

## RWE

### ENERGY MARKET INVESTIGATION REFERENCE

#### RESPONSE TO ISSUES STATEMENT

##### 1. Introduction

1.1 This submission is made on behalf of RWE npower Group plc, RWE Generation UK plc, RWE Innogy UK Holdings Limited and RWE Supply & Trading GmbH (referred to collectively or individually, as appropriate, as "RWE"), in response to the Competition and Markets Authority's ("CMA") Issues Statement published on 24 July 2014.

1.2 RWE welcomes the opportunity to comment on the issues that the CMA envisages being relevant to its investigation, specifically:

1.2.1 whether there are issues that the CMA has identified in the Issues Statement that should not be within the scope of its investigation or have been mischaracterised; and / or

1.2.2 whether there are issues that the CMA has not identified, or issues that the CMA has indicated it is not minded to pursue, but which it should consider.

1.3 RWE believes that an independent, evidence-led investigation by the CMA will demonstrate that, overall, the energy market in Great Britain is competitive, and will ensure that the facts about the operation of the market and the way in which suppliers compete are made clear for customers, government, regulators and other stakeholders. With this in mind, this response sets out RWE's comments on the following aspects of the Issues Statement:

1.3.1 key characteristics of energy markets, in particular electricity markets, which the CMA should consider when assessing the nature of competition with respect to the supply and acquisition of energy in Great Britain ("the Reference Market");

1.3.2 a number of fundamental elements of both the regulatory framework and supply and demand characteristics that will be subject to change over the next few years and which will be relevant to the CMA's assessment of competition in the Reference Market;

1.3.3 the impact that overarching government targets and objectives have on competition in energy markets and, consequentially, the way in which the CMA is proposing to assess these in the context of the investigation;

1.3.4 an observation with respect to theory of harm 1;

- 1.3.5 the CMA's theory of harm that market power in electricity generation leads to higher prices;
- 1.3.6 an additional consideration that RWE believes is relevant to theory of harm 4;
- 1.3.7 regulatory interventions and obligations that are relevant to competition in the Reference Market; and
- 1.3.8 the indication from the CMA that it is not minded to investigate further, *inter alia*, wholesale gas markets and the regulation of revenues from transmission and distribution.

2. **Key characteristics of energy markets (paragraphs 16 and 17 of the Issues Statement)**

2.1 At paragraph 17 of the Issues Statement, the CMA states that it will take "*a realistic approach in developing our theories of harm and deciding on whether an AEC exists. The benchmark against which we will assess an AEC is that of a 'well-functioning market', that is, one that works well for customers. ... [T]his benchmark is not based on an idealised or theoretical notion of a perfect market, but will reflect a realistic assessment of likely outcomes in the market in the absence of the AEC in question. In gas and electricity markets, given the above characteristics, a well-functioning market will generally be expected to require some form of regulatory intervention*".

2.2 RWE welcomes the CMA's stated intention to take a realistic approach in developing its theories of harm and deciding whether an adverse effect on competition ("AEC") exists in the Reference Market. RWE agrees that the characteristics listed in paragraph 16 of the Issues Statement are fundamental to the operation of energy markets, in particular electricity markets, in Great Britain. However, RWE makes the following observations:

2.2.1 With respect to non-storability (bullet point 1 of paragraph 16), RWE agrees that electricity is costly to store and electricity generation has to match demand at every point in time. However, for completeness, the CMA will wish to note that fuels including gas, oil and coal are each storable, even though electricity is not.

2.2.2 With respect to natural monopoly characteristics of transmission and distribution (bullet point 2 of paragraph 16), RWE notes that the conventional approach to regulated industries has been to seek to limit the regulated activities to that part of the value chain which is a natural monopoly and, to the extent feasible, to allow competition to work elsewhere. Such an approach does not characterise the current regulatory approach to GB gas or electricity markets. In other words,

the generation and supply markets are substantially regulated even though they are not natural monopolies.

- 2.2.3 With respect to generation costs (bullet point 3 of paragraph 16), the CMA states that the relative positions of coal and gas-fired plant depend on the prices of the input fuels, which are themselves variable. RWE wishes to note that the relative positions of coal and gas-fired plant are, in addition, dependent on carbon costs as well as fuel costs. This is because different forms of generation are more or less carbon intensive. For example, coal plant emits more than twice as much carbon dioxide per MWh than gas plant. This means that policies to price the carbon that generators emit will increase the marginal cost of coal generation plant more than that of gas-fired generation plant.
  - 2.2.4 With respect to wide variations in price during the day (bullet point 3 of paragraph 16), RWE notes that conventionally such price movement has been considered important since it means that intra-day price signals do convey investment signals to market participants who may decide it is worthwhile making investments in peaking plant which may only run for relatively short periods.
  - 2.2.5 With respect to the responsiveness of small scale customers to wholesale price changes (bullet point 4 of paragraph 16), RWE considers that smart meters, which are already significant for non-domestic customers will, together with the introduction of energy management software, be important in the longer term (see in particular paragraph 3.4 below.)
  - 2.2.6 With respect to the prevalence of regulation (bullet point 5 of paragraph 16), it will be necessary for the CMA to consider carefully the nature and extent of all forms of regulation, to ensure that it is consistent with the intervention which might be expected in a well-functioning market.
- 2.3 In addition, RWE believes that the non-domestic market has substantially different characteristics to the domestic market, in terms of the types of contracts available, the nature of the risks that business customers are seeking to manage and the level of understanding and awareness that business customers have of the energy market. We would therefore encourage the CMA to understand fully the differences in this market when making its assessment of how competition is working for microbusinesses.

3. **Forthcoming changes to the regulatory framework and supply and demand characteristics (paragraph 18 of the Issues Statement)**

3.1 RWE considers it will be critical for the CMA to take account of changes that are currently taking place within the energy markets in Great Britain, as well as those which are likely to come about in the next few years, when assessing theories of harm in the Reference Market and, in the event that any AECs are identified, developing potential remedies.

3.2 RWE agrees that the changes listed in paragraph 18 of the Issues Statement will be fundamental to this assessment. With respect to the changes that will be brought about by the introduction of electricity market reforms to create a power generation capacity market, RWE refers the CMA to its Initial Submission<sup>1</sup> and reiterates that the introduction of capacity markets can lead to reduced volatility in power markets if scarcity prices become less frequent. In addition, contracts for difference provide certain (i.e., a sure) income to low carbon generators without the requirement to forward hedge. The combination of these two initiatives is likely to reduce liquidity in the forward markets (and, therefore, is at odds with Ofgem's objective of increasing liquidity in longer-dated products).

3.3 RWE believes that the increased level of regulation in recent years has in fact led to the need for capacity markets. This has been evidenced, most obviously, through the contracts for difference ("CfD") regime. RWE originally advocated instead a limited extension to the ROC regime through a Low Carbon Obligation, which would have maintained the link of prices to the market and provided greater certainty than the more radical changes under the new CfD regime. The effect of this move towards greater intervention has not just impacted the technologies covered by the CfD arrangements and led to political and regulatory disturbances, but has also had a major effect on both the returns from conventional generation and the level of investment in such generation. As a result, further intervention has been necessary in order to promote capacity. In other words, when market participants observe that the generation market continues to be impacted by a myriad of political and regulatory initiatives, the investment risk becomes too high and so further intervention becomes necessary.

3.4 With respect to the first bullet point under paragraph 18, in addition to the roll-out of smart meters to all households and businesses by 2020, rapid technological growth and reduced cost of simple applications (Apps) will allow real time usage information to be readily translated into automated monitoring and remote control of energy usage. RWE considers that this will fundamentally change the interface with the customer, increase demand management and increase customer engagement. In addition, RWE believes that the supply markets will change fundamentally as they open up a different competitive dimension, for example,

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<sup>1</sup> Paragraph 6.23

through the extraction and commercialisation of data for the benefit of customers. This may include innovative marketing offers which are tailored to customer needs, based on their individual electricity data "footprints". For this reason, when the CMA assesses the theories of harm during the investigation and, if it were to identify AECs and then develop potential remedies, it will be important for the CMA to consider the effect of this technological shift and the impact that any potential remedies could have on competition in the future.

4. **The CMA's proposed approach with respect to government targets and objectives (paragraph 20 of the Issues Statement)**

4.1 The CMA states that overarching government targets and objectives will be treated as context during its investigation. With respect to emissions reductions targets, to which the CMA specifically refers, RWE agrees that these do not constitute an AEC.

4.2 However, the CMA will be aware that it is required to determine whether any feature or combination of features of each relevant market prevents, restricts or distorts competition in connection with the Reference Market. In RWE's view, the regulatory framework in the energy sector in Great Britain, including government targets and objectives, is clearly a "feature" of the Reference Market that is capable of preventing, restricting or distorting competition. Indeed, the CMA's *Guidelines for market investigations: Their role, procedures, assessment and remedies* (CC3 Revised) ("Guidelines") clearly contemplate that the regulatory framework can be a structural feature giving rise to an AEC. For example, paragraph 158 of the Guidelines states that:

*"Specific structural features identified in past investigations to be harming competition include aspects of the planning system, government policy and the regulatory system ..."*

4.3 Paragraph 379 of the Guidelines also states:

*"(a) In some cases, the legal framework, regulations or conduct applicable to a market may be a structural feature giving rise to an AEC... ",*

and RWE notes that in past inquiries aspects of the regulatory framework have been found to do exactly that. For example, in the BAA airports investigation, the Competition Commission stated in its Final Report<sup>2</sup> that it "*find[s] that the regulatory system is a feature which distorts competition between airlines...*"<sup>3</sup>. and that "*...there are a number of findings which, taken as a whole, lead us to conclude that regulation is a feature which restricts competition*"<sup>4</sup>. In addition, in the Rolling

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<sup>2</sup> 19 March 2009

<sup>3</sup> Paragraph 6.60

<sup>4</sup> Paragraph 6.59

Stock Leasing market investigation, the Competition Commission concluded at paragraph 43 of its Final Report<sup>5</sup> that *"the operation of the franchise system ... reduces opportunities for competition"* and in paragraph 50 that *"the interaction between the franchising system and the leasing of rolling stock for franchised passenger services determines many aspects of the structure of the market"*.

4.4 RWE submits, therefore, that the CMA is required to consider during its investigation whether government targets and objectives, as well as other aspects of the regulatory framework, constitute a feature giving rise to an AEC and that it is not appropriate for the CMA to have regard to them simply as "context". Indeed, as stated in its Initial Submission<sup>6</sup>, RWE's view is that the British energy markets have been subject to a range of regulatory measures which, whilst aimed at achieving important goals (such as consumer protection, addressing fuel poverty or lowering carbon), have also had consequences on the functioning of the market.

4.5 RWE's further comments with respect to regulatory interventions and obligations relevant to competition in the Reference Market are set out in Section 8 below.

#### 5. **Observation with respect to theory of harm 1 (paragraphs 26 – 40 of the Issues Statement)**

5.1 RWE notes that much of the Issues Statement focuses on vertical integration. Whilst investigating this theory of harm, it will be important for the CMA to note that energy suppliers in Great Britain have very different business structures and that a "one size fits all" approach would not be appropriate. As the CMA will be aware from RWE's Initial Submission<sup>7</sup>, RWE operates each of its supply, generation, renewable and trading businesses separately and is, RWE would suggest, a model for how a UK energy group should be structured so as to enhance liquidity and ensure transparency of profits across the value chain. Whilst the Group is vertically integrated, it does not and is incentivised not to move money between various parts of the value chain because all trades are done openly and transparently at market value and each entity has its own profit and loss account.

#### 6. **Theory of harm 3: market power in electricity generation leads to higher prices (paragraphs 44 – 48 of the Issues Statement)**

6.1 RWE notes that market power in electricity generation did not form part of the joint Ofgem, CMA and OFT investigation in the State of the Market Assessment;

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<sup>5</sup> 7 April 2009

<sup>6</sup> Paragraph 6.1

<sup>7</sup> Paragraphs 2.19-2.24

nor did Ofgem's decision document, when referring the energy market to the CMA, identify market power in electricity generation as a potential issue. RWE is, therefore, interested in understanding the CMA's conclusions in terms of theory of harm 3 and queries whether further investigation of market power in electricity generation is warranted.

6.2 RWE considers that it will be important for the CMA in making any assessment under theory of harm 3 to consider the different structures of energy suppliers (as highlighted in paragraph 5.1). Additional matters which will be of relevance will be the effects of Ofgem's introduction of a Transmission Constraint Licence Condition ("TCLC") together with the following matters:

6.2.1 the amount of capacity available in excess of system demand at any point in time and the extent to which prices are reflective of short run marginal costs;

6.2.2 the introduction of the Capacity Market;

6.2.3 the unpredictability of peak demand: in the UK, peak demand occurs during a very short period (an hour or two per day) during winter; at other times of the day and year, system demand is significantly lower than at the peak. In addition, peak demand is very dependent on weather (winter peaks can vary between days by several GW) and the level of generation from renewables;

6.2.4 whether there is evidence of any periods when marginal generation capacity at peak demand has been used up to the extent that all available generation in the Balancing Mechanism has been dispatched;

6.2.5 whether there is any evidence that transmission constraints are associated with periods of peak demand;

6.2.6 whether there is evidence of prices increasing at times of system peak and if so, the magnitude of those price increases;

6.2.7 whether there is competition in the market at times of system stress, for example, whether the closure, or announced closure, of the main sources of peaking capacity (oil units) suggests sufficient capacity in the market to supply the system at times of constraint;

6.2.8 the ability for National Grid as the System Operator to contract ahead of time and to enter into fixed price option contracts in the form of Short Term Operating Reserve ("STOR"), the prices available under those contracts and the impact on the market of providing STOR, as highlighted in paragraph 6.2.10 below;

- 6.2.9 the extent to which STOR, and the other balancing services available, such as the Transmission Constraint Management Service and the Firm Frequency Response Service, as well as the new Demand Side Balancing Reserve Service and the Supplemental Balance Reserve Service, present an alternative to the Balancing Mechanism;
  - 6.2.10 the extent to which tenders for STOR are rejected, what these tender rejections imply in terms of over capacity in the Reserve Market and the effect that this over capacity may have on price levels;
  - 6.2.11 market design features other than the TCLC, such as how cash-out prices are derived, including National Grid's "tagging" of actions taken to control flows into or out of constrained areas; and
  - 6.2.12 the introduction of a single cash-out price in the balancing market.
- 6.3 In addition, when considering issues relating to the generation of electricity, RWE considers that the CMA should include in its investigation all generators, including independent generators.

**7. Additional consideration relevant to theory of harm 4 (paragraph 49 of the Issues Statement): gas retail and energy services**

- 7.1 RWE noted in its Initial Submission<sup>8</sup> that in the context of gas, the activities of wholesale and retail gas supply, and activities connected therewith, are also clearly encompassed in the terms of reference. These connected activities include the provision of boiler services, the purchase of which, in RWE's view, influences customers' behaviour in relation to the purchase of retail energy.
- 7.2 In particular RWE submits that the CMA should consider the benefits that arise from legacy economies of density in the provision of boiler services (the installation, repair and maintenance of boilers) that are not available to other energy supply providers and whether a favourable position in the provision of boiler services to customers can be leveraged to establish a significant market position in energy supply.
- 7.3 It is RWE's experience that customers who purchase a package of boiler services and energy, or who perceive that they have such a package of products, may be less likely to switch energy provider and so, once lost, such customers are more difficult than other customers to win back.

**8. Regulatory interventions and obligations that are relevant to competition in the Reference Market (paragraphs 57 - 59 of the Issues Statement)**

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<sup>8</sup> Paragraph 3.8

- 8.1 RWE agrees with the CMA's statements that the prevalence of regulation is a key characteristic of both gas and electricity markets (bullet point 5 of paragraph 16) and that the regulatory framework will be subject to fundamental change in the coming years (paragraph 18).
- 8.2 RWE's view is that the energy markets in Great Britain have been subject to a wide range of regulatory measures and interventions which have affected the way these markets function. As set out in its Initial Submission<sup>9</sup>, RWE's view is that many of these regulatory measures and interventions are of questionable consumer benefit, are uncoordinated with other regulation and longer term policy development, or are imposed in a manner that is not cost efficient. In addition, many energy policies in Great Britain have been subject to multiple revisions (including, for example, ECO, smart, carbon floor price and feed in pricing), which has led to increased costs and increased uncertainty. RWE welcomes, therefore, that the CMA has stated its intention (in paragraph 57 of the Issues Statement) to assess the effect that these regulatory measures and interventions have on competition in gas and electricity markets and whether these regulatory measures and interventions reduce the incentives for energy suppliers to compete (hypothesis 4c).
- 8.3 RWE agrees that it will be important for the CMA to assess the impact on competition of two recent interventions by Ofgem in retail energy markets: the non-discrimination licence conditions that were introduced in 2009 and the tariff simplification reform, one of the measures resulting from Ofgem's Retail Market Review. RWE's views on the impact of the non-discrimination conditions are set out in paragraphs 6.6 – 6.14 of its Initial Submission, whilst RWE's views on tariff simplification are contained in paragraph 6.15 – 6.21 of the Initial Submission.
- 8.4 RWE welcomes, in addition, that the CMA has stated its intention (in paragraph 59 of the Issues Statement) to investigate whether the size threshold (250,000 accounts) below which a supplier is not required to meet broader social and environmental obligations may also act as a barrier to expansion. In so doing, RWE considers it will be important for the CMA to take into account any analysis conducted by DECC to assess the extent of any economies of scale advantages accruing to larger energy suppliers; whether the commercial value of the cumulative exemptions (in particular ECO and WHD) for smaller suppliers is proportionate, and whether there are alternative ways in which small suppliers can manage their costs in this regard. RWE submits, furthermore, that the CMA should also consider the other implications for competition of the current small supplier exemption regimes and refers the CMA to the points that RWE makes in this regard in its Initial Submission<sup>10</sup>.

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<sup>9</sup> Section 6

<sup>10</sup> Paragraphs 7.1 – 7.4

- 8.5 However, as noted at paragraph 2.2.6 this response, it will be important for the CMA to consider carefully the extent and form of any such regulation, to ensure that it is consistent with the intervention which might be expected in a well-functioning market. In this context, RWE considers that it will be important for the CMA to consider interventions by the regulator beyond those listed in paragraphs 58 and 59 of the Issues Statement, which may be “extra regulatory” in nature and, in RWE’s view, may have a distortive effect on competition. By this, RWE refers to activities, initiatives and interventions by Ofgem in the energy market in Great Britain which do not necessarily involve a formal consultation process leading to regulation but which are simply “interventions”, requiring steps to be taken by participants to “self-regulate”, with the implicit threat of formal regulation if action is not taken.
- 8.6 One such example is in relation to enforced transparency. RWE has always wanted to be open and honest with its customers in relation to their energy bills, so that customers are able to understand the long term direction of prices, as well as the components that make up their bills. By the same token, however, RWE does not wish to disclose commercially sensitive information that would reveal details of its commercial strategy and place it at risk of infringing competition law.
- 8.7 However, by intervening in the sector as it has done Ofgem has, in RWE’s view, put pressure on suppliers to reveal information which has put them in a difficult position and where perhaps a more considered approach by Ofgem would have been desirable in order to mitigate any competition risk (or at the very least to ensure there is no such publicly perceived risk) that energy suppliers may be exposed to.
- 8.8 For example, RWE commented to Ofgem at the time of its introduction that the granularity of the Consolidated Segmental Statement (CSS), combined with its annual publication, allows suppliers to infer one another’s hedge parameters, (this ability being enhanced by the reference hedge in the Supply Market Indicators), so all suppliers can make inferences about the retail price trajectory of all suppliers who are obliged to produce the CSS.
- 8.9 By way of further example, we attach correspondence from June this year in relation to falls in wholesale prices:
- 8.9.1 The chief executive of Ofgem, Dermot Nolan, published an open letter to suppliers dated 4 June 2014 in which he made clear his expectations that suppliers should explain these movements in wholesale prices and the implications they would have for suppliers’ retail pricing policies. (attached with RWE’s response as **Annex 1**); and
- 8.9.2 RWE came under pressure from Ofgem to publish its response to this letter, and eventually did so having satisfied itself that the contents of

this particular response did not contain information which was commercially sensitive (attached as **Annex 2**).

- 8.10 RWE also wishes to highlight that it is not only Ofgem that has presented such dilemmas to suppliers. Many similar initiatives (for example, the SME working group which led *inter alia* to energy suppliers agreeing to end auto-rollovers and establishing common procedures for terminations and contract continuations; quicker switching; debt; and direct debit credit balances) have come from government where energy suppliers have been encouraged to agree collective self regulatory action.
- 8.11 Energy suppliers have therefore been exposed to the demands of both the regulator and government in terms of self regulatory initiatives and often had to challenge such initiatives so as not to expose themselves to the risks of infringing competition law. Faced with an increasingly regulatory environment, this has not been helpful to the industry and has often exacerbated political debate and public misperceptions about collusion amongst energy suppliers.
9. **Matters that the CMA is not minded to investigate (paragraphs 60, 62, 63 and 65 of the Issues Statement)**

#### *Wholesale gas markets*

- 9.1 The CMA has indicated that it does not propose focusing on wholesale gas markets during its investigation, although the CMA has indicated that it will wish to understand in greater detail why wholesale gas markets appear to be working better than wholesale electricity markets and why gas suppliers have felt less need to integrate vertically than electricity suppliers.
- 9.2 As noted in its Initial Submission<sup>11</sup>, RWE's view is that neither wholesale gas nor wholesale electricity markets exhibit potentially harmful market features. For this reason, RWE considers that the CMA should take a balanced approach to the two wholesale markets in its investigation, which involves investigating neither or both. RWE would also note that wholesale gas and power markets are closely interrelated. The spread between wholesale gas and power prices is a key variable in hedging gas-fired power stations and the correlation between wholesale power and gas prices allows gas to be traded as a close proxy for UK power.
- 9.3 RWE's view, therefore, is that power market liquidity cannot be assessed in isolation from liquidity in the wholesale gas market. As such, in addition to the matters specified at paragraph 63 of the Issues Statement, RWE would expect the CMA to consider the implications of the interaction between power market liquidity and liquidity in the wholesale gas market during its investigation.

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<sup>11</sup> Paragraph 3.7

- 9.4 Gas is the major element of domestic energy consumption, the major element of energy bills, the major heating fuel, the major cause of concern in relation to fuel poverty, and the major variable cost and so issue of concern at times of cold weather. As noted above, gas is also the main price driver in the wholesale electricity market. Wholesale gas prices are by far the biggest single factor impacting domestic energy bills and hence RWE believes that if the CMA is investigating wholesale power, it should also investigate wholesale gas.

*The regulation of revenues from transmission and distribution*

- 9.5 The profitability of a supply company and the risks which a supply company faces strongly depend on the costs they face from regulated transmission, distribution and system operator companies. This is because network and system costs are not certain at the time of signing customer contracts and, occasionally, costs change even after volumes have already been delivered to customers. This uncertainty stems from regulatory decisions on allowed revenues for network and system operators and considerable tolerances within the regulatory framework and charging model including, for example, distribution losses incentive schemes.
- 9.6 While supply companies cannot influence these costs, they need to consider financial risks in their pricing approach which affects their profitability and customer bills.
- 9.7 RWE believes, therefore, that it is logical for the CMA to consider the profitability and risk/reward profile of those regulated businesses, particularly considering that supply companies need to forecast these to form a view on where network and system costs are likely to outturn.
- 9.8 In addition, the volatility in a supplier's cost base that may arise as a result of network and system cost uncertainties affects the attractiveness of certain products (e.g. fixed price products) or market segments (e.g. longer term products).
- 9.9 Furthermore, as noted in RWE's Initial Submission<sup>12</sup>, distribution and transmission costs are important for retail energy prices and RWE's expectation is that this will continue. For example, Ofgem announced on 11th July 2014 that it had approved, with effect from 1st April 2016, a new methodology for calculating generator transmission connection charges onto the National Grid. RWE is concerned that the new methodology reflects the costs that different generators impose on the system less closely than the existing methodology, and as a result may therefore reduce the efficiency with which the transmission system is used and developed, and may also increase transmission system costs and consumer bills.

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<sup>12</sup> Paragraph 5.3 of RWE's Initial Submission noted that transportation (network) costs accounted, in 2013, for an estimated 25% of a typical household dual fuel energy bill.

- 9.10 Furthermore, the increases in policy and regulation costs and network costs since 2007 have been stark (estimated increases of 129% and 58% respectively over that period)<sup>13</sup>. The expansion of renewables has been one of the factors behind the increase in network costs, as well as policy decisions to ‘socialise’ the substantial system costs of expanding renewables, rather than allocating costs to those that cause them.
- 9.11 In relation to wholesale gas and transmission and distribution costs, RWE therefore reiterates its view<sup>14</sup> that the CMA should consider during its investigation all elements of the cost of energy and that scrutiny and review of policy is important to ensure that costs are falling where they should.

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<sup>13</sup> Paragraph 5.4 of RWE’s Initial Submission

<sup>14</sup> Paragraph 5.7 of RWE’s Initial Submission

*NOTE: ANNEXES 1-2 ARE PROVIDED AS SEPARATE DOCUMENTS – CONTENTS ARE DESCRIBED BELOW*

**Annex 1:** Ofgem open letter to suppliers dated 4 June 2014

**Annex 2:** RWE response to Ofgem open letter dated 10 June 2014



Making a positive difference  
for energy consumers

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Date: 4 June 2014

**BY EMAIL**

[Paul.Massara@RWEnpower.com](mailto:Paul.Massara@RWEnpower.com)

Dear Paul

**Wholesale Costs**

I am writing to you today in relation to the significant falls in wholesale gas and electricity prices we have seen over the past year or so.

In a competitive market, I would expect the threat of losing market share to encourage suppliers to pass on sustained reductions in wholesale costs as savings to consumers as soon as possible. If that is not happening, it could be seen as further evidence that competition is not working for consumers as well as it should be. A concern that savings were not being passed on to customers was one of the reasons why we have proposed a referral of the energy market to the Competition and Markets Authority for investigation.

I should stress that pricing decisions are entirely a matter for individual suppliers. Each supplier will of course have its own strategy for purchasing energy, which will determine the impact of falling wholesale prices on its business. However, the downward trend in falling wholesale prices seems clear and should reduce wholesale costs increasingly over time.

Given the need to re-build consumer trust in the market it is important that suppliers explain to their customers these changes in the wholesale market and what impact they will have on their pricing policies. I would welcome an explanation of how you are doing this.

Yours sincerely

**Dermot Nolan**  
**Chief Executive Officer**



Paul Massara  
CEO RWE npower  
RWE UK Country Representative

Dermot Nolan  
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10 June 2014

Dear Dermot

### Wholesale Costs

Thank you for your letter of 4 June.

We constantly monitor wholesale prices and have noted the fall in prices particularly at the front end of the curve. The primary reason for the fall in prices is the exceptionally mild winter which we have had, which as you will know has detrimentally impacted on the profitability of retail energy supply.

Of course wholesale prices now make up a smaller element of those factors which affect retail prices. We calculated that in 2013 it made up 42% of the average dual fuel bill (down from 50% in 2011).

You note the relative movement of wholesale and retail prices and will be aware of the debate in 2011 and the Ofgem and NERA studies, which had very different conclusions. The Ofgem Supply Market Indicators contain a reference hedge model, and should suppliers hedge according to this model, then near term wholesale price changes would have a very limited effect on prices for standard retail tariffs, as the price for the corresponding energy is almost completely locked in by hedging.

In relation to your latest Supply Market Indicators report, wholesale costs are estimated at £617 for supplying a typical dual fuel customer for the period May-14 to Apr-15. This compares to a high for the last twelve months of £638, thus representing a drop of £21 or 1.6% of your current estimate of the average customer bill. This illustrates the impact of hedging in smoothing volatility in costs.

More recently in relation to the CMA referral, Ofgem has used econometric analysis on the relative movements of wholesale and retail prices. Whilst we have read this carefully it would be premature of us to comment at this stage. Suffice to say that the conclusions from the modelling are heavily dependent on the implicit and explicit assumptions, of which we do not at present have sight.

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We do not doubt that the CMA Review will look carefully at this and we encourage them to do so.

Tariff pricing decisions are made based on a forward looking view of the costs and market conditions and we typically are looking some period ahead on any pricing decision to minimise disruption for our customers. More factors affect pricing decisions than a drop in wholesale prices at the front end of the curve, particularly when you take into account that wholesale prices now represent a smaller percentage than they used to of retail prices.

The Consolidated Segmental Statements do not appear to us to give any indication that retail prices are inflated relative to wholesale prices.

The potential Labour price freeze has of course also complicated all pricing decisions further. The political and media pressures at the moment make it more difficult to reduce prices and then increase them again say next Spring. Then we are acutely aware that if the Labour party were to implement their proposed price freeze we will be living with the consequences of our standard tariff price for a very long time and beyond the level of risk that we could manage in the wholesale market.

However I can assure you that we review prices regularly and assess our options on a monthly basis.

In terms of explaining the impact of wholesale prices on the bill, the attached insert (headed "We've listened and we're making changes") was sent to customers from December 2013 with their first "new look" bill as part of our bill simplification project. As you can see, it includes a section headed "How your bill is made up". Online customers were sent a link to a page with the same content and an explanatory video.

In addition the purpose of our Energy Explained report and event was to bring some light to what had previously been a very muddled debate on the make up of the energy bill.

May I particularly endorse your comment on the need to re-build consumer trust in the market. The most important consideration currently at npower, on which I and my team are focused above all others, is the need to improve the way in which we deal with our customers. We are committed to increasing our investment in time and resource on customer issues, and clearly any pricing decision will be taken inter alia in the light of its effect on consumer trust and the other ways in which we could improve that trust.

Yours sincerely

A handwritten signature in black ink that reads "P. Massara".

**Paul Massara**

## We've listened and we're making changes

There's a lot going on in the energy industry and this year we have been reviewing everything we do and based on your feedback, we're making some changes.

When you asked us to make your bill easier to understand, we did just that!

We've created a bill that should help you see at a glance how much energy you're using, what you're paying for and if you're on the best tariff available. What's more, we've designed this with the help of our customers.

We hope you like it. With simple symbols and bold colours that make every bill easier to understand, it's one more way in which we want to help you manage your energy costs.

We've listened to your feedback on other areas where we can help make life a bit easier for you and we'll be making even more changes over the next few months which are outlined on the next page.

We will continue to act on feedback from you to make it as easy as possible for you to manage your energy.

Paul Massara  
Chief Executive, RWE npower



### Here's what to look out for:

#### Simplified Tariff Structure

We have moved away from complicated base tariffs and reduced the number of tariffs available. We are committed to offering a maximum of four simple tariffs. This will help us to simplify your energy costs and make it easier to ensure you're getting the best tariff available.

#### Helping you to choose the right tariff

From the beginning of April 2014, we'll also make sure it's always easy to see which one of our tariffs is cheapest so that you can work out what's best for your needs. To help you with this, we are introducing a tariff comparison rate. This will help you to understand the cost of your tariff so that you can easily compare the prices of different tariffs, at a glance, on a like for like basis.

#### Standards of Conduct

We want to be more open and transparent. Ofgem, the energy industry regulator, has issued a new licence condition which asks suppliers to explain how we treat customers fairly. We are fully supportive of this and view this not simply as a regulatory obligation but how we should do our business, day in, day out. That's what we are working towards and it's one of the reasons why we've made our tariffs simpler.

We'll be producing an annual statement each year so you can see how we are ensuring these standards are applied throughout our business, at all levels, from the boardroom to our call centres. You can see the first one online at [npower.com/creatingcustomerfairly](http://npower.com/creatingcustomerfairly).

Find out more:  
Your new look bill  
[npower.com/newbill](http://npower.com/newbill)

Energy savings advice  
[npower.com/savingenergy](http://npower.com/savingenergy)

Or call us on: 0800 073 3000 (landlines)  
0330 100 3000 (mobiles)

Monday - Friday 8am - 8pm  
Saturday 8am - 5pm

#### Worried about your bill?

We understand that you may have trouble paying your bills now and then. If you're worried about keeping up payments and managing your account to stay out of debt, or if you are already in debt for the energy you have used, the best thing to do is get in touch with us.

We can talk you through any schemes you may be eligible for and our services and products that could make a difference to the way you manage your energy bill. The earlier you get in touch, the sooner we can help. Online, over the phone, whatever's easiest for you - we'd like to help.

You told us you  
wanted a clear,  
simple energy bill...

npower

Phone calls calling us on a 0800 number is normally free when you call from a landline but charges may vary if you use a mobile. Calling us on a 0330 number will cost you no more than 10 or 20 pence from landlines or mobiles. If you get inclusive minutes with your package, calls on 0330 numbers will be part of these. However a separate customer and charging policy for npower is available from United Kingdom. P1501097 Reg. Gen. Sec. Ofc. 40, North Hill Business Park, Middlesbrough, Cleveland TS6 8PL

## Understanding your new bill

### What do I pay?

This shows your monthly payment amount and the date it will be taken out of your account each month. We will also show the dates your bill relates to.



### Your meter readings

This shows your most recent meter reading and the date it was taken. Your bill is based upon our estimate or your meter reading.

When you send meter readings in regularly, it helps us make sure you're paying the right amount for the energy you're using.



### How does this compare to last year?

These graphics help you see how much gas and electricity you've used, and if it's more or less than the amount you used over the same period last year.

### Your payments

This area shows the payments you've made since your last statement. The amount and payment date will be shown here.

You can also see how we've calculated your new Direct Debit payment.

Monthly payments	Amount
22 June 2013	£100.00
22 July 2013	£100.00
22 August 2013	£100.00
22 September 2013	£100.00
22 October 2013	£100.00
22 November 2013	£100.00
<b>Total</b>	<b>£600.00</b>

### How your statement adds up

Amount left to pay from your previous statement	£33.96
You've paid	£600.00
Total costs of energy used	£770.20
<b>Total left to pay</b>	<b>£164.16</b>

### Your tariff

Take a look at all the key details relating to your tariff. We've included an estimate of your costs over the next 12 months.



### Your energy use

This shows how much energy you've used and how much it costs. We've broken down your gas and electricity readings into sections.

A standing charge is a fixed fee you pay for every day you are connected to the gas and/or electricity network, set up to pay for maintaining your supply.

Cost	Amount
Meter reading	4824
17 April 2013 - Our estimate	4421
15 October 2013 - Our estimate	403
<b>Total kWh</b>	<b>418</b>
Connected to kWh	<b>4558</b>
<b>This cost</b>	<b>£13.99</b>
Standing charge of 41.5p a day for 182 days	£75.2
VAT at 5%	£11.58
<b>Total costs of gas used</b>	<b>£100.79</b>

## How your bill is made up

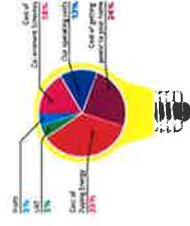
A recent power survey showed that customers think suppliers' profits could be as much as 40%, and that their bills are rising due to our increasing costs.

We believe you'd like us to be upfront about what really makes up the cost of a typical energy bill, and to give you better, transparent ways. So it may surprise you to hear that our bills are only about 5% - that's about the same as most supermarkets and far lower than many companies of our size.

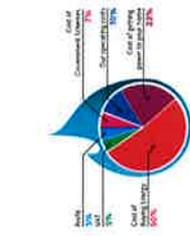
We've invested more than £5bn in the UK over the past six years, creating jobs, and investing in new, more efficient energy infrastructure. We're also offering government energy efficiency programmes that will help reduce the cost of energy in the long run. These investments should help bring down the cost of energy in the long run.

Here's how a typical bill is made up.

### Electricity bill costs



### Gas bill costs



These breakdowns are based on an estimate of costs at 20p/kWh, overall average consumption of 3,200 kWh for standard rate electricity and 11,500 kWh for mains gas.

The examples shown in this leaflet are for Direct Debit customers. More questions about your new look bill? Visit [npower.com/newbill](http://npower.com/newbill) for detailed information