CMA ENERGY MARKET INVESTIGATION

UPDATED ISSUES STATEMENT

RWE RESPONSE

INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

1. RWE notes the publication by the CMA on 18 February 2015 of its Updated Issues Statement ("UIS") in the Energy Market Investigation ("the Investigation"). RWE notes the updating of the CMA's theories of harm and overall current thinking. This document provides RWE's formal response to the CMA's UIS. It should be read in conjunction with RWE's responses to the Working Papers that underpin the UIS and are published as part of the CMA's consultation (together "RWE's Response").

Executive Summary

2. RWE provides below a high level summary of its views in relation to each of the Theories of Harm. More detailed analysis and commentary is provided in subsequent sections of this document.

Theories of Harm 1 to 3

Overview

3. RWE recognises the CMA's detailed and thorough analysis of many issues within Theories of Harm 1 to 3, and generally welcomes the initial views and direction of future work in these areas.

Theory of Harm 1

4. RWE considers that the market rules for wholesale electricity are fit for purpose, and that they do not generally lead to distortions in competition or inefficiencies.

5. RWE believes that the current market arrangements deliver significantly greater efficiency compared with a model based on day ahead mandatory scheduling.

6. RWE is supportive of a move to single imbalance prices and believes this will be beneficial for competition and efficient trading. RWE believes that the introduction of reserve scarcity pricing is complementary to the capacity market and that it does not result in a material risk of overcompensation for generators.

7. RWE shares the CMA's concerns about the lack of sufficient locational signals in the GB market, in particular with regards to transmission losses. The socialisation of transmission losses creates significant inefficiencies.

8. In relation to the Capacity Market, RWE would be supportive of changes to rules that allow all providers of firm capacity to compete in the capacity market on equal terms.

9. RWE is generally supportive of DECC's approach in relation to Contracts for Differences and Investment Contracts, but would note that a competitive auction for CfDs is essential for any future allocation of low carbon contracts.

Theory of Harm 2

10. RWE agrees with the CMA's overall current conclusion that it does not appear likely that firms have the ability and incentive to increase profits by withdrawing capacity in generation through the exercise of either unilateral or coordinated market power. This is, for example, supported by the significant losses that RWE's own conventional generation business is incurring in the UK.

11. RWE supports the CMA's findings that the wholesale gas market in GB is unlikely to be at risk of the exercise of unilateral market power and that liquidity in the wholesale gas market is more than sufficient for all suppliers to meet their hedging needs.

Theory of Harm 3a

12. As a leading trader of electricity products and one of the largest providers of liquidity in the wholesale electricity market, RWE's firm view is that prices and price formation are fully transparent and there is good availability of the most important wholesale electricity products. Market liquidity is sufficient for generators and suppliers to manage their positions, and does not act as a barrier to entry or expansion.

Theory of Harm 3b

13. RWE agrees with the CMA's initial view that vertically integrated firms do not have the ability or incentive to engage in customer or input foreclosure.

Theory of Harm 4

14. The CMA has pointed out that its analysis in relation to the retail energy market is currently less advanced than it is in relation to the generation market. RWE anticipates that, as the CMA's thinking develops, a number of the CMA's current concerns in relation to aspects of the retail market will be dispelled by the evidence. RWE continues to believe that an evidence led review will help support the very important goal of rebuilding consumer trust in the energy industry which, in turn, will help provide the stability required to promote continued investment.

15. RWE considers that both the domestic and SME segments of the market have high levels of engagement and that they are very competitive, with a large number of

new suppliers fighting to acquire and retain customers. In domestic, for example, there is an increasing importance of acquisition channels such as Third Party Intermediaries and switching sites; there are high levels of transfers between tariffs within supplier as well as switching between suppliers, and many other ways in which customers are engaging (particularly through digital developments). Switching rates are higher than many other sectors. As a result of this competition, overall retail returns are low. RWE notes that the average EBIT margin for supply businesses over the Relevant Period calculated by the CMA was only 2.8%[1].RWE's own experience as an owner of supply companies in a number of other countries is that it can achieve a higher return with less risk elsewhere in its group.

16. Whilst the market is competitive, the way in which competition works has been distorted by government and regulatory intervention.

17. It will be fundamental for the CMA to understand why the market functions as it does, and to consider carefully the implications for its analysis:

17.1 In the domestic segment, it is not appropriate for standard and non-standard tariffs to be considered in isolation, as pricing for standard and non-standard customers is inter-linked, and customers move between the two tariff types. Competition drives RWE npower to offer discounts to acquire and retain customers and these discounts can only be offered if a sufficient number of customers stay with RWE npower for a sufficient period of time. The pricing model adopted by RWE npower is not one which is peculiar to the Six Large Energy Firms, but is reflected across the market and, more generally, discounting to acquire and retain customers is a common business practice across a range of industries.

17.2 RWE does not believe that analysing profitability by customer or tariff is appropriate. Differences in average revenue from standard and non-standard tariffs cannot, in RWE's view, be considered as evidence of weaker competitive pressures on standard tariffs. These differences can arise for a variety of reasons, including the shape of the commodity curve, exemptions for small suppliers, and regulatory and political risks and interventions.

17.3 In 2013, [CONFIDENTIAL] of RWE npower's domestic customers transferred tariff. The scale of internal transfers is clear evidence that the narrow measure of engagement currently emphasised by the CMA (switching suppliers) is inappropriate. In fact RWE considers that even switching and transfers combined are too narrow a measure, as is explained later in RWE's Response. To the extent that there remain *inactive* customers, however, they benefit from competitive standard tariffs that are directly affected by the propensity of *active* customers to

1 Profitability of retail energy supply: profit margin analysis, Figure 4

switch supplier and / or transfer to a different tariff. RWE npower has to conduct itself on the basis that customers can and will engage.

17.4 Regulation, and in particular the Retail Market Review and Standard Licence Condition 25A ("SLC 25A"), has had a material impact on competition in the domestic segment. It has continued to shape the way suppliers compete and, although it has had some positive effects, it has limited innovation and product choice. Competition has also been affected by the design, and application, of exemptions from obligations such as the Energy Companies Obligation and Warm Home Discount. Regulation has not always been applied consistently or appropriately, nor has it always achieved the right balance between customer protection and allowing competition.

17.5 Price Comparison Websites ("PCWs") play an important role in increasing engagement and helping domestic consumers to make informed decisions about switching energy supplier, but the need for customer trust and transparency should take precedence over their commercial freedom to present information selectively. These requirements to ensure customer trust and transparency should also apply in respect of collective switching. RWE considers that PCWs should be directly regulated by Ofgem to ensure that they comply with these requirements.

17.6 In the SME / microbusiness segment, competition is also intense, and returns are modest. This is a market characterised by a diverse customer base with differing requirements and one in which there is very considerable natural churn as a result of the high business failure rate. The risks to which suppliers are exposed are greater than those to which suppliers in the domestic and Industrial & Commercial segments are subject.

17.7 Competition in SME is stimulated by the presence of over 1,000 third party intermediaries ("TPIs") operating in the segment. However TPIs are unregulated and there has been a lack of transparency as to how they operate. The bad practices of a minority of TPIs have, in RWE's view, affected the market, and it is time that they were properly regulated.

Theory of Harm 5

18. RWE welcomes the opportunity to provide its views on the broader regulatory framework, and the inclusion in the CMA's analysis of this additional theory of harm. RWE does not believe that the industry codes are per se too numerous or too complex. Some of the retail codes could be made simpler, but only if there were changes to the underlying drivers of complexity. These drivers include the significant levels of political and regulatory intervention in retail arrangements, which in RWE's view has at times led to inefficient and unnecessarily complex outcomes.

19. With regard to code governance, RWE does not believe that the current system provides an advantage to incumbents. However, it believes that there is room for improvement to governance arrangements which would aid the efficient operation of the market. In RWE's view, code changes should be managed by a single independent administrator, with uniform processes including a fixed maximum timetable for processing modification proposals. Decisions should be made by an independent codes' adjudicator applying criteria of promoting competition and economic efficiency, rather than on the basis of Ofgem's complicated set of primary and secondary duties. Policy tools other than code modifications should be used to promote important policy goals such as sustainability.

STRUCTURE OF THIS RESPONSE

20. This document is structured as follows:

20.1 We begin by providing a reminder of the structure and nature of the operations of the RWE Group in the UK. It is important for this structure to be borne in mind when considering issues around liquidity in the wholesale market and foreclosure.

20.2 We then comment at a high level on the CMA's overview of market outcomes. This is the backdrop against which the CMA discusses each of its updated theories of harm, and it is important that any misconceptions as to market outcomes are addressed up front, so that the analysis the CMA undertakes in relation to each of the updated theories of harm is properly framed and soundly based.

20.3 Prior to summarising RWE's conclusions, based on the evidence, we then take each updated theory of harm, and address the points raised by the CMA.

21. RWE notes that the CMA has not formed any conclusions at this stage on whether there are any features of the GB energy markets, or combination of features, which prevent, restrict or distort competition. RWE's Response is provided on the basis of the initial views of the CMA expressed in the UIS. To the extent that the CMA's views change RWE would expect full and proper consultation on the reasons for such change and reserves its rights in full.

RWE GROUP IN THE UK

22. RWE operates in the UK through the following companies:

22.1 RWE npower Group plc ("RWE npower");

22.2 RWE Generation UK plc ("RWE Generation");

22.3 RWE Innogy UK Holdings Limited ("Innogy"); and

22.4 RWE Supply and Trading GmbH ("RWEST").

23. Until recently, RWE also operated in the UK through RWE Dea UK SNS Limited ("RWE Dea UK"), the UK operating subsidiary of RWE Dea AG. RWE Dea AG has, however, been divested to a third party.

24. Certain services (such as audit, accounting, some HR functions etc) are provided across the RWE group through RWE Group Business Services GmbH and its subsidiary in the UK, RWE GBS UK Limited.

RWE npower

25. RWE npower is the retail energy supplier for around [CONFIDENTIAL] million residential accounts[2] and around [CONFIDENTIAL] Small and Medium Enterprise ("SME") business meters[3] in the UK.

26. RWE npower is organised into four segments, each with full ownership of its profit and loss account and end to end processes that impact customers:

26.1 RWE npower 'Domestic' serves [CONFIDENTIAL] million energy customer accounts, which breaks down as follows into electricity and gas customer accounts:

26.1.1 [CONFIDENTIAL] million electricity customer accounts;

26.1.2 [CONFIDENTIAL] million gas customer accounts.

26.1.3 Of these, approximately [CONFIDENTIAL] million are both electricity and gas customer accounts.

26.2 RWE npower 'SME' (branded "npower Business") serves [CONFIDENTIAL] accounts, [CONFIDENTIAL] supplied with electricity and [CONFIDENTIAL] with gas. [CONFIDENTIAL], although naturally customers may decide to buy both power and gas from a single supplier. These customers vary in size from businesses with the same consumption as a Domestic property to hotels and factories.

26.3 RWE npower 'Industrial & Commercial' ("I&C") (branded Business Solutions) supplies approximately [CONFIDENTIAL] of energy to [CONFIDENTIAL] typically larger business customers with a more bespoke offering than SME.

26.4 RWE npower 'Energy Services' develops RWE npower's energy service offerings such as the smart thermostat 'Nest' and boiler installation and maintenance. It is responsible for meeting RWE npower's energy efficiency and environmental

2 RWE npower supplies to around [CONFIDENTIAL] million meters/[CONFIDENTIAL] million customers.

3 This figure not does not include Industrial & Commercial accounts, which are outside the scope of the CMA's investigation.

obligations, such as the Energy Companies Obligation and feed-in tariffs ("FITs") and provides metering services to RWE npower and other companies.

27. These four segments are supported by Retail Energy Management, providing the commercial optimisation and commodity risk management function across the portfolio, and by corporate and financial services.

RWE generation businesses

28. RWE's conventional and renewable generation businesses are described in the sections that follow.

29. Over recent years, RWE has invested more than £6 billion in energy infrastructure for the UK, split roughly 50:50 between investment in conventional power plant and new renewable technologies, including an investment of more than £1.5 billion in two new highly efficient gas-fired power stations at Pembroke and Staythorpe.

RWE Generation

30. Over the period under review RWE Generation owned, operated and maintained a portfolio of gas, coal, oil and biomass stations together with a portfolio of smaller open cycle gas turbine generation assets.[4]Additionally its subsidiary, npower Cogen Limited, owns and operates distribution connected combined heat and power and Open Cycle Gas Turbine sites in the UK and also provides services to operate, maintain and commercially optimise combined heat and power sites under contracts with large industrial and commercial customers.

31. Over recent years the conventional generation business has diminished in size through a combination of efficiency programmes, station closures and expiry of contracts.

RWE Innogy

32. The expansion of renewable electricity generation is a cornerstone of RWE Group strategy. RWE Innogy has an operational portfolio of 935 MW and a potential development portfolio of over 4 GW, including wind farms, hydro plant and biomass generation. RWEST provides the route to market for all power generated by RWE Innogy (with the exception of volumes associated with sales of Levy Exemption Certificate ("LECs"), Renewables Obligation Certificate ("ROCs") and Renewable Energy Guarantees of Origin ("REGOs")which are sold directly to RWE npower).

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[4] Further details of RWE's generation assets can be found in RWE Facts & Figures, November 2013, pages 18-21 and 24-25: https://www.rwe.com/web/cms/mediablob/en/108808/data/2495606/49/rwe/investor-relations/presentations-videos/presentations/Facts-Figures-2013.pdf

RWEST

33. RWEST is a leading European energy trading house. RWEST is the interface between the RWE Group and global wholesale markets for energy and energy-related raw materials. Based in Essen, Germany, with main UK trading floors in London and Swindon, RWEST is the hub for all tradable commodities, in both their physical and/or derivative forms, including power, gas, coal, freight, oil, weather, emissions certificates and renewable energies.

34. RWEST provides the main route to the wholesale electricity and gas markets for the retail and generation businesses in the UK. It also trades on its own account (through the proprietary trading desks). In addition, the Principal Investments business unit invests in energy related businesses or assets including generation assets. Current investments include Lynemouth Power Ltd, an embedded coal fired power station with the potential for conversion to biomass and a solar farm.

35. The RWEST Commercial Asset Optimisation ("CAO") team provides services to both the generation and retail businesses. With respect to the generation business, the CAO team aims to maximise the value of the generation assets on the wholesale markets, by hedging and optimising generation capacity. The CAO team [CONFIDENTIAL]. The CAO team is responsible for all longer-term commercial input for the generation assets including fuel procurement, scheduling of plant maintenance and investment decisions. These services are provided pursuant to formal contractual arrangements which *inter alia* ensure that full value is transferred back to the generation business.

36. For the retail business, the CAO team manages the residual short term positions of RWE npower from "week ahead" to "within day", including balancing RWE npower's final contractual position versus demand. Again, these services are provided to RWE npower pursuant to formal contractual arrangements which *inter alia* ensure that full value is transferred back to the retail business.

Operation of RWE companies in the UK

37. Each of the RWE companies is a separate legal entity and is independently managed, both in terms of management responsibility and profit and loss accountability, with each of the entities having separate boards of directors[5] and reporting separately to RWE AG. The performance of each RWE company is measured and targeted by RWE AG against separate business plans.

[5] The Chief Commercial Officer of RWE Generation, a board member of RWE Generation, is also a board member of RWEST. In addition the Head of Commercial Asset Optimisation UK, an employee of RWEST, is a board member of RWE Generation.

Paul Massara, CEO of RWE npower, also holds a role as country chair, under which he is responsible for stakeholder management and managing RWE's relationship with the government. In this role, in order to ensure that a consistent RWE position is taken, he needs to be sufficiently apprised of the operations of the other group companies. Mr Massara is not involved in commercial decision making in relation to RWE Generation, RWE Innogy, or RWEST.

38. The operation of the whole group is considered at RWE AG Board level only. RWE AG agrees the strategy and business plans for each company once a year in line with an overall RWE AG strategy and to deliver an overall RWE business plan.

39. The vast majority of internal trading is between RWE npower and RWEST and RWE Generation and RWEST respectively, and these generation and retail volumes are traded openly and transparently on the wholesale power and gas markets. A small amount of trades are netted between RWE npower and RWE Generation, and these also go through RWEST. Transactions between the different companies in the Group and RWEST, as well as the minority that take place directly between the operating businesses, take place based on wholesale market prices and on a "willing buyer/willing seller" basis. More generally RWE has led the way in promoting liquidity in the GB energy markets, and adds significant volume and liquidity to those markets.

40. Market conformity/fair-value checks are performed by RWEST Risk Control to ensure the validity of these market prices (with ex-post valuation being carried out if fair value cannot easily be determined). (RWEST Risk Control is independent of RWE npower and RWE Generation, and reports directly to RWE AG.)

41. RWE npower buys LECs, ROCs and REGOs from other Group companies at market reflective prices and also sources the same from generators outside of the RWE group.

THE CMA'S OVERVIEW OF MARKET OUTCOMES

42. The CMA presents an overview of the market outcomes it has observed in relation to prices and profits, and quality of service, based on the evidence it has received so far.

Profits and pricing

Retail

Overall retail profitability

43. RWE notes that the average EBIT margin for the supply businesses of the Six Large Energy Firms over the Relevant Period calculated by the CMA was only 2.8%[6], which RWE does not consider to be excessive. The CMA has not established an appropriate benchmark so as to put its findings in context. In RWE's view the CMA should consider a number of benchmarks, including other retail sectors or a wider market index, given that they provide an indication of the level of profits generated in other competitive markets. By way of example, RWE has calculated that the weighted average EBIT margins over the Relevant Period for the FTSE 100 and

6 Profitability of retail energy supply: profit margin analysis, Figure 3, 15

FTSE 250 were 12.1% and 9.9%, respectively. These margins are considerably higher than the average margin of the Six Large Energy Firms over the same period.[7]

44. RWE also notes that EBIT margins vary significantly over the Relevant Period for both the average of the Six Large Energy Firms and RWE npower specifically. The variation in returns over time and between firms indicates that the energy supply industry is subject to high risks. In considering the profitability of energy suppliers, the CMA needs to take these risks into account properly. These include risks associated with commodity hedging, weather, delivery of government policy (Energy Companies Obligation, SMART), the recovery of transmission and distribution charges, credit risk, regulatory risk and political risk. Given the significant risks and associated volatility of returns, care needs to be taken when analysing profitability over a truncated period.

Domestic

45. In the UIS the CMA found that the Six Large Energy Firms' domestic EBIT was 3.3% (gas 4.4% and electricity 2.1%). [CONFIDENTIAL].

Cost drivers of price increases in recent years

46. RWE is firmly of the view that the key drivers of price rises in recent years have been sharp rises in social and policy costs alongside rises in network costs. Moreover, RWE believes that some policy interventions have created unnecessary extra cost. We discuss each topic in turn.

47. RWE notes the CMA's observations in relation to increases in average prices based on a measure of revenue / kWh. This is consistent with RWE's views on increases in costs (particularly social and policy costs from governmental and regulatory interventions) over the 2009 – 2013 period. RWE has highlighted these increases in various publications including its Energy Explained document[8]. The CMA calculates that the average revenue per domestic customer account between FY07 and FY13 has increased by 44% (£184) in real terms from £420 to £604. Of this increase 88% is driven by costs: £72 reflects higher wholesale costs; £40 reflects higher network costs; £43 reflects higher obligation costs and £7 reflects higher supplier (indirect) costs. The remaining increase relates to a modest increase in supplier profit margin from an unsustainable 0.5% EBIT margin (£2/account) in 2007 to a level of 3.9% (£24 /account) in 2013.

48. RWE notes that average EBIT margins over the period are modest. The reason RWE decided to highlight, in Energy Explained, increases in costs that were beyond

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7 Company annual EBIT and revenue data has been extracted from Bloomberg

8 http://www.npower.com/idc/groups/wcms_content/@wcms/documents/digitalassets/newbill_pdf_energy_bills.pdf

the control of energy suppliers, was to correct misperceptions that had been created in the market that energy suppliers were making excess profits.

49. It is government policy to transition the GB energy market towards lower carbon emissions and prompt greater participation of renewables. Of course RWE would not criticise such a policy intent, but the policy and the way it has been implemented in GB has increased bills for consumers, for example through the Renewables Obligation, EU Emissions Trading System ("EUETS") (and recently the carbon price floor), and feed in tariff costs. In addition there has been increasing intervention through energy efficiency obligations, some of which have been not been of optimum efficiency and cost effectiveness (see further at paragraph 51 below). Finally, the increased participation of intermittent renewables, particularly in remote locations (onshore and offshore), has increased network costs.

50. Since 2007, policy costs are estimated to have increased by around 120% and network costs by around 50%. However, clear explanations of these as a consequence of the transition to a low carbon energy system have been absent, and the focus on wholesale costs, energy company costs and profit as, incorrectly, the sole costs making up the customer's bill has continued. Indeed, RWE considers that this lack of clarity has contributed substantially to the political and media 'football' that the energy industry in GB has become over recent years, and the increased intervention this has prompted. In turn, investors have become more reluctant to invest because of the interventions and move away from a liberalised and stable market regime.

51. RWE believes, in addition, that unless such costs are explained, commentators will not be aware of them, risking inadequate scrutiny of their effectiveness in achieving policy objectives. For example the UIS refers, in paragraph 168, to the way in which policy costs fall disproportionately on electricity. This, to RWE, does not seem consistent with a decarbonisation policy which should promote the greater electrification of transport and domestic heat, and RWE has raised this over the years with DECC. In particular Feed in Tariff, Renewables Obligation ("RO") and Contracts for Difference ("CfD"), EUETS and carbon price floor costs are charged to electricity and not gas. It is RWE's view that the absence of proper information and debate about such issues has been unhelpful. One way in which this could be addressed would be to have an Office of Energy (OoE) that is independent of Government, Ofgem and the industry. The key success criteria for such a body would be to provide information that is valuable and trusted, be credible and professional, have a relevant and concise focus, provide value for money, improve policy outcomes and be valuable to a wide range of stakeholders.[9]

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9 RWE would highlight the Office of Budgetary Responsibility or the National Institute for Health and Care Excellence that have been established to perform roles with similar objectives. RWE will provide further details in due course.

52. RWE has set out below some examples of policy interventions which RWE believes has created unnecessary extra cost:

52.1 In September 2008 the Home Energy Saving Programme was launched. A key part of this was the creation of a £350m Community Energy Saving Programme (CESP). CESP came into force in September 2009. It was intended that CESP would be delivered through community based partnerships including local authorities and other community organisations working with energy companies to identify and target communities. Analysis in the Impact Assessment made a series of assumptions around the type of measures that would be installed and estimated that energy suppliers would contribute £311m (83%) to deliver 100 schemes around the UK. There was a significant increase in cost before completion at the end of 2012. For RWE, this resulted in an increase in costs which were [CONFIDENTIAL] times the level indicated by the Impact Assessment. RWE delivered 152 schemes to comply with its obligation.

52.2 As part of the same Home Energy Saving Programme the government made changes to the existing Carbon Emissions Reduction Target (CERT). Under the change in legislation a new target was introduced, which required 15% of the savings achieved in the extension period (August 2010 to December 2012) to be achieved in a subset of low income households, a Super Priority Group (SPG). One of the important aspects of policies of this nature is that those responsible for delivering the obligation do not incur costs finding those who are eligible for measures. In other words, costs should be spent for the benefit of beneficiaries, not in finding those beneficiaries. Energy suppliers were unable to identify SPG customers. Search costs escalated steadily through 2011 and 2012. Help came from the Department of Work and Pensions late in 2012, at which time RWE had already been exposed to these higher search costs.

53. The above examples are historic, relating to schemes which ended in December 2012. The situation has improved, but still under parts of the Energy Companies Obligation (e.g. the Home Heating Cost Reduction Obligation (HHCRO) - also known as Affordable Warmth) there is:

53.1 A lack of data sharing in terms of those eligible for measures, although this is scheduled to improve;

53.2 Lack of access to databases or data sharing information showing where premises are suitable for energy efficiency measures and have not already been installed;

53.3 Constraints, in that Affordable Warmth is restricted to measures to households in private tenure only.

Competition has led to pricing strategies that involve discounts

54. RWE notes the CMA's comments in paragraph 15 in relation to the higher revenue per kWh derived from SVT than from non-standard energy tariffs, and notes the CMA's suggestion that the gross margins earned by energy firms from customers on SVT are higher than those earned from customers on non-standard. RWE's deals with these points in more detail at paragraphs 134-140 below. However, by way of introductory comment, RWE would say:

55. RWE would not consider it appropriate to make direct comparisons between standard (SVT) and non-standard product average revenues, even if the management information were available to do so. This is because RWE believes SVT and non-standard products are subject to a different cost base. For example, they are hedged in a different manner and, amongst other things, SVT customers will tend to have higher metering costs (from prepayment customers), debt costs, social tariff costs and more generally a higher cost to serve, when compared to customers on non-standard products which tend to attract dual fuel, direct debit customers who manage accounts on line.

56. Moreover, RWE considers this average revenue differential partly reflects competition driving firms to offer discounts to acquire and retain customers. Suppliers need to ensure that their pricing strategies allow them to compete for new customers and to compete to retain existing customers. Competition has resulted in the retail energy market being characterised by an introductory pricing model:

56.1 Suppliers increasingly seek to attract new customers by offering them introductory discounts to the tariffs that they might normally expect to pay;

56.2 In the energy market, the introductory discount model has been adopted not just by most of the Six Large Energy Firms, but also by smaller and mid-tier suppliers, and in the context of SME as well as domestic customers.

57. RWE knows that it will lose a proportion of its customers every year and needs to recruit new customers in their place. RWE has to offer discounts to acquire and retain customers and invests significantly in customer acquisition. The level of the discounts that RWE offers in order to remain competitive and attract and retain customers is determined by, amongst other things, business plan targets and prevailing market conditions. [CONFIDENTIAL]. RWE's incentive is to ensure that its non-discounted products are competitive in order for sufficient customers to remain on them for sufficiently long and not to squander the investment it has made in acquiring them.

58. As described in more detail in paragraph 136, RWE submits that the business model involving discounts for new customers has important implications for the CMA's interpretation of the evidence it has so far collected. In particular:

58.1 Customers on Standard Variable Tariffs and customers on non-standard tariffs cannot be considered in isolation [CONFIDENTIAL];

58.2 Differences between SVT and non-standard tariffs cannot be regarded as an indication that SVT tariffs are somehow unfair or that suppliers are overcharging SVT customers; and while a price difference may indicate that an individual may gain from switching (all else equal), such a difference necessarily occurs when discounts are used, and should not be taken to indicate a competition problem; and

58.3 Given the customer journey, the way in which RWE prices energy, and the inter-dependence of SVT and non-standard products, it makes no real sense to consider profitability for these products separately.

59. In relation to the measurement of profitability by tariff / customer segment, RWE notes that there are, in any event, some significant evidential, conceptual and practical challenges in being able to analyse profitability in this way:

59.1 In terms of the evidence: RWE has not tracked historic profitability by tariff / customer segment, because [CONFIDENTIAL].

59.2 In terms of the practical constraints: [CONFIDENTIAL].

59.3 In terms of the conceptual challenges: RWE notes that it does not make economic sense to allocate costs such as acquisition costs and overhead costs (which are incurred to acquire and serve a customer throughout its time with the company) to individual tariffs.[10]

60. RWE does not consider that it is likely to be the only supplier in this position. RWE notes that discounts from SVT are also offered by small and mid-tier suppliers and these may sometimes be higher than the discounts offered by the Six Large Energy Firms. RWE would observe that the existence of such price differentials between SVT and non-standard tariffs among small and mid-tier suppliers is likely to point to higher costs to serve SVT customers.

61. The points above also have significant implications for the proper interpretation of the CMAs evidence on gains from switching.

62. In a situation where SVT and non-standard products are subject to (i) a different cost base and (ii) competition to acquire and retain customers involves offering discounts, it cannot be surprising that there is at least some gap between discounted and non-discounted products.

10 RWE's comments on the methodology that the CMA appears to have adopted in apportioning costs between SVT and non-standard products in order to form a view on relative profitability between tariff types will be provided in response to the Working Paper on retail profitability, published on 16 March 2015.

63. That said, RWE believes there are reasons to believe the CMAs analysis is significantly overstating customers' actual return from switching for reasons discussed in its response to the CMA Gains from Switching Working Paper.

64. In any event, RWE does not believe that the CMA should properly find evidence of competition driving discounts to acquire and retain customers and conclude that the industry is suffering from a competition problem. Discounting to acquire customers is a normal business practice that occurs across a range of industries.

65. Rather, RWE considers that, since discounts are good for customers the CMA should consider even well-meaning calls to dampen incentives to offer discounts to consumers with a significant degree of scepticism.

SME

The causes of changes in RWE SME margins

66. The EBIT margin of RWE's SME segment over the last three years has averaged [CONFIDENTIAL]. In 2014, RWE's SME EBIT margin was [CONFIDENTIAL]. The [CONFIDENTIAL] seen in the earlier part of the period are the result of two main factors:

- [CONFIDENTIAL]

Although [CONFIDENTIAL]). From 2012, RWE undertook an overhaul of its SME business which has put the business on a sustainable basis.

- Structural industry change

The inclusion of contract end dates on bills puts customers in a strong position to regularly review and negotiate their contracts. In the course of 2013, triggered by pressure from the Government, all of the large players in the SME market decided to stop their practice of auto-rollover of their SME customers, further improving the customer position. However, since this was stopped by the Six Large Energy Firms, Ofgem has decided not to ban auto-rollover contracts formally, meaning that SME customers who now switch suppliers may not be aware of whether they will be auto-rolled over or not depending on whether they switch to a big or small supplier. It seems to RWE that these changes are better managed via regulation.

67. The average margins shown by the CMA over the relevant period are [CONFIDENTIAL].

68. RWE also notes that RWE's SME segment faces greater risks than Domestic or I&C, including high levels of business failures and business movers, customer credit and bad debt risk, and (as compared to the I&C segment) the extent to which the SME segment takes on wholesale cost and other cost risk. Therefore a

reasonable return for the SME business might well exceed the returns typically seen in the Domestic or I&C segments.

69. RWE notes from the CMA profitability analysis that the average margin in SME gas significantly and consistently exceeds that in power, [CONFIDENTIAL].

The causes of price variation across microbusinesses

70. The CMA states in paragraph 18 that it has found considerable variation in the prices paid by microbusinesses. It is important for the CMA to understand the variety in characteristics of microbusinesses and hence the structure of pricing in the SME market, and [CONFIDENTIAL] model that RWE adopts. This structure is driven by aggressive competition in relation to the acquisition of new customers. The [CONFIDENTIAL].

71. It is also important to recognise that RWE [CONFIDENTIAL]. In general, therefore, as in the domestic context, RWE is able to offer better prices if it knows what volume of gas or power will be required. RWE therefore [CONFIDENTIAL]. In any event, because RWE competes actively to acquire *and retain* customers, RWE must constantly ensure that its prices across <u>all</u> products are competitive.

72. It is RWE's view that, in both domestic and microbusiness supply, returns should be assessed on a net margin basis, after taking into account all costs, not a gross margin or revenue basis.

73. In relation to customers on Deemed and Default tariffs, RWE considers that the CMA will wish to note that in addition to pricing differentials being subject to SLC7.4:

73.1 That it [CONFIDENTIAL] Deemed customers who have been with RWE for more than [CONFIDENTIAL], and of those, RWE is receiving payment from [CONFIDENTIAL]. This highlights both the small number of Deemed customers (the market is working in that Deemed customers are continually being contacted by TPIs and rapidly move to new terms) and the profitability (debt) issues relating to Deemed customers.

73.2 In respect of Default customers, namely those who have advised that they do not wish to renew their contract but have yet to complete the transfer, these represent [CONFIDENTIAL] of RWE's SME customer base. [CONFIDENTIAL] of RWE's default customers stay with RWE for [CONFIDENTIAL]; RWE has [CONFIDENTIAL] default customers who have been with RWE for [CONFIDENTIAL].

<u>Generation</u>

74. RWE's detailed comments in relation to profitability in generation are to be found in its response to the CMA's working paper on this topic.

Conventional Generation

75. Based upon the level of profitability achieved by RWE, and the significant losses incurred in the UK over recent years, RWE supports the CMA's initial views that returns over the relevant period are in line with or below the cost of capital. RWE also notes that substantial losses have been reported for 2013 and 2014, and that the outlook remains negative for the next few years.

Renewable Generation

76. RWE supports the CMA's initial views that returns for renewable generation over the relevant period are in line or below the cost of capital. RWE also supports the CMAs assertion in the Profitability Working Paper (paragraph 95) that returns are expected to increase as its assets under construction become operational. However as the support regime changes to CfDs, returns achievable on new assets are expected to decrease as a result of the competitive auction process and development risk will increase.

Quality of service

77. As per its initial submission RWE acknowledges that it has not always delivered the levels of domestic customer service to which it aspires.

78. RWE has had to make significant investments in trying to overcome the IT issues created by its legacy systems in order to improve customer experience. RWE invested over [CONFIDENTIAL] in a new SAP system in order to improve customer service. However, issues associated with migration of customers onto the new SAP billing system have been a cause of real operational difficulty and customer dissatisfaction. RWE is currently making significant progress towards addressing these issues.

79. RWE remains focused on its objective of providing customers with a great customer service and has undergone a complete refocus of its retail business in order to achieve its goal to be number one for customer experience.

80. RWE has made it easier for customers to contact npower through free phone numbers, social media channels, and developed their digital capability including webchat. Self-service accounted for [CONFIDENTIAL] of contact in 2014.

81. RWE introduced a Customer Transformation Programme, to help focus their business in a more customer centric way and adopted a new way of working (NWOW), which is used to deliver systematic, sustainable improvement specific to each customer team and process.

82. Paragraphs 21 to 25 of the UIS focus on the quality of Domestic service of the Six Large Energy Firms. However the complaints review of Q4 2014 revealed that the

small suppliers are facing similar issues. RWE considers that when addressing the quality of service and complaints, the whole market should be included.

83. Whilst the CMA has indicated that the number of recorded complaints has increased fivefold from 2007 to 2013, the total number of complaints received by four of the Six Large Energy Firms has reduced from Q1 to Q4 in 2014. RWE has seen the biggest percentage reduction at 25%.

84. As far as billing issues are concerned, 98% of all of RWE's customers are billed on time - its number of late invoices has declined from more than [CONFIDENTIAL] in January of last year to less than 90,000 now.

85. The CMA has drawn out that trust in other energy suppliers is considerably below the extent of trust in a customer's own energy supplier. Indeed, as GfK notes[11], the proportion of survey respondents who said they trusted their own energy company was higher than for any other type of organization (including local authorities). RWE recognises that the CMA might have been concerned if large numbers of consumers did not trust other suppliers, and a lack of trust was driving distrusting customers not to shop around or switch. However, the CMA's survey results show that is not the case. First, most domestic customers report that they either trust (or are neutral in terms of trust) towards other energy suppliers. Second, whether survey respondents do or do not trust in other energy suppliers does not seem to have an economically significant effect on their propensity to switch or shop around.

86. RWE knows that it can provide its domestic customers with a better service because it has done so in its SME business. RWE's SME business is currently joint second for customer satisfaction and its aim is to be number one. Its customers tell RWE that they want RWE to provide a reliable and high quality service, value for money, and that RWE can demonstrate that it is changing for the better. Customers say[12] that RWE is better than its competitors at recognising and rewarding loyalty, and getting things right first time for joiners and renewers. RWE has achieved this through significantly investing in its SME business, which it continues to do, and by careful research into customers' needs in the SME segment, for example through its Customer Transformation Programme. RWE recognises that whilst competitive pricing is essential, its customers value more than price alone.

UPDATED ToH 1 (THE MARKET RULES AND REGULATORY FRAMEWORK DISTORT COMPETITION AND LEAD TO INEFFICIENCIES IN WHOLESALE ELECTRICITY MARKETS)

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11 See paragraph 52, 'Energy Market Investigation: A report for the Competition and Markets Authority by GfK NOP.'

12 TLF, Satisfaction survey of energy supply competitors in the SME market for Q3 2014

87. Overall, RWE considers that the market rules for the wholesale electricity markets, as updated by recent and forthcoming changes, are fit for purpose, and that they do not generally lead to appreciable distortions in competition or inefficiencies. RWE's more detailed comments appear below, and in its responses to the following Working Papers: The wholesale electricity market rules; Locational pricing in the electricity market in Great Britain; Capacity; Analysis of generation profitability; and Legal and regulatory framework. While RWE has some concerns regarding the wider regulatory framework, these relate to wider code governance and decision making rather than the rules themselves and, as such, are addressed below in the context of Theory of Harm 5.

Market rules

88. RWE supports the CMA in its review of the wholesale electricity market rules, although RWE considers that the wholesale electricity market rules (as updated by recent and forthcoming changes) are fit for purpose and do not generally lead to appreciable distortions of competition. In terms of the CMA's specific areas of focus, RWE makes the following observations:

Self-dispatch

89. As the CMA notes, there is no binary distinction between self-dispatch and centralised dispatch. The "self-dispatch" BETTA arrangements in place today effectively include central dispatch of generation from an hour before the delivery period. Many markets with self-dispatch – including GB, Germany etc – also include coordinated liquid day-ahead auction markets which perform a similar function to centralised day-ahead "pooled" arrangements such as those seen in Ireland, Spain, Italy and the old England and Wales Pool. The comments below therefore apply at a general level in comparing open market arrangements based around day-ahead auctions, self-dispatch and a residual balancing mechanism (central despatch in short timescales) with markets based on a centralised scheduling and dispatch algorithm at the day-ahead stage and through to delivery and bearing in mind that there are material similarities between the two.

90. RWE believes that the BETTA arrangements in place today are a significant improvement over the Pool arrangements. In part this relates to governance (a topic that we otherwise address under Theory of Harm 5). The more flexible governance arrangements introduced under NETA have delivered on one of government's main objectives for NETA, namely to make the governance of the wholesale electricity market rules much more open, transparent and flexible in the face of changing circumstances. Moreover, as set out below, RWE also believes that the BETTA arrangements deliver significantly more efficiency and transparency in the determination of market prices than centralised dispatch.

91. As for technical efficiency, RWE believes that the current arrangements, based on self-scheduling and de facto central dispatch at gate closure, deliver significantly greater efficiency compared with a model based on day ahead mandatory scheduling. While centralised dispatch is only as good as the - inevitably simplified – dispatch algorithm used, self-dispatch allows operators to consider a larger number of variables and constraints and to look beyond a single day to incorporate opportunity costs associated with annual environmental constraints, maintenance requirements etc. In this respect, RWE shares National Grid's observation that self-dispatch is more efficient because plant owners are better able to factor in the increased maintenance costs associated with more frequent stops and starts than under central dispatch. Self-dispatch also better promotes efficiency in response to changing circumstances during the day by allowing prices and power station dispatch to respond more flexibly to evolving drivers of supply and demand.

92. RWE does not believe that self-dispatch (a) puts a greater burden on each party to forecast imbalance costs than centralised dispatch, (b) reduces price transparency or (c) rules out locational pricing, and we outline our thoughts on these topics in more detail in our response to the working paper.

93. In RWE's view, central dispatch can only be considered in the context of a pooling arrangement whereby wholesale trading takes place around centrally determined pool prices. This entails significant changes to the current wholesale market arrangements, that would risk reducing competition "for the market" between competing exchanges and the brokered over-the-counter markets. A move to mandatory or predominantly financial trading based on pool prices (e.g. to a model similar to Nordpool) is also likely to result in significant barriers to participation and competition in the wholesale markets due to the increasingly onerous nature of financial regulation, in particular following forthcoming changes to the regulation of financial (rather than physical) transactions and counterparties under the Revised Markets in Financial Instruments Directive "MIFID II".

94. RWE shares the CMA's observation in paragraph 37 that the self-dispatch model is unlikely to provide significant incentives in favour of vertical integration. The BETTA market design requires the settlement of generation imbalances separately from those associated with demand, and provides strong incentives on generators and suppliers to manage their risks. Market liquidity (both within-day and forward)is sufficient for generators and suppliers to manage their imbalance positions. As noted in the CMA Working Paper on wholesale electricity market rules, the extent of "self-supply" is limited in practice[13]. Cash out prices remain unattractive compared with forward prices and parties do not "spill" significant volumes into the imbalance market. Future reforms to cash-out to introduce a single price also remove any conceivable benefit of integration from this source.

[13] CMA Working Paper, Paragraph 9 (b), Page 5

95. RWE would agree with the CMA's initial view in paragraph 38 that wholesale electricity prices are not opaque and with the observations that prices and price formation are transparent. In fact, RWE believes that wholesale electricity prices are very transparent, and that self-dispatch increases price transparency because the strong incentives on parties to manage imbalance risks results in significant volumes of forward trading in liquid markets. All market participants can readily access forward market prices via the trade platforms and day-ahead auction prices are readily and publicly observable. In addition, the BETTA market design provides incentives for market players to trade actively within-day and make plant available in the balancing mechanism to access the benefits of competitive re-dispatch. This means that self-dispatch increases transparency because prices are also available within-day and as close to dispatch as possible.

Cash-out pricing

96. RWE is supportive of a move to single imbalance prices and believe this will be beneficial for competition and efficient trading. While RWE supports the move to a more marginal price signal, we recognise industry concerns about an immediate move to PAR 1 and would recommend that the question is best resolved empirically by adopting PAR 50 or 100 as a starting point and reviewing the need to narrow further in the light of experience.

97. RWE does not believe there is a risk, even under PAR1, of market power being created for a generator as a result of becoming a price setter in the balancing mechanism. The issue of price setting plant was identified as part of the Electricity Balancing Significant Code Review ("ESBCR") and under the relevant Balancing and Settlement Code ("BSC") modifications in the context of the move to single marginal prices. While a move to a lower averaging volume may increase the scope for a single plant to set prices, such actions would require perfect foresight that such a plant was marginal combined with limited competition, as opposed to the reality of a highly competitive balancing mechanism with very limited ability to forecast balancing actions accurately. In addition:

97.1 Market manipulation of this kind would be easily detected, given that all actions and prices in the balancing mechanism are transparent, reported on the central information platforms and subject to significant regulatory scrutiny and oversight;

97.2 The benefits from such conduct would be limited to the balancing acceptance itself, which by definition would be small under a PAR1 (or even a PAR50 or PAR100) rule. There is no wider benefit to an imbalance position under dual cash-out and any attempt by a large player to run a significant spill position under single price cash-out would be self-defeating as it would leave the system long and accepting bids not offers (and vice versa). It would also be highly visible to regulators. The inability to predict bid-offer acceptances also makes it virtually impossible to leverage control over cash-out to a wider contractual position via secondary impacts on forward market prices; and

97.3 The phased approach to the relevant BSC modifications also provides significant comfort against any potential issues arising in this regard, such that any future reductions in the PAR can be taken in light of emerging experience. RWE is confident that the potential for market manipulation as a result of the reduction in PAR values is very low.

98. RWE does not believe that the introduction of reserve scarcity pricing ("RSP") at the same time as the Capacity Market will result in a significant risk of overcompensation for generators. In a competitive Capacity Market, it will be necessary for successful units to take into account changes to expected revenues arising from the energy market, including those influenced by cash-out reform. Indeed, we expect that the effects of ESBCR would already be built into forward prices and hence reflected in our bids and, we presume, those of other participants. To the extent that they are not already built in, as confidence in the effects of the proposed changes improves, these will be increasingly priced into projected energy market revenues and, hence, capacity auction bids, thereby avoiding sustained risk of overpayment.

99. RWE acknowledges that there may be a small risk of over-compensation in some of the initial longer-term agreements agreed prior to the proposed changes potentially being included. However, the long duration of those agreements coupled with the lead time of the agreements (i.e. 4 year lead time) means that the inclusion (or not) of infrequent levels of high prices are likely to be insignificant in the context of the other material risks (e.g. commodity input prices, carbon price, regulatory and political risks)that such projects must take into account over these extended timescales.

100. RWE believes that the reform of cash-out is complementary to the Capacity Market. In addition to its role in providing a signal for installed capacity across the year, cash-out reform – and RSP in particular - will also lead to more efficient short-term price signals reflecting the value of shorter-term flexibility and availability in the face of greater renewable intermittency. Furthermore, a properly functioning energy market will reduce the requirement for a capacity mechanism and over time prices in the capacity mechanism would be expected to become lower, all else being equal, as other measures help to mitigate the 'missing money' problem.

Locational pricing

101. Locational pricing in the GB electricity industry should be considered in the context of:

101.1 The efficient siting of power stations and demand must recognise the long run marginal cost impact of investment in transmission assets;

101.2 A transmission charging regime must reflect the trade-off between long run costs (investment) and short run costs (congestion and losses);

101.3 The charging regime must allow for the recovery of transmission costs (both investment and congestion) that have been efficiently incurred; and

101.4 The efficient dispatch of generation should be considered in the context of short run costs of using transmission (congestion and losses)

101.5 RWE shares the CMA view that a well-functioning market would have sufficient location signals. These provide efficient incentives for short run and long run decisions (investment, shutdown/ mothballing, dispatch and consumption).

102. Currently, losses are socialised and there are no signals to optimise dispatch of plant to minimise losses. RWE agrees that this is likely to result in significant costs that are borne by consumers as a result of inefficient location and dispatch, unnecessary losses and distorted competition.

103. Constraint costs are significant, particularly following the implementation of 'Connect and Manage' in 2010, which allowed connection of plant even where wider reinforcement works had not been completed.

104. Transmission charges should reflect the cost of connecting capacity at a point on the system and can, if properly designed, provide the correct trade-off between constraints and investment in transmission infrastructure.

105. RWE supports the conclusion of the CMA that the support mechanism for renewables investment is the best way of providing incentives for low carbon investment[14] and that the locational pricing regime should not be distorted to deliver renewables investment

106. RWE recognises the overall social welfare benefits of locational pricing (noting that there will be distributional effects of any change). Under the zonal transmission losses scheme and in submissions under Project Transmit we have highlighted the potential impact of the current arrangements on customers (see for example RWE submissions on the most recent CUSC Modification proposal on transmission charges)[15].

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[14] CMA Working Paper, Paragraph 26, page 10

[15] *Project TransmiT: Decision on proposals to change the electricity transmission charging methodology*", Ofgem, 25th July 2014

107. RWE is frustrated with the delays in introducing locational pricing. The benefit of locational charging for transmission losses has been estimated at £276m net present value (NPV).

108. Locational signals currently play an important role in investment decisions and it is important that these continue to provide an efficient economic signal to the developers of generation projects and network transmission users, and therefore should not be dampened further, as Ofgem currently proposes to do (via CMP213). Modelling commissioned by RWE[16] has demonstrated a potential customer welfare loss from this proposal of £2,785m net present value ("NPV") in the modelled period 2014 to 2030 which includes a significant increase in transmission losses and constraint costs. The Ofgem commissioned analysis of the proposal also indicates a significant potential customer welfare loss and increases in transmission loss and constraint costs, albeit they believe it is offset by other "benefits, not captured in the modelling, which will result in long-term benefits to consumers".

The Capacity Market and Contracts for Difference

Capacity Market

109. RWE agrees with the view set out in paragraph 53 of the UIS that there are strong arguments for introducing a capacity mechanism. We have set out our views relating to the interaction of the capacity mechanism with the reforms to the imbalance mechanism under the EBSCR in paragraphs 94-98 and in our response to the Working Paper on wholesale electricity market rules. In addition, RWE would make the following observations:

109.1 RWE would expect market rules that ensure all providers of firm capacity to compete in the capacity market on the same terms. RWE supports equitable treatment of all providers of capacity, including Demand Side Response ("DSR"). In this regard, RWE would note that:

109.1.1 All capacity should be eligible for the same tenors of long-term contract as new capacity. The failure to create a level playing field in this regard (as in others) risks building new plant inefficiently in cases where it would have been cheaper to maintain existing plant to provide capacity over the same tenor.

109.1.2 Offering 15-year contracts against the price in the current year's auction in the absence of any future demand estimate begs the question of whether or not new capacity is actually required in years 5-19 (i.e. years 2 – 15 of a contract starting in 4 years' time). The implicit assumption that the new build is required to meet future demand expansion is highly questionable given the prospect that net

[16] Project Transmit: Modelling the Impact of the WCM 2 Charging Model, NERA and Imperial College, October 2013 (the NERA/Imperial College Modelling Report 2013) at https://www.ofgem.gov.uk/ofgempublications/85153/consultationresponsefromrwe2.pdf

demand for capacity in the capacity market falls due to energy efficiency measures, increased used of storage and temporal switching of demand (in part facilitated by Smart metering) and as significant capacity is built under the nuclear and renewable CFDs.

109.1.3 DSR, which can demonstrate that it can deliver firm capacity against a committed baseline, should be eligible to provide capacity on equal terms to generation. However, RWE would note that a portion of the annual year-ahead auctions leading up to the 2017 year ahead auction (known as the Transitional Arrangements) is ring-fenced for DSR to cater for concerns in the DSR community about committing to response over longer horizons. It would also be more efficient if all forms of firm capacity were eligible for these year-ahead auctions.

110. RWE agrees that the question of whether the penalty regime provides an appropriate incentive to ensure reliable delivery of capacity is important. RWE's view is that non-delivery penalties should reflect the value of capacity during times of scarcity, rather than being capped at annual income levels. The capping of penalties to annual payments increases the likelihood that some projects in receipt of a capacity agreement will not be built and undermines the role of the capacity market in ensuring security of supply.

111. The capacity market is designed to provide year-round system security and system stress events are not confined to peak winter periods. As such it is appropriate to recover the costs by reference to suppliers' market shares over a broad winter period in the way that has been implemented or through a year-round average charge.

Contracts for Difference

112. The UIS raises a number of questions relating to the allocation of CfDs. RWE supports the principle of separate pots of funding for established and less established technologies on the basis that long term environmental targets (e.g. the 2030 decarbonisation of electricity) will require the deployment of technologies such as off-shore wind in significant volume. Alternatives such as the use of maxima and minima could have resulted in other distortions and impact on costs for consumers. In order to deliver technology cost reduction, required to deploy at volume, it is sensible to support innovation and industrial commercialisation in the short term.

113. Investment contracts ("ICs") were introduced by DECC in order to prevent a hiatus for technologies / projects that were unable to invest against the Renewable Obligation ("RO") and requiring Final Investment Decision to be made in advance of the CfD policy being finalised. RWE was supportive of the award of ICs in this specific context to avoid investment hiatus.

114. RWE agrees with the CMA that the lack of competitive tendering for any future ICs for low carbon technologies, which distorted the original rationale for ICs, should be considered as a potential concern for consumer interests. A competitive auction for CfDs is essential for any future allocation of low carbon contracts.

115. With regard to the CfD Intermittent Reference price, RWE agrees with the CMA's initial view in paragraph 62 that it is unlikely that any generator would have the ability and incentive to manipulate the reference price. This is due not least to sufficient liquidity in the hourly day-ahead market, which was recognised by Ofgem in its statutory consultation on the Secure and Promote licence condition[17].

UPDATED ToH 2 (MARKET POWER IN GENERATION LEADS TO HIGHER PRICES)

116. RWE refers to its previous submissions regarding market power in generation[18] and agrees with the CMA's view in paragraph 74 of the UIS that firms do not have the ability or incentive to increase profits by withdrawing capacity in generation, through the exercise of either unilateral market power ("UMP") or coordinated market power.

117. Prior to the publication of the UIS, RWE's primary concerns were that:

117.1 the CMA's model does not reflect the working of the GB power market;

117.2 the CMA's model incorrectly assumes the power portfolio is completely unhedged at delivery, whereas in reality the vast majority of our power station portfolio is hedged in advance;

117.3 the results of the CMA's analysis are highly sensitive to the modelling assumptions and in particular to the lack of dynamic constraints; and

117.4 the approach does not take into account the regulatory constraints and external scrutiny that the market faces.

118. RWE therefore welcomes the recognition in the Working Paper on Market Power in Generation that:

118.1 the CMA's initial results represented an upper bound estimate of the technical feasibility of withdrawing capacity and that they did not take into account several important practical constraints on the ability and incentive of generators to exploit UMP;

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17 https://www.ofgem.gov.uk/ofgem-publications/84508/wholesalepowermarketliquiditystatutoryconsultationonthesecureandpromotelicencecondition-pdf

18 RWE's submission of 12 December 2014 regarding the CMA's unilateral market power (UMP) methodology and RWE's submission of 6 February 2015 regarding further analysis of the CMA's UMP model and assumptions for the stack model.

118.2 the CMAs recognition that once it begins to apply filters to its modelling results to illustrate the impact of uncertainty and to exclude results based on relatively low profit opportunities, that its model suggested there were minimal opportunities to increase profits by withdrawing capacity;

118.3 the CMAs initial view that the profitability analysis does not provide evidence that excessive returns have been earned or that wholesale market prices have been above the competitive level;

118.4 that, in relation to the possibility of exercising coordinated market power in the wholesale market, the CMAs initial view is that the three necessary conditions for coordination (paragraph 73) are not likely to be met; and finally;

118.5 that the CMAs overall current conclusion that it does not appear likely that firms have the ability and incentive to increase profits by withdrawing capacity in generation through the exercise of either UMP or coordinated market power.

Wholesale gas

119. RWE supports the CMA's findings that the wholesale gas market in GB is unlikely to be at risk of the exercise of UMP, that there are no substantial barriers to entry in gas storage projects or interconnection projects, and that liquidity in the wholesale gas market is more than sufficient for all suppliers to meet their hedging needs. RWE therefore agrees with the CMA's conclusion that wholesale gas should not fall within the scope of this inquiry.

120. RWE would note that, having recently concluded its sale of RWE DEA AG, it no longer has any upstream gas assets.

Updated theories of harm relating to vertical integration

121. Paragraph 82 of the UIS sets out summary views on potential benefits of vertical integration. RWE welcomes the CMAs recognition (at paragraph 86) that there are different degrees of independence of operational units within the firms and the degree of generation and supply balance. RWE considers that a distinction should be made between vertical integration at an operational or strategic level and RWE's business model, according to which the Generation and Supply businesses are separately operated and managed.

122. RWE believes that there are benefits in terms of lower costs to customers from its vertical ownership model. In particular having a single route to the wholesale market for our Generation and Supply businesses via RWEST is an efficient approach and leads to reduced costs for both businesses. The vertical ownership model with each business hedging its position separately provides additional liquidity in the market and RWE, through its proprietary trading business, is also a very active trader and contributes significantly to wholesale market liquidity.

123. We would note that RWE's business model provides some benefits from reduced cost of credit which is a function of its ownership structure as part of a larger Group, limited benefits in terms of reduced collateral costs and some small benefits through the ability to avoid transaction costs for a small minority of hedging volumes. One of the main reasons for limited benefits from collateral is that because conventional generation businesses buy fuel and carbon as well as selling power, their collateral requirements are relatively small. Hence RWE would expect the total collateral requirements across the UK Generation and Supply Businesses to be approximately equal to the collateral requirements of the Supply Business only.

124. RWE also believes that there are cost benefits achieved through being able to access certain other shared services such as HR, accounting, tax and legal.

125. RWE would agree with the conclusion in paragraph 83 of UIS that any benefits of a natural hedge are more likely to apply to companies with significant volumes of nuclear or renewable generation. However, given that the wholesale market is sufficiently liquid to manage bulk commodity risks, RWE would expect the incentive to use any potential natural hedge to be insignificant compared to the benefits of generation and supply businesses focusing on managing and hedging their own risks. Moreover, for RWE's generation portfolio (predominantly gas fired generation), there would not appear to be any significant natural hedge benefit. More detail is set out in RWE's response to the Working Paper on Liquidity.

UPDATED ToH 3a (OPAQUE PRICES AND LOW LIQUIDITY IN WHOLESALE ELECTRICITY MARKETS DISTORT COMPETITION IN RETAIL AND GENERATION)

126. As a leading trader of electricity products and one of the largest providers of liquidity in the wholesale electricity market, RWE's firm view is that prices are fully transparent and there is good availability of the most widely traded wholesale electricity products. RWE therefore agrees with the CMA (in paragraph 95) that there are no significant problems with respect to transparency and (in paragraph 100) that liquidity does not distort competition or act as a barrier to entry or expansion.

127. Paragraph 90 of the UIS notes that independent generators have said that there are limits to liquidity (lack of shape trading further out) which affects their businesses. RWE recognises that there may be less or no liquidity for so-called "shape" products which would allow a supply or a generation business to directly hedge its "annual shape" (for example a single month or day for delivery in two years) or its "daily shape" (half-hourly detail for electricity) before the liquid annual, seasonal and quarterly products cascade into more granular products closer to delivery. RWE considers this to be a result of the lower demand for such shape products because generators and suppliers lack certainty on specific shape requirements at these horizons and are able to hedge a substantial proportion of

such risks with the more standardised products. It is, therefore, natural that the wholesale market does not routinely provide for such tailored granularity at these horizons and we see similar situations in other commodity markets. This is explained further in RWE's response to the Working Paper on liquidity.

128. RWE's Supply Business hedges its risks using standard wholesale products and considers shape risk to be a normal commercial risk for an energy retailer. Compared to other risks, such as network cost risks or weather driven demand variation risks (called 'swing'), the financial risk from hedging customer demand with wholesale bulk products first, which are then dynamically refined closer to delivery, is considered a residual risk. RWE believes that risk management via bulk products is sufficient to ensure an acceptably low level of risk, particularly given the other uncertainties in the supply portfolio and around customer demand which will become more predictable closer to delivery.

129. Given RWE's business model of independently hedging its Supply and Generation Businesses, any improvement in liquidity is a benefit to ourselves as well as other participants in the market and, as a leading proprietary trader, RWEST benefits from and actively seeks to promote greater wholesale market liquidity.

130. RWE agrees with the CMA[19]that there is some evidence that liquidity has improved in the designated Secure and Promote market making windows, but that this may be at the expense of liquidity in other parts of the day. Hence RWE would support an extension of the market making windows to cover a greater portion of the day, as long as the requirement to post bid and offer prices during the windows 100% of the time is relaxed to some degree. This is a very exacting requirement, which has a high cost for RWE in terms of the complexity of the IT systems required to guarantee 100% systems reliability and opportunity cost for traders (during the current windows, traders are not able to have sufficient focus on their proprietary and route-to-market activities).Initial set up costs could be considered sunk but there is still significant monitoring, maintenance and on-going infrastructure costs from a systems perspective. A wider window with a reduced availability requirement – say 80% - would also be more in line with commercial market-making agreements.

UPDATED ToH 3b: VERTICALLY INTEGRATED ELECTRICITY COMPANIES ACT TO HARM THE COMPETITIVE POSITION OF NON-INTEGRATED FIRMS TO THE DETRIMENT OF CONSUMERS, EITHER BY INCREASING THE COSTS ON NON-INTEGRATED ENERGY SUPPLIERS OR REDUCING THE SALES OF NON-INTEGRATED GENERATING COMPANIES

131. RWE agrees with the CMA's initial view in paragraph 103 of the UIS that vertically integrated firms do not have the ability to foreclose generators or the incentive to

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19 Paragraph 94 UIS, and paragraph 97 of the CMA's Working Paper on Liquidity

do so. RWE also agrees with the CMA in paragraph 107 of the UIS that vertically integrated firms have no ability or incentive to engage in customer or input foreclosure.

UPDATED ToH 4 (ENERGY SUPPLIERS FACE WEAK INCENTIVES TO COMPETE ON PRICE AND NON-PRICE FACTORS IN RETAIL MARKETS, DUE IN PARTICULAR TO INACTIVE CUSTOMERS, SUPPLIER BEHAVIOUR AND/OR REGULATORY INTERVENTIONS

Observations on the nature of competition in domestic retail markets

132. Acknowledging that the CMA is at an earlier stage in its analysis of Theory of Harm 4 than it is in relation to other theories of harm, RWE is keen to help the CMA to better understand the nature of competition in the domestic retail energy market. This market is competitive, although RWE considers the shape of competition has to a significant extent been distorted by government and regulatory intervention. It is important that the CMA is very clear on why the market functions in the way that it does. We preface our more detailed comments in relation to Theory of Harm 4 with a summary of the way the market works, and in particular the significant interplay between pricing of standard and non-standard products.

133. For the reasons given below, RWE believes that the evidence relied on by the CMA in support of its contention that there have been weaker competitive pressures on SVTs than on non-standard tariffs does not indicate a competition problem that the CMA should be concerned about.

The role of pricing strategies and the proper interpretation of the evidence of pricing differentials before the CMA

134. In interpreting the difference in prices between SVT and non-standard tariffs, a first point to make is that both direct and indirect costs differ between SVT and non-standard customers. We discuss this further below at paragraphs 174-175.

135. The second point to make is that suppliers need to ensure that their pricing strategies allow them to compete for new customers and to compete to retain existing customers. Competition has resulted in the retail energy market being characterised by an introductory pricing model as described above in paragraphs 56-58.

136. To understand the significance of competition to acquire customers the CMA will wish to note in particular that:

136.1 in RWE's domestic business, [CONFIDENTIAL] of its customer accounts joined RWE in the last three years; and

136.2 every year [CONFIDENTIAL] customer accounts leave RWE for another supplier or transfer to a different RWE tariff.

137. To frame the CMA's consideration of this business model, RWE notes that business models involving introductory discounts are common across many retail markets, including mobile telephony, pay TV, mortgages and insurance. Moreover, RWE considers that, since discounts are good for customers, the CMA should consider even well-meaning calls to dampen incentives to offer discounts to consumers with a significant degree of scepticism.

138. Domestic customers move between SVT and non-standard products over time:

138.1 In 2014 [CONFIDENTIAL] of RWE's SVT customers left RWE for another supplier or transferred to a different RWE tariff;

138.2 In 4 years RWE's internal transfers increased from around [CONFIDENTIAL] in 2009 to [CONFIDENTIAL] in 2013;

138.3 In just five years, the proportion of RWE's customer accounts on non-standard tariffs has increased from around [CONFIDENTIAL] and

138.4 Amongst other factors, RWE has found that the differential between SVT and non-standard tariffs has an important influence on both customer acquisition and customer retention (or attrition), and RWE needs to ensure that its SVT and non-standard tariffs are competitive not only when considered against other tariffs of the same type but also when considered against other tariff types.

139. RWE submits that the business model involving discounts for new domestic customers has important implications for the CMA's interpretation of the evidence it has so far collected. In particular:

139.1 Customers on SVTs and customers on non-standard tariffs cannot be considered in isolation – [CONFIDENTIAL]. More specifically, a supplier's price for a non-standard tariff on offer today (which may include a significant discount with a view to attracting new customers) has an impact on the demand for that supplier's (and others') SVT tariff in the future. [CONFIDENTIAL]. SVT tariffs affect the rate of internal transfers from SVT to non-standard products and also the rate of customer losses. In other words, the pricing of SVT and non-standard fixed term tariffs [CONFIDENTIAL]; and

139.2 Differences between SVT and non-standard tariffs cannot be regarded as an indication that SVT tariffs are somehow unfair or that suppliers are overcharging SVT customers; and while a price difference may indicate that an individual may gain from switching (all else equal), such a difference necessarily occurs when discounts are used, and should not be taken to indicate a competition problem. Further detail is contained in paragraphs 188 – 191.

140. RWE manages its domestic business at [CONFIDENTIAL]. As a result, RWE believes that it would be misleading for the CMA to look at the profitability or pricing of SVT products in isolation since [CONFIDENTIAL] competition works in the industry. To do so would fail to take into account the costs of acquiring customers at the outset and the discounts customers receive during the period where they take a non-standard product. It would be equally misleading to consider discounted products in isolation, [CONFIDENTIAL]. Further detail is contained in paragraphs 55 - 56.

There is competitive pressure to acquire and retain customers

141. RWE's customer base is active and awareness of their ability to switch tariff or supplier is high[20].

142. As RWE doesn't know which of its customers are going to leave or transfer onto another npower tariff, [CONFIDENTIAL]. In particular, RWE does not treat new and existing customers differently – all our products are equally available to new customers and existing customers who switch internally. Customers on the standard variable product are not 'locked in' and there are no barriers to them switching to another fixed product with RWE or switching supplier.

143. RWE must price its SVT at a level which is competitive and which will enable it to retain customers and not squander the investment it has made in acquiring them, given that competitors are competing for these customer with their discounted products. [CONFIDENTIAL]; some customers will actually switch supplier while others will be successfully retained by switching them to a tariff with the same supplier.

144. Price competition in the domestic market has, in addition, been shaped by regulation, including SLC25A, SLC27 and RMR. RWE's comments in this regard are set out in paragraphs 226-234 below.

145. Any strategy to engage with and retain customers must take into account non-price as well as price factors. Good customer service builds customer trust and loyalty. Other non-price factors such as customer choice and the reassurance offered by some of the longer term fixed price tariffs (which may be at a premium to the SVT at launch but may be cheaper over the term due to increases in SVT) are equally important. [CONFIDENTIAL] and RWE would urge the CMA to fully reflect them in its analysis.

146. In relation to the measurement of profitability by tariff / customer segment, RWE's comments concerning the significant evidential, conceptual and practical

20 78% in the CMA's customer survey

challenges in being able to analyse profitability in this way are set out in paragraph 59 above.

147. RWE's comments on the methodology that the CMA appears to have adopted in apportioning costs between SVT and non-standard products in order to form a view on relative profitability between tariff types will be provided in response to the Working Paper on retail profitability, published on 16 March 2015. A simple allocation of costs (i.e. using simple drivers) is likely to understate costs attributable to SVT and overstate margins.

Customers who purchase SVT are heterogeneous and a proportion of customers on SVT are relatively more expensive to serve

148. The market is further complicated by the fact that customers are not homogeneous. There are [CONFIDENTIAL] million RWE accounts on SVT[21] and these comprise a broad spectrum of customers across different payment and meter types, consumption levels and socio-demographic groups which, we believe, leads to a number of these customers being relatively more expensive to serve. RWE makes [CONFIDENTIAL] on the proportion of these customers who are relatively more expensive to serve. Unlike independent suppliers who may choose to focus on the higher value, lower cost to serve customers, RWE must serve a broad spectrum of customers.

149. It is RWE's view that, when looking at the returns being made in the market and thereby drawing inferences about competitiveness (although RWE is making this comment without prejudice to its view that the market cannot properly be segmented between SVT and non-standard tariffs), this must be done on a net margin and not a gross margin basis. Whilst RWE does [CONFIDENTIAL], clearly the costs for online direct debit fixed term customers (the "vanilla" product mainly offered by many small and mid-tier suppliers) will be lower than the costs (e.g. bad debt costs) for some other tariff types. Whilst some smaller suppliers offer a broader range of products, Ofgem's analysis[22] indicates that 79% of small suppliers' domestic customer accounts are direct debit (compared with [CONFIDENTIAL] of accounts for RWE). Smaller suppliers are therefore likely to have lower costs. In addition, some smaller suppliers benefit from the exemption from Energy Companies Obligation and Warm Home Discount ("WHD") costs.

150. With respect to the broader range of tariffs offered by smaller suppliers, RWE understands that First Utility has in total 1.39 million customers, of whom 15% are on SVTs. First Utility currently has a discount of 19% (at Ofgem's medium user consumption level) between its SVT and its cheapest tariff, higher than many of the larger suppliers. Indeed, Extra Energy has the highest differential at 21.7%.

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21 As at end February 2015

22 Ofgem's Monitoring Social Obligations 2013 annual data report

151. The UIS suggests that SVT customers may be more vulnerable. SVT customers are not, however, a homogeneous group. For example, direct debit customers do not tend to be considered vulnerable. There have of course been numerous social policy interventions in the energy market – e.g. the Carbon Savings Community Obligation and Affordable Warmth Obligation (HHCRO) under the Energy Companies Obligation; WHD (RWE has [CONFIDENTIAL] pensioners receiving pension credit in its WHD scheme); provisions about disconnection, and ensuring ability to pay on repayment plans (tailored affordable plans). In addition SLC 27.2.A ensures that there is no price discrimination in relation to pre-payment and receipt of bill customers compared to direct debit customers. Indeed, with the same prices as receipt of bill customers, protection is effectively given to pre-payment customers (as permitted under SLC 27.2.A) despite their increased costs to serve.

Additional observations in relation to the price differential between SVT and non-standard

152. To the extent that the CMA remains concerned about the extent to which there is a differential between non-standard and SVT tariffs, it is important to note that, in practice, the differential depends on market conditions: in particular, greater numbers of customers may prefer fixed price tariffs to variable tariffs when energy costs and hence prices are expected to rise.

Incumbency and entry

Evidence on competitive pressure from the evolution of market shares

153. Competition in the domestic market needs to be looked at in the round. There has been sustained competition between the Six Large Energy Firms throughout the Relevant Period, as well as phenomenal growth among smaller and mid-tier suppliers over the last five years: the CMA acknowledges in paragraph 116 of the UIS that independents have gained market share.

154. RWE wishes the CMA to note that it does not believe that there are any significant barriers to entry or expansion in the retail supply of energy in Great Britain. This is clearly evidenced by the large number of recent and successful new entrants (there were 9 suppliers in 2011 which has now increased to 27) and the growth of a number of suppliers above the 250,000 account threshold. These independent suppliers actively compete in the market and provide a credible and increasing competitive constraint on the Six Large Energy Firms.

155. To the extent that independent suppliers interviewed allege there are potential barriers to entry, RWE notes that these are clearly surmountable and that in many cases market based solutions have been developed, in some cases between potential entrants and existing suppliers to facilitate entry. RWE would also like to highlight that Ofgem and DECC have developed a large number of policies and initiatives in recent years to support small suppliers looking to enter the market,

including for example "Secure and Promote" and the Energy Companies Obligation and Warm Home Discount exemption thresholds and numerous statutory and *de facto* exemptions. It is RWE's experience that the UK electricity market rules and obligations have been developed with a strong bias towards increasing the number of suppliers.

156. The domestic supply market is dynamic and competitive. RWE must compete vigorously to maintain or grow its customer base. This is reflected in the variations in market shares among the Six Large Energy Firms and the rapid growth of the smaller suppliers. RWE notes that, contrary to the CMA's initial view, market shares of the Six Large Energy Firms have not been stable and have declined consistently over the Relevant Period:

156.1.1 There is considerable variation in market shares over time among the Six Large Energy Firms;

156.1.2 Suppliers experience significant gains and losses quarter-on-quarter; and

156.1.3 As the CMA acknowledges, the smaller suppliers have grown rapidly, as their combined market share has increased from 1% to 7%/ 8% over the last three to four years. In 2014, they accounted for [CONFIDENTIAL] of total gains[23] and [CONFIDENTIAL] of RWE's losses.

157. The CMA states in paragraph 115 that "historical incumbency still appears to have an effect on customer behaviour today" and goes on to refer to the proportion of customers who have been served by an incumbent supplier for ten years or more. RWE notes that of those customers who split fuels across suppliers, BG has over a 70% share of the single fuel gas market. It should also be noted that those larger suppliers that have retained their pre-liberalisation brand names, such as BG and Scottish Power, have higher levels of incumbent customers.

158. RWE queries in addition whether the evidence cited supports the assertion that the CMA has made. In particular, the CMA's assertion does not recognise that customers may choose not to switch from their incumbent supplier for a number of reasons (such as service, brand or price), or that customers may have switched tariffs offered by that supplier a number of times.

159. RWE does recognise a number of the issues raised by the independent suppliers, in particular those relating to regulatory risks and industry systems and settlement. However, RWE considers these to be issues that impact all suppliers in the market in the same way and which do not specifically disadvantage small or new suppliers.

23 Infographic: Bills, prices and profits, 26 February 2015 https://www.ofgem.gov.uk/publications-and-updates/infographic-bills-prices-and-profits

160. RWE notes that the independent suppliers questioned consider that the Six Large Energy Firms each have a base of inert or 'sticky' customers to whom they are able to charge high prices, which in turn enables them to cross-subsidise deep discounting to attract new customers, and that this constitutes a barrier to entry.

161. In this respect, RWE submits that the growth of independent suppliers and recent (material) increases in the proportion of domestic customers who are choosing non-standard tariffs demonstrate clearly the dynamic nature of competition in this market. RWE forecasts that [CONFIDENTIAL].

162. Moreover, as set out in more detail in paragraphs 56 to 58 above, RWE considers that the fact that suppliers offer discounts to attract new customers reflects how competition works in the energy market (and other markets such as mobile telephones and insurance). RWE does not consider that this type of 'see-saw' or 'waterbed' pricing is a barrier to entry for potential suppliers and notes that the majority of independent suppliers adopt the same pricing strategy. Indeed their exponential growth in recent years shows that this is not the case.

163. RWE would reject outright any suggestion that its prices for non-standard tariffs are cross-subsidised from prices charged for SVT. RWE does not consider the evidence indicates that there is 'cross subsidisation'. In particular, as previously explained, [CONFIDENTIAL]. As RWE would imagine is the case for all competitors both in the UK supply and similar markets such as mobile telephony, pay TV, and mortgages, RWE acquires customers and must retain them for a period to make a profit. Since smaller suppliers equally can seek to win and retain customers, it is not clear to RWE this is evidence of a competition problem with which the CMA need be concerned. In practice, to the extent that the CMA is concerned, RWE notes in paragraph 155 above that there has been strong growth of small independent firms who, in some instances benefit from regulator mandated cost advantages in the form of subsidies. They also benefit from the exemption in SLC 27.2A from offering a broad range of payments types, for some their business model continues on that basis and they do not have the complex legacy customers of older suppliers (i.e. they have more "vanilla" direct debit online customers). In summary, the available evidence flatly contradicts the theoretical concern that the pricing structure acts as if it were a barrier to entry and expansion of smaller suppliers.

164. Further details are provided in RWE's response to the Working Paper on "Case Studies on Barriers to Entry and Expansion in the Retail Supply of Energy in Great Britain". RWE would also note that, overall, the working paper itself does not include any economic assessment of barriers to entry and expansion and that many of the criticisms of the market made by independent suppliers are unsubstantiated and speculative. RWE would welcome the opportunity to comment on any further work the CMA intends to undertake with respect to assessing potential barriers to entry or expansion.

The impact of regulation on price competition

165. Whilst RWE considers that the retail energy market is competitive, RWE agrees with the CMA that the nature of price competition between the Six Large Energy Firms has changed several times since liberalisation, due in large part to changes in the regulatory regime. RWE considers that regulatory intervention in the retail supply market (particularly in the context of SLC 25A and RMR) has changed the way in which suppliers compete: narrowing the dimensions of competition; restricting tariff and product innovation; and limiting the ability of suppliers to develop more niche tariffs. This is discussed further below in paragraphs 220 to 229. RWE's observations on the regulatory regime and how it has impacted on price competition are contained in its response to the Working Paper on the pricing strategies of the large energy firms in the retail supply of electricity and gas to domestic consumers.

166. Some actions by the industry regulator Ofgem (in particular the publication of the SMI) have, in RWE's view, made it more difficult for energy suppliers to build trust with consumers. When the SMI was first published, the Ofgem reports showed *gross* margin, but this was reported / described in the press as *net* margin. It took some time before the misconception that Ofgem's calculations represented profits earned by suppliers changed. NERA published its analysis of supplier profitability in December 2009 and thereafter until late 2011, and in 2011 NERA also published a specific report looking at the differences between energy supply margins estimated in Ofgem's SMI analysis and NERA's work. Even now, there remain concerns around the way in which the SMI is prepared and used by Ofgem, and a further report from NERA was commissioned by Energy UK and published in January 2015, in which NERA identified a series of factors which could potentially bias the estimate of margins upwards. We discuss the impact of regulation further in paragraphs 226-247 below.

Observations on the measurement and interpretation of retail profitability: the evidence shows that overall retail returns are low

167. The CMA has found that the Six Large Energy firms' domestic EBIT was 3.3% (4.4% gas and 2.1% electricity) over the Relevant Period. [CONFIDENTIAL].

168. RWE also recalculated the profitability of the Six Large Energy Firms, based on the Consolidated Segmental Statements ("CSS") for the period 2009 to 2013[24]. RWE examined the impact of excluding British Gas ("BG") who are observed to have been the largest supplier of gas during the Relevant Period. RWE found that BG had higher than average profitability in both gas and electricity over this period, with the difference in gas being considerably larger. Excluding BG from the

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24 RWE bases its analysis on the CSS data because the CMA's analysis has been redacted. The CSS data are available here: https://www.ofgem.gov.uk/publications-and-updates/energy-companies%E2%80%99-consolidated-segmental-statements

analysis reduces the weighted average EBIT margin on gas for the period from 4.1% to 0.6% and reduces the weighted average EBIT margin on electricity from 2.4% to 2.1%. Excluding BG reduces the combined supply EBIT margin for both fuels from 3.0% to 1.7%.

169. Overall RWE is concerned that given the continuing high degree of political, regulatory and technological risk to which it is exposed, this level of profitability may seriously undermine the ability of the energy sector to maintain and attract required levels of investment going forward. As far as the RWE Group itself is concerned, the supply business in the UK is competing for resources against supply companies in other countries, and it is the case that RWE can achieve a higher return with less risk elsewhere in the Group. We may expect the position to be similar at the macro level where investors (corporate or individual) make investment decisions across globalised capital markets.

The relationship between tariffs and costs over time

170. As explained at paragraphs 55 to 58, the relationship between standard and non-standard pricing is a complex one and understanding it is fundamental to understanding the way competition works.

171. The CMA also seeks to understand the extent to which changes in standard and non-standard tariffs are associated with changes in direct costs. More specifically, the CMA seeks to understand (i) the evolution of SVT prices in terms of movements in expected direct costs and (ii) the evolution of non-standard tariffs in terms of movements in expected direct costs.

172. The CMA states in paragraph 126 of the UIS that "the gap between the SMI measure of direct costs and the average SVT seems to widen over time, and particularly from around 2009 onwards". According to the CMA, this indicates a potential weakening of competition in SVT over time, even if the analysis has not taken into consideration reductions in gas SVT tariffs that were recently announced by each of the Six Large Energy Firms. The CMA claims, in paragraph 124, that in a competitive market, it would expect prices to respond to changes in variations in expected costs and, in paragraph 131, that the evidence that the CMA has reviewed appears to suggest in recent years that there has been weaker competitive pressures on SVT than on non-standard tariffs.

173. Details of the CMA's analysis is set out in the Working Paper on Cost Pass Through. RWE is concerned with the preliminary but premature conclusions that the CMA appears to have drawn on the basis of what RWE considers to be a highly limited analysis:

173.1 RWE believes that [CONFIDENTIAL] mean that the CMA should not seek to understand the evidence in the way it is currently doing by focussing on individual tariff types. The nature of competition means that tariffs (and margins) for the different tariff types are inextricably linked (as discussed in paragraphs 55- 58 above).

173.2 RWE notes that levels of profitability in the early years of the Extended Period were extremely low, and unsustainable. Although margins recovered to some extent during the middle and latter part of the period analysed, RWE remains concerned at levels of return given the wide spectrum of business and non-business risks that it faces. In the UK supply business, RWE is subject to significant risks including commodity hedging, weather, volumes, delivery of government policy (e.g. Energy Companies Obligation and Smart), recovery of transmission and distribution charges and regulatory and political risk.

173.3 The CMA uses data from SMI. RWE notes that NERA's report on the SMI analysis by Ofgem (a copy is provided at Annex 1) highlights that it fails to take into account discounted tariffs (e.g. online) thereby over-stating revenue, fails to take into account current consumption information thereby also over-stating revenues and fails to take into account certain costs.

173.4 The CMA does not explicitly allow for the possibility that the widening of the gap may be due to one or more other potential explanations such as (i) regulatory changes and (ii) changes in the costs omitted from the CMA's analysis.

173.5 In understanding the extent of observed movements in prices in response to costs, RWE submits that it is important for the CMA to take proper account of:(i) changes in the delay with which wholesale-price changes affect expected hedged costs, on the basis of which RWE (and, presumably, other suppliers) take their pricing decisions and (ii) the increasing media and political comment and intervention in relation to standard price changes (vastly larger than that which is prompted by non-standard changes). RWE submits that this environment has resulted in suppliers being more circumspect about changing SVT prices (because of its reputational cost), and it will also have had an effect on the period for which such prices have to continue unchanged. Indeed the failure by Government and others to properly explain the reason behind price changes and the increasing contribution of policy and network costs (to which we refer in paragraph 50 above) results in there being (absent a significant change in wholesale costs) little understanding of or sympathy for any standard price change. The effect is that standard prices cannot readily be changed frequently and RWE has to plan on the basis that a change will have to last for a long period of time.

174. In addition, the CMA interprets its observation on the evolution of SVT prices relative to costs as a potential weakening of competition in that segment. RWE considers that any such analysis must be done on a net rather than a gross basis. In addition, RWE respectfully submits that this conclusion has been drawn without taking into account several aspects that pertain specifically to SVT customers. In particular, there should be adequate consideration of the relative cost to serve

SVT customers, particularly legacy customers. RWE notes that it does not [CONFIDENTIAL]. However, RWE does believe that cost to serve is higher for SVT customers and provides some primary drivers of why it understands this to be true:

174.1 They require greater levels of contact with RWE's customer-facing teams because of lower take up for self-service online;

174.2 They have a higher proportion of complex metering arrangements;

174.3 More non-standard customers pay by direct debit, so there are higher costs for SVT customers; and

174.4 They account for a disproportionately large share of the 'vulnerable-groups' customer costs.

175. RWE, therefore, considers that, once these specificities are taken into account, the gap between cost benchmark and SVT (net) prices would be significantly smaller.[25]

176. In addition, RWE believes there are other reasons (not relating to costs) which may explain why discounts to SVT may have increased:

176.1 SLC 25A resulted in defined term discounts from SVT, because of the exemption from the non-discrimination prohibition for price differentials or any bonus offered on a time limited basis. RMR then removed the ability to offer any discount, except for dual fuel and online which must be continuously applied on a daily basis;

176.2 A downward sloping wholesale cost curve makes it more likely that fixed products will be offered at lower prices;

176.3 SLC 27.1 exempts a supplier having less than 50,000 customers from the obligation to offer a wide choice of payment methods. A new supplier may therefore have a very different payment profile from an established supplier and, as a consequence, some suppliers have a different, more complex and more costly customer profile than others (for example, the smaller suppliers have a 14 percentage points higher Direct Debit mix compared to RWE). This further exacerbates the price differential between smaller supplier's fixed tariffs, the fixed tariffs of all suppliers, and SVTs;

176.4 Exemptions from obligations such as the Energy Companies Obligation and WHD have a distorting effect on competition; and

[25] RWE notes that it is particularly due to the more costly servicing of legacy costs that some of RWE's competitors (e.g., Ovo) target predominantly non-standard tariff, online direct-debit customers.

176.5 The proposed Labour party policy to implement a price freeze (with no commitment regarding costs) poses an extra complication in relation to changes to SVT prices.

177. With respect to the methodology that the CMA has adopted for the purpose of its study, RWE has serious concerns about several aspects of it, including that the methodology does not account for differences in the hedging approaches deployed for SVT and non-standard products, respectively; ignores the fact that the [CONFIDENTIAL]; does not deal with the implications of the existence of several determinants of the pass-through rates other than 'competition'; does not specify how the CMA will deal with menu costs and investment expenditures that may affect marginal costs; and neglects the role played by volume considerations in measuring movements of SVT prices.

178. In addition, the cost measures deployed by the CMA do not accurately reflect the costs that energy companies have to incur in order to deliver energy to their consumers. In particular:

178.1 The method that the CMA applies to estimate several energy-cost constituents, including (i) wholesale costs, (ii) network charges and (iii) Energy Companies Obligation scheme costs, are likely to understate the true cost levels; and

178.2 There are a number of cost items that are currently omitted from the analysis, but which the CMA should include in its cost calculation, including electricity imbalance (cash-out) costs; unmetered consumption and unbilled volumes (such as theft); gas and power demand variation cost (also referred to as 'swing'); gas reconciliation difference cost and Smart metering costs.

179. RWE's more detailed comments in relation to the CMA's analysis of cost pass through are set out in its response to the Working Paper.

Active customers

180. In terms of the specific concern that there are some domestic customers on SVT which are disengaged:

180.1 RWE acknowledges that there is a spectrum of engagement and would accept that there are some customers who, in spite of extensive efforts on RWE's part, could be considered inactive. However, RWE does submit that the CMA needs to recognise that inactivity may be a conscious choice; consumers may be on the best deal for them. Moreover, RWE does not consider it follows that the CMA needs to be concerned about the current level of customer inactivity.

180.2 Indeed, RWE considers that customers, generally, are engaged and, as described further in paragraphs 210 – 211, RWE has taken a significant number of steps in the last two years to increase the volume and clarity of communications with customers. In this respect RWE submits that the CMA must come to an overall assessment of the extent of engagement, in particular:

180.2.1 Switching between suppliers is in RWE's view an inappropriate and inadequate measure of the extent of customer engagement;

180.2.2 Switching tariffs (or in an SME context negotiating a renewal tariff) should certainly be seen as an indicator of active engagement, particularly given that a customer investigating the possibility of switching supplier may consciously choose to remain with his existing supplier albeit perhaps with a different tariff (or a negotiated renewal);and

180.2.3 Other measures of engagement should also be taken into account by the CMA, including in a domestic context, the proportion of customers who have online billing, use of consumption tracking tools and, in an SME context, the proportion of customers who have negotiated their renewals ([CONFIDENTIAL]).

180.3 Moreover, RWE has to conduct itself on the basis that customers can and will engage. *Inactive* customers benefit from prices that are charged based on the propensity of *active* customers to switch supplier or transfer to a different tariff. RWE knows that a significant proportion of its customers will move each year but it does not know who they will be and, as explained above, RWE has to price not only to acquire new customers but also to retain existing ones.

181. Thus, RWE disputes the initial view expressed in paragraph 133 that there are a *significant* number of domestic energy customers who are relatively inactive. To the contrary, RWE considers that its customer base is active and the pace of engagement is increasing. For example:

181.1 89%[26] of customers know that they have the option to switch supplier;

181.2 [CONFIDENTIAL] of its customer account base has joined npower in the last 3 years;

181.3 Every year over a [CONFIDENTIAL] of its customer accounts leave npower for another supplier or transfer onto a different npower tariff;

181.4 Internal transfers have increased from around [CONFIDENTIAL] million in 2009 to [CONFIDENTIAL] million in 2013;

181.5 The number of RWE accounts has decreased from [CONFIDENTIAL] in 2009 to [CONFIDENTIAL] in 2015, with all but [CONFIDENTIAL] of these net losses being in-area. In 2014, [CONFIDENTIAL] of RWE's customer account losses were to small suppliers, compared to [CONFIDENTIAL] in 2013;

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26 GfK report, Figure 35

181.6 There has been a significant change in the profile of its accounts. The proportion of RWE's accounts on SVT has reduced from [CONFIDENTIAL] % in 2010 to [CONFIDENTIAL] % in 2014 and currently stands at [CONFIDENTIAL] %;

181.7 RWE proactively introduced simpler tariffs prior to the introduction of RMR, which encouraged customer engagement;

181.8 npower.com has been developed to make customer switching more engaging and more simple. npower.com achieved more than [CONFIDENTIAL] visits in 2013 compared to [CONFIDENTIAL] in 2012;

181.9 Switching time has reduced from two weeks plus three weeks in 2011 to two weeks plus three days in 2014;

181.10 [CONFIDENTIAL] % of npower accounts now have online billing, up from around [CONFIDENTIAL] % on 2013 and around [CONFIDENTIAL] % in 2009;

181.10.1 RWE has continually sought new ways of engaging with customers, such as Energy Tracker, a free online tool to track electricity and gas consumption each month. In 2014, Energy Tracker was viewed over [CONFIDENTIAL] times by customers;

181.10.2 RWE has, in addition, made it easier for customers to contact npower through free phone numbers, social media channels, web chat and RWE has made npower.com more responsive, adjusting automatically for mobile users and has updated the free app for Apple and Android devices;

181.10.3 RWE expects that the roll-out of Smart meters will prompt further customer engagement;

181.11 251 tariffs were launched in the domestic supply market in 2014, a 70% increase compared to 2013. The smaller suppliers launched 165 (66%) of those tariffs;

181.12 The number of suppliers in the domestic market is at an all-time high of 27 (Cornwall Domestic Energy Market Snapshot October 2014).

181.13 Brokers and switching sites have grown over recent years. Around [CONFIDENTIAL] of RWE sales are now made through switching sites.

182. The CMA has highlighted concerns about the engagement of customers on SVT. Looking at 2014, [CONFIDENTIAL] of npower's customers who started 2014 on SVT either switched supplier or transferred to a different npower tariff during the course of the year. RWE considers that this demonstrates real engagement on the part of SVT customers.

183. To the extent that there are customers who are less engaged in the market, RWE does not operate in a way which disadvantages these customers and indeed works

hard to engage them in the market. As described in paragraph 148 above, RWE also ensures that those customers who have so far been unable to switch are protected, and continues to innovate to enable more customers to switch if they wish to do so.

184. In summary, RWE would suggest that the increasing – historically high – levels of engagement, and the impending changes in the market, suggest a very different picture from one in which customers are disengaged and there is unilateral market power.

Gains from switching

185. RWE recognises that some customers could potentially save money by switching to an alternative tariff, but is firmly of the view that the methodology used by the CMA systematically overestimates the potential savings consumers could actually realise. More detailed comments in relation to the CMA's analysis of gains from switching are set out below and in RWE's response to the Working Paper.

186. Whilst some savings may be theoretically available, RWE does not consider all the projected savings identified by the CMA's methodology are available in practice or would remain available if all customers switched to them. In particular, RWE believes that the CMA has made a number of assumptions, for example in relation to consumption, treatment of discounts, and customer choice parameters, which tend in the round to significantly overestimate the potential level of savings:

186.1 The savings are all based on dual fuel customers but these savings are not available to around 4 million UK homes with no mains gas connection;

186.2 The methodology does not take proper account of customers' actual preferences, as revealed by their behaviour. In particular the methodology does not properly recognise the value of certain product features. The CMA seems to be suggesting that customers have very few fixed preferences which impact their choice set, but provides no evidence of actual switching behaviour to support this assertion. At a very minimum, a wide range of product attributes should, for this reason, be held fixed in the switching scenarios;

186.3 RWE considers that it is unrealistic to assume that consumers will continually switch to take advantage of all possible gains. The CMA has stated that it will not use an *'idealised or theoretical notion of a perfect market'* in its assessment of the Energy market, and yet the CMA's analysis, which assumes that customers always achieve the 'optimal' ('cheapest') tariff and ignores important elements of the product offering such as discounts, rewards and exit fees, appears to be ignoring the realities of both the market and customer behaviour;

186.4 Furthermore, the snapshot approach used in the methodology raises a number of issues, including it does not take sufficient account of changes to tariffs over time, or customer demand over time. RWE notes that the savings estimates are essentially based on a projected price and projected consumption level. Both of these, however, may change during the course of the year. As such, projected savings are therefore very unlikely to equal outturn savings;

186.5 For example, the focus in the UIS on scenario 4 – the scenario estimating the highest projected savings and, in RWE's view, one of the least reflective of customers' actual preferences – gives a wholly misleading picture to the public on the pricing of energy suppliers. This is particularly concerning at a time of such intense political and media scrutiny.

187. In interpreting such evidence, it will be important for the CMA to understand that any apparent gains through switching may change considerably over time. The current differential is likely driven by the current wholesale market situation (amongst other factors). Moreover, it should be noted that overall the economic returns being earned by retail suppliers are low and it is simply not the case that there is a significant surplus that is being retained by suppliers (see paragraph 167 – 168 above).

188. RWE notes that the results of the CMA's gains from switching analysis are not consistent with the GfK customer survey results which demonstrate that a high proportion of customers, including those who have been with their supplier for over ten years, are aware that they can switch tariff or supplier and have searched the market in the last three years. Where customers who have searched the market have subsequently decided not to switch the most likely reasons are satisfaction with existing tariff, customers being confident they are on the best deal and not thinking the available savings are sufficient to switch.

189. These survey findings are not consistent with a market where, as the CMA argues in the Working Paper on gains through switching, the vast majority of customers could save between £158 and £234 (although RWE would note its response to the Working Paper and its comments on the accuracy of these figures). The survey findings are instead consistent with customers making active choices, including to stay with their existing supplier, that reflect their individual tariff and supplier preferences, as well as price.

190. The CMA is right to recognise that just because customers do not switch when there are apparent savings to be made, this does not mean that there is a competition concern. The CMA cites one possible reason as being that the quality of service provided by their current supplier outweighs the financial gain on offer. RWE considers that there may be other important explanations for a customer apparently "failing" to switch. Indeed RWE considers that the CMA's use of the term "failing" is misconceived. That term seems to pre-suppose the equivalence of the product currently taken by the customer with the product to which the customer has "failed" to switch, when there may be no such failing and, instead,

a positive choice by the customer to take a particular tariff product. Even switching and transfers taken together is a very narrow measure of engagement, but at the very least, RWE believes that transfer numbers need to be given equal prominence to supplier switching numbers whenever switching is quoted. Ofgem's focus in recent years has been to encourage internal switching (through the requirement to publish relevant and alternative cheapest tariff) and therefore RWE believes it would be perverse for internal transfers nevertheless not to be given due weight. In addition the CMA should also take into account measures such as increased engagement through digital channels.

191. RWE supports the need for further substantive analysis to be undertaken by the CMA if it is going to be able to draw conclusions on which it will be able to rely as to the implications for competition of customer inactivity.

192. RWE's advisers have considered in detail the GfK NOP survey (and have raised concerns relating to the specific weighting scheme used). Based on the GfK report, the CMA makes two broad preliminary observations in paragraph 136:

192.1 Firstly, the CMA notes that about half of survey respondents said they had never switched suppliers, and around a third of respondents said they had never considered switching or thought it was impossible. The CMA also suggests that certain groups of customers, e.g. those aged 65 and over, could be overrepresented among those who had never considered switching or thought it not possible to switch;

192.2 Secondly, the CMA reports its initial view that customers on SVT may be less engaged with the energy market, as they are less likely to have considered switching, shopped around, switched provider or switched tariff with their existing provider.

193. RWE considers that the survey presents only a partial picture, as it is based on only one factor of customer engagement (switches to a different supplier) and fails to take account of other factors. As a result, the conclusions that GfK has drawn from the survey significantly understate the actual level of customer engagement:

193.1 In particular the survey indicates that barriers to switching are low: RWE notes that the survey results clearly demonstrate average switching of suppliers in the energy market (at 27% over the last three years) is higher than in many other areas, including mobile phone network providers (24%), and current account providers (12%) even though, according to the survey, customers appear to trust other energy suppliers (27%) rather less than they trust these other service providers (mobile phone network providers (43%), banks offering current accounts (52%).

193.2 This fails to take into account transfers to another tariff of the same supplier. On average every year [CONFIDENTIAL] of RWE npower's customer accounts transfer to another tariff or switch supplier. The true level of switching and transferring in the energy market for the three year period is therefore likely to be considerably higher than 27%

193.3 For energy, the survey shows that 89% of customers know they have the option to switch suppliers.[27] Nearly half, i.e., 44% of all customers, have exercised their option to switch suppliers[28]. In addition, only 10% of customers who switched in the last three years thought switching was difficult.[29] Two thirds of customers who had switched in the past three years stated that they were likely to switch in the future[30];

193.4 Moreover, the level of switching between suppliers must be evaluated in the light of customer satisfaction. Switching is remarkably prevalent considering that over 70% of customers report that they are either very or fairly satisfied with their energy supplier[31] and only around 10% express some degree of dissatisfaction. Those who are satisfied also report lower likelihood of switching between suppliers in future;

193.5 The survey also shows that 47% of customers have shopped around for energy suppliers[32] and that more than two thirds of those customers, 68%, have shopped around in the last year. This implies that around a third of all customers have shopped around within the last year.

193.6 In addition, the GfK survey shows that a large majority of the customers who search and do not then switch cite positive reasons for staying with their existing supplier's offering. Specifically, 68% of those who decide to stay with their existing supplier after having shopped around cite the reason for not switching as being related to satisfaction with their current deal[33]. In addition, 13% cite the quality and reliability of their existing supplier[34].

193.7 Moreover, the evidence does not support a view that the degree of customer engagement constitutes a barrier to entry or expansion:

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27 GfK report, Figure 35.

28 GfK report, para 73.

29 GfK report, Figure 65.

30 GfK report, Figure 22.

31 GfK report, Figure 23.

32 GfK report, paragraph 69 and Figure 19

33 This is a striking finding since those individuals have searched the market and found their existing deal was a good one. GfK report, Figure 49 reports that 68% of those who did not switch after shopping around said they were confident that they were on the best deal (20%) or their existing tariff was satisfactory (39%) or they didn't think they would save enough money (17%).

34 GfK tables, tab 'T1251'.

193.8 The survey evidence shows that there is a large pool of respondents who describe themselves as likely to switch in the future: 45% know that they have the option to switch and consider it likely that they will switch[35];

193.9 The survey also shows that energy suppliers make frequent attempts to acquire new customers which would seem improvident if customers were unlikely to switch as a result;

193.10 Perhaps more importantly, RWE notes that focussing solely on switching between suppliers will significantly underestimate the level of engagement with the energy market and the survey does not sufficiently explore switching between tariffs within existing supplier. As noted above, the survey shows that 89% of customers know they have the option to switch suppliers and nearly half, i.e., 44% of all customers, did so. In addition the survey shows that 76% of customers know they have the option to change tariff with their existing supplier and that 28% of customers have done so.[36]Switching between tariffs offered by a supplier is an integral element of customer engagement and the true level of engagement is even greater than suggested by 44% of customers having switched suppliers. Retail energy suppliers are aware of the fact that their respective rivals continually launch new products and tariffs with a view to attracting customers from others. This constant competitive pressure forces the suppliers to respond with their own attractive offers, as otherwise the suppliers would not be able to retain their customers.

194. Trust is not a barrier to engagement: in interpreting findings from the GfK survey, it is important for the CMA to keep firmly in mind that RWE npower actively invests in seeking to win its customers' trust. If large numbers of consumers did not trust other suppliers ***and*** a lack of trust was driving distrusting customers not to shop around or switch, there might have been cause for concern. However, such a concern is unfounded, as most customers report that they either trust or are neutral in terms of trust towards other energy suppliers.[37] Moreover, the degree of trust in other energy suppliers is not found to have an economically significant effect on the propensity to switch or shop around.[38]

195. In RWE's experience, there has been a marked increase in transfers between npower tariffs in recent years. The proportion of customers on RWE's standard variable tariffs has decreased from [CONFIDENTIAL] % to less than [CONFIDENTIAL] % in the last 6 years and this is expected to fall further to [CONFIDENTIAL]. RWE therefore has reason to believe that the level of switching

35 GfK survey, Figure 21.

36 GfK report, para 98.

37 GfK report, Figure 5 reports that 61% of customers either trust or are neutral in terms of trust towards other energy suppliers.

38 GfK report, Figure 17

as perceived by the CMA will increase materially if switching between tariffs with the existing supplier is incorporated in the measure of switching, as it should be.

Price comparison websites and smart meters

196. PCWs play an important role in helping customers to make informed decisions about switching energy supplier. Trust and transparency between suppliers and consumers are essential for the success of the retail energy markets and it is vital that PCWs do not act in a way that is inconsistent with this objective.

197. The Confidence Code as amended will undoubtedly be helpful in ensuring that transparency is improved but, in RWE npower's view, good consumer outcomes will not be entirely assured by the steps Ofgem has taken, nor will good customer outcomes necessarily be assured for suppliers. It is important, in RWE npower's view, that PCWs are more directly regulated. As the market moves to quicker switching it will become even more important that PCWs provide the correct information to consumers. A number of potential barriers still exist in the PCW sector to re-building the trust that is so badly needed in the energy market. These are not wholly addressed by the recently revised Confidence Code and the changes that will apply in due course. They include the following:

197.1 While PCWs from 1st April 2015 will need to be transparent on whether they receive a commission from a supplier they are not required to show full market view of tariffs as a default position. Customers will still need to opt in where PCWs choose not to display all results but RWE npower believes that a full market view should be the required default position to ensure full transparency;

197.2 Because PCWs have to rank products only by price, this may discourage consumers from investigating other products which may be more expensive, but which may nevertheless be more suitable for their needs (for example longer term fixes and energy efficiency propositions), and may discourage innovation on the part of suppliers in relation to product design (for example RWE npower's Nest tariff appears lower in the PCW ranking table); previously customers could search on 'green' tariffs enabling them to engage with that particular area of the market; the inclusion of additional search facilities such as 'value added' could lead to increased engagement in energy efficient type tariffs giving great choice to customers; and

198. The changes to the Confidence Code do address the fact that the current methodology widely used for making comparisons had the potential to lead to inconsistency, as it allowed different methods to be used by PCWs for calculating the savings that a customer may make on switching. However, the use of Estimated Annual Costs approach set down in the supply licence and the option to use to use an alternative methodology still leaves scope for some inconsistency in what customers experience.

199. RWE npower feels that the overall approach across all PCWs should be consistent and the customer should be clear on how any potential savings are calculated. RWE considers that the amendment of the Confidence Code by Ofgem was necessary to promote consumer trust and confidence, but that it has not gone far enough to secure good outcomes for both consumers and suppliers. If there is a balancing to be done of the issues of transparency and trust on the one hand and the freedom of PCWs to innovate and promote their services on the other, RWE's view is clear: trust and transparency should take precedence.

200. RWE npower considers that it would be in the best interest of consumers if:

200.1 Energy price comparison websites showed as a default, all tariffs available, regardless of any commission arrangements;

200.2 PCWs enabled consumers to filter on key characteristics that are important to consumers (i.e. exit fees, fixed term length, energy efficiency);

200.3 New and existing customers were treated equally (i.e. suppliers allowed (as npower does)and PCWs facilitated both new and existing customers switching tariffs via the PCW);

200.4 All commissions were disclosed at point of sale;

200.5 PCWs were directly regulated by Ofgem, along with all Third Party Intermediaries, to ensure that they comply with relevant requirements;

200.6 The comparison methodologies were agreed and consistent across PCWs;

200.7 PCWs were required to observe the same levels of transparency in a collective switching context as in the context of traditional switching.

201. As to marketing restrictions, both suppliers and PCWs are in a position of similar strength and, whilst the balance of power might change from time to time or from one party to another, the resulting terms reflect a balanced commercial negotiation. The restrictions that are imposed on PCWs by RWE go no further than are necessary in order to ensure that the investment npower makes in acquiring the customer in the first place is not undermined.

202. RWE's more detailed comments in relation to PCWs and collective switching are set out in its response to the Price Comparison Websites Working Paper.

Smart meters

203. RWE supports the deployment of smart meters in the UK on the basis of the benefits that this can bring in terms of consumer engagement and helping consumers to manage their energy consumption and costs. However, RWE wants

to ensure that the programme is delivered in a way which maximises the benefits to consumers, both directly and indirectly via reduced supplier costs.

204. RWE is concerned about the rising costs of smart roll out driven by delays to the programme, most recently the decision to push the DCC 'go live' date back to 1 April 2016 with a 6 month contingency beyond that. A rigid 2020 deadline for full roll out compresses the timescales for delivery with significant field force and back office implications for cost and also health & safety. It also gives rise to significant programme delivery risk that will be borne by both customers and suppliers.

205. RWE considers that there are a number of outstanding challenges to the successful implementation and completion of the rollout of smart meters, some of which are technical in nature, some of which are customer related. These include critical design issues in relation to high rise and multi-occupancy properties and also to PPM smart meter installations, as well the need to ensure appropriate consumer awareness and reassurance which will be critical in gaining access, avoiding refusal of installation and realising the full benefits.

Supplier behaviour

Is there evidence of UMP

206. As described in paragraphs 153–164 and 180-195, above, RWE considers that the domestic supply market is dynamic, customers are active and the pace of engagement is increasing.

207. The CMA refers to "arguments" that the Six Large Energy Firms attempt to keep their SVT customers disengaged, so as to retain them on high tariffs. It states that it has not yet taken a view on the strength of these arguments. RWE can only speak for itself, but such a comment is totally at odds with the actions that RWE has taken. RWE does not (indeed is not able to) keep SVT customers disengaged. Any inactive customers there may be on SVT are charged the same prices as those customers who are active.

208. Because RWE is not able to distinguish which of its customers are going to switch to another supplier or transfer onto another npower tariff, RWE must conduct itself on the basis that all customers can and will engage. Therefore RWE does not differentiate in the SVT it charges.

209. As RWE has previously described in paragraphs 54 and 56, [CONFIDENTIAL].

210. It has been RWE's policy to seek to clarify, simplify and place its customers in control. The last two years have seen a significant increase in the volume and clarity of communication with customers about their tariff and alternatives:

210.1 The major change made over the last two years to RWE’s standard product offer was to move away from the two tier tariff charging basis earlier than required under RMR. RWE converted its standard tariffs from two tier to standing charge products in May 2013 (and made profiling reconciliation payments).RWE also changed direct debit discount structures to a reduced daily standing charge and removed the IGT surcharge (to keep its gas tariffs simple and easy to understand). RWE reduced the number of discounts by removing the dual fuel discount of £10 a year(which further reduced complexity)and to offset this, the annual gas standing charge was reduced by £10;

210.2 RWE developed a simple, clear and easy to understand bill. The new bill is based on extensive consumer research, and RWE has also sent out understand-a-bill (which breaks down the bill) to all customers. Key customer requirements, such as payment amount and payment date, are included above the fold on the right hand side of page 1. More comprehensive information about the customer’s account is included on page 2, setting out clearly the meter readings, consumption, the price and the total cost. Any relevant discounts are highlighted. The key facts section gives clear details of the customer's tariff and price including a rate per kilowatt hour, as well as other tariff options. The best tariff prompt encourages customers to think about alternatives, with a summary of the customer benefit, including details of our cheapest tariff on their current payment method, and our cheapest tariff overall; and

210.3 RWE has also created a new team to audit every piece of written communication sent out – to analyse it, improve it, or remove it if it was not fit for purpose – and make sure customers’ needs are prioritised. RWE is using four key attributes to measure every piece of communication:

210.3.1 It must be clear and easy for the customer to understand;

210.3.2 It must clearly explain what the next steps are;

210.3.3 It must explain how RWE can help and how customers can contact them; and

210.3.4 It must reflect the customers’ individual circumstances.

211. By way of further evidence that RWE has not attempted to keep customers disengaged, RWE has set out below is a summary of some of the information that it has sent to standard customers over recent years, on a voluntary basis, in order to inform them about other npower tariffs:

211.1 In 2011 Tariff Guides were provided to all new customers, home movers, customers who changed tariffs and to customers at non-standard product ends to explain the types of products that were available. These are attached in Annex 2. These are still issued.

211.2 In 2013, RWE communicated to all customers that they could save money by switching tariffs or payment method, as follows:

Is your energy tariff right for you?

We have a range of energy tariffs including online, price guarantee, green and standard tariffs, so there's something to meet everyone's needs. We also offer a range of ways to pay for your energy. To find out more and make sure that you're on the most suitable tariff for you, call us on 0800 197 4846 and see if we can save you money. Please have your up to date meter readings to hand.

An example statement is attached in Annex 3.

211.3 In January 2015, RWE wrote to [CONFIDENTIAL] customers who had been with npower on the standard tariff for more than five years, stating "*As a loyal customer on our standard tariff, we wanted to write to remind you that we have other tariffs available which may suit you better...... There's no need to change if you'd prefer not to, but if you'd like to find out more you can go to npower.com or call our UK-based customer service centre on 0800 xxx xxxx. Your bill or statement will also tell you if you could be saving money".* The letter and enclosed calendar, which stated (January): "*These days it's quicker and easier to switch to a tariff that could save you money. There are lots of deals available, so it could pay to check regularly*", are attached in Annex 4.

211.4 When RWE wrote to standard customers about its 16 February 2015 price reduction, over and above its regulatory obligations, RWE included a statement about switching, namely:

"And remember, you can always go to npower.com/products to check you're on the tariff that suits you best".

211.5 In addition, since April 2014, RWE's bills and annual statements, as required under RMR, have included details of annual consumption; estimated annual costs; the relevant cheapest tariff information and estimated annual savings; alternative cheapest tariff information and estimated annual savings; the Tariff Comparison Rate; the text "*Remember - it may be worth thinking about switching your tariff or supplier*"; and the exact tariff name and exact payment method. The annual statement also shows estimated annual costs on the basis of the previous 12 month period and a bar chart giving information about the customer's annual usage. An example of a bill and an annual statement is attached in Annex 5. RWE also explained the changes that had been brought about under RMR in a leaflet that was sent to customers, again on a voluntary basis. An example is attached in Annex 6.

211.6 Finally, there are a number of encouragements to customers on RWE's web pages to look for alternatives. Examples are attached in Annex 7.

212. The CMA states that higher prices for SVT for gas and electricity, compared with non-standard tariffs, provides some support for the view that these suppliers can segment the market and price discriminate. We have previously discussed the causes of price differences between SVT and non-standard tariffs – see paragraphs 168 - 170.

213. In addition, in paragraph 146 (referring to its observations at paragraphs 125 and 126), the CMA expresses the view that reductions in different measures of direct costs do not appear to have translated *rapidly* into reductions in the SVT in recent years, which might be suggestive of weak competition. RWE has considered the evidence the CMA has developed in paragraphs 164 - 166 above. RWE disagrees with this statement and considers that the analysis undertaken by the CMA thus far does not provide a robust basis from which this initial conclusion is drawn.

214. As noted in paragraphs 173-179 of this response, RWE has concerns that the initial view that the CMA expresses in relation to UMP is based on a highly limited analysis. For example, its cost-pass through analysis does not explicitly allow for, amongst other factors, changes in the delay with which wholesale price changes affect expected hedge costs on the basis of which RWE (and we assume other suppliers) take their pricing decisions. In particular, with respect to the speed of pass-through (as opposed to the degree of pass-through), the CMA has yet to consider further whether there are any asymmetries in the observed relationship between cost and price movements over time, a phenomenon sometimes referred to as 'rockets-and-feathers'[39]. Indeed, the CMA notes in its Working Paper that the CMA "*may further produce descriptive statistics*," (e.g. a comparison of the time it takes for an increase in costs to be followed by a price change and the time it takes for a decrease in costs to be followed by a price change[40]) but acknowledges itself that the data does not currently offer enough variation to perform a direct econometric test such as, for example, an asymmetric error correction model.[41]

215. The CMA notes, in addition, in paragraph 147 that it has observed a wide dispersion of indirect costs per domestic account between the Six Large Energy Firms, which may be indicative of relatively weak price competition. The CMA goes on to indicate that it will need to develop this analysis further before drawing firmer conclusions. RWE welcomes this statement and looks forward to discussing with the CMA the output of its further analysis.

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39 Rockets-and-feathers, or asymmetric pass-through, is said to occur when prices rise relatively fast in response to increasing costs, but fall slowly when costs decrease.

40 Cost pass-through paper, Para. 41.

41 RWE notes that – even if the CMA was able robustly to demonstrate that prices respond asymmetrically to cost increases and decreases, respectively (which it has not done so far) – such evidence would not necessarily constitute evidence of competition problems or harm to consumers in the GB retail energy market. For a detailed reasoning, see, e.g., NERA, 'Asymmetrical Price Response in Energy Supply: A Review of Ofgem's Analysis (Report for Energy UK), 13 May 2011.

216. Based on the limited evidence put forward by the CMA to date, RWE does not agree with the CMA's claim that the dispersion of indirect costs is indicative of weak competition. Some suppliers may have relatively higher indirect costs (e.g., due to relatively lower efficiency in serving customers), but may – for instance as a result of a superior hedging 'techniques' – have lower wholesale electricity costs. Companies that have costs that are too high overall, will struggle to remain competitive unless they make conscious efforts to reduce the costs. However, even those suppliers with low costs have an incentive to increase their efficiency further, as that gives them a competitive edge or allows them (at least temporarily, as long as its rivals have not caught up) to improve their profitability.

217. Professor Stephen Littlechild, in a submission to the inquiry[42], states [p.3]: "Rather, competition is a rivalrous discovery process taking place over time. The participants have different abilities. The process is characterised by learning but also by errors. Market conditions are changing constantly and unpredictably – not least, in this case, as a result of changing regulation. Of course high cost suppliers will be wanting and trying to reduce their costs. Some will manage to do this, others will fail and eventually perhaps leave the market. But at the same time low cost suppliers will be wanting to stay ahead of the game, and exploring ways of further reducing their own costs."

218. RWE would ask the CMA to bear in mind that energy suppliers entered the Relevant Period with some fundamentally different positions on cost base, driven from legacy, geographic, business and strategic model considerations. By way of example RWE entered the Relevant Period with multiple systems operating over a wide range of locations, and has been working to address its cost base via a number of efficiency programmes (Project Strand, Customer Transformation Programme, etc.) to sustainably reduce underlying operating costs, notwithstanding that indirect costs have remained higher than expected, driven by a number of unexpected and one off costs relating from the implementation of a new customer services / billing system in the domestic business. RWE management are absolutely committed [CONFIDENTIAL].

219. We would also suggest that when considering cost efficiency that the CMA should consider performance delivered on the "direct" cost base. Whilst at the macro level these costs are subject to a lower level of influence than the indirect cost base, a strong performance in areas such as hedging policy and obligation delivery can have a significant impact on the overall level of cost efficiency delivered for customers.

220. [CONFIDENTIAL]. Even if direct costs are allocated appropriately, profitability of tariffs should be compared using EBIT (not EBITDA or gross margin) margins[43],

42 http://www.eprg.group.cam.ac.uk/wp-content/uploads/2014/08/Submission-to-CMA-7-Aug-2014.pdf

43 Even though EBITDA margin may avoid some of the complications concerning asset valuation and the measurement of intangible assets, RWE npower has made a number of recent investments in digital and smart capabilities. We

because indirect costs also vary between tariff types and it is relevant to take into account depreciation costs for running the business.

221. In the next stage of the investigation, the CMA must ensure that any analysis it undertakes of the overall tariff level profitability is carefully considered. More specifically, in relation to the measurement of profitability by tariff / customer segment, RWE notes in paragraph 57 that there are some significant evidential, conceptual and practical challenges in being able to analyse profitability in this way.

Tacit coordination through public price announcements

222. RWE agrees with the CMA's initial view in paragraph 153 that certain behaviour or practices of the Six Large Energy Firms – in particular, the use of price announcements –are likely to be consistent with unilateral incentives. In particular, RWE agrees with the CMA's finding in paragraph 152 that there is no evidence to date 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. RWE is clear that RWE conducts itself independently in the market and that public price announcements in relation to SVTs do not provide a route to tacit coordination among suppliers.

223. Nevertheless, in the Working Paper on co-ordination in the retail market facilitated by price announcements, the CMA appears to maintain a concern that structural or behavioural aspects of the market may give rise to a weakening of competition. RWE does not consider this concern to be well founded. Specifically, RWE wishes to emphasise that:

223.1 The CMA places undue emphasis on the timing of price change announcements. The CMA's concern appears to be that suppliers announce price changes in relatively close succession, and that the timing of announcements reduces expected gains from switching. RWE does not consider this concern to be well founded. The components of the cost base are similar for the Six Large Energy Firms. However the cost components have risks that are managed differently in each company, and so pressures in those costs will vary by company. When one company faces pressure to the extent that it needs to increase prices, generally speaking other companies will be similarly facing cost pressures to varying degrees and so will need to consider their competitive responses. [CONFIDENTIAL]. However, due to variations in the mix of the common cost components across suppliers, small differences in the way in which the firms are affected by cost shifts may arise, which in turn can give certain suppliers a slight cost advantage over the others. Those suppliers may, therefore, have an incentive to delay their price

consider that such investments, and other investments made by RWE npower, should be taken into account in a profitability assessment. These investments will be reflected in depreciation / amortisation charges within EBIT. We consider, therefore, that the EBIT margin is a more appropriate profitability metric than the EBITDA margin increase for a while or to offer a lower price, in the hope of increasing their market shares, a competition-enhancing effect.

223.2 The evidence shows that the time span between the first and the last price-change announcement has often been two to three months or more, and that there is a great deal of variation in the number of days passing between the first and the last of a series of announcements. Furthermore, the magnitude of price changes within that time span are very varied (e.g. a rise of 4.5%-16% in late 2011, a fall of 1.3%-5.1% in early 2015).

223.3 Current levels of transparency are largely due to:

223.3.1 suppliers' efforts to further customers' understanding of the cost of their energy. For example, RWE has on two occasions published "Energy Explained", the purpose of which is to increase the media's, politicians', stakeholders' and domestic customers' understanding of the cost drivers in the energy industry. Initiatives such as these are for the benefit of customers and aim to enhance customers' trust in their energy suppliers; or

223.3.2 regulatory interventions. For example Ofgem has since 2009 required the Six Large Energy Firms to produce an annual consolidated statement showing costs, revenues and profits for the different segments of their generation and supply businesses;

223.4 market shares are not particularly stable. There is considerable variation in market shares over time among the Six Large Energy Firms and as the CMA acknowledges, over the last three years independent suppliers have grown rapidly, from 1% to 7% for electricity and from 1% to 8% for gas; and

223.5 there are considerable cost asymmetries as well as substantial variation in EBITDA margins both over time and across suppliers.

224. More detail on RWE's views in this context are contained in its submissions in relation to the price announcements methodology (31 October 2014), its response to the CMA's price announcements data request (31 October 2014), its comments on the CMA's price announcement methodology (13 November 2014) and its response to the Working Paper on co-ordination in the retail market facilitated by price announcements.

225. The CMA indicates in paragraph 153 that it intends to consider price reductions. RWE npower adopts the same approach to price reductions as it does to price increases, except that there is no regulatory requirement to provide customers with notice 30 days in advance, meaning that announcement and implementation dates are likely to be closer together.

Regulatory interventions

226. RWE considers that regulatory interventions have impacted on its ability to compete.

Prohibition of price discrimination (SLC 25A)

227. RWE supports the views expressed by Professor Stephen Littlechild and Professor George Yarrow that the effect of SLC 25A was to restrict competition. RWE believes the primary impact on competition was that suppliers were restricted in their regional electricity pricing differentials[44].

228. SLC 25A required that suppliers should not unduly discriminate in price (or other terms) without objective justification. There was an exemption for time limited differentials, provided that such differentials would revert after a time period to the terms and conditions offered to other customers. As a result a number of limited term offers, loyalty discounts etc. were introduced. Unfortunately such tariffs were not permitted under RMR.

229. RWE notes, in addition, that the online market started to grow at the same time as the introduction of SLC 25A and with the greater visibility created by online comparisons came new opportunities to compete on non-standard tariffs in order to attract new customers. [CONFIDENTIAL].

230. RWE continued to adhere to the spirit of SLC 25A following its lapse in 2012, as a result of Ofgem's published statements about watching suppliers' pricing behaviour and implicit threats of further licence amendment[45]. As the CMA notes, Ofgem clarified in December 2014 that energy suppliers are not bound by SLC25A. [CONFIDENTIAL]

231. RWE expects that individual suppliers will respond to competitive pressures in setting prices. Therefore, to the extent that regulatory constraints have been an active barrier to regional pricing, RWE agrees that the CMA should expect to see the market to move away from the status quo. RWE does not therefore believe that the CMA needs to be concerned about it being in suppliers' mutual interests to continue to act as if SLC 25A is still in place. Changing prices is costly in the energy supply business however and therefore it may take time for prices to adjust although in its most recent non-standard product launches, RWE has already begun to flex regional pricing structures.

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44 SLC25A in spirit covered (i) regional differentials, (ii) payment type differentials, (iii) gas vs power differentials. In practice the gas vs power differential limits were expressed only in the gas SLC25a and not clearly so. SLC27.2A on payment type differentials arose from EU legislation and the regulatory gave guidance that discounting prepayment relative to SLC27.2A would not give rise to censure. Accordingly, with prepayment aligned to receipt of bill (ROB), SLC27.2A took effect on ROB vs direct debit (DD) differentials. Hence overall SLC25A was in effect a licence condition on regional electricity differentials.

45 Ofgem "Decision on Standard Condition 25A in the Gas and Electricity Supply Licences", 26 October 2012: https://www.ofgem.gov.uk/ofgem-publications/39471/decision-standard-condition-25a-gas-and-electricity-supply-licences.pdf

Retail Market Review tariff rules

232. RWE and several other industry participants have set out previously the impact of the RMR in constraining product innovation, specifically the 'four tariff rule' and the limitations on offering a discount unless it accrues day by day (i.e. loyalty discounts are not permitted) and is for dual fuel or online. The RMR restrictions resulted in RWE not being able in practice to offer discounts that reward loyalty, and not being able to offer variable capped products or variable discounted products at a discount from SVT.

233. Accordingly, whilst RWE supports the intentions behind RMR, namely greater transparency, simplicity and comparability for customers, implementation of RMR has led to some unintended consequences; the RMR measures have restricted the options offered to consumers and thereby have dampened competition. By way of example, the restriction to four core tariffs makes it harder for RWE to differentiate itself from its competitors and has reduced RWE's incentive to launch innovative or niche tariffs due to the need to appeal to the mass market with the four tariffs on offer:

233.1.1 RWE had to discontinue sales of its Juice tariff in the run up to RMR, because green energy is considered a niche product and RWE has to offer tariffs that appeal to a wide customer base in order to be able to continue to attract and maintain customers in numbers.

233.1.2 RWE is [CONFIDENTIAL].

233.2 The way Ofgem managed the treatment of white labels has also been problematic. On the basis of the initial proposals for the four tariff regime, RWE had in effect [CONFIDENTIAL]. However, the approach subsequently changed and British Gas ("BG") can offer the Sainsburys tariffs without them counting towards the four tariffs that were BG's limit, so leading to a very different outcome for BG. In addition Ofgem appears now to be changing its approach more generally in relation to RMR, so there has been something of an inconsistent approach even over a relatively short period.

234. However, RWE would not criticise all aspects of RMR. Although RWE was providing simplified information about its tariffs to its customers in advance of RMR, it has provided a consistent framework for the provision of information about alternative tariffs and through the supplier cheapest relevant and alternative tariff provisions, it has promoted customers transferring to an alternative tariff offered by the same supplier. Similarly the TCR, as long as properly explained, further promotes transfers of this nature. Finally, the requirements that all tariffs have to be made up of a standing charge (if any) and a single unit rate has added further impetus to a number of other measures aimed at increasing customer engagement in the

market; we refer to this again in the section on the increasing pace of engagement in the market in paragraph 175 above.

Social and environmental obligations and policies

235. RWE accepts that the government is increasingly using energy suppliers as agents in the delivery of government social and environmental policies and agrees with the CMA that the costs of social and environmental obligations are among the main drivers of prices increases. The nature of the implementation has caused considerable supplier cost risk and uncertainty that had to be taken into account in pricing decisions. In particular, the Energy Companies Obligation is a substantial obligation which increases risk (if a company doesn't discharge its obligation as effectively as others), particularly as the obligation is predominantly to achieve carbon reductions and not to spend defined sums.

236. RWE notes the CMA's comment in paragraph 168 that the costs of these obligations/policies fall disproportionately on electricity rather than gas and that, combined with the different carbon intensity of electricity and gas, this results in a situation in which the domestic consumption of electricity attracts a much higher implicit carbon price than the domestic consumption of gas. RWE considers that this is inconsistent with a decarbonisation policy, which should prompt greater use of electricity for transport and domestic heating rather than relatively increasing the costs of electricity compared to gas. This is a policy question (on the shadow price of carbon as reflected in gas and electricity consumption and the effect of the shadow price) and a practical question (the ubiquity of electricity connection making it easier to apply obligations (e.g. Green Deal) and taxes (heating fuels other than piped gas being harder to tax consistently). Paragraph 168 goes on to state "we will wish to consider the potential implications this has for competition, for example on the viability of electrical heating systems as an alternative to gas". RWE also believes that customer engagement in the market for the supply of electricity and gas is influenced by customer engagement in the forward markets of gas and electricity consumption and saving devices (e.g. boilers, insulation, heat pumps, demand management devices).

237. RWE noted in its Initial Submission that in the context of gas, the activities of wholesale and retail gas supply, and activities connected therewith, are also clearly encompassed in the terms of reference. These connected activities include the provision of boiler services, the purchase of which, in RWE's view, influences customers' behaviour in relation to the purchase of retail energy.

238. In particular RWE submits that the CMA should consider the benefits that arise from legacy economies of density in the provision of boiler services (the installation, repair and maintenance of boilers) that are not available to other energy supply providers and whether a favourable position in the provision of

boiler services to customers can be leveraged to establish a significant market position in energy supply.

239. It is RWE's experience that customers who purchase a package of boiler services and energy (and vice versa), or who perceive that they have such a package of products, may be less likely to switch energy provider and so, once lost, such customers are more difficult than other customers to win back.

Settlement and reconciliation

240. RWE recognises the potential for the issues described by CMA in paragraphs 169-174 to occur. It is preferable if the settlement cost can better reflect actual consumption thereby aligning customer and supplier incentives. RWE notes and support Ofgem's consideration of these issues and general commitment to better settlement in gas and power. Examples of better settlement are better temporal resolution, more rapid convergence of historic accuracy so that the reconciliation period can be shrunk, and visibility of individual meter points. RWE believes that better settlement is vital to achieve the low carbon transition and will enable new entry business models.

241. With regard to gas and power settlement systems, RWE's view has always been that high temporal resolution should be developed in the domestic sector, that this should be planned over at least a five year period to enable efficient system spend and that high temporal resolution settlement should be elective first and mandatory second. RWE's issues with the Xoserve Nexus rollout for settlement has been one of pace and programme management.

242. In relation to electricity, RWE has supported development of (elective) half-hourly settlement since at least 2006 (the Elexon Evolution Steering Group). RWE continues to support this. What RWE does not support, however, are decisions being taken late in a process, rushed implementation, or requiring measures to be implemented on a mandatory basis without a period in which high temporal resolution settlement is elective (this is the basis on which RWE opposed Balancing and Settlement Code modification P272).

The broader regulatory picture

243. In broader regulatory terms, RWE agrees with the comments made by Professor Stephen Littlechild that Ofgem appears to have focused more on protecting consumers over the Relevant Period than in promoting competition.

244. In general, RWE considers that there have been inefficiencies caused through the use of policy or regulatory interventions and decisions which are not clearly directed at a single outcome. For example in relation to transmission connection, transmission charging and locational pricing we would argue that the objective should be solely one of economic efficiency, whereas such decisions have been

determined through other considerations, most often being sustainability and/or political objectives, e.g. regional subsidies to intermittent generation. Similarly, in the context of the capacity market, we believe the objective should be secure sufficient capacity to meet a defined security objective at minimum cost however the design encourages new build and refurbishment over existing capacity, even though that might be the least economic solution.

245. RWE considers that there has been something of a lack of clarity and certainty for suppliers. For example, a concern has been the expansion of regulatory initiatives designed for the Domestic sector but applied inappropriately to the SME sector. For example, Ofgem currently proposes that, from 2017, suppliers will no longer be able to object to customers leaving, which currently suppliers may do (only) on the basis of customer debt or that the customer is still in contract. This increases the risks associated with supplying microbusinesses: RWE may lose a customer whose expected energy requirements it has already purchased forward; additionally, RWE will face increased bad debt risk. Suppliers will need to take account of the changes to the objections process in determining their competitive offering, and therefore this has the potential significantly to alter competition on the market. Specifically, it may result in higher prices to reflect these additional risks to the supplier.

246. It is very important that the regulatory framework strikes a balance between customer protection and allowing competition in the market. Most SME regulatory interventions have achieved this balance, but removal of objections is an example of a regulatory intervention that may benefit some customers but is likely to have a significant distortive effect on competition.

247. RWE would also note that there has been a significant amount of regulatory change from DECC as well as Ofgem. Further detail is provided in RWE's response to Question 37 of the Retail Supply Financial and Market Questionnaire.

Microbusinesses

248. RWE's experience is that the microbusiness market is a highly competitive and dynamic market as reflected by the diversity of suppliers and of businesses, customer preferences, the role played by Third Party Intermediaries and the strong indicators of customer engagement.

249. As the CMA acknowledges, there are over 30 suppliers serving SMEs. This reflects RWE's own experience of a highly competitive market on which there are a growing number of suppliers and on which RWE faces fierce competition from the rest of the Six Large Energy Firms and from the independent suppliers. Over recent years a number of new entrants have emerged with single fuel or dual fuel offerings. In some instances, independent suppliers such as Opus Energy have grown in scale almost to the size of the Six Large Energy Firms.

250. In an SME context, microbusinesses face no barriers to engaging in the retail energy market. RWE's experience is that customers are active in seeking the best deal and [CONFIDENTIAL]: in 2014, RWE gained [CONFIDENTIAL] meter points and lost [CONFIDENTIAL]. This means RWE constantly needs to compete to acquire and retain customers and to ensure that its pricing and service offering to all customers remains competitive.

250.1 Microbusinesses represent a highly diverse range of businesses with differing customer preferences. Many of RWE's customers are astute businesses who are experienced at negotiating with suppliers across their business. They are incentivised to keep costs down and will purchase the product that best meets their needs. At the same time, there is also a high failure rate for small businesses, with over 40% of new SME businesses going out of business within three years[46], meaning that RWE needs to compete hard to maintain customer numbers, and [CONFIDENTIAL]. The diversity of customers is acknowledged by the CMA to some extent: the CMA recognises that microbusiness customer characteristics may differ significantly, and highlights the wide range of consumption levels and spend of customers falling within the microbusiness definition.[47] However, this does not go far enough: level of consumption is not the only differentiator. Other key customer characteristic differentiators include:

250.1.1 The type of business, for example food service and hospitality businesses tend to have high energy demands for their refrigeration and plant and equipment, and a leisure centre may have a high requirement for heating and ventilation (e.g. for a swimming pool or gymnasium), whereas a small office-based estate agency business may primarily require usage for lighting during opening hours. Likewise, different types of businesses are exposed to different macroeconomic risks;

250.1.2 How energy intensive the business is (i.e. how much the business spends on energy relative to total operating costs);

250.1.3 The complexity of metering including sub-metering (which can have a very significant impact on the costs of serving the customer, and in some cases might determine whether RWE can supply them);

250.1.4 Creditworthiness of the business, which can vary considerably, from new start-ups who have no credit history to long established companies with a stronger credit rating;

46 Office for National Statistics Statistical Bulletin: Business Demography, 2013

47 Microbusiness working paper, paragraph 3

250.1.5 The demands of the business's own customers, which will depend on, for example, the type of business, its trading hours/hours of operation and patterns of consumption;

250.1.6 Whether the business is an owner or a tenant (which will not only affect the customer's requirements, but can also affect the risk to RWE associated with the customer);

250.1.7 The legal status of the customer, which varies widely and ranges from sole traders, partnerships, limited companies, property trusts, charities to owner occupiers with mixed business and domestic consumption (such as living quarters above a public house or in a hotel); and

250.1.8 Whether the customer is part of a larger corporate group (whether the customer has a single site or is part of a multi-site group).

251. The product structure also has to be a match for the business concerned, including relevant metering and consumption characteristics as well as risk mitigation options which may reduce the unit price paid by the customer.

252. Competition is also stimulated by the 1,000 plus third party intermediaries ("TPIs") acting on behalf of suppliers or customers. TPIs target customers at acquisition and renewal, which we would expect to help ensure the market is competitive both in terms of acquisition and renewal product offerings. TPIs can provide customers with a very useful service, particularly smaller businesses that may not have the time or resource to devote to energy supply. Some TPIs also provide other value add services such as bill validation and energy audits, which can provide businesses with additional ways to engage with their energy usage.

253. That said, the operation of TPIs is unregulated and there is a lack of transparency for customers as to how they operate. This could mean that customers do not necessarily get the best deal through TPIs. RWE recognises that the effectiveness of the TPI market may be impacted by the minority of TPIs that have bad practices, and that proper regulation of the TPI market is an urgent priority. Uncertainty as to how TPIs operate could therefore operate as a barrier to engagement. RWE would urge the CMA to have regard to this in the context of this inquiry. In this regard, RWE notes that this issue has been under consideration by Ofgem for close to 4 years[48] and, as the CMA notes, Ofgem currently proposes to wait for the outcome of the CMA investigation and take into account the CMA's findings in relation to TPIs.

48 Ofgem first proposed the accreditation of TPIs in November 2011 – RMRN on domestic proposals 23 November 2011 157/11

253.1 There are high levels of engagement in the market. RWE discusses in its response to the Microbusiness working paper what it regards to be the key measures of engagement, and would highlight the following here:

253.1.1 In 2014, [CONFIDENTIAL] of RWE's customers whose contracts came up for renewal had negotiated either their current contract or the previous renewal.

253.1.2 [CONFIDENTIAL] % of RWE's electricity and [CONFIDENTIAL] % of its gas customers are on its Fixed (contract) product, and will have actively moved onto that product. As the CMA notes, across the industry, on 1 April 2013, [CONFIDENTIAL] of electricity customers and [CONFIDENTIAL] gas customers were on acquisition products, indicating a recent switch.

253.1.3 On average RWE's SME customers contacted RWE [CONFIDENTIAL] times in 2014. Even of its longstanding Tariff customers (acquired at privatisation), more have contacted RWE over [CONFIDENTIAL] in the last three years ([CONFIDENTIAL]) than have not contacted RWE in that time ([CONFIDENTIAL]).

253.1.4 RWE's research shows that most customers [CONFIDENTIAL] quotes before choosing their energy supplier.

253.1.5 In 2014, RWE acquired [CONFIDENTIAL] meter points and lost [CONFIDENTIAL] (on a base of [CONFIDENTIAL]). This is a combination of the short lifetimes of many new SME businesses, high levels of business movers and other gains and losses.

254. RWE competes actively to acquire and retain customers and specifically seeks to engage with customers and encourage them to engage with RWE:

254.1 RWE aims to foster customer loyalty and one of the key ways in which it does this is by providing great customer satisfaction. RWE's SME business is currently joint second for customer satisfaction and its aim is to be number one. RWE's customers tell it that RWE provides a high quality service, value for money, is reliable and demonstrates that it is changing for the better. They say RWE is [CONFIDENTIAL] RWE has achieved this through [CONFIDENTIAL], for example through its Customer Transformation Programme. RWE recognises that whilst competitive pricing is essential, its customers value more than price alone.

254.2 RWE keeps its product offering under review to ensure it gives customers the choice and features they want. RWE recently introduced its new Flexible product to replace its auto-rollover product. Prior to full launch, RWE explored the product options and then tested these concepts with its customer panel. This product gives customers the certainty of a fixed price for 12 months, with the [CONFIDENTIAL].

254.3 RWE constantly reviews its pricing to ensure it is competitive. Under the '[CONFIDENTIAL] model introduced in 2013, RWE offers [CONFIDENTIAL].

254.4 RWE actively seeks to engage with customers and to encourage them to engage with it. RWE set out in its response to the Microbusiness working paper the numerous measures it has taken to help SME businesses understand the energy market, and RWE set out there some of the examples of its letters to customers aimed at ensuring they have all the information they need and that those who could be on a cheaper product with RWE are aware of this.

Theories of harm

255. In RWE's view, microbusinesses face no barriers to engaging in retail energy markets and overall there is no problem with low engagement.

256. The CMA appears to have focused mainly on switching between suppliers, which is just one measure of engagement. Engagement may also be indicated by negotiating with the customer's existing supplier, obtaining quotes from the customer's existing supplier or another supplier (whether or not the customer ultimately changes supplier or product), contacting the supplier to discuss service or further product requirements, making changes to payment method or for example signing up for online self-service, or actively choosing to stay with their supplier when moving business premises. RWE refers to paragraph 253.1 for the significant evidence of engagement in the SME segment.

257. Even if looking at switching between suppliers only, the figures quoted by the CMA do not obviously indicate any lack of engagement. Last year, RWE gained [CONFIDENTIAL] meter points and lost [CONFIDENTIAL] (on a base of only [CONFIDENTIAL]), and if this is in any way representative of switching across the industry, this would indicate that switching rates are high.

258. Furthermore, as the CMA acknowledges in its Working Paper on microbusinesses, many microbusinesses report being happy with their existing supplier, meaning that the CMA should be very cautious indeed to interpret customers' decisions not to switch suppliers as indicating a lack of customer engagement. RWE's current customer satisfaction levels are very high ([CONFIDENTIAL] customer satisfaction)[49] and RWE also knows that customers value customer service, brand and price in roughly equal proportions.

259. There are also no significant barriers to search. RWE estimates that a customer can obtain a tailored quote in less than 30 minutes, meaning that a customer can obtain quotes from multiple suppliers in a short period of time. This will take account of the specific attributes of the customer's business, any complex metering issues (which can not only have a very significant impact on the cost of

[49] TLF, Satisfaction survey of energy supply competitors in the SME market for Q3 2014

serving that customer and therefore on the price quoted, but ultimately may determine whether RWE has the capability to take on the customer) and their credit status. The wide range of businesses in the SME market means that it is common for specific attributes to be material to the price quoted.

260. The complexity of customer demand and preferences and the variety of products on the market mean that Price Comparison Websites have struggled to establish themselves in the business customer marketplace. However, as noted above there is a very active TPI market and TPIs offer valuable support to customers, and are particularly useful for those with specific requirements, and can help them understand and evaluate differences between suppliers' offerings. TPIs target customers at acquisition and renewal, which RWE would expect to help ensure the market is competitive both in terms of acquisition and renewal product offerings. Many customers avail themselves of the services of TPIs [CONFIDENTIAL]. That said, the operation of TPIs is unregulated and there is a lack of transparency for customers as to how they operate. This could mean that customers do not necessarily get the best deal through TPIs. RWE acknowledges also that uncertainty as to how TPIs operate could operate as a barrier to engagement. In this regard, RWE notes that this issue has been under consideration by Ofgem for close to 4 years[50]. Indeed, RWE made this point to Government again at the time of the move away from auto-rollovers, stressing the importance of TPI regulation with the increased engagement that would result from the end of auto-rollovers. However, as the CMA notes, Ofgem currently proposes to wait for the outcome of the CMA investigation and take into account the CMA's findings in relation to TPIs.

261. RWE agrees that SME energy prices are generally not published.This is not surprising as a number of factors will be involved in constructing a price and SME prices are often the result of negotiation. In fact this negotiation is a key feature of the SME market. As the CMA acknowledges in its Microbusiness working paper, the lack of published prices also allows suppliers to offer prices tailored to a customer's situation and to manage risks associated with a customer. RWE agrees with this. RWE set out in its response to the Microbusiness working paper examples of the ways in which RWE is are able to tailor its quote to meet specific customer circumstances and advantages of being able to quote as close to point of sale as possible.

262. Importantly, however, RWE's customers do not lack the information they need to engage in the market and ensure they are on the deal that is right for them:

262.1 RWE does communicate prices for Deemed and Default customers who respectively have either not entered a contract with RWE or have given notice to terminate their agreement but have not yet switched supplier.

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50 Ofgem first proposed the accreditation of TPIs in November 2011 – RMRN on domestic proposals 23 November 2011 157/11

262.2 In addition RWE writes to these customers quarterly updating their prices in a letter headlined "We'd like to lower your electricity prices", with a very clear number to call.

262.3 Furthermore, in relation to the significant majority of customers in a contract, 60 days prior to the point of contract renewal RWE writes to them indicating their renewal price for a Flexible contract [CONFIDENTIAL] and encouraging them to contact RWE to see whether there may be a better deal available for them.

262.4 Given that Flexible is a new product, RWE is currently in the process of determining the appropriate contact strategy for these customers. However, any customer will, at a minimum, receive 4 bills a year, a letter 60 days before their contract expires and a further letter 30 days before contract expiry, even if they do not contact RWE.

263. Since, as noted above, a microbusiness can obtain a number of competing quotes with minimal effort, RWE agrees with the CMA's observation in its working paper that the lack of published prices allows suppliers to offer prices tailored to a customer's situation, and to manage the risks associated with a customer, and would go further and state that it believes its approach assists the customer to find the right deal. It is unlikely that a series of generic published prices would be able to take into account the differing requirements and characteristics of customers with very different businesses, and so it is not clear that suppliers would be able to make these generic prices capable of constituting offers that could be accepted to form a contract.

Indicators of potential detriment

264. RWE acknowledges that at the beginning of the relevant period, [CONFIDENTIAL].

265. RWE acknowledges that [CONFIDENTIAL]). However, RWE no longer applies auto-rollover terms and any customer who does nothing at the end of their contract [CONFIDENTIAL].

266. [CONFIDENTIAL]. RWE notes in addition that customers typically stay on these products [CONFIDENTIAL] % of Deemed customers and [CONFIDENTIAL] % of Default customers stay on the product for [CONFIDENTIAL]), which RWE does not consider is consistent with disengagement.

Overall current thinking and next steps

267. RWE looks forward to working with the CMA and providing it with the evidence needed to investigate the supply of energy to microbusinesses. RWE expects the CMA to find that the market is highly competitive.

UPDATED ToH 5 (THE BROADER REGULATORY FRAMEWORK, INCLUDING THE CURRENT SYSTEM OF CODE GOVERNANCE, ACTS AS A BARRIER TO PRO-COMPETITIVE INNOVATION AND CHANGE)

Number and complexity of Codes

268. In paragraphs 190 – 201 of the UIS, the CMA invites views on whether the number of codes adds barriers to entry and whether the system of industry code governance and current codes arrangements generally strike the right balance between providing companies with a degree of insulation from regulatory risk whilst allowing for pro-competitive innovation and change.

269. RWE recognises that the Codes themselves are complex. Three factors drive this complexity:[51]

269.1 At the generation/wholesale level, the interactions between generators, consumers and the transmission and distribution systems are inherently complex.

269.2 At the retail level, the decision to allow multiple parties to own and operate meters is to our knowledge unique in the world. Whatever its merits, competition in metering adds a whole layer of additional complexity.

269.3 Excessive regulation at the retail level has also led to rules that impose costs on all parties, large and small, both established and emerging. These costs inevitably flow to consumers.

270. Given the first point above, RWE is of the view that the codes that set rules for generation and trading are themselves generally appropriate (i.e., their content is appropriate— RWE discusses the governance issues below). The fact that there are multiple codes can help entrants, because it means that they do not need to take on so many obligations. For example, a trader does not need to sign up to the Connection and Use of System Code (CUSC), because it does not own/ operate physical assets.

271. While the complexity of the codes (at the generation, wholesale and retail levels) may appear daunting, it also has advantages. They provide detailed, highly explicit rules that make implementation and compliance more straightforward, and protect parties from subjective or inconsistent application of the rules (in contrast to some other jurisdictions).

272. With regards to the codes and arrangements that set the rules for retail energy, RWE does not see potential for significant reforms to the codes themselves, unless

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51 The second and third of these points apply not only to the industry codes that the CMA focuses on, but to the larger set of codes and arrangements that apply to the retail part of the industry, including for example the Green Deal Agreements, the Debt Assignment Protocol for prepayment meters, and arrangements that may be required in the future for switching and switch back inside the statutory cooling off period.

these were to flow from changes in the underlying drivers of complexity (excessive regulation). In general, there is however room for improvement in terms of the governance arrangements.

273. With regards to the number of codes, RWE believes that while it might be possible to combine some codes, there would be little benefit, except to the extent that it led to a more uniform system of governance across those codes. However, combining codes is not a necessary precondition for governance reform.

Code Governance

274. With regards to governance arrangements therefore:

274.1 RWE does not accept that current arrangements are skewed in favour of the interests of incumbents or that they represent a barrier to entry or to innovation. The code governance arrangements contain significant safeguards to protect the interests of smaller players for example the "critical friend" role enshrined in the Code Administrators' Code of Practice. In our experience these safeguards have proven to be effective. Moreover, many modifications have been brought forward by smaller players, such as P272 and DCP126.[52] Panels are not dominated by the larger players (for example just one of the current 12 members of the BSC Panel is from the six larger suppliers).

274.2 RWE does however believe that there is the potential to streamline the governance procedures. RWE recommends reforms as follows: (1) having a single code administrator for all codes; (2) adopting uniform governance procedures across all codes; (3) setting fixed timelines for the processes of code modification and decision-making; (4) as discussed below, having an independent codes adjudicator with a remit to focus on competition and economic efficiency. This would reduce costs and complexity, avoid potential for conflict of interest, and accelerate decision-making, to the benefit of consumers.

Case for an independent Codes adjudicator

275. RWE believes that Ofgem's role in code governance acts against the interest of consumers for two reasons. First, Ofgem's broad set of statutory objectives mean it has to use a single policy tool (code modifications) to pursue multiple goals. This leads to inefficiency and confusion. Code modifications should be made on the basis of promoting competition and economic efficiency, while other policy aims (sustainability, security of supply) are best attained through the use of dedicated instruments. For example, it is not efficient to attempt to support renewable generation by distorting the transmission charging or connection arrangements.

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52 Smartest Energy raises mod P272, with which the CMA is already familiar. Haven Power raised Distribution and Connection Use of System Agreement Change Proposal 126 (DCUSA DCP126)

276. Secondly and more broadly, it appears that Ofgem has not always been able to resist political pressure to introduce new policies via the codes, with results that have entailed inefficiency, micromanagement and unnecessary costs, all to the ultimate detriment of consumers. The case of BSC Modification Proposal P272 provides one example where Ofgem's broad set of statutory duties has led to an economically inefficient outcome that imposes costs without providing a corresponding consumer benefit.

277. Requiring Ofgem to weigh up conflicting objectives has at times led to opacity and regulatory uncertainty.

278. RWE believes this problem should be resolved by having decisions on Codes made by an independent codes adjudicator, separate from Ofgem. This adjudicator should make its decisions on the basis of promoting competition and economic efficiency.

Role of National Grid

279. There are potentially significant conflicts of interest for National Grid. National Grid is a privatised company, acting in many capacities (e.g. transmission owner, system operator, metering, onshore/offshore network build/own/maintain, interconnector owner etc). At the same time, it has administrative roles in relation to codes that govern the commercial terms of agreements of which they are the beneficiaries. For example NGT is administrator to the Connection and Use of System Code.

Conclusion on codes

280. In conclusion we believe that the codes are generally fit for purpose in generation and wholesale. In retail, the codes are generally appropriate given the constraints under which they exist. RWE does not therefore see potential for significant reforms to the codes themselves, absent significant changes in policy. There is however room for improvement to code governance through the creation of a uniform system of governance under a single administrator, with fixed timelines. Decisions on codes should be made by an independent codes adjudicator, on the basis of promoting competition and economic efficiency.