce measures that promote a healthy, well-functioning market that allows efficient and sustainable businesses to attain a fair margin and enable continued innovation and investment to the benefit of consumers. The ability of suppliers to recover their efficient operating costs in meeting their regulatory requirements and the needs of their customers forms a vital part of this work.

On this basis we are supportive of Ofgem performing a review of the operating costs allowance provided under the Default Tariff Cap (DTC). The major driver for such a review is the fact that the original baseline costs used to set the operating cost allowance are over six years old and are only subject to annual indexation. It is right, therefore, that Ofgem perform a review to determine whether in the current market suppliers can recover their efficient operating costs.

Ofgem must also recognise that the market has evolved since the DTC was established and they should reflect this in their approach. For example, Ofgem must consider the correct balance in further incentivising efficiency from suppliers whilst ensuring that high and innovative customer service standards are taken forward. If Ofgem overly focus on efficiency, for example by constantly favouring a lower quartile cost efficiency in different areas, this will make it challenging for suppliers to deliver the ever-increasing levels of customer service standards that customers expect and deserve.

It is vital that the level of allowance is set to a level that allows all efficient suppliers, including small suppliers and those with innovative business models, to stay solvent and deliver high qualities of customer service for customers.

It is concerning that this Call for Input has been released before the final version of the linked Request for Information. A more effective approach would have been to finalise the RFI, allow time for suppliers to answer and then for Ofgem to consider the responses to this. This would have then allowed the Call for Input to have been published after this period which could have had a number of benefits, such as allowing for a more focussed approach to the areas to be considered. Considering the period of time before Ofgem plan to enact any changes, it is not clear why such an approach was not taken, and why suppliers were not allowed more time to respond.

It is also important that this workstream is joined up with other related DTC workstreams already underway, such as those on EBIT, debt-related costs and payment levelisation. Taken together, it is essential that the decisions made on these various workstreams allow for efficient suppliers to recover their costs. Ofgem also need to take account of any Government consultation (expected this Summer) on options for a new approach to consumer protection, as well as on the future of the cap itself. This may well have an impact on the need for, timing and scope of any operating costs allowance review.

We have in an appendix to this letter responded to the specific questions Ofgem has raised in the Call for Input. However, below we set out some high-level key messages that Ofgem needs to consider as part of any operating costs review:

- How to strike the right balance between having regard to efficiency and the investment necessary to enable the expected levels of customer service, particularly in light of the continued challenging conditions consumers face.
- The need to ensure that suppliers can recover their efficient smart metering costs reflecting the challenges facing suppliers at this point in the programme.
- How to further incentivise moves to smart through for example cost placement.
- Where cost could be placed on the unit rate, as opposed to the standing charge to better support low consumption consumers.
- The need for a methodology that is clear, simple, and updatable, as necessary, to reflect changing industry costs / to reflect market conditions.
- The creation of a new, separate allowance to cover industry costs that it is updated annually on a pass-through basis.

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
Call for Input on the operating cost allowances

1. Do you agree with the scope set out in the introduction section for the operating cost review?

EDF agrees with the intended scope of the operating cost review that has been set out in the Call For input (CFI). We also agree that an appropriate data collection exercise should be a key driver in determining the final scope of any operating costs review.

However, Ofgem must also recognise that the market has evolved since the DTC was established and they should reflect this in their approach. For example, Ofgem must consider the correct balance in further incentivising efficiency from suppliers whilst ensuring that high and innovative customer service standards are taken forward. If Ofgem overly focus on efficiency, for example by constantly favouring a lower quartile cost efficiency in different areas, this will make it challenging for suppliers to deliver the ever-increasing levels of customer service standards that customers expect and deserve.

2. Do you agree with the areas that we consider are outside the scope of this review? Do you consider that there should be anything else in the scope of this review?

Aside from the areas set out in the CFI, at this stage we are not aware of any other areas that should be outside the scope of the operating cost review. We do, however, recommend that Ofgem adopt an alternative approach to setting an allowance for the recovery of industry charges. We support a distinct separate allowance and methodology for industry costs which would be updated as costs change on a pass-through basis.

3. What are your views on the case for review we identify in this section?

EDF agrees that there is a strong case for a review.

4. Do you agree that there is sufficient reason to carry out a review?

Yes. The original baseline costs used to set the operating cost allowance are over six years old and are only subject to annual indexation. Over the past six years, the market and suppliers operating context has, however changed significantly. We are, therefore, supportive of Ofgem performing a review to determine whether in the current market suppliers can recover their efficient operating costs. As we outline in our covering letter Ofgem must also use this review as an opportunity to consider the correct balance in further incentivising efficiency from suppliers whilst ensuring that high and innovative customer service standards are taken forward.

In addition, Ofgem must consider how smart meter installs can be further incentivised through cost placement when looking at each component aspect of the review.

5. What cost lines do you think should be included within operating costs?

We agree that the items identified in Table 2 should all be included in any appropriate coverage of operating costs.

6. Do you consider there to be any new costs which may have not been included within the existing core operating costs allowance?

One area we have identified are the costs of capital associated with the CfD scheme, which are not currently recovered by the SVT cap methodology. In future years, this cost is forecast to increase materially. We would encourage Ofgem to consider this cost as part of this review, though we recognise that Ofgem could also consider it via its work on setting the correct level of Working Capital for EBIT or within the CfD allowance itself as opposed to the Operating Cost allowance. The important thing, as a cost efficiently incurred by suppliers, is that it is ultimately reflected somewhere in the DTC's cost stack.

In addition, we also incur significant costs because of implementing key regulatory initiatives – e.g., Market-wide HH settlement programme. The costs associated with delivering these schemes should be appropriately reflected in any operating cost allowance.

7. Do you consider that any new costs would be offset by corresponding benefits?

No. We are not aware of any currently.

8. Do you consider there to be any costs included within the core operating costs allowance but are now no longer incurred?

No. We are not aware of any currently.

9. What external events do you think have impacted (or will impact) operating costs? Are these impacts permanent or temporary? Can you provide evidence on how costs have been affected, and by how much (i.e., per customer)?

There are several factors that we see as having a material impact on operating costs:

- As outlined in our response to Question 6, some industry costs have not been properly updated or incorporated into the DTC.
- Inflation has contributed to increases in operating costs, beyond the CPI allowance within the SVT methodology in some areas. We expect these impacts to be enduring.

- Industry change – market wide HH settlement will incur higher settlement costs in addition to internal costs of implementation. We expect these impacts to be short term (implementation) and enduring (settlement process costs).

- Energy crisis and cost of living – has seen impacts on our customer base and increased demand where we have incurred additional costs to maintain service levels. It is not yet clear whether these trends will endure.

- Linked to the above is new regulatory requirements that will be implemented before the new allowance is finalised e.g., customer service changes.

- Smart meter rental costs have increased with lower customer appetite also driving increased installation costs.

10. What time period do you think we should use for the updated baseline for core operating costs and why?

An initial re-baseline of costs for the previous 12 months will ensure alignment with latest operating context. Such an approach would strike the right balance between ensuring cost-reflectivity, mitigating the impact of shorter-term changes in costs on cap prices and administrative effort.

We also recommend an approach that results in more frequent and regular updates of Smart Metering costs and Industry Charges - given the current operating context. However, these should be focussed reviews to ensure that they do not add unnecessary administrative burden for suppliers.

11. What factors should we seek to correct for in setting an enduring benchmark?

Ofgem must consider the correct balance in further incentivising efficiency from suppliers whilst ensuring that high and innovative customer service standards are taken forward. If Ofgem overly focus on efficiency, for example by constantly favouring a lower quartile cost efficiency in different areas, this will make it challenging for suppliers to deliver the ever-increasing levels of customer service standards that customers expect and deserve. Therefore, we recommend that Ofgem address the following factors when setting an enduring benchmark:

- Ensuring the correct balance between operational costs and service provision – the current methodology takes a cost-centred approach which should be carefully balanced with customer outcomes.

- More broadly ensuring the baseline does not penalise suppliers for investment in enabling key customer outcomes (e.g., HH settlement, Smart metering rollout).

- Flexibility for unforeseen market events and challenges.

12. What are your views on the options of our overall approach? Do you agree with our minded to approach?

Subject to our comments in response to Question 11, EDF agrees with Ofgem continuing with a top-down approach for benchmarking. A bottom-up approach is likely to involve significant complexity.

13. Do you have any alternative approach for calculating the efficient level of core operating costs across suppliers?

See our response to Question 12.

14. Which benchmarking approach options do you think we should be considering?

If Ofgem overly focus on efficiency, for example by constantly favouring a lower quartile cost efficiency in different areas, this will make it challenging for suppliers to deliver the ever-increasing levels of customer service standards that customers expect and deserve.
That is why we consider a weighted average cost would be a more effective benchmark when all factors are considered.

15. How should we develop a framework for choosing between benchmarking options?

Considering the efficiency and non-efficiency measures outlined will be key in informing the best outcome for consumers. It would be appropriate for the different options to be assessed based on their impact on efficiency and non-efficiency measures.

16. What non-efficiency factors linked to customer bases do you think drive cost variation among suppliers? Should we control for these through an adjustment or benchmark metric?

We see some of the key factors as below:

- Geographical presence, tenure, and associated staff costs.
- Investment to achieve key customer outcomes – smart installation, HH settlement, service levels.
- Market forces and demand / supply pressures in parts of our cost base – e.g., smart metering installation costs.
- Cost inflation – variability likely due to different contractual mechanisms across supply chain.
- Customer characteristics / demographics – variability caused by, for example, contact channel preferences, 'offline' costs (e.g., paper bills).

- Number and type of PSR customers and customers in vulnerable circumstances and associated high cost of servicing.
- Costs of servicing legacy prepayment.
- Levels of smart penetration.

A process to reflect these where possible within a benchmark metric is more appropriate than managing periodic adjustments.

17. Are there other parameters over which you think operating costs would materially differ?

We support the continuation of the approach whereby the operating cost allowance does not vary by tariff type e.g., fixed/default, on the basis that operating costs across tariff types are broadly similar. However, we would welcome consideration of the differing costs between smart and legacy meters, to allow a consideration of how smart can be further incentivised via cost placement.

18. Do you think there are any operating costs that would materially differ between serving single rate and multi-register electricity meter customers? If so, please provide evidence to support your view.

We do not consider there to be significant differences in servicing costs for these different meter types at present.

19. What is your view on the extent to which we should prioritise allocating costs between different parameters currently not included in our cost data breakdown?

We would support the current outlined approach and areas of proposed investigation although breaking supplier costs into these more granular areas in a robust way (e.g., PSR, Online / Offline) will be challenging.

However, we would welcome consideration of the differing costs between smart and legacy meters, to allow a consideration of how smart can be further incentivised via cost placement.

20. In the event that some of the cost drivers are impacted by recent events, how should we treat these costs to determine an allowance on an enduring basis?

Where these are temporary costs then Ofgem should consider a temporary allowance. However, for enduring costs Ofgem must ensure that any additional costs suppliers faced are reimbursed on an ongoing basis.

21. What drivers of change in the payment method differential should we consider as part of this review? Please provide evidence of any reported cost changes.

Ofgem should utilise the data received via the shortly to be released RFI to further consider this issue.

22. How have the recent external events affected drivers of differences in the payment method differentials? Are they one-off or permanent impacts?

Market and economic uncertainty mean that this level of demand and differential will be a feature of service provision in the market for the short to medium term.

23. Are there other payment methods we should consider when setting the payment method uplift? If so, what are they? Please provide evidence of any differences in operating costs associated with serving these customers using other payment methods (if identified) relative to DD.

We would encourage Ofgem to consider whether Smart PAYG should be a distinct payment method from Legacy PPM. Smart PAYG should have lower operating costs, and this should be considered based on the results of Ofgem's forthcoming RFI.

24. What variations do you observe within the three existing payment methods? (e.g., does the frequency of DD payments vary beyond monthly across supplier customer base?) How do these variations relate to costs (e.g., does the frequency of DD payments cause changes in operating costs)?

The majority of our DD payments are taken monthly. Our Standard Credit customers pay on receipt of bill which we would typically issue either monthly or quarterly. We do not segment our costs across payment methods in this way and it is, therefore, challenging to conclude on any impacts to operating costs in the short period of time Ofgem has allowed to respond to this consultation.

25. Should we use the same benchmarking approach for core operating costs and the payment method differential? Are there any additional or different considerations than for the core operating cost benchmarking approach?

We would propose the same approach being used.

26. Do you have initial views on whether we should benchmark payment differentials individually, or use the same benchmark for each supplier?

EDF would support benchmarking payment differentials individually.

27. What is your view on how we should allocate the identified cost categories between payment methods?

To answer this question, we would need to assess that cost drivers associated with each category.

28. If we updated the core operating costs baseline, what factors should we consider when considering options for updating smart metering costs over time?

Ofgem should consider:

- The challenges and costs associated with delivering against a hard target of installs in a market with increasing smart penetration (both recruitment and installation).
- The variability of costs in this area driven by market forces.
- The potential to 'disincentivise' smart meter penetration.

We would broadly support any moves to incentivise smart metering through cost placement as well as more frequent updates to Smart Metering costs; to reflect the changing market dynamics.

29. What approach should we take to setting the allowance for smart meters in the cap and why?

We would propose a measure based on the annual net cost of smart installation, with the enduring efficiency benefits included as they are realised in the future.

If the recovery is not sufficient to meet the costs actually incurred by suppliers in meeting the obligation, this impacts suppliers' ability to invest in smart metering and ultimately the realisation of the essential net zero benefits of smart metering.

30. Do you think a separate allowance to update smart metering costs in our operating cost review should be considered, if so, what approach do you suggest?

Yes. As above.

31. Are there sufficient reasons to indicate that there may be a need for a review of the industry charge methodology?

Yes, EDF would support such industry charges being subject to a separate, specific, and regularly updated allowance under the cap.

32. What are the important changes in industry charges since 2017?

See our response to Question 33.

33. What advantages and disadvantages do you think we should consider when developing an approach to setting and updating industry charges?

Industry charges (e.g., SPAA, DCUSA, Elexon etc) have increased overtime at a faster rate that the allowance provides for, which only increases with CPIH. This divergence in actual costs compared to the allowance is leading to an industry shortfall of over a £100M. A large driver of the differential is Elexon costs of the MHHS programme, and REC costs. Contrary to the original thinking on industry costs movements, such charges have been proven not to directly follow CPIH, being driven by other factors such as industry change programmes. On this basis, a revised approach to industry costs recovery is essential.

Industry charges are mandated for all suppliers to pay at the same rate and so should be treated differently to other operating costs. We recommend that a specific allowance is set for industry charges.

34. Do you have an initial preference between the potential approaches?

As set out above, we recommend industry charges are separated out as a distinct component and are updated annually on a pass-through basis.

35. Do you agree with our considerations for updating the benchmark? Are there any other approaches we should explore for incorporating future costs?

We support the proposed approach and setting enduring cost allowances without the need for frequent benchmarking.

36. Which option do you think we should use to allocate costs across the standing charge and unit rate?

EDF would support costs being placed on the unit rate where possible to lower the impact of energy costs on low consuming vulnerable customers.

However, we would also need to consider this in the context of supporting electrification and considering the balance of cost recovery between electricity and gas.

37. Are there other options for allocating costs across the standing charge and unit rate which we should consider?

EDF does not have any other options to consider currently.

38. What is your view on the extent to which we should prioritise this topic in our review?

At this stage we do not have a strong preference for either option presented in the CFI. We agree that the data gathering exercise will inform consideration of what approach to take.

However, we do welcome a focus on this area and the extent to which costs could be placed on the unit rate rather than the standing charge to help support low consumption consumers.

39. Should we include published working papers as part of our policy development process. If yes, are there any particular topics covered in this CFI that you would like us to expand on through a working paper?

We are supportive in principle in Ofgem using working papers as part its policy development process. However, it is unclear at this stage on what an appropriate process moving forward should involve given the scope of any operating costs review has yet to be determined.

EDF June 2023