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DRAFT ORDER – FORMAL CONSULTATION

Dear David,

The Energy Market Investigation (Prepayment Charge Restriction) Order 2016

Thank you for the opportunity to provide comments on the draft order.

EDF Energy agrees, on balance, that the introduction of a temporary regulated price cap for prepayment meter (PPM) customers may offer some short-term protection to customers who find it difficult to switch, pending the resolution of the current technical constraints regarding the PPM infrastructure. The comments we have included in this response are intended to help the CMA to reduce the risks and costs of implementing a price cap to the benefit of prepayment customers and limit the potential for any costs falling disproportionately to non-PPM customers.

An accurate baseline for the cost matrix is essential to ensure updates to the price cap reflect actual costs. We believe some weaknesses remain in the way that this baseline has been calculated and in the methodology for updating some of the costs. This inaccuracy may lead to divergence between allowed and true costs during the lifetime of the PPM Price Cap, which is not in the interests of customers, suppliers, or the regulator and may undermine trust in the industry.

The CMA or Ofgem will need to closely monitor these costs and act if a divergence occurs, consulting with suppliers on alternative sources of data and appropriate adjustments.

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 Toby Allen or myself. This letter and its attachment may be published on the CMA's website.

Yours sincerely,

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1. General and Interpretation

- 1.1 EDF Energy welcomes the change in scope of the prepayment meter (PPM) price cap so that it only applies to those customers who do not have interoperable smart meters.
- 1.2 There is concern that customers may refuse a smart meter if they wish to keep the price cap, thereby undermining the smart roll-out programme. CMA/Ofgem should review the evidence as to whether customers are being discouraged from having smart meters fitted in the planned mid-term review in 2019.
- 1.3 We recognise that a balance is being sought to keep the price cap cost-reflective without introducing onerous processes for Ofgem and suppliers. However, we are concerned that if a divergence between actual costs and those used to construct the price cap were to occur, at times benefitting customers and at other times not, this will result in a lack of trust in the mechanism over its lifetime. A distrusted price cap would not be in the interests of customers, suppliers, or the regulator. Appropriate mechanisms need to be in place to monitor the evolution of costs and to adjust the mechanism should divergence occur, subject to rigorous consultation with suppliers and other stakeholders.

2. Prepayment charge restriction

Benchmark and baseline

- 2.1 A significant potential source of divergence in allowed and actual costs is the approach used by the CMA to calculate the energy/non-energy costs split in the benchmark. The split of costs observed by First Utility and OVO Energy, when setting tariffs live-on-supply in June 2015, will not be the same as the split calculated by the CMA, based on the segmental statements of major suppliers for 2015 (which relate to large suppliers not medium sized-ones).
- 2.2 In particular, the split of energy/non energy costs for PC2 customers varies significantly to the splits observed by EDF Energy due to the methodology used by the CMA. The methodology assumes policy and other costs for PC2 meters are the same as for a single rate meter, despite PC2 customers' higher typical consumption, with the difference in cost in the baseline bill of a PC2 meter being assigned to wholesale energy costs. This results in too large a proportion of a PC2 bill being assumed as energy costs. The CMA's models give a higher average £/MWh energy cost for PC2 meters than for single rate meters when we would expect the reverse to be true.
- 2.3 We note that the £/MWh wholesale energy cost calculated by the CMA for the baseline to be used in the wholesale index calculation includes energy costs between August 2014 and January 2015. This is a surprising basis to use, as we would expect suppliers, including OVO and First Utility, to have purchased energy over a longer period.

- 2.4 The assumed baseline for adjustments to policy costs is another potential source of divergence. It is assumed within the cost matrix that First Utility and OVO Energy's live-on-supply tariffs as at June 2015 were priced based on policy costs in 2015/16, whereas many of the prices of these tariffs would have been set many months previously, based on the 2014/15 costs. The significant step-up in costs between 2014/2015 and 2015/2016 will not, therefore, be reflected in the updates to these costs.

Network Costs

- 2.5 EDF Energy welcomes that the CMA now proposes updating network costs based on network company charging statements rather than on allowed revenues, as this will be a simpler and more accurate method. After reviewing the network costs in Annex 3, we would like to make the following detailed points:
- (a) The gas load factors need to be updated in the model as well as the unit rates. Gas load factors for 2015/16 would have changed for Winter 2015 to the October 2015/16 values, and load factors for Summer 2016 should be the October 2015/16 load factors and not 2014/15.
 - (b) The Distribution Loss Adjustment Factor used is the peak period only – a weighted average based on a typical customer would be more accurate and avoid overstating the losses.

Policy costs

- 2.6 EDF Energy continues to have concerns about using Office for Budget Responsibility (OBR) projections as the basis for policy cost adjustments. We welcome removing the Carbon Reduction Commitment (CRC) element of the forecast as this is an improvement to the accuracy of this methodology, but we still believe that there are a number of ways in which these projections may result in a divergence of allowed and actual costs.
- 2.7 A cost update methodology which only observes total costs and not the level of demand over which these costs are shared will not reflect changes in cost per customer. Demand for both electricity and gas has been declining in recent years and there are an increasing number of exemptions (e.g. we note that Energy Intensive Industries (EIs) are now exempted – meaning that non-EI customers will pick up an increased proportion of the total charge).
- 2.8 The exclusion of smart costs from the mechanism means that a substantial element of total policy costs will not be updated. The CMA stated in its final report that these costs appear to be stable. However, smart meter rollout costs (net of supplier benefits) may increase in the period to 2020.
- 2.9 All policy costs are subject to changes in Government policy. We welcome the recognition in the draft licence conditions for the need to have a mechanism to replace a data source if it no longer is available or suitable and for Ofgem to consult with suppliers on potential replacements.

- 2.10 EDF Energy proposes that the CMA or Ofgem should review the accuracy of all the policy forecasts used and consider whether an over/under recovery should be allowed in subsequent periods if those forecasts proved inaccurate as well as replacement data sources.

Wholesale costs

- 2.11 The proposed six-month wholesale energy cost hedging approach proposed in the EMI Final report and Initial Consultation is a significant improvement on the previously proposed 'snapshot' approach of using a single day to set such costs.
- 2.12 However, as stated above, the baseline that wholesale costs are adjusted from does not match our own calculations and is a potential source of divergence. This issue, combined with potential volatility in wholesale prices, which will be passed through to the price cap on a six-monthly basis, risks undermining trust in the PPM cap mechanism to set PPM prices.

EDF Energy
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