Energy Market Investigation
Updated Statement of Issues
Response of E.ON

1 INTRODUCTION

1. To date, E.ON has made one substantive submission to the Competition and Markets Authority ("**CMA**") in the form of its response (the "**First Issues Response**") to the Energy Market Investigation Statement of Issues (the "**First Issues Statement**") published on 24 July 2014. E.ON has, of course, also submitted to the CMA a large number of responses to questionnaires and other requests for information.

2. On 18 February 2015, the CMA published its updated issues statement (the **"Updated Issues Statement"**). This document represents the response of E.ON (the "**Updated Issues Response")** to the Updated Issues Statement.

3. We comment below specifically and in turn on each of the revised theories of harm identified by the CMA. We have taken into account the working papers published by the CMA which we have seen to date (the "**Working Papers**") but reserve the right to comment on the remaining Working Papers within the timescale set out by the CMA. We also comment below on some of the introductory context set out by the CMA in the Updated Issues Statement.

2 EXECUTIVE SUMMARY AND CONCLUSIONS

4. **E.ON agrees that the market rules governing self-dispatch are efficient and effective. E.ON also considers that the introduction of a single cashout price under the Electricity Balancing Significant Code Review ("EBSCR") would remove the current distortion caused by dual cashout prices and dual imbalance accounts.** However, we have concerns with other elements of the proposed reforms, in particular the combination of a price average reference volume of 1MWh ("**PAR1**") and reserve scarcity pricing ("**RSP**"), which will create extreme, volatile and unpredictable cashout prices. These elements are unnecessary to ensure efficient balancing and are not required to incentivise new flexible generation.

5. **E.ON generally supports cost reflective charging and locational signals. Reforms in that regard must, however, not increase complexity and unpredictability for market participants.** Whilst E.ON would support the introduction of locational transmission losses as a cost reflective approach resulting in a more efficient outcome, we have significant concerns about locational charging of constraints. Locational constraint charges or locational energy pricing are likely to be difficult to implement and result in increased complexity. The unpredictable and volatile nature of such costs would make it very difficult for parties to respond to the signals, increasing the risks faced. Additionally, locational energy pricing would

have a significant impact on the liquidity in each of the energy price zones, particularly in Scotland (likely to be a separate price zone due to system constraints).

6. **E.ON agrees with the CMA that the Capacity Market ("CM") is a necessary intervention in the UK market.** Without it the UK could see risks to security of supply. The CMA is right to look at the interaction between the CM and other reforms such as Ofgem's EBSCR on cashout pricing, but E.ON believes that the risk of over-compensation due to the interaction is low. We also share the concerns raised by the CMA with regard to the unbalanced levels of certainty the CM provides due to differing contract lengths and welcome further investigation into this area. E.ON also encourages the CMA to explore whether the mechanism for penalties and recovering costs can be improved.

7. **E.ON welcomes the broad support for Contracts for Difference ("CfDs") and agrees that a competitive approach will lead to a more efficient outcome for customers in meeting the 2020 renewable targets.** We agree that in the very short term, there is a strong argument for having separate funding pots, but it is important that over time we move to technology neutral auctions. Like the CMA, E.ON is concerned with the Financial Investment Decision ("**FID**") enabling process, including the magnitude of the budget and the non-competitive nature of the process. E.ON also has concerns with the power of the Secretary of State to direct the CfD counterparty to award CfDs in a non-competitive manner, especially where this could take up a large proportion of the budget.

8. **E.ON agrees with the result of the CMA's analysis that generators do not have market power to increase profits and raise prices.** In its First Issues Response, E.ON expressed its view that market power does not exist in generation markets in any form which would allow a generator or group of generators to manipulate wholesale market prices to the detriment of the customer. We, therefore, recognise and welcome the CMA's current thinking that firms do not have the ability or the incentive to increase profits by withdrawing generation capacity, be this through unilateral market power or coordinated market power.

9. **E.ON notes that the CMA's data analysis has confirmed the views of suppliers and generators that the GB wholesale electricity markets are sufficiently liquid and traded and prices transparent, with large volumes being traded over platforms**. Nevertheless, E.ON supports any measures to further increase liquidity, as E.ON's business model is based on independently managed businesses trading at arm's length and operating in liquid wholesale markets across Europe. We are, therefore, happy to continue to support Ofgem to monitor and to attempt to improve liquidity.

10. **E.ON notes that neither the CMA's own assessment nor the responses it has received indicate that there is room for customer or input foreclosure, by vertically integrated electricity companies acting unilaterally or through coordination.** E.ON equally did not believe this was an issue and we referred again to our own internal organisational structure in support of this view. Again,

our intention to implement a strategy under which our supply business will be legally separate and under different ownership from our conventional generation business would suggest that we do not see foreclosure as an issue of concern in this market.

11. **E.ON has concerns regarding the analysis that leads to the CMA initial finding that since around 2009 there has been a divergence between the average standard variable tariff ("SVT") bill and expected direct costs, which could be regarded as a sign of a weakening of competition**. E.ON looks forward to the CMA further developing this work, both in terms of the data and assumptions used. It is particularly important to understand the impact that energy purchase hedging can have when assessing the potential costs associated with both SVT and non-SVT customers and how this can result in different outcomes depending upon the movements in the wholesale market.

12. **E.ON does not generally consider that prices respond more quickly to increases in wholesale costs than to reductions.** Any price event, whether up or down, has an impact for suppliers and therefore no price movement decision is taken lightly. In our experience, being the first supplier to respond to rising costs and increase prices carries a heavy price in terms of customer response and losses and criticism by the media and other stakeholders. Part of E.ON's reaction to such impacts has been to increase prices as late as we can and decrease them as soon as we can. This is evidenced by our last two standard variable price increases and our recent price cut in January 2015.

13. **E.ON does not believe that it has unilateral market power over its customers.** A supplier cannot rely on a customer who might currently not be active in the market continuing to be so. The CMA customer survey shows that most people are aware they can switch and a great number indicated that they were satisfied with their current supplier. We would suggest that just because a customer is on an SVT, it does not mean either that they are not engaged or that they are not active.

14. **E.ON does not believe that the CMA's customer survey reveals any evidence for significant barriers to switching to another supplier.** E.ON does recognise that there might be a more vulnerable segment of customers who tend not to switch and hence are more likely to be on SVT. However, customers on SVT are not a homogenous group, and there are those on SVT who have switched in the past and will or may do so again in the future and therefore competition to retain such customers also provides protection to those who are vulnerable and perhaps less active.

15. **E.ON has seen the impact of price comparison websites ("PCWs") in terms of increasing transparency in the market to enable switching and recognises that many customers use this channel.** PCWs have an important role to play in the market and it is important that customers have trust and confidence in the information they are receiving.

16. **E.ON has a firm belief that the ongoing smart meter rollout will facilitate many things in the energy industry, overcoming many of what might otherwise be seen as the potential barriers to greater customer engagement.** Automatic reading of meters will ensure that bills are almost always accurate, switching processes are improved and the customers will have the ability to engage with their consumption. We can therefore expect that this will result not only in a better experience for customers, but also in the provision of more diverse and innovative products and services.

17. **E.ON does not believe there is evidence of it "exploiting" any market power through making excessive margins from its domestic customers.** [✂].

18. **E.ON agrees with the CMA view that there is not tacit coordination through public price announcements by suppliers in the energy market.** As we said in the First Issues Response, we believe that the GB energy market lacks a number of the fundamental characteristics of markets which may be conducive to coordination and the conduct of suppliers in the market is not consistent with coordination. E.ON agrees with the CMA's initial view that the behaviour it has observed in relation to public price announcements by suppliers is likely to be consistent with unilateral incentives and supports the view that the company that announces price increases first risks losing more customers than those that follow, which gives a unilateral explanation for the clustering of price announcements.

19. **E.ON reiterates its concerns regarding the impact of regular changes in Ofgem's regulatory requirements/approach and the ever-increasing volume/complexity of regulation.** The layering of regulation upon regulation impacts competition and stifles innovation in the market. The sheer volume of such requirements requires significant resources, not only financial but also in terms of the necessary management focus to ensure compliance. This naturally reduces the capacity and capability we have to focus resources on innovation, as well as reducing the incentives for innovation.

20. **E.ON supports the principle behind Ofgem's intention to move away from rules based regulation and towards principles based regulation.** However, we fear this will be a lengthy and difficult transitional period, during which we have two approaches in parallel, creating further risks for suppliers.

21. **With regard to Retail Market Reform ("RMR"), E.ON agrees with its principles of a simple, open and transparently fair market, but would suggest that whilst it has been successful in some areas, it has created issues in others, potentially impacting innovation.** We further welcome the CMA's recognition that suppliers are increasingly being used as agents of delivery of government social and environmental policies and would reiterate how we believe this could be addressed as set out in the First Issues Response.

22. **E.ON believes that the supply of energy to SMEs is a market in transition, where increasing competition is being seen.** E.ON recognises the growing level of

participants in the SME market and the impact this has had in terms of increasing churn. E.ON has therefore sought to drive greater engagement with SME customers at contract renewal through proactive and clear communications. As a result, we are not only seeing greater engagement at renewal, but also increased customer satisfaction.

23. **E.ON sees the increasing number and activity of third party intermediaries ("TPIs") as a significant improvement in the market, helping to engage customers, increase transparency and ultimately increase competition.** E.ON has implemented a Code of Conduct for TPIs wishing to engage with us to ensure they work to a set of high standards. E.ON welcomes and encourages greater TPI regulation and the implementation by Ofgem of a market wide Code of Conduct in order to improve standards, increase transparency and hence increase customer trust in these brokers.

24. **E.ON believes that some aspects of the current broader regulatory framework harm competition.** E.ON made this point in the First Issues Response and therefore, generally welcomes the CMA's intention to test the broader regulatory framework for its potential to act as a barrier to pro-competitive innovation and change.

25. **E.ON believes that whilst certain areas of the current code governance system could be improved, it is vital that the right system of checks and balances remains in place so that all power is neither vested in Ofgem or in the industry**. E.ON has some doubts whether the number of codes itself adds to barriers to entry and/or expansion. The codes reflect the complexity of the industry and whilst we support their simplification where possible, bringing them together would not necessarily reduce this complexity. It should, however help with the parties collateral requirements under the codes.

26. **E.ON does not believe that the nature of industry participation in the current governance arrangements favours the large energy firms over new entrants, smaller parties and customers**. The code panels typically have mix of members from different backgrounds and generally are formally required to operate independently and not represent their companies' interests. They also only have a limited role in the change process. In practice there are a number of ways that newer/smaller parties are supported in making changes to the arrangements which we support and believe work well.

3 E.ON'S RESPONSE ON ISSUES RAISED BY THE CMA

3.1 Prices and profits

27. The CMA has used the financial information provided by the companies it defines in paragraph 4 of the Updated Issues Statement as the Six Large Energy Firms[1] to produce a number of statistics on prices and profits and considers the potential implications of those observations under updated theory of harm 4, concerning competition in retail energy markets.

28. It is important to note the efforts that E.ON has made, and continues to make, to address the costs of its retail supply business in the period since 2007 when that business was making unsustainable losses.

a. [✄].
b. [✄].
c. [✄].
d. [✄].

29. The work that E.ON has undertaken in the above areas are key drivers for the change in our profitability over the period of 2007 to 2014. However, we comment further on these observations in the relevant sections of the updated theory of harm 4.

3.2 Quality of service and complaints

30. The CMA comments that there have been considerable concerns about the quality of service offered by the Six Large Energy Firms, noting in particular that the complaints received more than doubled between 2013 and 2014 (although it acknowledges that this was primarily driven by increases in complaints about two suppliers concerning billing). E.ON would wish to comment as follows:

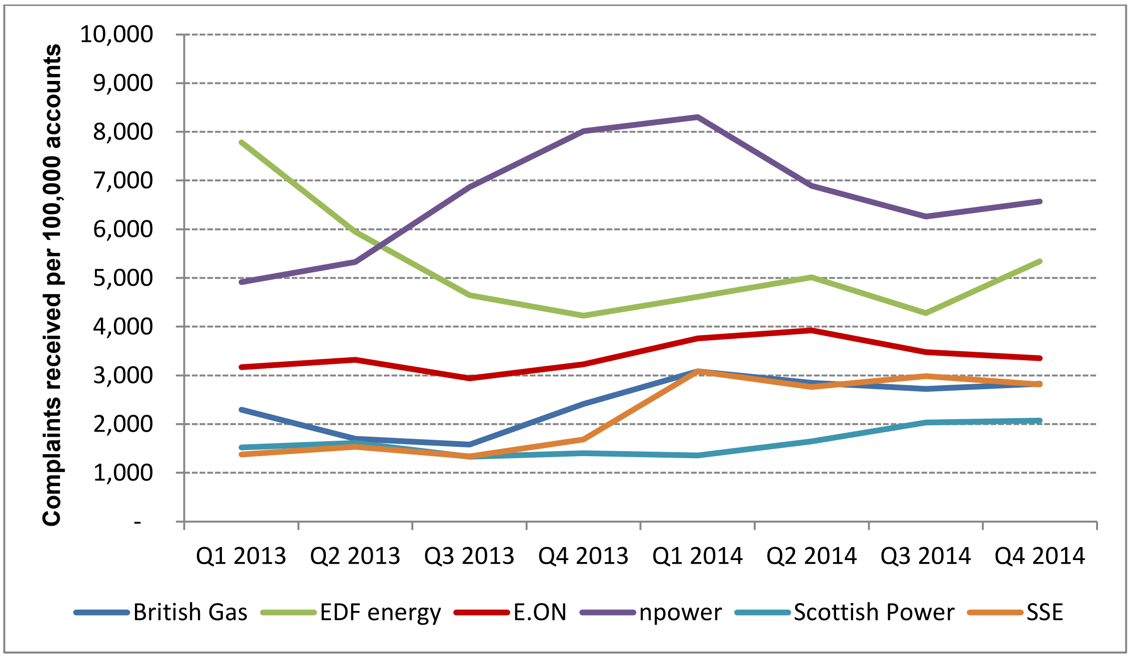
a. E.ON is by no means complacent about its quality of service and accepts that it does sometimes get things wrong. When that happens, we will seek to put things right for its customers. However, we have, as part of our Trusted Energy Partner strategy[2] placed great emphasis on seeking to improve our customer service, [✄]. As we set out in paragraph 99 of the First Issues Response, we have used net promoter score ("**NPS**") as a measure of our customers' satisfaction with us, [✄].
b. Similarly, in the last three years, we have won the uSwitch award for customer satisfaction outright twice (2012, 2013) and were highest of the larger suppliers in 2014[3];

[1] We will adopt the same terminology for the purposes of this response.
[2] We shared our "Trusted Energy Partner" strategy with the CMA at our site visit on 22nd September 2014, and also in our Opening Statement at the formal Hearing on 4 March 2015.
[3] uSwitch added two smaller suppliers to their survey for the first time

c. Our own complaints numbers did not double between 2013 and 2014. As Ofgem's chart below shows, whilst the total did increase a little in 2014 over 2013, our numbers have been falling again since Q2 2014;

d. The CMA refers to the service and complaints performance of the Six Large Energy Firms. However, it is also the case that some of the smaller suppliers saw complaints levels rise in this period. See *https://www.ofgem.gov.uk/about-us/how-we-work/working-consumers/supplier-performance-consumer-complaints*;

Figure 1: Largest Suppliers – Complaints received by company per 100,000 accounts



Source:https://www.ofgem.gov.uk/about-us/how-we-work/working-consumers/supplier-performance-consumer-complaints

e. We noted in paragraph 23 of the First Issues Response our view that political rhetoric and media comment might be influencing customers' attitudes towards suppliers in general, in a similar way to the view suggested by the CMA in paragraph 25 of the Updated Issues Statement. We would support the CMA's view therefore. In addition, although the CMA points out that trust in other energy companies is below that in retail banks, car insurers and mobile phone companies, it is also the case that the proportion of people who would tend to distrust their energy company is lower for their own energy company (16%) than it is for Local Authorities (20%), retail banks (20%), car insurance (20%) and mobile phone network providers (23%).

3.3 CMA Updated theory of harm 1: the market rules and regulatory framework distort competition and lead to inefficiencies in wholesale electricity markets

31. The CMA has updated theory of harm 1 to consider a wider scope of rules and regulatory framework governing wholesale electricity. We welcome this broader scope of investigation which now includes areas such as self-dispatch, locational pricing, the proposed modifications to cashout under the EBSCR and elements of the Electricity Market Reform ("**EMR**").

3.3.1 Summary of E.ON's view

32. E.ON agrees with the CMA that the CM is a necessary intervention in the UK market, without it the UK could see risks to security of supply. The CMA is right to look at the interaction between the CM and other reforms such as Ofgem's EBSCR on cashout pricing, but E.ON believes that the risk of over-compensation due to the interaction is low. We also share the concerns raised by the CMA with regards to the unbalanced levels of certainty the CM provides due to differing contract lengths and welcome further investigation into this area.

33. E.ON supports cost reflective charging and locational signals, such as exists in Transmission Network Use of System ("**TNUoS**") charging. Whilst E.ON would support the introduction of locational transmission *losses* as a cost reflective approach resulting in a more efficient outcome, we have significant concerns about locational charging of *constraints*. Locational constraint charges or locational energy pricing are likely to be difficult to implement and result in increased complexity. The unpredictable and volatile nature of such costs would make it very difficult for parties to respond to the signals, increasing the risks faced. Additionally, locational energy pricing would have a significant impact on the liquidity in each of the energy price zones, particularly in Scotland (likely to be a separate price zone due to system constraints).

34. E.ON welcomes the broad support for CfDs and agrees that a competitive approach will lead to a more efficient outcome for customers in meeting the 2020 renewable targets. We agree that in the very short term, there is a strong argument for having separate funding pots, but it is important that over time we move to technology neutral auctions.

35. Like the CMA, E.ON is concerned with the FID enabling process, including the magnitude of the budget and the non-competitive nature of the process. E.ON also has concerns with the power of the Secretary of State to direct the CfD counterparty to award CfDs in a non-competitive manner, especially where this could take up a large proportion of the budget.

36. E.ON notes that there is no mention in the updated theory of harm of the risk transfer mechanism to suppliers. Under CfDs, all the risks (market price; plant performance; capacity mix) are passed to suppliers in real time. This leaves all suppliers (regardless of their size or customer numbers) exposed to having to forecast and price this to customers, creating significant complexity and inefficiency in the market.

37. Further comments on each of these areas are given below.

3.3.2 Market Rules

Self-dispatch

38. E.ON agrees that the current arrangements for self-dispatch in the market are efficient and effective. The market is liquid and transparent, which allows

participants the information and ability to manage the dispatch of their plant as effectively as a central dispatch system. Indeed, we would agree with the view in the research by National Grid that, in some instances, it may be more effective, as generators are better able to factor in the maintenance costs associated with switching into their decisions than was the case when National Grid was doing so.

Changes to cashout prices

39. E.ON agrees with the implementation of a single cashout price. This removes a distortion caused by the arrangements forcing companies to have two imbalance accounts, one for demand and one for generation. This sometimes forces companies into two imbalance positions when in aggregate their net position would be more balanced.

40. A single cashout price would indeed provide parties with a more beneficial price when their imbalances are helpful than is currently the case. The current price is based on the market price for the settlement period concerned. It is not clear that this could be described as penal, but it may be less efficient than the price the company would have experienced had it been able to trade that imbalance in the market. Therefore, the change should be positive.

Criticisms relating to PAR1 and Reserve Scarcity Price

41. E.ON opposes the introduction of a PAR1 as we believe that it makes the cashout prices too extreme. PAR1 simply means that the imbalance price is set on the most extreme priced 1MWh action that National Grid takes, i.e. marginal pricing. This position is potentially made worse by the introduction of the RSP and the introduction of a price for involuntary demand response equal to the Value of Lost Load ("**VoLL**", set at £3000/MWh rising to £6000/MWh).

42. The RSP is a way of valuing reserve actions so that they can feed into cashout prices. This is expected to be calculated as a percentage of VoLL. This percentage will increase as the size of the margin on the network reduces. This means that at times it should rise to near VoLL. The calculation of this percentage, or Loss of Load Probability, is not a precise science and will be based on a complex estimating calculation carried out by National Grid. We are concerned that by multiplying the results of this calculation by a very large number such as VOLL, there is a real risk of introducing inefficient pricing signals into the market.

43. A marginal price with these VoLL related prices will make the price so extreme at times that it will penalise those who are unlucky enough to be in imbalance at this time. The rationale for making cashout prices more marginal is that this higher cost will incentivise parties to invest in more reliable plant and better forecasting. However, a better than average balancer can be worse off than a poor balancer if it is unlucky enough to be in imbalance at the same time that an extreme price occurs. This can be sufficient to wipe out the benefit from its good performance in previous periods. Making the market more risky in this manner is also likely to be a barrier to entry, especially to smaller suppliers with relatively

large forecasting risk. Indeed, small suppliers have been generally opposed to the modification.

44. E.ON therefore agrees with some of the concerns raised by the CMA about the interaction of PAR1 with the RSP.

45. The CMA raises concerns about the introduction of this major reform at the same time as the CM and the potential for over-compensation as a result. Given the history of intervention in setting of cashout prices since the implementation of the New Electricity Trading Arrangements ("**NETA**"), it is possible that generators might not factor any increased payments resulting from sharper cashout prices into their capacity mechanism bids, as there will be a risk that there would be pressure on the regulator to intervene should high imbalance prices occur.

46. However, E.ON believes that the competitive pressures in the CM, as evidenced in the first auction and recognised by the CMA, will drive the impact of any lack of confidence to the lowest possible levels in the CM offer price; a generator who takes a very risk averse view of future cashout income risks losing in the CM auction. It is also worth noting that a generator that does not factor in the potential price impact of the cashout reform is also unlikely to factor in the increased risk associated with PAR1 and RSP as highlighted above, which may result in under-compensation. Therefore, E.ON believes the risk of over-compensation is low, and the overall position may be neutral as it could be countered by the risk of under-compensation.

The absence of locational signals in charging for transmission constraints and losses

47. The CMA has raised the issue of the lack of locational signals in costs of transmission constraints and losses and suggested that there could be clear benefits from their introduction. This issue is described in further detail in the "Locational pricing in the electricity market in Great Britain" Working Paper. The Updated Issues Statement refers to a lack of locational pricing for transmission losses and constraints. The Working Paper goes wider than this and explores locational energy pricing, where the energy price in the wholesale market is influenced by constraints (and possibly losses) on the network.

48. The CMA expects locational pricing to deliver certain benefits, namely:

a. Locational losses would remove a technical inefficiency where northern generation could be favoured over southern plant, even though it is more expensive when losses are considered.
b. Locational pricing would reduce a cross subsidy between northern and southern customers. Prices would be higher to southern customers and they should in turn consume less whereas the opposite would be the case for northern customers.
c. It would incentivise more efficient siting decisions from energy intensive industries and generation plant.

49. E.ON (and formerly Powergen) has long supported cost reflective charging and locational signals, such as exists in TNUoS charging. However, the issue is a controversial one, as locational signals result in a redistribution of costs between parties, with generation in the south of the country generally benefiting from the changes whilst northern generation sees higher costs. The reverse effect is true for customers.

50. Given the nature of the issue, parties tend to be polarised as to whether it is a good idea. Companies with predominantly southern generation support locational signals whilst others, particularly Scottish companies, oppose change. The Scottish companies are generally successful at gaining support of the Scottish Government by characterising this issue as a threat to the Scottish generation industry, even though these reforms should directly benefit Scottish consumers.

Transmission Losses

51. The idea of introducing locational transmission losses has been around since privatisation and indeed was included in a list of outstanding issues in the Pooling and Settlement Agreement that still needed to be addressed at that time. A number of proposals have since been introduced attempting to introduce locational losses, but although supported in principle by Ofgem, none have been implemented.

52. Since the Balancing and Settlement Code was introduced under NETA attempts have been made to introduce locational losses on three occasions; in 2002, 2005 and 2008. The first two proposals were initially approved by Ofgem but subsequently rejected following successful legal challenge.

53. The latest proposal (P229) was rejected in September 2011 by Ofgem, on balance, even though it was considered to be a more cost reflective solution and to have a positive cost benefit for customers. The reasons given for rejection were that there would be a significant redistribution of costs between parties and that European legislation may soon supersede the arrangements making them redundant. However, over three years have passed and no such legislation has been forthcoming, but Ofgem might have been referring to legislation which would potentially split GB into two or more zones for energy pricing. This is discussed below in the context of locational energy pricing.

54. Powergen/E.ON supported the introduction of zonal transmission losses as it is a more cost reflective approach and should result in a more efficient outcome. As an owner of a predominantly southern generation fleet it would have resulted in our plant becoming more competitive in the market through a removal of a cross subsidy to other generators and a reduced cost base. It would however have introduced some complexity into how we price and dispatch plant, and how we set prices for customers, as it would introduce a regional effect where before there was none.

55. Were a locational charge to be introduced in future, then we would expect our predominantly southern generation fleet to become more competitive as its costs

will be lower, while the costs of offshore wind generation capacity might increase compared to the current regime. E.ON would be likely to support future locational changes. However, whether we would need to review the detail of any proposals to check that overall they improve the competitiveness and efficiency of the market, for example to check the impact on the efficiency of the retail market and the costs in relation to changes to systems and processes, particularly at a time of significant change to retail metering and settlement processes.

Constraint Costs

56. At a high level, E.ON does not support locational charging of constraints, primarily due to the difficulty of the change and the complexity that would result. The unpredictable and volatile nature of such costs would make it very difficult for parties to respond to the signals, increasing the risks faced.

57. Simply put, you can have two approaches to locational charging of constraints:

a. You can set a single energy price for two areas which have a transmission constraint between them and charge the cost of managing the constraint on a locational basis (e.g. locational balancing use of system charges or constraint charges);
b. You can set different energy prices in the two areas which reflect the local generation and demand plus how much power can be traded between them due to the constraint. In effect both areas are treated as separate energy markets. This second approach is locational energy pricing.

58. These approaches are discussed in more detail below.

Locational constraint charges

59. Locational constraint charges are a relatively recent idea compared with locational losses. They were first raised under a proposal from National Grid in March 2009 (GB ECM-18) when it was asked by Ofgem to consider whether constraint costs could be allocated to those who cause them. This was in response to concern about the levels of constraint costs being incurred on the boundary between Scotland and England, an often constrained part of which used to be the Scotland to England interconnector prior to the introduction of the British Electricity Trading and Transmission Arrangements ("**BETTA**") in 2005. It also was raised as part of Ofgem and DECC's wider review of transmission access at that time (the Transmission Access Review or "**TAR**").

60. This proposal would have seen some of the costs of this constraint being paid by generators in Scotland, as it was their output which was causing the issue. E.ON supported the proposal, as it was a targeted approach seeking to address an issue which was expected to be transitory in nature. However, we were concerned about introducing the solution more widely into the network without further consideration of its potential effects on the market. In March 2010, Ofgem decided to veto the proposal as it was concerned that the improved cost reflectivity was not worth the increased complexity it would bring to the

arrangements, and was particularly concerned that the charge would be calculated after the event and would not therefore provide a signal that generators could respond to.

61. Locational constraint charging appeared to have been effectively closed off in July 2010, when DECC issued its proposals for TAR. DECC had assumed responsibility for this in August 2009 when there was significant disagreement between the industry and Ofgem on the best way forward. In these proposals DECC introduced the Connect and Manage regime. As part of this it put in place a licence obligation on National Grid (Condition C26), which mandates that constraint costs have to be socialised. This means that National Grid cannot introduce locational constraint cost charging unless the Government removes this requirement.

62. Whilst E.ON generally supports the introduction of cost reflective charging, we are likely to be unsupportive of introducing locational charging of constraint costs. This would be a difficult and complex change to achieve. With a highly interconnected network with an ever changing balance of supply and demand, different constraints occur in different places and at different times. It would be very difficult, if not impossible, for parties to predict where and when they will occur, yet alone take action to avoid a potential locational charge.

63. Constraint costs currently form part of the total costs which are recovered through Balancing Services Use of System ("**BSUoS**") charges. BSUoS charges are highly unpredictable and difficult to forecast at present and are becoming more volatile. They are a significant risk to retail businesses in particular. The current thinking in the industry is around how this BSUoS charge volatility can be reduced and it is the highest priority issue that users have raised with National Grid. Making them more cost reflective is likely to increase the unpredictability and complexity of the charges, exacerbating the risk for companies. There is little point in increasing the cost reflectivity of charges if parties cannot respond effectively to the signals provided and manage the risk caused by their volatility.

Locational Energy Pricing

64. Locational energy pricing can be achieved in a number of ways. One way is to form price zones to reflect the main constraint or constraints that exist in an area. An example of this would be if the GB market was split into two price zones to reflect the constraint between England and Wales, and Scotland. In this instance a separate market price would be achieved in each area respectively, to balance the local generation and demand and also taking into account the amount that can be traded between the two zones over the network connection between them. Therefore, the network between them is treated as an interconnector.

65. Sometimes the prices will be the same when there is enough network capacity to allow generation from the cheaper zone to be sold to the more expensive zone to bring its price down (and the cheaper zone's price up). At other times the capacity will not be sufficient to allow them to converge fully (i.e. when there is a

constraint). Splitting markets into price zones is something which is provided for under European legislation. The Capacity Allocation and Congestion Management ("**CACM**") Code requires transmission system operators ("**TSOs**") and regulators to periodically review whether pricing zones should be split to reflect constraints that exist (or indeed whether two existing zones should be joined to reflect a lack of constraints). Ofgem is due to review the situation in the GB market soon.

66. Another way to do this is to implement the same principle, but for every entry and exit point on the network. This means that there are hundreds of zones, each with their own price. This is sometimes referred to as locational marginal pricing ("**LMP**") and is hugely complicated. Like the fully system locational charging of constraints, parties do not know where the constraints are going to occur and therefore are unlikely to be able to take action to account for them. This complexity is likely to represent a significant barrier to entry.

67. E.ON does not believe that locational energy pricing would bring significant benefit so as to outweigh the impacts. Apart from the complexity it would bring for market participants, a key issue with locational energy pricing is that it can undermine liquidity in the traded markets. At present power is traded on a GB basis. If the GB market were to be split into two, for England and Wales, and Scotland, then liquidity would be reduced, particularly in the Scottish zone.

68. It is also worth noting that the CMA cites in its Working Paper, academic work that illustrates the sorts of cost benefits which could be achieved by the introduction of locational energy pricing. It is not clear what the assumptions are for this, but if the work is based on current constraints between Scotland and England then it may overstate these benefits. Although significant congestion exists on this boundary at present, it is expected to reduce dramatically when the new undersea cable, the Western Link, is completed (planned for 2016).

3.3.3 The Capacity Market and Contracts for Difference

Capacity Market

69. E.ON agrees with the CMA that the CM is a necessary intervention in the UK market, as without it the UK could see risks to security of supply. The CMA is right to look at the interaction between the CM and other reforms such as Ofgem's EBSCR on cashout pricing. Indeed, DECC went to some length to consider these interactions when designing the CM.

70. The principle of DECC's market wide CM is that it operates alongside the energy market. Capacity providers will take account of income from both markets when assessing investments. So long as the CM design is efficient and competitive, which the CMA agrees it is in broad terms, CM offer prices from capacity providers will reflect their underlying energy market income. In other words, as cashout prices rise, the CM offer prices of reliable plant should fall, making them more competitive in the CM and driving down the CM price overall.

71. The CMA states that generators may not account for these (cashout) payments in their CM offers due, for example, to a lack of confidence that prices will be allowed to rise to these levels. This lack of confidence that prices can rise is actually a key part of the so called 'missing money' problem that led DECC to introduce a CM in the first place; the alternative is a lack of investment in security of supply. The competitive pressures in the CM, as evidenced in the first auction and recognised by the CMA, will drive the impact of low confidence to the lowest possible levels in the CM offer price; a generator who takes a very risk averse view of future cashout income risks losing in the CM auction. It is also worth noting that a generator that does not factor in the potential price impact of the cashout reform is also unlikely to factor in the increased risk associated with PAR1 and RSP as highlighted above, which may result in under-compensation. Therefore, E.ON believes the risk of over-compensation is low, and the overall position may be neutral as it could be countered by the risk of under-compensation.

72. One related issue the CMA may wish to explore further is the unbalanced levels of certainty the CM provides. New entrant capacity providers will have up to 19 years certainty of their capacity income (4 year lead-time plus 15 year agreement). Certainty of energy market income, including cashout, will be much less than this. There is a risk the CM design biases investment towards CM based investments rather than energy based investments. For example, a combined cycle gas turbine ("**CCGT"**) relies on its efficiency in the energy market to compete with a lower capital cost peaking generator. The lower cost peaking generator has 19 years' certainty of its key source of revenue (the CM) whilst the CCGT has much less certainty of energy market income. It may be more difficult for the CCGT to compete in the CM as it has to reflect this uncertainty in its CM offer price. The result is that the CM design could encourage more low capital cost peaking generators than an efficient market would, this could eventually result in higher energy prices and higher emissions.

73. E.ON has some sympathy with the view expressed by demand side response ("**DSR**") operators that they cannot compete without access to longer term agreements. The discrimination in contract lengths offered to different types of plant risks distorting the market in many ways, for example by encouraging new entrants on 15 year agreements when keeping a slightly more expensive existing generator running for a few years may have been cheaper overall. We have consistently argued that all capacity providers, whether new or existing, DSR or generation or storage, should have access to the same products (i.e. same contract lengths) in the CM. As part of the CM design process we commissioned some work by auction experts who agreed with this principle and suggested some ways it could be introduced. We shared this work with DECC (and provided it to the CMA on 9 March 2015 in response to a request at our fromal Hearing on 4 March 2015.).

74. DECC explored a number of options when deciding on the CM penalty mechanism and the mechanism it has implemented is less severe than initially proposed. The penalty is now related directly to the CM auction price; for plant that received

agreements in the 2014 auction this is around £800/MWh[4]. The penalty exposure is also capped so that a capacity provider cannot lose more than its overall CM income in any given year, it also cannot lose more than twice any individual month's CM income in that month.

75. E.ON agrees this is an area the CMA should explore. We understand that DECC softened the penalty exposure, mainly through reducing the cap, due to fears that new investors would be discouraged. Clearly uncapped penalty exposures would be inappropriate; however there is a trade-off to be made between penalty risk and CM auction price (the higher the risk the higher the price is likely to be). E.ON believes some penalty risk exposure is important to ensure delivery of capacity and to encourage secondary trading of capacity, it is not clear that this balance has been made efficiently in the CM design.

76. E.ON agrees with the CMA that the mechanism for recovering costs may not be efficient. In theory, the costs of the CM should be passed on to suppliers and consumers based on the demand for that capacity, which drives the amount of capacity to procure. Demand for capacity is effectively determined by the size of a customer's meter, its maximum possible demand at the system peak. However, in today's market, a charge based on a customer's maximum possible demand at peak, related to the size of its meter, would be extremely difficult to implement and give customers little ability to change their demand for capacity.

77. It is important to distinguish between the demand for capacity and the demand for energy. DECC's current cost recovery mechanism is variable and spreads the costs over peak periods in winter, defined as 4-7pm on workdays between November and February. This methodology does not mirror the demand for capacity which is effectively a fixed demand rather than one that varies based on energy use over a period.

78. The greatest risk to efficiency in cost recovery is the reliance on demand forecasts. Currently, suppliers must forecast their share of demand over periods of high demand; their costs are based initially on these forecasts which are then reconciled up to 18 months later. This means that suppliers are exposed to risks if their forecasts are incorrect; it also means that costs for customers switching suppliers or for new entrant suppliers are likely to be incorrect. We have consistently argued that whatever the methodology to recover costs, it should be based on a fixed charge set by Government. Government would then use its own balance sheet to manage fluctuations in recovered costs, with a lower cost of capital than suppliers.

[4] The penalty is now related directly to the CM auction price with a formula set out in Schedule 1, Paragraph 5(3) of The Electricity Capacity Regulations 2014. This formula states that the penalty rate per MWh is based on the payment made to the capacity provider per MW of capacity (in other words the relevant auction clearing price, adjusted for inflation) multiplied by 1/24; for plant that received agreements in the 2014 auction this is around £800/MWh in 2012 money.

Contracts for Difference

79. E.ON welcomes the broad support for CfDs and agrees that a competitive approach will lead to a more efficient outcome for customers in meeting the 2020 renewable targets. The design of the support mechanism will also help to attract new sources of finance. It also has the potential to unlock projects at a lower cost of capital relative to the Renewables Obligation ("**RO**") as risk is reduced through the nature of long term contracts.

80. In the very short term, there is an argument for having separate CfD pots, so that some technologies that have the potential to lower costs over the next few years, such as offshore wind, can be supported during this transitional phase. However, over time it is important that we move to technology neutral outcomes, and we believe that the Government should set out a clear pathway for achieving this. It would seem appropriate that once the 2020 targets have been met, the switch to technology neutral auctions should begin to take place, especially as the target going forward should be around carbon as opposed to supporting any particular technology class. If the Government had adopted a descending clock auction for CfDs, we believe it would have more easily supported the transition from technology specific to technology neutral auctions, in particular, by allowing constraints to be applied in the first instance to support some technologies in the short term. This could be relaxed over time, so that eventually all technologies compete against one another.

81. From an investor perspective, RO transitional arrangements have been important in providing confidence to the market, especially as a number of projects were originated and developed before EMR was introduced, and therefore the economics were based on the RO. The reality is that the transitional arrangements will mostly apply to onshore wind projects due to the shorter construction times. Given that it is one of the cheapest renewable technologies available today, it is arguable that the efficiency benefits of forcing those projects into the CfD regime are relatively small. Furthermore, the first auction has been designed with a budget that will already lead to intense rivalry amongst developers, thereby allowing customers to benefit in the first year of EMR. The results of the first auction appear to have delivered this outcome, with over 2GW of capacity being offered a contract, costing customers up to £110m per year less than it would have in the absence of competition. We also believe that projects looking to commission under the RO will only have the choice for the first allocation round because the timescales are so tight for commissioning projects by 31 March 2017.

82. Like the CMA, E.ON has been concerned with the FID enabling process. Whilst the intentions were good, to support projects that needed to make an investment decision, we nevertheless have been concerned about the magnitude of the budget that has been provided under this process given the non-competitive nature of the process. This leaves much less budget available to later projects in the development pipeline, that may be able to secure supply chain deals at a lower cost, especially if some of the cost reduction initiatives in wind are realised.

83. Indeed, the results of the first auction demonstrate that much lower prices could have been realised, with onshore and offshore wind clearing prices delivering at almost 20% less than the administered strike prices published in December 2013. Furthermore, in the case of biomass, state aid approval has still not been given, and so it has clearly not helped to support any early investment decision. It would have been preferable for those projects to compete for a contract under the enduring CfD allocation arrangements.

84. E.ON also has concerns around the power of the Secretary of State to direct the CfD counterparty to award CfDs in a non-competitive manner, especially where this could take up a large proportion of the budget. DECC has recently consulted on proposals based around the Swansea Tidal Lagoon project to enter into bilateral discussions with the developer and it was announced in the Budget on 18 March 2015 that this would be taken forward. However, the annual cost of the scheme is estimated at £50m per annum, which is the equivalent to most of the budget allocated to established low cost renewable technologies in the first allocation round. If Government wishes to support First Of A Kind ("**FOAK**") technologies, it would in our view be preferable to support it via the use of government grants, as opposed to utilising some of the CfD budget which will inevitably displace much lower cost schemes.

85. E.ON agrees with the CMA that manipulation of the CfD reference market is unlikely to be feasible, certainly when the reference market has high levels of liquidity in the day-ahead market. During the EMR consultation process, we advocated that all forms of generation, whether baseload or intermittent, should have the same day-ahead reference price, especially given the high levels of liquidity in this market. Liquidity is not at these levels the further out you go, but we note the analysis within the Working Paper which showed that the risk of manipulation for the baseload reference price is low.

86. E.ON notes that there is no mention in the updated theory of harm of the risk transfer mechanism to suppliers. Under the CfD mechanism, all the risks (market price; plant performance; capacity mix; commissioning dates) are passed to suppliers in real time. This leaves all suppliers exposed to having to forecast and price this to customers, creating significant complexity and inefficiency in the market. It would be much cheaper for customers if these risks were centralised within Government – an argument that was made during the development by the vast majority of suppliers.

3.4 CMA Updated theory of harm 2: market power in generation leads to higher prices

87. In the First Issues Response, E.ON set out its views in relation to the CMA's then theory of harm 3 that market power in generation leads to higher prices. E.ON expressed its view, at paragraph 68, that market power does not exist in generation markets in any form which would allow a generator or group of generators to manipulate wholesale market prices to the detriment of the customer. E.ON went on to note, in paragraph 69 of the First Issues Response,

that it did not see evidence of either unilateral or coordinated market power in generation in the energy market.

88. E.ON therefore recognises and agrees with the CMA's current thinking that firms do not have the ability or the incentive to increase profits by withdrawing generation capacity, be this through unilateral market power or coordinated market power.

89. In relation to uncertainty, as a practical constraint to exploiting unilateral market power, we would agree that generators do not have perfect knowledge of demand or wind, even at dispatch. We would add that, whilst REMIT provides transparency on expected generation plant availability, it does not provide perfect knowledge of the operational state of competitors' generation plant. Also, whilst limited transmission system information is made available, it does not provide perfect knowledge of the operational implications for individual generation plants.

90. [✂].

91. In respect of GB generation, E.ON would like to highlight that there is necessarily a component of GB trading that needs to be incorporated into the assessment of Asset beta for GB generation and trading. E.ON's work in respect of GB Trading Asset betas would indicate a higher Asset beta (of well above 1) when drawing upon the comparison groups of hedge fund and asset managers.

92. E.ON notes the CMA's analysis of GB generation and trading Return on Capital Employed ("**ROCE**") using a carrying value basis demonstrates that achieved industry average returns for the period 2009-2013 are near or below the cost of capital proposed by the CMA. In relation to the comments made in paragraph 71 of the Updated Issues Statement, around impairments, E.ON would comment that, as we mentioned at our formal Hearing on 4 March 2015, we have made a significant write-down of our own GB generation plant in 2014, [✂].

3.5 CMA Updated theory of harm 3: vertical integration

93. In the First Issues Response, E.ON was clear that, whilst the CMA had defined vertical integration to mean "where both the Supply Business and the Generation Business are ultimately held under common ownership", we were not vertically integrated in how we managed our operations. As we made clear there, the E.ON group has chosen to structure our business in such a way as to be dependent on liquidity in wholesale markets, we trade volumes that are greater than 100% of our generation and 100% of our supply, through our traded volumes we buy more than we supply to our customers or than we generate and, as Table 1 in the First Issues Response showed, our total supply volume is significantly greater than our total generation volume.

94. We have also, since submission of the First Issues Response, announced on 30 November 2014, our intention to divide the E.ON SE Group into two with future E.ON focussing on customer solutions, distribution and renewables; and NewCo,

the new corporate group, focusing on power generation, global energy trading and exploration and production. This reinforces our belief in, and dependence upon, the liquidity of wholesale markets.

3.5.1 CMA Updated theory of harm 3a: opaque prices and low liquidity in wholesale electricity markets distort competition in retail and generation

95. As we set out in the First Issues Response, E.ON considers that liquidity in wholesale electricity markets is sufficient and does not create a barrier to entry. Nevertheless, E.ON supports any measures to further increase liquidity, providing they do not give rise to other distortions or adverse effects, as E.ON's business model is based on independently managed businesses trading at arm's length and operating in liquid wholesale markets across Europe. We would therefore support the CMA's initial view on liquidity. [✀].

96. Whether Ofgem's Secure & Promote licence conditions have led to an improvement in liquidity is, as the CMA suggests, uncertain. [✀].

97. We would also agree with the CMA's initial view that there are not significant problems with regard to transparency, with the large volumes being traded over platforms where prices are visible to all market participants.

98. In the First Issues Response, E.ON referred to evidence given in Ofgem's State of the Market Assessment ("**SMA**") which showed the extent to which E.ON in GB, through E.ON Global Commodities ("**EGC**"), both sold its generation externally and purchased power for its supply business externally. This appeared from Table 2 in the First Issues Response, which had appeared at page 97 of the SMA and showed that E.ON traded proportionately more than the other major suppliers did in 2012 and was proportionately the biggest trader on "purchased" volumes and second biggest trader on "sold" volumes in 2013.

99. We noted that each of E.ON's GB supply and generation businesses was under management pressure to maximise its financial performance. The lower collateral costs of such a larger business would allow a greater volume of trading to be economic and thus aid market liquidity. Whilst it is possible for our trading business to use the output of our generation plant to meet some of the demand of our supply business, the trading business is not incentivised to do so. In particular, the trading business would not maximise its profit, which it is incentivised to do, by taking this course unless such trades would also have been sensible even if the counterparties had been external (minus a small adjustment for transaction costs). Mere co-ownership of supply and generation does not materially reduce the functioning of the wholesale market.

100. We note the CMA's view that it is appropriate that Ofgem continues to monitor and to attempt to improve liquidity and we are happy to continue to support Ofgem in this. Following our strategy announcement referred to above, we will continue to have a strong interest in ensuring that liquidity is sufficient and at least remains so.

3.5.2 CMA Updated theory of harm 3b: vertical integration leads to foreclosure

101. The CMA indicates that it did not receive responses to the First Issues Statement which indicated that either customer foreclosure or input foreclosure was a major concern to responding parties. E.ON's First Issues Response equally did not believe this was an issue and we referred again to our own internal organisational structure in support of this view. Again, our intention to implement a strategy under which our supply business will be legally separate and under different ownership from our conventional generation business would suggest that we do not see foreclosure as an issue of concern in this market.

102. E.ON agrees with the CMA's initial view that vertically integrated firms do not have the ability or incentive to foreclose generators (either acting unilaterally or through coordination) or to engage in customer or input foreclosure. Our intention to divide the E.ON SE Group into two companies demonstrates that we do not see foreclosure as an issue.

3.6 CMA Updated theory of harm 4: energy suppliers face weak incentives to compete on price and non-price factors in retail markets

103. We note the CMA's comment that it has begun its analysis of the evidence it has collected on retail markets and that its initial views on retail theories of harm are at an earlier stage of development than those relating to wholesale electricity and vertical integration. The CMA therefore states that these are initial observations and views on both the domestic and microbusiness retail markets.

3.6.1 Summary of E.ON's views

104. E.ON notes the CMA analysis which suggests that the average SVT bill against expected costs since around 2009 has diverged and the initial view from the CMA that this appears to be consistent with what it has characterised as a weakening of competition over the SVT. E.ON has severe concerns regarding this analysis and conclusions, and looks forward to the CMA further developing this work. A key component of the costs faced by suppliers relates to the cost of buying energy from the wholesale market, and suppliers generally manage this risk by hedging these costs. It is important to understand the impact that such hedges can have when assessing the potential costs associated with both SVT and non-SVT customers and how this can result in different outcomes depending upon the movements in the wholesale market.

105. Analysis of bill expectations and expected costs without fully taking into account factors such as hedging, competitive pressures and other non-commodity costs can seem to indicate that prices rise more quickly than they fall. E.ON does not generally consider that prices respond more quickly to increases in wholesale costs than to reductions. E.ON keeps energy prices and its costs to recover under very regular review, including the above drivers as well as the potential impact of making a price change, whether an increase or decrease. Any price event, whether up or down, has an impact for suppliers and therefore no price movement decision is taken lightly. In our experience, being the first supplier to

respond to rising costs and increase prices carries a heavy price in terms of customer response and losses and criticism by the media and other stakeholders. Part of E.ON's reaction to such impacts has been to increase prices as late as we can and decrease them as soon as we can. This is evidenced by our last two standard variable price increases and our recent price cut in January 2015.

106. E.ON does not accept the initial view from the CMA that there are significant numbers of domestic energy customers who are relatively inactive, which may give suppliers unilateral market power. E.ON does not believe that less active customers reduce incentives to compete, as a supplier cannot rely on a customer who might currently not be active in the market continuing to be so. The CMA customer survey shows that most people are aware they can switch, but may not do so, due to satisfaction with their current supplier. We would suggest that just because a customer is on an SVT, it does not mean either that they are not engaged or that they are not active.

107. The CMA suggests that there are significant barriers to switching, but we would suggest that overall, the customer survey does not show this to be the case, customers simply do not choose to switch. E.ON does recognise that there is a more vulnerable segment of customers who tend not to switch and hence are likely to be on SVT. These may be older and less savvy or younger and on lower income and struggling financially. Some of these customers may face higher barriers to switching. However, customers on an SVT are not a homogenous group, and there are those on SVT who have switched in the past and will or may do so again in the future given sufficient (cost or service) incentive.

108. E.ON does not take any of those customers for granted, and the fact that they are on a SVT provides protection via competition to the more vulnerable and perhaps less active customers on SVTs. A supplier needs to have a competitive SVT to ensure these customers do not leave, thereby ensuring that the more vulnerable customers also receive a competitive SVT as there is consistent treatment between them.

109. E.ON has seen the impact of PCWs in terms of increasing transparency in the market to enable switching and recognise that many customers use this channel. PCWs have an important role to play in the market and it is important that customers have trust and confidence in the information they are receiving.

110. E.ON has a firm belief that the ongoing smart meter rollout will allow the facilitation of many things in the energy industry, overcoming many of what might otherwise be seen as the potential barriers to greater customer engagement. Automatic reading of meters will ensure that bills are almost always accurate, reducing the need to concentrate a large proportion of customer service in this area. Improved data around customers' usage will allow for the provision of more diverse and innovative service to customers. E.ON sees the facilitation of time of use tariffs as something that will start to materialise towards the end of this decade. However, it is important to note that the simpler tariff structure due to RMR may constrain some of these benefits.

111. E.ON has actively sought to engage its customers in a number of different ways, including inviting them to get in touch through our Best Deal For You ("**BDFY**") programme, proactively contacting customers and giving information to customers through their quarterly bills and annual statements.

112. E.ON does not believe there is evidence of it "exploiting" any market power through making excessive margins from its domestic customers. [✄].

113. Our strategy of being our customers' Trusted Energy Partner seeks to provide a sustainable business model; [✄].

114. E.ON agrees with the CMA view that there is not tacit coordination through public price announcements by suppliers in the energy market. As we said in the First Issues Response, we believe that the GB energy market lacks a number of the fundamental characteristics of markets which may be conducive to coordination and the conduct of suppliers in the market is not consistent with coordination. E.ON agrees with the CMA's initial view that the behaviour it has observed in relation to public price announcements by suppliers is likely to be consistent with unilateral incentives and supports the view that the company that announces price increases first risks losing more customers than those that follow, which gives a unilateral explanation for the clustering of price announcements.

115. E.ON raised its concerns about the impact of regular changes in Ofgem's regulatory requirements/approach and the ever-increasing volume/complexity of regulation in our response to the First Issues Statement. We would re-iterate these concerns. However, the CMA has focused on a few specific areas of regulation, most notably RMR. E.ON agrees with the principle behind RMR in terms of a simple, open and transparently fair market, but would suggest that whilst it has been successful in some areas, it has created issues in others. Improvements to comparability, simplicity and fairness have resulted in potentially misleading information to customers, a stifling of innovation and an increase in the difficulty to reward loyal customers.

116. [✄].

117. E.ON sees the increasing number and activity of TPIs as a significant improvement in the market, helping to engage customers, increase transparency and ultimately increase competition. E.ON has implemented a Code of Conduct for TPIs wishing to engage with us to ensure they work to a set of high standards. E.ON welcomes and encourages greater TPI regulation and the implementation by Ofgem of a market wide Code of Conduct in order to improve standards, increase transparency and hence increase customer trust in these brokers.

118. E.ON notes the potential indicators of harm identified by the CMA, particularly around profitability. [✄], the SME business carries a number of significant risks and these risks must be properly taken into account before an accurate assessment can be made regarding levels of profitability for supply to SMEs. E.ON has ceased auto-rollover contracts, based upon customer feedback, recognising the potential impact these contracts can have on customers. E.ON

actively seeks to engage with customers not on fixed term fixed price contracts, including those on deemed or Out of Contract ("**OOC**") products.

3.6.2 Observations on the nature of competition on domestic retail energy markets

119. The CMA makes some observations on the nature of competition in domestic retail markets and we feel it useful to provide some similar information as context for our subsequent comments. A significant focus of the CMA is to make a comparison between customers on a SVT and those on non-SVT tariff (in recent years primarily a fixed tariff, but could be a range of alternatives such as capped, discounted variable etc.). **Figure 2** below shows a segmentation of E.ON customers by tariff over a range of tenures to provide context for our later comments.

Figure 2: Segmentation of E.ON domestic customers by tariff and tenure.

[✂]

Source: E.ON internal data

120. [✂].

The impact of regulation on price competition

121. The CMA describes the nature of price competition between the large energy firms since liberalisation, with the initial focus being on SVT, conversion of domestic customer to dual fuel in "home" area and to attract new dual fuel customers in other areas. The evolution of the market from SVT to a broader spectrum of tariffs post-liberalisation is not surprising. As the market opens, suppliers start to compete with familiar products (SVT) and at the same time develop their product ranges in a way that is informed by the better understanding they have gained of their customers' needs. The focus on dual fuel customers is also clear as supplier seek to minimise costs.

122. The CMA suggests that the introduction of Standard Licence Condition 25A ("**SLC 25A**"), allowed exemptions for promotional tariffs offering temporary discounts on the SVT and that this may have led to an increase in the number of tariffs. E.ON does not consider that the introduction of SLC 25A by itself led to more tariffs, rather that market evolution led to more tariffs. Even without SLC 25A, it is likely that a greater product range would have developed, although these may have been more enduring compared to the promotional products that were allowed under SLC 25A.

123. The RMR reforms were introduced by Ofgem in the belief that the benefits of simplicity outweighed the advantage of segmented tariffs in attracting customers.

124. E.ON agrees with the principle behind RMR in terms of a simple, open and transparently fair market. E.ON acted before RMR came into force to reduce our number of tariffs to simplify matters for customers.

125. However, RMR greatly limits the ability to offer more innovative tariffs which are valuable to consumers and hence focuses competition onto price of the shortest fixed price product. Regulatory intervention has therefore significantly determined the nature of competition; a focus on price not innovation.

The relationship between the standard variable tariff and non-standard tariffs

126. The CMA analysis shows that gas and electricity revenues per kWh from the SVT are consistently higher than the average revenue from non-SVT (12% for electricity and 13% for gas).

127. [✂].

Evolution of an average SVT bill against costs

128. The CMA analysis suggests that the average SVT bill against expected direct costs since around 2009 has diverged, with bills increasing above costs. The initial view from the CMA is that this appears to be consistent with what it has characterised as a weakening of competition over the SVT. More detail of the analysis has been provided in the "Cost Pass Through" Working Paper.

129. Our understanding is that the CMA's analysis is suggesting that its cost measures are 'industry-wide'. Normally, in such an analysis of cost-pass through, you would want to look at those costs that are common to all suppliers separately from those that are firm-specific. However, the marginal wholesale cost for supplying at any point in time to any individual supplier will depend on what it has already hedged. Therefore, the CMA's wholesale costs do not represent an 'industry-wide' cost measure at all – they are a hypothetical cost measure, but neither do they reflect the costs actually incurred by any individual supplier.

130. E.ON notes the CMA's view in its Cost Pass Through Working Paper that only marginal costs should be relevant for price setting, and that hedging should only affect profitability. We note that the CMA believes that the 1 year forward hedge adopted in its analysis is not a hedge but in effect the marginal price. We disagree and believe that the CMA analysis is in effect a 1 year forward hedge profile, where 100% of the energy for the next year is deemed to have been purchased at any point in time. A true marginal cost is only known at the point of delivery through the cash-out mechanisms, but this would not deliver a sustainable business as a supplier would have no idea what its cost was until after delivery.

131. E.ON has strong reservations over whether this assumption is appropriate for the residential SVT product as E.ON believes that customers value the reduction in volatility that pricing with some reference to hedged costs provides – a declining forward purchase percentage provides a buffer against volatility that the CMA's basis of analysis does not. For example, if the doubling of wholesale energy prices in 2007-2008 had been passed through to customers over the same period, this would have caused substantial customer detriment. E.ON urges the CMA to reconsider the suitability of this theory to the SVT product.

132. It should be recognised that a hedge is developed by a supplier to hedge a specific product and risk and that these can be very different, for example, between a residential product and that sold to a corporate customer. Additionally, a fixed cost base that is locked in intermittently (annually in the CMA's analysis) does not effectively hedge a variable price product, as this can only be achieved with a hedge that tracks wholesale movements, rather than sampling at discrete points.

133. E.ON is also concerned that the practicalities of energy purchasing have not been considered in the CMA's analysis and it includes some implicit pitfalls within it, which affects its analysis and would be detrimental to both customers and suppliers. In our view, the main ones are:

a. Purchasing period – a supplier would need to actually purchase at some point for delivery, and would not be able to achieve the continuous line presented in the CMA's analysis. This would create significant risks for customers, who would be exposed to prices at discrete points in time (yielding unknown outcomes or stability). Suppliers would also be exposed to significant competitive risk if they purchased at the 'wrong' (in hindsight) time. This could lead to suppliers altering what would otherwise be their normal purchasing behaviour, which could in itself create other problems or inefficiencies;
b. If the customer market became based on, for example, an October start contract, as is common with Industrial and Commercial customers, all suppliers would purchase 1 year contracts starting in October. If traders knew this was how the retail market worked (and broadly when suppliers would come to market), it would be likely that prices would be squeezed upwards each year ahead of suppliers coming to market, to the detriment of customers;
c. Liquidity considerations would need to be taken into account, meaning that the purchasing approach outlined in the CMA's analysis could not achieve the stated prices in practice. It is unrealistic to expect a vibrant wholesale market to exist if suppliers only come to market sporadically; and even in today's continuous market (where liquidity is sufficient – see paragraph 95) there is insufficient liquidity to purchase for all customers in one go. E.ON's SVT volume for example, would take several weeks to purchase even if E.ON was the only buyer in the market;
d. Volume risks – suppliers would be exposed to significant volume risk at the point of price setting and sign up. This would be likely to result in higher prices for customers as all suppliers would have to add a premium to account for managing the long/short position encountered.

134. It should also be noted that the current customer preference for 1 year fixed products may not continue, and therefore the 1 year forward benchmark may not be appropriate in the long run. In addition, the 1 year fixed products that are currently the most price aggressive, are only available for limited periods. Accordingly, some suppliers may hedge this on a buy-to-back basis, where one wholesale market trade is roughly 25,000 customers' volume; clearly, for a major suppliers' SVT portfolio of millions of customers this is clearly not appropriate.

135. A number of costs cannot be known until at/near delivery, so when setting prices suppliers need to make assumptions of costs and charge a premium associated with the risk. For example, the RO is published in October for application from the following April (although the supplier carries RPI risk during this time). Any product which straddles one RO year to the next creates significant risk for suppliers, which have been amplified in recent years as DECC have made material assumption changes in the setting of future targets. For other costs – small scale Feed-in Tariffs ("**FiTs**"), BSUoS and EMR – suppliers have no certainty of costs until after delivery. These costs are heavily impacted by generation asset performance over which suppliers have no influence, and will grow over the coming years.

136. The CMA data is taken from a generally flat or falling wholesale trend, during which time a short term wholesale approach is likely to have yielded lower prices than a declining hedge as is used to manage SVT risks. This is circumstantial and clearly not always the case. Further, it does not prove customer harm from such an approach; suppliers are not blessed with perfect foresight, so have to hedge on a basis that is sustainable in all wholesale market environments.

137. In addition to our concerns above regarding the methodology, we also have concerns regarding the data used, particularly where the CMA figures seem to rely on Ofgem's SMI analysis for non-energy costs. E.ON notes, for example, that in the Cost Pass Through Working Paper, the graph on slide 9 shows a forecast reduction in non-energy costs of around £10 per customer at the start of 2014. This does not reflect the scale of cost changes announced by the Government in the 2013 Autumn Statement (£30-50 per customer depending on which components are included), implying substantial fundamental inaccuracies.

138. E.ON therefore has severe concerns regarding the analysis and conclusions, and requests that the CMA revisits the work using more appropriate cost forecasts (e.g. those submitted by suppliers) and a set of assumptions that is appropriate to the GB retail energy market.

Description of hedging between SVT and non-SVT

139. A key component of the costs faced by suppliers relates to the cost of buying energy from the wholesale market (although this element as a proportion of the bill is declining). The Updated Issues Statement does not take account of different approaches to hedging future energy costs and, in particular, does not discuss the potential benefits in this context that SVT customers may at times enjoy compared to non-SVT customers. This aspect is discussed below in more detail.

140. E.ON, and many other suppliers, chooses to hedge these costs in order to manage the risk that we take from our customers in providing them with a price with significantly less volatility than that of the energy wholesale markets. A supplier could choose not to hedge, but this would expose it to whatever the imbalance price was – exposing its shareholders to volatile and unknown returns, a choice

that very few (if any) suppliers would be willing to make. The key question is then how to hedge different products effectively.

141. In the context of retail energy markets, a hedge is a purchasing strategy for wholesale energy designed to reduce risk. There are two key risks being managed:

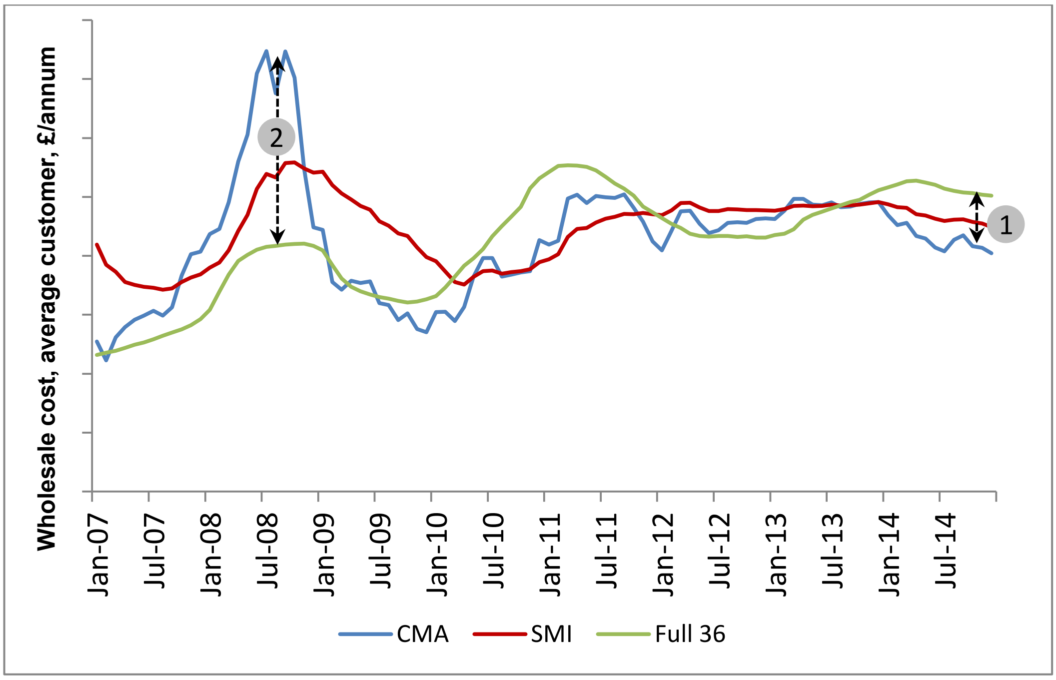
a. Competitive risk; and
b. Wholesale cost volatility.

142. Sufficient numbers of customers can and do switch, and may do so, ensruing that market participants are incentivised to price competitively. This means that suppliers cannot expect to recover their hedge costs if they are uncompetitive for the product concerned, so must seek to hedge competitively.

143. A key element of the products that suppliers offer to customers is the insulation from price volatility through infrequent retail price changes. To deliver this, a forward purchasing approach is required to smooth out the wholesale volatility that the supplier is exposed to. The key choice is then the length of the hedge. The competing pressures on the hedge can be seen graphically in **Figure 3**, comparing the CMA's 1 year benchmark (short hedge), and a theoretical 36 month hedge (long):

a. A very long hedge removes wholesale cost volatility; however it creates competitive risk to participants in a downward-trending market, where they might find themselves out of the market compared to others. This can be seen at point 1 in **Figure 3,** which shows the recent advantages of a short hedge given the reduction in the wholesale market.
b. Equally, a very short hedge does not manage wholesale cost volatility, and may provide a competitive dis-advantage in an upward-trending market. A clear example is at point 2 in **Figure 3**, where a short hedge would have had significant cost disadvantages compared to a longer hedge.

Figure 3: Illustrative comparison of wholesale costs across different hedge lengths



Source: E.ON internal data

144. As future prices are never known in advance, a hedge which works across the cycle is needed, which will be between the extremes of very long and very short, managing the full risks seen.

145. SVT and fixed term, fixed price products have different risk profiles. SVT customers want infrequent, small price changes, and so the hedge is set up to deliver that while balancing competitive risk. This would mean that, subject to the market, suppliers would seek to reflect any significant cost trends through a price change. [✂].

Figure 4: E.ON hedge used for SVT electricity demand

[✂]

Source: E.ON internal data

146. By contrast, customers on fixed tariffs are exposed to the potential for a significant price change at the point of renewal. At the point of pricing for the period of sale, future cost changes cannot be passed through. Therefore it is appropriate to have cost certainty to deliver margin confidence.

147. In the current market, with falling wholesale prices, shorter hedges will likely have a cost advantage compared to longer hedges. [✂].

148. The CMA's cost pass through Working Paper states that 'higher' pass through will occur in competitive markets. However, the CMA needs to take into account that for the SVT, suppliers seek to insulate customers from short term market trend.

Customers value this as it prevents small swings impacting bills and delays bill shock over time. The CMA must take this into account when considering the appropriate time frame to analyse pass through of costs.

Price increases and price reductions

149. E.ON does not generally consider that prices respond more quickly to increases in wholesale costs than to reductions but, given that this is an issue which is frequently raised, agrees that this is an area that warrants further discussion.

150. Energy prices, especially gas prices, have been incredibly volatile over the recent period, which, when coupled with non-commodity cost pressures especially from government programmes and regulated network charges, has led to a general long-term trend of increasing costs – although E.ON does accept that there have been times of downward movement in wholesale costs.

151. E.ON keeps energy prices and its costs to recover under very regular review. When we look at these costs and prices we see reflected in the numbers both the impact of past buying decisions we have made – our hedge – but also our reflection and expectation of what future costs will be. These will be partly commodity and therefore partly hedged, but will also include third party costs, such as transmission and distribution costs, environmental and social obligations and costs arising from regulatory/policy requirements. Therefore, we are effectively both backward and forward looking at the same time.

152. [✂].

a. [✂].
b. [✂].
c. [✂].
d. [✂].
e. [✂].

153. Any price event, whether up or down, has an impact for suppliers. It has a cost, is disruptive in terms of business as usual processes etc. and usually causes customers to contact our contact centres. Therefore, no price movement decision is taken lightly.

154. Customers respond to the fact that a price movement has been made, as well as to the resulting price. There is a negative impact on customer numbers when we increase prices and a smaller positive impact when we reduce them.

155. [✂].

156. As we made clear in paragraph 115 of the First Issues Response, being the first supplier to respond to rising costs and increase prices carries a heavy price in terms of customer response and losses, as well as criticism by the media, by consumer advocates and social commentators, by Members of Parliament and by

Ministers. This is not something that any supplier wants to do, but sometimes, because of the factors above, they have to do this.

157. Part of E.ON's reaction to such impacts has been to increase prices as late as we can and decrease them as soon as we can. This is evidenced by our movement of prices after other similar companies (whom we believe are likely to all be facing comparable cost movements) for our last two standard variable price increases and before other such companies for our recent price cut in January 2015.

158. In relation to a price decrease, the risk is that although falling costs enable a supplier to make a decrease now, rising costs over the next period (of which a supplier will have some, albeit uncertain, visibility) means that the supplier may have to subsequently raise prices by a greater amount than if the supplier had not reduced them. Given the asymmetric impacts around price increase and decreases, this can sometimes lead to a decision to not decrease prices in order either to avoid having to make a future increase, or to delay or reduce the size of a future increase. The fact that, in the face of a temporary reduction in wholesale costs, the impact of a decision not to reduce prices in the short term may be that a future price increase is avoided, delayed or reduced may not however be as widely-reported as the temporary reduction in wholesale costs.

159. However, regulatory costs are generally much less visible (and potentially also less predictable). In practice, most cost increases over the last few years have been driven by these regulatory costs, most significantly from social obligations (the Carbon Emissions Reduction Target ("**CERT**"), the Community Energy Savings Programme ("**CESP**") and then Energy Company Obligation ("**ECO**")), although environmental obligations and network costs have also generally increased. Because these costs are not fixed, they only become visible to non-suppliers in retrospect, when suppliers publish results. This means that analyses which include these, for example Ofgem's SMI, can indicate that these costs are falling, when in fact they are rising.

3.6.3 The CMA's views on "Inactive" Customers

160. The initial view from the CMA is that there are significant numbers of domestic energy customers who are relatively inactive, which may give suppliers unilateral market power.

161. As E.ON discussed in paragraph 83 et seq. of the First Issues Response, E.ON does not believe that less active customers reduce incentives to compete, as a supplier cannot rely on a customer who might currently not be active in the market continuing to be so. E.ON recognises that there are some customers who are less active than others but we would note that 'active' is not the same as 'engaged', since customers can be engaged without actively switching (either to another supplier, or to another tariff offered by their existing supplier). Customers may have engaged with the market but decided to stay with their supplier, for price, service or brand reasons.

162. The CMA customer survey shows that most people are aware they can switch (89% know), but may not do so, even when approached by their own or other suppliers and 70% are confident they would make the correct decision when switching. Of those customers who didn't switch to a supplier who approached them, 39% said they would not switch because their existing tariff was satisfactory, compared to only 9% who said they would not switch because it was too much effort. It is noteworthy that 73% of customers were satisfied with their current energy supplier.

163. We would therefore suggest that just because a customer is on an SVT, it does not mean either that they are not engaged or that they are not active. Importantly, E.ON cannot distinguish such customers from those who are truly inactive, in the sense of being entirely disinterested in any form of switching. E.ON therefore needs to treat every SVT customer as if they are potentially engaged and active, including in terms of competitive pricing and service quality.

164. As a result of Ofgem's RMR, the SVT has become the tariff to which every customer must be returned after a fixed tariff. [✄]. They may stay there for a day, a week, a month, a year or more but we do not know when or whether they will move off the SVT, or whether they will do it to move to another tariff of ours or to one of another supplier. This may be of their own accord, because they are prompted by something they read, or see on TV or radio, because they receive a call from another supplier, or because they receive poor service from us.

165. Many SVT customers have shown that they are or can be active by switching in the past, and are likely to stay active or become active again in the future. Those customers are more likely to switch if SVT prices are higher and they perceive they are not getting a good deal.

166. [✄].

Figure 5: E.ON internal switching data for electricity

[✄]

Source: E.ON internal data

Figure 6: E.ON internal switching data for gas

[✄]

Source: E.ON internal data

167. We would suggest that even customers with whom it is more difficult to engage could choose to become active at any time. They cannot be taken for granted as they do respond to "push" factors such as poor service, incorrect billing or the perception of being overcharged. Therefore, even if a customer is not (currently) active on price we do still face competitive pressures to serve them well to reduce the chance they will leave us to one of our rival suppliers. This applies to

all of E.ON's customers, because we cannot distinguish active and engaged customers from those who are truly inactive

Gains from switching

168. The CMA analysed gains from switching showing that 95% of dual fuel domestic customers could have saved on average between £158 and £234 per year between Q1 2012 and Q2 2014.

169. E.ON welcomes the CMA's recognition of the potential caveats and limitations to the analysis, particularly not accounting for the impact of exit fees (which had a heightened relevance over the 2012-2014 period when non-standard prices were generally falling). We note that the CMA intends to do further analysis in this area, potentially addressing some of these limitations. However, some limitations, such as the assumed link between electricity and gas consumption, may remain and therefore the analysis should still be viewed with caution. We also note the CMA's emphasis on the fact that the results of their analysis cannot be relied upon to measure aggregate welfare loss as the equilibrium prices would be likely to change if all customers paying higher prices switched.

170. We note that the analysis focuses on the value of the price signals that were available to customers and therefore the incentive for them to engage based upon price alone. We believe that there are other routes for engagement of customers such as great customer service.

Barriers to switching

171. The CMA suggests that there are significant barriers to switching and has conducted a customer survey to help it analyse this.

172. The CMA does recognise that some customers do not switch (presumably between suppliers) because they feel that the quality of service they receive outweighs the potential financial gains. This does not mean that these customers would not be willing to switch internally.

173. The CMA customer survey which has been used to gather evidence around barriers to switching broadly agrees with similar evidence we have collected in the past. Most people are aware they can switch (89% know), but do not do so, even when approached by their own or other suppliers. 70% are confident they would make the correct decision when switching and of those customers who didn't switch to a supplier who approached them, many more (39%) said they would not switch because their existing tariff was satisfactory rather than the number of customers (9%) who indicated they would not switch because it was too much effort.

174. Those who do switch tend to do it regularly and generally say price is the main driver of choice, although they may have already filtered out certain choices prior to the final decision being on price. Overall, the customer survey shows that there do not appear to be significant barriers to switching to another supplier

(and even fewer to a customer switching to another tariff offered by its existing supplier). Many more customers simply do not choose to switch to another supplier because they are happy with their current supplier, rather than because it was too much effort to do so. Even then, the 9% of customers for whom it was too much effort could easily switch if they wished to do so, and E.ON cannot differentiate such customers from its more active or engaged customers.

175. E.ON does recognise that there is a more vulnerable segment of customers who tend not to switch and hence are likely to be on SVT. These may be older and less savvy or younger and on lower income and struggling financially. Some of these customers may face higher barriers to switching.

176. Those customers who struggle to switch form a portion of those on SVT. Simplifying massively, you could distinguish customers into three groups:

a. those that are very active and constantly chasing the best rates (say, Group 1);
b. those who may be on SVT but are engaged, have switched in the past and will or may do so again (say, Group 2); and
c. those who are harder to engage and more reluctant to switch (say, Group 3).

177. E.ON may be able to identify customers in group 1, but cannot identify between customers who may be in groups 2 and 3.

178. Ofgem has previously raised a concern that Group 1 customers do not offer any constraints on the way that suppliers treat Group 3 customers but we would suggest that this does not take into account the impact of Group 2 customers. Whilst Group 2 customers may be less active than those very active customers in Group 1, they do know they can switch and would do so if they had sufficient (cost or service) incentive to do so or may one day just suddenly decide to switch again, whether prompted by an external factor (e.g. a call from a competitor, or a Government or Ofgem campaign, or perhaps hearing something on Moneybox). Group 2 customers therefore provide a constraint on suppliers' treatment of Group 3 customers, because E.ON must treat every customer in Groups 2 and 3 as if they belong to the more active and engaged customers in Group 2.

179. E.ON does not take any of those customers for granted, and the fact that they are on a SVT provides protection via competition to the more vulnerable and perhaps less active customers on SVTs. A supplier needs to have a competitive SVT to ensure these customers do not leave, thereby ensuring that the more vulnerable customers also receive a competitive SVT as there is consistent treatment between them.

180. [✂]. As we explained to the CMA at the formal Hearing on 4 March, our SVT was as at that date the cheapest of the larger suppliers, with paper billing, although there were two smaller suppliers who had a cheaper SVT than E.ON did. With paperless billing, two were cheaper and a third rounded to the same £ as E.ON.

Price comparison websites and smart meters

181. The CMA has conducted an initial review of the role of PCWs in helping customers to overcome barriers to engagement and notes the increase in switching via PCWs.

182. E.ON has seen the impact of PCWs in terms of increasing transparency in the market to enable switching, with levels of switching via PCWs increasing from around 16% in 2011 to around 31% in 2014. 71% of those who have shopped around in the last 3 years having used a PCW and 53% switched via this channel. This shows that many customers use PCWs to aid switching decisions taken by customers through other routes (e.g. directly with a supplier).

183. With regards to Ofgem's recent decisions around PCWs, E.ON believes that:

a. PCWs have an important role to play in the market, increasing transparency for customers, albeit with a focus on price rather than non-price factors. In order to achieve this, it is vital that customers have trust and confidence in the information they are receiving;
b. However, it is important to find the right balance. The Ofgem rule requires PCWs to provide free advertising for parties they have no contract with, as a price of being accredited. The CMA considers this to be 'stringent' and unlike other markets with PCWs. E.ON acknowledges this is a major market intervention which might increase transparency, but agrees that the CMA should look into whether this outweighs the risk of reducing PCW growth;
c. E.ON does have concerns with Ofgem's standardised methodology to estimating the savings from switching, particularly the full year comparison for customers. Should a customer be on a fixed term tariff that ends during this timeframe, the methodology assumes that the customer moves to the incumbent supplier's SVT and then uses this as a basis for the cost savings comparison. This can be very misleading and can actually result in the customer moving to a tariff that has significantly less savings than identified or even potentially cost them more.

184. The CMA also considered the potential role of smart meters in terms of improving engagement. The analysis suggests a reduction in energy bills and the potential for more engagement.

185. E.ON has installed more than 400,000 smart meters to date and believes the steps we have taken and lessons we have learnt in the foundation stage will provide an excellent platform to ensure the most efficient and effective rollout to 2020.

186. Once a customer has had a smart meter installed, we have seen from our data that they are saving an average of around 4% on electricity and 1% on gas. We have recently begun sending additional advice to our smart meter customers to help them to get the most out of their In Home Display ("**IHD**") and how to use this information to save energy. We have received positive feedback on this from

customers and hope to see this reflected in further reductions in energy consumption in the future.

187. To further assist our customers we have made improvements to our IHD model to improve the display's clarity, its functionality, and to reduce the unit cost. It is important that customers are able to see their current and cumulative energy consumption clearly, to set budgets and to use their IHD to view historic consumption. These functions are important in assisting customers to understand their energy use and helping them to make permanent energy savings. [✂].

188. Back office efficiencies are a key benefit of the smart rollout. However, the true value of this benefit cannot be realised until mass volumes are achieved. As 2015-2020 are transition years we will be running two systems – one for smart customers and the other for classic meter customers. However, as we reduce the amount of classic meter customers and increase the number of smart customers, the savings will begin to add up and this will be reflected in customers' bills in the longer term.

189. E.ON has a firm belief that smart meters are a facilitator of many things for the energy industry. As we said in paragraph 88 of the First Issues Response, we believe that smart meters, their associated infrastructure and integration with wider digital capability will overcome many of what might otherwise be seen as the potential barriers to greater customer engagement with and innovation in the market, in a number of ways:

a. Automatic reading of meters will mean that bills are almost always accurate, overcoming the need to concentrate a large proportion of customer service activity on metering problems and customers are more likely to know what they use and what they pay;
b. Improved industry processes, not directly linked to smart metering but delivered via the Data and Communications Company, should resolve many of the problems which result in suppliers offering a poor service to customers, particularly during the switching process; and
c. Improved data around customers' usage will allow for provision of more diverse and innovative service to customers – though by the nature of innovation, we cannot be sure which potential products will succeed.

190. In addition, the timely, accurate and detailed availability of energy consumption information will assist customers in understanding whether they are able to participate in some form of Demand Side Response. Whether this is linked to how a customer uses their energy, or linked to specific appliances or generating equipment, the use of a smart meter will be critical in providing visibility of energy that is taken from the grid or exported onto it. Access to this information by energy suppliers, network companies and other third parties (such as energy aggregators) will enable the market for Demand Side Response services for all customers to expand in the future.

191. E.ON sees the facilitation of more innovative time of use tariffs as something that will start to materialise towards the end of this decade (although we already see some suppliers moving down this path such as British Gas and Free Power Saturdays/Sundays), potentially helping to manage peak demand in a more cost effective way. However it is important to note that time of use pricing is already a feature of the electricity market, and has been for a long time – for example, 15% of customers use Economy 7 meters. Smart meters are however an enabler which could facilitate more varied time of use tariffs, especially in conjunction with other smarter technologies such as batteries and electric vehicles.

192. [✂].

193. Whilst the recent trend has been towards simpler tariff structures via RMR, this is likely to constrain the benefits of the smart metering programme and prohibit innovation in products which could help to engage more customers. E.ON would therefore welcome the opportunity to offer more innovative and personalised products to our customers in the future, helping to ensure the full benefits are realised.

3.6.4 Supplier Behaviour

Unilateral market power ("**UMP**")

194. The CMA states that elements of the evidence it has reviewed to date appear to be consistent with the hypothesis that the six large energy firms have UMP over their SVT customers, with the CMA concluding that the survey suggests large numbers of disengaged customers. It is suggested that this insulates suppliers from competitive pressures and that SVT customers are more likely to be disengaged. The CMA intends to assess whether suppliers deliberately keep their SVT customers disengaged.

195. First of all, E.ON does not agree that UMP arises in relation to SVT customers for the reasons mentioned above. Specifically, even those SVT customers that might be considered as disengaged (i.e. those in E.ON's Group 3) benefit from the greater activity and engagement levels of customers in Groups 1 and 2. E.ON does not believe that it has UMP, nor would it accept a suggestion that it has sought to keep its SVT customers disengaged.

196. E.ON has actively sought to engage its customers, having proactively invited them to get in touch through our BDFY programme. BDFY was launched at the end of September 2012 and offered best tariff checks based on customers' energy usage available online or by speaking to any customer service advisor. E.ON proactively contacted customers and also added information about how to access a personal check on every bill. [✂]. We provide BDFY information to customers through their quarterly bills and annual statements as well as informing them of any changes to the standard tariff.

197. E.ON would not therefore agree that it attempts to keep its SVT customers disengaged.

198. E.ON has also introduced a service called Price Alert, which was open to customers to opt into. If a customer opts in to Price Alert when they sign up for a product, we will notify them by email if we introduce a new version of that product, so that they can see whether that is a better deal for them or not.

199. Furthermore, E.ON would suggest that it cannot and does not "exploit" any market power such as to achieve excessive margins from its domestic business.

Figure 7: Domestic profitability

[✂]

Source: E.ON internal data

200. [✂].

201. Although some customers may not switch frequently and therefore are on SVTs, as we have said in paragraphs 165 to 167 above, those customers cannot be taken for granted and could leave (it is often very hard to get these customers back by their nature, so E.ON fights hard to make sure we retain them). We therefore face competitive pressures to retain those customers as well as to attract new customers.

202. [✂].

203. [✂].

Tables 1a and 1b: Assumptions from E.ON value model on customer proportions in each tariff segment

Table 1a

[✂]

Source: E.ON internal data

Table 1b

[✂]

Source: E.ON internal data

204. [✂].

205. [✂].

206. [✂].

Table 2a and 2b: Assumptions from E.ON value model on customer proportions in each tariff segment

Table 2a

[✂]

Source: E.ON internal data

Table 2b

[✂]

Source: E.ON internal data

207. [✂].

208. Our strategy of being our customers' Trusted Energy Partner seeks to provide a sustainable business model. [✂].

209. [✂].

210. The CMA has begun an analysis of segmentation by tariff type in order to better understand the levels of profitability. [✂].

211. The CMA has also considered calculating the ROCE for energy suppliers. E.ON would suggest that EBITDA margin on revenues or turnover is the most appropriate. EBITDA is readily available and is consistently used to measure to assess the profitability of an energy supply business, as typically used for many Service/Retail businesses. Further, the Retail business is asset light with the majority of investment being in intangible assets, which are not all captured on the balance sheet and are inherently difficult to get robust MEA values for. The difficulties in obtaining reliable values for capital employed further support the use of a return on sales measure or relevant financial ratio (as set out in the CMA's market investigation guidelines). E.ON notes that EBITDA measures cannot pick up all the differences in risks across different types of businesses, and the CMA will have to take that into account, in particular when using EBITDA to examine different segments of a supplier's business. However, for a method of benchmarking E.ON's overall supply business with other Supply/ Retail businesses, in our view EBITDA is more reliable than ROCE measures.

<u>Tacit coordination through public price announcements</u>

212. The CMA has formed an initial view that the behaviour it has observed in relation to public price announcements by suppliers is likely to be consistent with unilateral incentives and intends to investigate the assertion made by some suppliers that the company that announces price increases first risks losing more customers than those that follow, which gives a unilateral explanation for the clustering of price announcements.

213. The CMA notes that it has found no evidence of pricing plans changing in response to subsequent announcements, either by altering the price or changing

the date. Before considering price announcements, the Updated Issues Statement and, in particular, the Working Paper on Coordination assess whether the conditions for coordination to be sustainable are present in GB energy retail. This is undertaken by reference to the CMA's guidelines on market investigations. The CMA found that there are some characteristics of the supply of gas and electricity to domestic customers that may be conducive to coordination, but that there are factors which make it more difficult for firms to reach and sustain coordination.

214. We first address the CMA's thinking on the conditions for coordination and encourage the CMA to conclude that the conditions for coordination to be sustainable are not present. We then comment on the reasons why the price announcements made by energy suppliers should be considered as being associated with a highly competitive market rather than one which is susceptible to coordination.

215. As we said in the First Issues Response, E.ON believes that the GB energy markets lack a number of the fundamental characteristics of market(s) which may be conducive to coordination and that the conduct of suppliers in the market is not consistent with coordination. This is supported to some extent by the CMA's findings in paragraph 151 of the Updated Issues Statement and in the Working Paper. The points below should serve to reinforce a conclusion that tacit coordination is not possible.

216. First, there are simply too many suppliers either for the larger suppliers to reach an understanding and monitor the terms of any coordination or for the coordination to be internally sustainable. The fact that there are at least six major energy suppliers operating in the GB energy markets means that tacit coordination would be highly unlikely, either from the point of view of reaching a common understanding on coordination or a mechanism for disciplining any supplier deviating from the common understanding.

217. This point is explored in the First Issues Response (and so is not explored in detail again here, other than to repeat that it would be in effect unprecedented for an industry with so many suppliers to be susceptible to tacit coordination). As the CMA concludes its analysis of coordinated effects, we would encourage it to give this factor greater prominence.

218. Second, the CMA's analysis to date already points to a number of other factors undermining the ability of retail energy suppliers to reach an understanding and monitor the terms of coordination. In particular, the CMA notes that there are some differences in business models and short- to medium-term differences in energy costs.

219. In E.ON's view, these differences, combined with the number of suppliers, critically undermine the incentives and ability to reach a common understanding. There are very material differences in the electricity generation/supply balances

between the six largest retail suppliers. These differences will be enhanced by the structure resulting from E.ON's strategy announcement noted above.

220. The CMA has noted how the differences in business models have resulted in differing commercial strategies adopted between the six largest suppliers. It is regulation which plays an important role in driving some of the similarities in pricing structures adopted by the six largest suppliers. The Pricing Strategies Working Paper makes it clear that, even within the constraints of regulation, the commercial strategies of the six largest suppliers differ.

221. The Working Paper on Coordination appears to assume a degree of homogeneity in the retail of electricity and gas. Whilst this is true of the underlying product, this ignores the scope for differentiation on quality of service and additional services/products. In E.ON's view, customers value quality of service highly and this is an important factor in the choice of supplier (or encouraging a customer to stay with their existing supplier). This gives greater scope for differentiation between suppliers.

222. The scope for differentiation is likely to be enhanced with the further roll-out of smart meters. To the extent permitted by regulation, suppliers will be capable of providing more innovative solutions to customers, further breaking down any homogeneity in the customer offer. Indeed, it is noted paragraph 189 that the roll-out of smart meters could lead to a demand-side response requiring further product innovation.

223. Third, the Working Paper on Coordination appears to underplay the lack of external sustainability of coordination. This significantly underplays the constraint exercised by the number of rapidly growing suppliers other than the six largest suppliers (to the extent that any coordination analysis is focussed on the six largest suppliers). The CMA notes that these supplies have grown rapidly in the past years.

224. The Working Paper on Coordination refers to the Working Paper on Barriers to Entry and notes a number of obstacles to entry and expansion by smaller suppliers. It should be noted that the evidence presented in the latter Working Paper is mixed. Whilst some of the smaller suppliers consider that certain of the obstacles raised by some suppliers are not barriers for them. There is no consistent pattern of significant barriers to entry or expansion being shown through the CMA's case studies. Indeed, the extent of entry and the rapid growth of suppliers other than the six largest suppliers show that entry and expansion is possible. The extent of competition, and the ongoing threat of further competition, from suppliers other than the six largest suppliers will continue to undermine any prospects for coordination.

225. In the Updated Issues Statement, the CMA notes that there may be a segment of retail energy markets that is relatively disengaged and that the level of disengagement may be sufficient for coordination over this segment to be externally sustainable. In order for such external sustainability to arise in theory,

the larger suppliers would need to be able to coordinate around those disengaged customers without such coordination being impacted by the level of competition from smaller suppliers.

226. The Updated Issues Response has already noted that fact that it is not possible for suppliers to differentiate between those customers who are engaged and those who may be less engaged. This means that it is not possible for the less engaged customers to be a focal point for coordination without an impact on those customers who are more engaged and coordination becoming externally unsustainable.

227. Turning to the CMA's analysis of price announcements, as E.ON said in the First Issues Response, there is a degree of transparency over pricing in GB energy retail markets (driven in large part by regulation), as well as elements of supplier costs (due to the impact of regulation and the commonality of certain costs). The GB energy markets are also highly competitive. One would expect in this context a supplier to take account of likely pricing initiatives of other suppliers and its own competitive positioning compared with other suppliers when determining its own prices

228. Strong competitive forces therefore push us to take account of competitors' behaviour, as well as that of customers. E.ON will use competitor intelligence such as publicly available information to assess the likely pricing strategies of other suppliers, in particular with regards to price increases/decreases, and will use that information as a factor in determining our own pricing strategy. The information which E.ON gathers is not, however, perfect or complete. This natural supplier behaviour of taking into account of its competitors' actions and positions should not be conflated with the behaviour of suppliers in a market which is susceptible to tacit coordination. This behaviour is consistent with that of suppliers active in competitive markets.

229. As mentioned above, there is a degree of commonality of costs between suppliers. Broadly, we are all experiencing the same transmission, distribution and transportation costs, as well as environmental costs, VAT and efficient social costs.

230. It is therefore not surprising that suppliers may, on occasions, start to need to think about price changes at similar times. There are likely to be some distinctions caused by different hedging strategies, and other costs, but certain types of costs faced by suppliers and their movement are likely to be broadly similar. In fact, in the future with the introduction of EMR, certain additional costs are likely to converge, as all suppliers pay the costs of CfDs and the capacity mechanism.

231. The CMA refers in paragraph 153 of the Updated Issues Statement to some suppliers having stated that the company that announces price increases first risks losing more customers than those that follow, which would provide a unilateral explanation for observations of clustering in price announcement

behaviour. We strongly support that view. As we described above, and in the First Issues Response, the impact of making a price increase in the domestic energy market is significant.

232. [✄].

233. These sorts of experiences mean that, as a result, when taking any price decision in a competitive market like the retail energy market, it is to be expected that a supplier would take account of both likely pricing initiatives of other suppliers and its own competitive positioning compared to other suppliers when determining its own prices.

234. The impact of this response in the market is one of the underlying reasons as to why E.ON pre-announces price rises. We need to be able to ensure that we are not accused of being anything other than entirely open about the level and extent of any price change and we need to ensure that, in the event of a price increase, any mitigating actions are also understood. It is also the case that, pursuant to Standard Licence Condition 23 ("**SLC 23**"), an energy provider that wishes to proceed with a Unilateral Contract Variation is required to give customers a minimum of 30 days' notice in advance of the changes taking effect. E.ON also publishes information regarding our tariff prices generally as required under SLC 22.

235. We also note the CMA's comments in paragraph 152, that it has found no evidence, despite a review of price announcements over the last ten years, of announced pricing plans changing in response to subsequent announcements made by rivals, either by altering the price or by changing the date on which the new prices came into effect.

236. Finally, we will not repeat here all the points we made in the First Issues Response but would support the CMA's initial view that the behaviour it has observed in relation to public price announcements by suppliers is likely to be consistent with unilateral incentives.

3.6.5 Regulatory Interventions

237. The CMA recognises the level of regulation around the supply of electricity and gas and its potential impact on the shape of competition and intends to investigate this further. Before we comment specifically on SLC 25A and RMR, we would like to make the following broader comments.

238. E.ON reiterates its concerns about the impact of regular changes in Ofgem's regulatory requirements/approach and the ever-increasing volume/complexity of regulation raised in our response to the First Issues Statement. The layering of regulation upon regulation impacts competition and stifles innovation in the market. The sheer volume of implementing and managing these requirements requires significant resources, not only financial (such as change and IT budgets) but also in terms of the necessary management focus to ensure compliance. This naturally reduces our capacity and capability to also deploy resources on

innovation, as well as reducing the incentives for innovation, given the costs required to ensure compliance of new systems/products.

239. E.ON supports the principle behind Ofgem's intention to move away from rules base regulation and towards principles based regulation. However, we fear this will be a lengthy and difficult transitional period, during which we have two approaches in parallel, creating further risks for suppliers.

Prohibition of price discrimination (SLC 25A)

240. The CMA discusses the potential impact that SLC 25A might have had in the market, citing in particular evidence received from two former regulators, which heavily criticises it and suggesting it has had an impact on suppliers' pricing of SVTs. It also suggests that Ofgem has provided very mixed messages in relation to SLC 25A, first expecting suppliers to abide by the spirit of the condition even though it had expired, and then in December 2014 informing suppliers that they expect them not to follow its terms.

241. E.ON notes from paragraph 35 of the Working Paper on Pricing Strategies of the Six Large Energy Firms that those suppliers appear to have adopted quite different strategies to comply with SLC 25A[5]. Some put their out of area prices up (e.g. Scottish Power), some put their in area and out of area prices up (e.g. EDF, out of area standard increase, in area Economy 7 increase) and others put their in area prices down (e.g. E.ON, with its no mains gas discount and Economy 7 reduction).

242. For E.ON's own part, it continues to compete including through its SVT, which as we explained in paragraph 180 above, is one of the lowest priced in the market.

243. The real problem is not so much with SLC 25A in itself, as with the regular changes in Ofgem's regulatory requirements/approach, including its mixed messages once this regulation expired, and the ever-increasing volume/complexity of regulation (which smaller suppliers have also cited as a meaningful obstacle for them in the Barriers to Entry Working Paper[6]). This has had a negative impact on the ability of suppliers to innovate.

Retail Market Review tariff rules

244. The CMA notes that it has heard mixed views on RMR, and that it intends to investigate this further.

245. E.ON discussed its views on the RMR rules at paragraphs 136-139 of the First Issues Response and also cited their impact on preventing innovation (paragraph 106, First Issues Response) and product differentiation (paragraph 133, First Issues Response). However, we agree with the overall principle behind RMR in

[5] Energy Market Investigation: The Pricing Strategies of the Six Large Energy Firms in the retail supply of electricity and gas to domestic customers, paragraph 35.

[6] Full name of Working Paper: Case Studies on barriers to entry and expansion in the retail supply of energy in Great Britain

terms of a simple, open and transparently fair market. To this extent, we acted before RMR to reduce our number of tariffs to simplify this for customers.

246. The RMR reforms have not yet been fully in place for a year yet, so their full impact is not necessarily clear. However, we would suggest that they have been successful in some areas whilst creating new issues in others:

a. Comparability: RMR has introduced a tariff comparison rate ("**TCR**"), supposedly to make it easier for customers to compare between suppliers. However, the TCR does not hold true across a range of different levels of consumption and therefore, for example, it risks a low consuming customer selecting a more expensive tariff if they were to simply compare TCRs. In addition, there is no dual fuel TCR so customers have to make individual choices on electricity and gas, creating complexity and potential confusion.
b. Simplicity: Some of the changes introduced by Ofgem around common use of terminology and language, to help customers have a better understanding of industry terminology, should be viewed positively as helping to reduce confusion. However, RMR does stifle innovation on product structure, restricting choice. This is by design given the belief that too many tariffs are a barrier to customer switching. The removal of percentage based schemes potentially makes it easier for customers to understand discounts, although it is our experience that some other suppliers are discounting by fractions of a p/kWh which is perhaps not easier for all customers to understand.
c. Fairness: Limiting the cash discounts allowed makes it more difficult to offer innovative tariffs that reward loyal customers, such as those E.ON had introduced and that were subsequently banned by RMR. In addition, it is our view that the RMR rules around making the SVT the default tariff after a fixed contract and that this should be the cheapest variable tariff has led to there only being a single variable tariff[7].

Social and Environmental Policies

247. The CMA has recognised that energy suppliers are increasingly being used as agents of delivery of government social and environmental policies and discusses the impact of the 250,000 customer exemption level. We discussed the distortive influence that this exemption has on the market in the First Issues Response, at paragraphs 140-145 and indicated the actions that we believe Government should take to improve the fairness of the burden on customers and help remove the competitive distortion.

248. First, E.ON believes that it is more progressive if all government programmes, including energy efficiency, small scale FiTs, the RO and EMR were funded out of general taxation as opposed to energy customers. The cost of these policies is representing an ever increasing proportion of the bill. By contrast, the Renewable Heat Incentive is funded out of general taxation which we believe is a much better way to finance these schemes.

[7] The alternative would be a two speed variable tariff, where customers coming off a fixed tariff went on to the cheapest tariff and others who didn't move were on the more expensive variable tariff – this feels less fair.

249. If the cost of these programmes continues to be recovered from energy customers, there are a number of factors to consider. In this context, the CMA notes that the cost of these policies falls disproportionately on electricity rather than gas customers.

250. Whilst some policy costs such as ECO are recovered from both electricity and gas customers, other programmes such as the RO, small scale FiTs and EMR are funded via a levy on electricity customers only. This will particularly impact those households who reside off the gas grid, especially where they are using electricity for space heating. Even where the costs of a programme are recovered from both electricity and gas customers, it is typically on a 50:50 basis, whereas gas represents a larger proportion of the typical energy bill. Therefore it may be more equitable for the costs to be recovered on a different basis such that it does not discriminate against those customers who are not connected to the gas grid.

251. However, it is the case, and follows from the above, that, whilst practically every home in the country is connected to the electricity grid, a smaller proportion is connected to the gas grid. This practicality has underpinned some of the decisions in relation to the question which bill should be used. In relation to EMR for example, there was more logic around attaching it to electricity bills given that it was really all about electricity and not about gas.

252. We agree with the CMA in looking at the potential impact for competition in terms of the viability of electrical heating systems as an alternative to gas. In order to meet our long-term carbon reduction goals, there will need to be virtually zero emissions from residential buildings in 2050, so nearly all heating will have to be zero carbon, most likely via electrification of heating. It is therefore important that competition in this area is not reduced as a result of policies which place cost on electricity alone.

253. Social obligation exemptions are facilitating a change in competition in the marketplace. Some of the lowest fixed price contracts in the market are being offered by small suppliers, who can afford this by being exempt from much of the obligation. We are concerned that this is distorting competition in this part of the market to the detriment of those customers choosing to be with a larger supplier as well as less active customers (Group 3 customers as described in paragraph 176) of the larger suppliers who end up picking up the ECO and Warm Homes Discount ("**WHD**") tab for their more active fellow electricity consumers.

254. However, we also accept that for some smaller suppliers, the cost of delivering the obligations once they reach the current 250,000 customer account threshold may be high, including the need to have additional expertise outside the core retail proposition and compliance related costs. That however does not imply that maintaining or increasing the exemptions threshold is the right approach. Indeed, Utility Warehouse have rightly argued that the small supplier exemption

which enables it "to offer a lower price compared with other suppliers was unfair and inefficient"[8].

255. Instead of smaller suppliers potentially reining back on their customer growth strategy for fear of breaching any specified threshold, a better solution would be to alter the rules in the context of ECO to more easily allow for secondary trading. This would help ensure obligated parties could meet their obligations in a cost effective way by having access to a pool of measures delivered by other market participants. So a larger supplier for example could deliver measures on behalf of a smaller player, and through such trading, could be achieved at a cost which is not prohibitive.

256. An alternative mechanism for addressing the threshold issue under ECO would be to set a buy-out price that would allow smaller energy suppliers to discharge their obligations by paying into a central fund, which could then be competitively tendered for other participants to deliver those measures. This market mechanism would encourage the most efficient delivery operators to install more measures and be rewarded for this, whilst providing a low cost way for smaller suppliers to expand. Both of these mechanisms would allow for the removal of the exemption and hence avoid distorting the energy market.

257. In December 2013, the Chancellor announced that the cost of the WHD would be met by the Government for the next two years. One option going forward would be for Government to fund this on a permanent basis and for a Government agency rather than suppliers to implement the policy, thereby removing the administrative costs of delivering ECO for all suppliers. Alternatively, a combination of much greater data sharing and paying out funds only to the "Core Group" of customers under ECO would minimise the cost of administration, and therefore make it cheaper for all suppliers to deliver this programme[9]. At present, some customers who may have been eligible for the WHD have switched to a smaller supplier but are not eligible for the scheme. Removing this exemption would address this point of unfairness for those customers who should be entitled to support.

Settlement and reconciliation

258. The CMA has some initial concerns that elements of the settlement system for both electricity and gas fail to provide the right incentives for suppliers to compete in retail markets. The CMA also suggests that the roll-out of smart meters should allow improvements to settlement of domestic customers by removing the need for profiling but is concerned that there are currently no proposals for half-hourly settlement of domestic customers even after full roll-out of smart meters.

[8] Paragraph 150 of Working Paper: Case Studies on barriers to entry and expansion in the retail supply of energy in Great Britain

[9] We did some work on this in the context of WHD in 2013, which showed a significant difference in costs between cases where E.ON had to verify customer applications as against the simple payment of data matched Core group customers.

259. In terms of gas settlement, E.ON would agree with the CMA position as a fair reflection of how the process works. However, we would suggest that the update of the gas settlement system has been comprehensive - the industry has spent the past 5 years preparing and developing the replacement for the current gas settlement processes and systems. During that time consideration has been given to addressing the issues highlighted in the Updated Issues Statement. As a result we are confident that after the implementation of the changes the processes for gas settlement and reconciliation will be more accurate than they are today.

260. The accuracy of the gas settlement process under the new arrangements will also be more flexible as suppliers will be able to submit as many readings as they choose to use into settlement. This will remove any imposed constraints and allow supply companies greater control over the costs that they are exposed to via the settlement processes.

261. In terms of electricity settlement, Ofgem has been leading work for the last 18 months on how to mandate the adoption of half hourly settlement for all electricity customers. This only becomes relevant once smart meters are deployed to customers. It is our view therefore that the more widespread adoption of half hourly settlement is something which will be driven by market participants, through the current code modification processes, as they seek to maximise the opportunities presented by smart meters.

262. Electricity usage profiles and the reconciliation process are more sophisticated and accurate than those currently used in the gas market. The barriers for suppliers to choose to settle their customers on a half hourly basis have started to be addressed by Ofgem and the industry as part of the BSC Modification Proposal 272 which mandates half hourly settlement for larger business customers.

263. The removal of these barriers and the delayed deployment of smart meters (the DCC will now not go live until mid-2016) signal that progress is being made in this area but that benefits will not be possible for a number of years.

3.6.6 Microbusiness

264. The CMA has reviewed a range of information relating to microbusinesses in order to assess this area of the market, but notes that the majority of suppliers (including E.ON) do not distinguish between microbusinesses and SMEs. We treat all our SME customers as microbusinesses and therefore use the terms interchangeably in this response. As such, the CMA has faced challenges to isolate microbusinesses and present consistent information. As a result, the CMA states that the initial views they have reached are less advanced and the focus of their work in the next phase of the investigation will be to try to construct a more robust evidence base.

265. The CMA presents its initial views in the Updated Issues Statement with a more detailed description in the associated Working Paper “Microbusinesses”. Our comments below are a response to both of these documents.

Describing microbusinesses

266. In the Working Paper, the CMA sets out a description of microbusinesses and of suppliers in the market. E.ON shares the view that it is challenging to segment microbusinesses and would emphasise that, even within the definitions of microbusinesses, there is a hugely diverse range. At the very small end, microbusinesses can typically consume less than domestic customers with bills of a few hundred pounds (<2MWh), whereas towards the larger end, they can consume up to 100MWh with bills of many thousands of pounds. We would also note that the data the CMA presents in the WorkingP shows that, for the majority of microbusinesses, energy costs are a small percentage of their total business costs.

267. [✂].

268. We have seen a number of market developments, both through competitive pressures/supplier action and through regulatory obligation, for example, the ending by a number of suppliers of auto-rollover on contracts, E.ON’s introduction of a Code of Conduct for brokers, the putting on bills of contract end dates. [✂]. E.ON does not however agree that microbusinesses have such distinct characteristics or needs that they should be considered to represent a distinct customer group or market, to be considered and treated differently from other SMEs.

3.6.6.1. Potential Issues

269. The CMA set out a number of potential issues in the microbusiness segment based upon its initial analysis. These are around:

a. Engagement: whether microbusinesses face barriers to engaging in the retail energy market;
b. Transparency: As most energy contracts are negotiated and prices not published, whether this limits transparency in the non-domestic market; and
c. Brokers: whether they are operating effectively and fairly.

270. We comment upon each of these in turn, consistent with the approach taken in the Working Paper.

Engagement: whether microbusinesses face barriers to engaging in the retail energy market

271. The CMA identifies that microbusinesses may have less incentive to engage in the market as energy is a small proportion of their total business costs and is small in absolute terms, and E.ON agrees that this is a key reason why some microbusinesses may be more difficult to engage with. We have implemented a

number of measures to improve engagement and have seen a positive impact from this. These are discussed further below.

272. The CMA notes that switching supplier is one measure of customer engagement and helps to exert competitive pressure on suppliers. E.ON recognises the growing level of participants in the market, with new entrants and TPIs coming to the market. [✂].

Figure 8: Annual E.ON SME Churn %

[✂]

Source: E.ON internal data, Excludes New Connections[10]

273. [✂].[11] Notwithstanding that, we note that switching is not the only measure of engagement, as customers may not switch due to a positive decision to stay with a supplier, potentially following a price renegotiation with that supplier.

274. Brokers are also driving greater engagement in the SME market. Ofgem estimates that there are over 1,000 TPIs operating in the non-domestic energy segments, from large organisations to individual advisers. Whilst we agree with the CMA that TPIs initially focused on large businesses (indeed the first TPIs became active in the industrial and corporate sector) due to their commission based approach, our experience is that we have seen their activity increasingly move towards the smaller businesses.

275. [✂]. We were the first supplier to put contract end dates on bills in response to customer feedback and stakeholder views received in 2012. This has now been implemented across the market as part of the RMR changes in March 2014, with all suppliers having to clearly state contract end dates and notice dates on customer bills. In addition, E.ON has significantly improved its renewals journey, in response to customer feedback, improving the initial offer letter, providing all customers with two reminder letters during their notice period, and following this up with an outbound telephone call should customers not respond to this communication.

276. [✂].

Table 3: Customer activity at contract renewal (direct renewals)

[✂]

Source: E.ON internal data, SME KPI report week 10

[10] Some of E.ON's SME customers are also landlords or property developers renovating or building domestic or commercial premises, who require an installed supply of energy in order to prepare a premise for sale or rental. These customers are treated as a SME New connection and are placed on an evergreen product until the responsibility for the supply is taken on by an owner or tenant.

[11] Based upon Cornwall Annual TPI report stating churn had increased from 1 in 6 to 1 in 5 customers switching in the last year.

Table 4: Customer activity at contract renewal (TPI renewals)

[✂]

Source: E.ON internal data, SME KPI report week 10

277. [✂].

278. [✂].

279. [✂].[12]

280. The CMA notes that the tenure of a customer with a supplier may be indicative of inertia, but we would agree with the CMA that it could also be due to satisfaction with the tariff and service offering of the supplier, or that the customer could have switched between tariffs from the same supplier. [✂].

281. [✂].

Figure 9: Top down SME NPS Score

[✂]

Source: E.ON internal data

Transparency: As most energy contracts are negotiated and prices not published, whether this limits transparency in the non-domestic market

282. E.ON agrees that there is not as much transparency in relation to supplies to SMEs (including microbusinesses) as there is in the residential market. There is no equivalent in SME, for example, of SLC 22 in the residential market which requires the terms and conditions, including charges, of contracts to be made available to any person upon request. Supplies to microbusiness are based upon negotiated prices, with suppliers only publishing their deemed prices (although E.ON does publish both its deemed and OOC prices on its website), which does impact the SME market relative to the domestic supply market. The CMA quotes an internal E.ON document from 2014 which describes the SME market as "increasingly complex and opaque" and this applies to suppliers as well as customers. In the SME market suppliers do not have visibility of the rates being offered and agreed by their competitors, beyond what can be gleaned through legitimately obtained (and in compliance with competition law) competitive intelligence.

283. Nevertheless, the SME market is characterised by a wide range of suppliers and active competition for customers. In addition, third parties, such as TPIs and brokers, actively approaching customers to try and persuade them to change supplier, which enhances transparency and the competitive dynamic in the SME market.

[12] [✂]

284. In the SME market it is harder than in the residential market to compare offers from suppliers, which arises through a lack of consistency between suppliers as to their treatment of certain costs. TPIs and brokers can however play an important role in improving SMEs' awareness and in facilitating comparisons between suppliers' offers.

285. E.ON's approach in the SME market is that it does not use pass through products – a fixed price accepted by a customer will remain fixed at that level, even if E.ON suffers increases in elements of these costs – we refer to this as "fixed means fixed". By contrast, other suppliers "pass through" increases they suffer in costs, having provided to be able to do this in their contractual terms. Both approaches are legal and legitimate in a competitive market[13] and could create differentiation but a) we think our approach makes it simpler for our customers to understand our products and provides an easier basis for comparison of prices with suppliers with like approaches and b) the fact that there are (at least two) different approaches does make it more difficult overall for customers to compare prices.

286. We also believe that our cessation of contract auto-rollovers, a move we made based upon customer feedback, assists customers more in comparing different prices. In addition, TPIs have a helpful role in aiding customers making comparisons in this market, and given their increasing numbers and activity, this should provide pro-competitive forces.

Brokers: whether they are operating effectively and fairly

287. In the SME market, TPIs and brokers help improve the visibility of competing suppliers' prices for all SME customers (including microbusinesses). As indicated above, Ofgem estimates that there are over 1,000 TPIs operating in the non-domestic energy segments, from large organisations to individual advisers. In feedback from our customer immersion sessions, we note that many of our smaller business customers have experienced increased contact with TPIs, many even getting daily calls.

288. E.ON therefore sees the increasing number and activity of TPIs as a significant improvement in the SME market, helping to engage customers, increase transparency and ultimately increase competition. E.ON has had concerns about the conduct of a small minority of TPIs, potentially undermining trust in TPIs as a whole. In order to improve this for our customers, in 2012 we implemented a Code of Conduct for TPIs wishing to engage with us to ensure they worked to a set of high standards, including the disclosure of commissions. Those standards are audited annually for participating suppliers. As a result of this, we terminated a number of agreements with brokers that would not work to these standards (including some of the largest brokers in the market today).

289. E.ON welcomes and encourages greater TPI regulation and the implementation by Ofgem of a market wide Code of Conduct in order to improve standards,

[13] We operate a pass-through approach in our I&C business, for example, but believe "fixed means fixed" is more appropriate for SME customers.

increase transparency of commissions and hence customer trust in these brokers. We have been disappointed at the slow pace of Ofgem's work on implementing a market wide Code of Conduct which we had hoped would be in place before now (and has apparently now been stalled pending the CMA's deliberations)

Margins and profitability

290. The CMA has conducted analysis of the levels of profitability for supply to SMEs and uses this as a proxy for microbusinesses, commenting that EBIT margins for supply to SMEs exceed those for supply to either domestic or industrial and commercial customers. Whilst it is the case that the profitability of E.ON's SME business is higher, the SME business carries a number of significant risks and these risks need to be properly taken into account when considering E.ON's actual levels of return. These risks must be properly taken into account before an accurate assessment can be made regarding levels of profitability for supply to SMEs. We comment upon each of these risks in turn:

a. The SME market, (including microbusinesses), has an incredibly diverse customer base, ranging in in size from customers who consume less than a typical domestic customer (<2MWh) to those who are many times larger (up to 100MWh). The costs to serve, metering costs and overheads remain relatively fixed and this is reflected in our standing charge which is the same across all similar meter points. As a result, profits across the customer base can range considerably. The key risk in this area is associated with the difficulty in projecting volume requirements in such a diverse customer base, and the impact this can have should outturn volumes be significantly different from those forecast.
b. The SME business carries a higher debt risk than other sectors, [✂].
c. [✂]. As indicated above, E.ON does not offer pass-through contracts – fixed means fixed. We therefore take a significant risk on the pricing of these contracts, both in terms of commodity risk, but also significantly in terms of third party costs and regulatory costs. Whilst we forecast these costs and price these in to the fixed term price, there is significant volatility and risk given our limited ability to react to inaccuracies in the forecasts or changes to the external environment. [✂].
d. [✂].

Table 5: Proportion of E.ON's volume on fixed prices

[✂]

Source: E.ON's internal data

291. The CMA identifies a variety of different tariffs that microbusinesses may be on, a number of which are default tariffs. We note that the CMA recognises that customers may prefer the flexibility of an evergreen contract and therefore that customers on these tariffs will often not be disengaged. However, the CMA does identify issues with some of these tariffs and we comment on them in turn.

292. [✂].

Table 6: SME customers by product type

[✂]

Source: E.ON's internal data

Auto-rollovers

293. The CMA notes that its analysis showed that rollover prices were typically higher than negotiated prices. E.ON has ceased auto-rollover tariffs, with customers who have not agreed a new fixed contract moving onto a variable priced product (evergreen tariff) with a 30 day notice period. We actively seek to engage customers both before they move to this tariff and again after they are on it, via outbound telephone contact, as described above.

Deemed and OOC tariffs

294. The CMA also suggests that its evidence shows that margins on deemed and OOC tariffs tend to be higher than on other products. However, we would highlight that the nature of these types of tariff is that they have a very specific purpose and are tailored to reflect the risks of those tariffs. Given their specific nature, they also account only for a relatively modest proportion of customers. We comment on deemed and OOC tariffs below:

a. Deemed tariffs: These tariffs apply to customers that have not signed up to a contract but consume energy, most typically when a customer moves into a new property and starts to consume energy without a contract. Suppliers are required to publish the terms of deemed tariffs and there is a specific licence condition for deemed tariffs, which requires suppliers to ensure that the terms of these tariffs are not unduly onerous (SLC 7). These contracts carry a significantly higher level of risk, primarily due to bad debt (regulation prevents us from recovering debt from deemed customers leaving us) but also commodity risk as we have limited information on the volumes and duration of need of that volume that the customer may use. In addition, there is a significant cost to serve of customers on deemed tariffs.
b. OOC: These tariffs apply to customers who have terminated their contracts, with the intention of switching to a new supplier, but have yet to do so. Again, these tariffs carry significant bad debt risk as we have no way of knowing when the customer may leave, and often they do so without paying their bill. In addition, they carry commodity risk as we have to ensure we continue to provide them with product and do not know when the need will cease. Finally, there is again heightened cost to serve.

295. The very high level of risk associated with these tariffs should be properly taken into account, when considering E.ON's actual levels of return. It should also be noted that, because both of these products are intended to be transition

products, whilst the return may be higher than on other products, it is generally for a shorter period of time. It is also worth noting that customers on OOC rates made an active choice to terminate their contract and hence are engaged, but even so do not necessarily leave us immediately (however, we do not know when they will).

296. We actively seek to engage all customers moving on to a variable tariff, with outbound telephone calls, in order to offer these customers fixed tariff contract alternatives to their current choices.

Next steps

297. We note that the CMA recognises that their analysis in this area is less advanced than in other areas, particularly given the difficulty in segmenting microbusinesses. The CMA intends to investigate this segment further and we look forward to commenting on this process and any ensuing results.

3.7 CMA Updated theory of harm 5: the broader regulatory framework, including the current system of code governance, acts as a barrier to pro-competitive innovation and change

298. The Updated Issues Statement identifies a general theme relating to the impact that regulation has on competition in energy markets. In particular it has been suggested to the CMA that the code system may distort incentives, increase barriers to competition and stifle innovation. In particular the following issues are being investigated further:

a. Whether the number of codes in electricity adds to barriers to entry and/or expansion; and
b. Whether the current code governance acts as a barrier to pro-competitive innovation and change.

Whether the number of codes in electricity adds to barriers to entry and/or expansion

299. The Working Paper on Codes mentions 7 codes for electricity each with their own governance and administration arrangements. These are listed as:

a. The Balancing and Settlement Code ("**BSC**");
b. The Connection and Use of System Code ("**CUSC**");
c. The Distribution Connection and Use of System Agreement ("**DCUSA**");
d. The Grid Code ("**GC**");
e. The Distribution Code ("**DC**");
f. The System Operator/Transmission Owner Code ("**STC**"); and
g. The Master Registration Agreement ("**MRA**").

300. The Green Deal Arrangements Agreement, which supply licensees are obliged to sign, should also be added to the above list. Suppliers also need to sign up to a

number of Codes of Practice, such as the Smart Metering Installation Code of Practice ("**SMICoP**").

301. The CMA intends to look at whether this is an issue for competition, by exploring the following three issues.

<u>Whether the current system of industry code governance acts as a barrier to pro-competitive innovation and change?</u>

302. There is undoubtedly a cost for all suppliers associated with dealing with the complexity of rules that exists. In particular, for all suppliers, a lot of work is spent dealing with potential changes to industry codes. This includes attending industry workgroups and panels, as well as responding to consultations on the changes proposed. Whether the number of codes directly contributes to this is less obvious. The above codes cover a vast range of technical and commercial issues, involving generation, distribution, transmission and supply. The complexity of the rules they contain reflects the complexity of the industry.

303. Bringing the codes together would not necessarily reduce this complexity; it would simply continue to exist in one place. The key issue for parties is actually gaining a clear understanding about which rules apply to them in their particular context. Some codes, such as the CUSC, help parties by identifying which sections apply to different types of network user. Others are less helpful in this respect, although code administrators do a lot to help parties, particularly smaller parties, to understand and meet their obligations. Some parties do not have to sign all of the codes, so bringing all of the codes together into one would make this task more difficult for them, as they would need to consider and discount rules that are from codes which do not currently apply to them.

304. By bringing together the codes, or some of the codes, then some cost savings may be realised, but this should not be overstated. Whilst it may seem that savings could be made on rationalising the number of panels, it is highly unlikely that a single Panel could be brought together with the necessary knowledge and experience necessary to deal with the significant breadth and volume of change proposals that the current Panels have to deal with collectively. Similarly, a single code administrator may have a smaller number of staff than the aggregate of the current code administrators, but it would still need to be big enough to meet the demands of dealing with the wider range of issues that the aggregated code would cover, including having people with the necessary knowledge of the detailed rules. The main savings are likely to come in the numbers of support staff needed, such as finance and HR functions, which is likely to be a modest saving, perhaps at one full time equivalent role per current code.

305. However, that does not mean that the rules could not be simplified in some instances. Simplifying the arrangements is something which all parties would be supportive of in principle. The priority of this would need to be assessed against the considerable change which is currently needed to reflect the changing

marketplace by supporting policy initiatives, new technology and new business models.

Does the need for coordination between different code governance arrangements acts as a delay to reform?

306. The need for coordination between codes does introduce a degree of complexity into dealing with changes to the arrangements which might necessitate altering more than one code simultaneously. E.ON agrees this could work better in practice. Work is currently underway to improve such cross code coordination, led by Ofgem and the code administrators. This has not been a priority for previous Ofgem governance reviews, but it is right and timely that Ofgem and the industry address it now. It is not clear that this is a major barrier to innovation. Multiple changes have been progressed before.

307. Nevertheless, it is understandable that smaller parties may feel the burden of going to two panels to raise changes more than larger companies. However, often they are assisted through this process by code administrators who will help them write their proposal and even present it to the Panel for them if necessary.

Does the number of codes add to overall collateral requirements?

308. The collateral requirement of the Codes is an issue for all participants. It tends to be more of an issue for those parties with lower credit ratings, or who are unrated. This is because some codes require more collateral from lower rated parties, and/or the cost of providing collateral is higher for these parties. This tends to mean smaller parties are affected more as they have lower credit ratings, but this is not always the case as larger parties can attract lower ratings too.

309. It is possible that by bringing the codes together that the collateral required from parties could be reduced. For example, the net liability of parties might be reduced if they are a net creditor under one code and net debtor under another. It would need to be explored whether there are any legal issues with netting off exposures in this way, when they relate to very different obligations and services.

310. It may also be worth considering more generally the collateral requirements of codes and also those of network operators such as the Distribution Network Operators (“**DNOs**”). For example, it might be possible for the shareholders of network operators to be exposed to more risk rather than seek to offset it fully onto network users.

3.7.1 System of industry code governance

311. The Updated Issues Statement also questions whether the extent of industry participation in the current governance arrangements favours the large energy firms over new entrants, smaller parties and customers, and whether the timescales and processes for making changes create barriers to innovation. There are a number of issues raised in the Updated Issues Statement which we

comment upon in turn. Overall, our view is that, whilst there may be improvements that could be made to the overall codes process, it is vital that the right system of checks and balances remains in place so that all power is neither vested in Ofgem or in the industry. The balance needs to be retained between the different interests.

Ofgem belief that the current code governance arrangements are appropriate for incremental, non-contentious changes, but do not cope with delivering significant reforms

312. It is self-evident that a complex, controversial change will take a longer time to implement than a simple, uncontroversial one, if you aim to develop, assess and implement them properly to consider the effect they will have on the market and customers. That said, we agree that the code arrangements are not particularly well suited to introducing major policy changes such as required to introduce NETA or BETTA. However, changes of this type typically are introduced through legislative means with a government or regulator led project. This allows large changes to be coordinated across different parts of the market at once, but also requires the necessary level of consultation with the industry, Parliament and other affected stakeholders.

313. Large reforms can be progressed quickly through the code process. Faster switching is an example of this, which took 12 months to progress even though it was a radical and complex change. Some other high profile changes have not been so quick.

314. The Working Paper on Codes points out that Ofgem raised concerns about the Significant Code Review ("**SCR**") process. The implication appears to be that the code process is the weak point in the arrangements as Ofgem commented: "Experience has shown that SCR process can take a long time, and whilst we can direct the change to be raised following an SCR, it is ultimately for the industry to develop and deliver it under the 'standard' code change process". It has not been our experience that the code process has been the cause of longer timescales for the SCRs. This can be illustrated by looking at what happened in two of the most recent SCRs.

315. The significant code review Project Transmit took 3 years and 10 months, from the time it was first launched to the Ofgem implementation decision on the CUSC modification (CMP213) which was raised as a result. However, the time the industry spent assessing CMP213, from the change being raised to the Panel recommendation, was just under 12 months. The rest of the time was in the Ofgem controlled parts of the process.

316. The EBSCR had been in progress for 2 years and 7 months by the time the final modification report went to Ofgem for decision, in March of this year. Of this, 10 months was spent in the code process itself. Therefore, it would not be accurate to entirely blame the code governance processes for the long timescales of SCRs.

Indeed, given the complexity of the issues that have been considered, the code processes have progressed these changes relatively quickly.

317. It would also be incorrect to categorise these long running changes as the large energy firms opposing change or innovation which would benefit new entrants. Of the Six Large Energy Firms, three support Project Transmit and three do not. Similarly, in the EBSCR, three of the Six Large Energy Firms support the main proposals from the SCR whereas three do not. Indeed, it is the independent suppliers who appear most concerned about the EBSCR proposals, particularly the proposals for more marginal imbalance pricing.

318. Indeed it would be unfair and inaccurate to characterise the large energy firms as incumbents trying to hold onto existing processes and trading arrangements. Most innovation and change tends to be led by the larger companies in order to drive improvements for customers.

View of some independent suppliers that code panels have no desire to implement change, as they largely reflect the views of incumbents

319. As we mention previously, it is not accurate to describe the existing large energy firms as incumbents trying to prevent the implementation of change, as much of the change in the industry is led by these companies. The CMA has received some concerns from some parties that the code panels benefit the Six Large Energy Firms. This is not the case. The code panels typically have mix of members from different backgrounds and generally are formally required to operate independently and not represent their companies' interests. Some panels have a greater proportion of the Six Large Energy Firms in their membership than others. The BSC Panel has eleven panel members of which one comes from one of the Six Large Energy Firms. The UNC Panel has ten members of which two come from the Six Large Energy Firms, while one comes from a new entrant supplier. The CUSC Panel consists of nine voting members, four of whom come from the Six Large Energy Firms. Other panel members tend to be consultants and representatives of trade associations or consumer bodies.

320. The above code panels also only have a limited role in the change process. They tend to administer the timetable for the progression of the change, often within limits set out in the code. The panels do make a recommendation on whether the change proposal should be implemented, but ultimately Ofgem makes the final decision. The code recommendation only affects whether Ofgem's decision can be appealed or not.

321. Therefore, if a Panel opposed an innovative change that Ofgem wanted to introduce, the limits of its powers would be to keep the appeal option open by voting against the change. However, raising an appeal is a non-trivial exercise for a party to undertake, akin to undertaking a legal challenge. Therefore, people will use this route sparingly and only for very high value and controversial changes. Since the appeal mechanism was introduced in 2004 there has only been one appeal raised, by E.ON in 2007, although it is likely that RWE would

have also used the appeal route for Project Transmit had the Panel not voted to recommend the change. Even if the code panel had any inclination to inhibit or stifle change, which EON disputes, their ability to do so would be very limited.

322. Some of the retail focussed codes such as the MRA and DCUSA have a higher proportion of the Six Large Energy Firms represented on their Panels. For example, the MRA Executive Committee consists of one DNO, two suppliers and one representative from the BSC Agent. The two supplier representatives currently come from two of the Six Large Energy Firms. However, the role of these code panels is narrower in scope than with codes such as the BSC. The Panels no longer make recommendations on whether Ofgem should approve a code change. Instead, this has been devolved to a development board. The MRA development board has a membership split into two constituencies, suppliers and DNOs. Both constituencies have to support a change for it to go ahead. The supplier constituency is split into seven representatives. Six of these are from the Six Large Energy Firms and one from an independent supplier.

323. A model which may be preferable to the MRA change board is that of the DCUSA. This has an open voting process which takes place by email, so that parties do not have to turn up to a physical meeting each month to make their recommendation. It has a one party, one vote principle so all parties can take part. The voting is still split into constituencies, so a majority of each constituency have to agree to a change for it to be recommended.

324. We can understand how in theory the large energy firms may have an advantage over new entrants in the code process simply because they better understand how the market and the code governance arrangements work. That said, in practice there are a number of ways that newer parties can be supported in making changes to the arrangements. New entrant firms often employ staff who have previous experience of the market and understand the code change processes. Also, there are a number of consultants who specialise in supporting smaller parties and new entrants in understanding the codes and participating in the code process. These seem to be particularly effective as they allow groups of smaller parties to pool their resources to gain access to this support. Additionally, code administrators are required under the Code Administrators Code of Practice to act as a “critical friend” to smaller parties and to help them progress changes through the process.

325. In most codes, all parties are able to raise changes. The Grid Code currently does not allow industry parties to raise changes, as only National Grid is able to do so. However, the industry has formally raised this as an issue and has suggested that the Grid Code should be under open governance the same as other codes. This is currently being considered and we believe this is likely to result in this situation changing.

No binding timescales for decision making for certain codes

326. E.ON agrees that this might be a fair criticism for some codes such as the Grid Code which does not appear to have formal timescales for progressing changes. However, the BSC, MRA, GDAA, DCUSA, and CUSC all have timescales for assessing modifications. For example, the BSC and CUSC have timescales of 5 and 6 months respectively. This can be extended by the code panels, but only if Ofgem does not object.

327. Of course, for some modifications which are complex to introduce these timescales do need to be extended. The Working Paper on Codes gives three examples of where initiatives appear to have suffered as a result of a lack of binding timescales for decision making:

a. The work to introduce locational losses – As a supporter of locational losses, we are disappointed that this has not been implemented. This has not however been as a result of the code processes. For the first two modifications, Ofgem decided to implement the modifications, but its decision was successfully challenged in the courts on both occasions on procedural grounds. The final modification was simply not approved by Ofgem, even though there was a positive cost benefit case to do so. We were disappointed with that decision, but we accept that sometimes we and Ofgem will disagree on what arrangements will benefit competition and customers.
b. P272 – This took quite some time to get to an implementation decision, although again it is not clear that this was direct result of the code processes. P272 was a controversial modification and it was right that it should be thoroughly assessed. It was opposed by a number of suppliers, not because they wanted to prevent innovation, but because of the lack of overall benefit it appeared to deliver. We also believed that forcing a specific group of customers onto a certain type of metering arrangement was not a particularly customer focussed approach. E.ON made this point in our response to the Report Phase Consultation:

"We believe that Customers can already elect to have HH settlement, tariffs are offered by some suppliers, however customers prefer not to be HH unless their capacity makes it an absolute necessity – and even then it is resisted. By mandating the movement to HH we are taking away customer choice and not allowing competition in the market to drive behaviour."

The code process did take around a year and a half to come to a code panel recommendation. However, the majority of the time that P272 has taken has been in dealing with issues associated with implementing it. This is reflective of the difficulties that P272 has created in practice and were not fully captured in the original decision to implement it. Such issues are still being addressed, such as knock on problems with distribution charging and transmission charging.

c. Project Nexus – E.ON is very supportive of Project Nexus. The gas settlement systems are very much in need of being updated. We agree that this has taken longer than it should do and are keen for it to be delivered as soon as is practicable. Some of this delay has been necessary in order that Nexus can deliver a solution to support smart metering. It is not clear whether a different code governance structure would have changed the outcome of this project, although we would note that often network companies are placed in the position of delivering change, which they are reluctant to do unless their price controls allow for this. This can hold up change that would bring innovation and competition for their users and for the benefit of customers more generally. This is why we are pleased that Ofgem has recently taken more of a project management role of Nexus, which is something which we have supported for a while. We are more confident that this will allow the timely delivery of the project.

3.7.2 Wider regulatory impact

328. As we mention above, although we do not believe that the number of codes or the processes for changing market rules are necessarily a major barrier to entry or innovation in the market, we do agree that the energy industry is inherently complex. Understanding obligations under the market rules and dealing with the volume of changes is a significant undertaking for large, small, existing and new entrants alike. However, the market rules contained in the Codes are not the only source of this complexity and change.

329. In the First Issues Response, E.ON outlined how the regulatory framework is highly complex with a greater amount of regulation on the industry than ever. We gave the example of the supply licence which now runs to more than 400 pages and which has doubled in size in recent years. Obligations relating to traditional supply activities are far greater due to changes brought in under the Retail Market Review. Additionally, obligations now extend to other areas such as Feed-in Tariffs, Smart metering, Green Deal, ECO (and before that, the Carbon Emissions Reduction Target the Community Energy Savings Programme WHD, the Renewables Obligation, Theft of energy, and the Carbon Reduction Commitment.

330. A great deal of a company’s effort and resources can be taken up with making sure it meets these obligations and ensuring that its systems and processes are suitable to do so. This can act as a barrier to entry and can also limit the resource companies are able to allocate towards innovation, such as to bring in a new product or service, or to introduce systems and process improvements to better serve their customers.

331. In addition, the industry is currently experiencing a high degree of external change to market rules and processes, such as EMR, smart meter roll out, the introduction of European codes, changes to imbalance pricing, settlement reform and customer switching reforms. Dealing with this amount of change again limits a company’s ability to innovate.

332. There is some evidence that the burden of the current change programme is now being understood. One example relates to the area of settlement reform and the

introduction of next day switching. Ofgem has recently set out a timetable for this work which aims for implementation in 2019 which, although very challenging, should allow suppliers time to concentrate on implementing other significant initiatives such as Project Nexus, P272, TRAS and Smart Metering before bringing in further changes to the settlement process. Nevertheless, the impact of ongoing change on parties continues to be significant.