

Inquiry Manager
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

22nd April 2015

British Gas Trading vs The Gas and Electricity Market Authority Appeal

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, 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 has owned electricity networks in the past but this was prior to the application of the RIIO-ED1 process. Our comments reflect our experience and are therefore high-level in nature as we are not in possession of the key facts. In addition to the points we raise in the attached annex, we suggest that the CMA bears in mind the following overarching considerations:

- The regulation of monopoly activities through price controls involves the assessment of a large number of complex factors. Any final determination by Ofgem will inevitably include decisions that are more or less generous over each activity, with the proviso that the control can be re opened under certain exceptional circumstances. It is therefore appropriate for the CMA to understand whether or not the overall package over-rewards companies. EDF Energy would be concerned if the appeal process cherry-picked only certain items that appear favourable to the appellant.
- In setting the price controls Ofgem must have regard to the ability of the relevant licensee to be able to finance its activities. Although this is not a primary duty of Ofgem, we regard it as central to the ability of network companies to raise finance at low cost (and for the reputation of the GB energy regulation system more generally). We are therefore unsurprised that Ofgem places importance on finance ability since we understand the asymmetric consequences of Ofgem getting this wrong.

We would like to stress that our overall interest is aligned with our customers. We want them to benefit from a robust network that is efficiently operated which evolves as the market and technology develops.

Our detailed responses are 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 Sebastian Eyre on 020 7752 2167, or myself.

EDF Energy
40 Grosvenor Place, Victoria
London SW1X 7EN
Tel +44 (0) 20 7752 2187

edfenergy.com

*EDF Energy plc
Registered in England and Wales.
Registered No. 2366852.
Registered office: 40 Grosvenor Place,
Victoria, London SW1X 7EN*



Yours sincerely,

Paul Delamare
Head of Customers Policy and Regulation

Comments on the matters raised in Centrica's appeal

Inappropriate mechanisms to return double-recovered revenues from the previous price control period.

We are not in a position to make any definitive comments on this issue as Ofgem did not fully explain their rationale for the compensation mechanism adopted. For this reason, we cannot be certain that merely stating they have "made an appropriate inter generational balance", including an assessment of the impact on current consumers in terms of affordability, means they have indeed done so. We also agree with the argument that changes to the asset life policy will also have a redistributive impact for consumers as they too have an intergenerational impact.

Consumers who have overpaid need be refunded quickly as a matter of principle.

Inappropriate incentive targets for IIS (interruption incentive schemes) and BMCS (Customer satisfaction) are based on old information and as a result too lenient. Rewards are also more easily obtained, and more substantial, than penalties.

The calibration of the IIS is a complex matter with many variables, and we have not followed the process in any detail. However, we note that a DNO's IIS performance can vary from one year to the next for many reasons that are outside of the control of the DNO; for example, weather conditions can significantly impact on the performance of overhead lines, and similarly ground conditions can impact on the performance of buried cables. In addition, major outages may result from a particular set of causes that may not be repeated for many years. We do not therefore attach particular importance to any one particular year even if it is the most recent one.

We are concerned that the targets under the BMCS have been relaxed as it was set below the average performance of the DNOS in the customer satisfaction survey and complaint metrics. This would have the effect of not creating an effective incentive mechanism. As a general design issue, it is also of concern that the price control rewards the performance above more than it penalises failure to meet the targets. We would urge the CMA to establish the rationale behind Ofgem's decisions in this area.

Unwarranted ex-post change to information quality incentives (IQI). The IQI scheme seeks to encourage DNOs to prepare well-justified business plans during the process of preparing the Price Controls. After the DNOs had submitted their business plans, the Authority decided to adjust the IQI scheme to the benefit of DNOs erroneously.

We note that the appellant argues that because the Authority decided to adjust the IQI scheme after the DNOs submitted changes to their business plans, the adjustment could not have had an incentive affect for the RIIO-ED1 price control. While this would appear to be the case, we urge the CMA to examine the use of the IQI throughout the RIIO-ED1 process in order to assess whether the "rules of the game" were sufficiently clear to the DNOs in the first place. If they were not, then the incentive properties of the IQI would have been weak anyway, and any adjustments Ofgem later makes would have not altered this position, but could possibly be justified as a means to deliver a fair and acceptable package of price control proposals.

Unwarranted transitional arrangements for change in asset life policy proposes to apply an 8 year transitional period for all DNOs in respect of the introduction of a new, longer and more realistic, asset life assumption. By doing so they are favouring the DNOs at the expense of consumers and transferring costs between generations of consumers.

We believe that BGTL raises sensible questions about the “blanket” use of transitional arrangements (for the introduction of economic depreciation for new assets). We regard Ofgem’s need to take account of a licensee’s ability to finance its activities as fundamental to the success of the regulatory framework in terms of enabling network companies to efficiently raise finance. However, the test should properly be applied to each relevant licensee.

Unwarranted change in cost of debt indexation has meant that the cost of debt is biased in favour of the DNOs and against the interests of future consumers. There was no attempt to assess the efficiency of this measure. It also represented a departure from the index used in all other RIIO controls including WPD’s fast track control.

In developing its “trombone” index, Ofgem seeks to better match DNOs’ forecast interest costs with forecast index movements that provide the lowest sensitivity to interest rate movements. We regard such an approach as sensible in that it reduces a DNO’s exposure to regulatory risk (and hence, other things being equal) lowers the DNO’s overall cost of capital. Whether or not there is merit in Ofgem understanding whether a DNO’s existing portfolio of debt has been raised at an efficient cost depends on the practicability of such an exercise (it would require Ofgem to precisely understand market conditions at the time of issuance without the benefit of hindsight). We believe that irrespective of the conclusions of such a review, Ofgem’s approach to reducing interest rate risk is a separate matter.

**EDF Energy
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