CMA
Competition & Markets Authority

ENERGY MARKET INVESTIGATION

Summary of hearing with E.ON on 4 March 2015

Background

1. E.ON welcomed the CMA's investigation as it considered that the investigation would help to dispel a number of myths about the industry and restore stakeholder and consumer confidence in how the market operated. The energy industry had gone through many changes in the past ten years or so, including Great Britain becoming a net importer of gas around 2004, increases in gas prices from around 2005 and a number of pieces of EU and UK government legislation, such as the EU's 20:20 targets and the UK Climate Change Act, which led to a series of further UK reforms such as the Electricity Market Reform (EMR) and Feed in Tariffs. Other environmental and social measures, such as the Energy Company Obligation (ECO) and the Warm Home Discount had also been introduced and together all of these had combined to increase consumers' bills. The financial crisis had reduced people's incomes and had also led to a general decrease in trust in businesses. Alongside this, energy suppliers, regulators and government had failed to adequately explain the rationale for various policy changes, and the reasons for the costs these imposed, to consumers. Together with increases in energy prices this had led to consumers' loss of trust in the market.

2. E.ON had responded to consumers' loss of trust by putting in place a strategy to increase its customers' satisfaction levels in order to become their 'trusted energy partner'. [✂] E.ON's customer satisfaction ratings had improved significantly since it had adopted this strategy, which included engaging with its customers about the best deals it could offer them, and it was now the best rated of the large energy suppliers for residential customer satisfaction and the number two rated energy supplier for small and medium-sized enterprises (SMEs).

3. E.ON had recently decided to split its business into two separate companies. One, which would retain the E.ON name, would focus on supplying energy to consumers, while the other (known as NewCo) would handle E.ON's conventional energy generation business. The new E.ON would focus on renewable energy sources, such as solar, energy distribution and ways of helping different kinds of energy customers manage their energy use with the

help of new digital technologies, such as smart meters and internet-connected appliances.

Market rules and regulatory framework

4. E.ON considered that the current system of self-dispatch worked well as it allowed generators and suppliers to manage their dispatch obligations in line with their individual plans and portfolios. There would also be a need for short-term dispatch, and it was right that this was managed centrally by National Grid. There was no need for a major reform of the current dispatch system. There was also no current problem with liquidity in the market from E.ON's perspective, but it noted that it would not have any difficulty with the introduction of a compulsory day-ahead market, which it considered would only further increase liquidity.

5. E.ON supported the move to a single cash-out price as it would reduce risk for participants in the market, who currently had to run two separate imbalance accounts. E.ON was opposed to the move to PAR 1 imbalance pricing as it considered that it would unnecessarily punish participants who were usually in balance but might very occasionally be out of balance for one or two half-hour periods, for example because of a generator failure. E.ON's view was that PAR 1 imbalance pricing could seriously affect smaller suppliers that might not be able to absorb the imbalance penalties as readily as larger ones. E.ON thought that the current means of calculating imbalance pricing worked well and provided appropriate signals to the market.

6. E.ON had concerns that increased volatility in cash-out prices would not feed through into market prices such that they would influence investment in generation capacity. E.ON also noted that there had been a number of changes to cash-out prices since the introduction of the New Electricity Trading Arrangements/British Electricity Trading and Transmission Arrangements (NETA/BETTA system), and on that basis it speculated that the latest changes might be reviewed again.

7. E.ON supported the introduction of Contracts for Difference (CfDs) and their allocation by competitive auction. It considered that by the time that the 2020 targets were met, these auctions should be technology-neutral as by then some low-carbon technologies which were currently at a developmental stage should be in a more advanced state. [✂]

8. E.ON was in favour of the introduction of the capacity mechanism as it considered it would be a good way of addressing the shortfall in investment in generation (the 'missing money' issue) and because it provided a competitive mechanism for allocating investment in generation. E.ON did have some

concerns about the deductions made to the required capacity ‘pot’ on which the mechanism was based, which might, in some instances, favour less efficient generation plant.

9. E.ON did not consider that the fact that suppliers would have to bear the risk of volatility/variation of cost recovery in relations to CfDs and the capacity mechanism was fair, as these risks were very difficult to predict, and the increased costs associated with them would need to be recovered from customers. E.ON’s view was that it would have been better if government had set a fixed amount that suppliers would have to pay and for government to cover any fluctuations on its balance sheet. Having suppliers handle the risk of predicting those costs and managing any fluctuation would raise the overall cost of the mechanism for consumers.

10. E.ON did not support the inclusion of interconnectors in the capacity market, due to how these were being treated for these purposes, because these were transmission, not generation, assets. E.ON would be supportive of non-UK generation capacity taking part in the UK capacity market. E.ON was interested to see how the interconnectors would be de-rated for the purposes of the auction, as an indicator of how reliably the interconnectors would perform.

11. E.ON considered that the capacity mechanism should be altered so that all plant, including new and existing generation capacity and demand-side response, should be able to compete for contracts of the same length. E.ON also had concerns about the power held by the Secretary of State to award CfDs on a non-competitive basis, which could be used to support large projects for developing energy sources. If used, this power could undermine the competitiveness of existing generation technologies. E.ON’s view was that it would be better to support large projects of this type through other funding mechanisms.

12. E.ON had participated in the capacity market auction. [✂]

13. E.ON was in favour of locational pricing since it would mean that costs would be better reflected and this would create a potential for more efficiency, better profitability and better investment decisions. E.ON would support a zonal losses scheme. It considered that locational constraint charging could become very complex, difficult for market participants to take any action in response to it and with potentially unforeseen effects for competition.

14. E.ON noted that having more than one pricing zone could address issues about constraints but might lead to major reductions in liquidity. It might be better to introduce locational pricing on a locational constraint basis rather than by locational marginal pricing, if locational pricing were to be introduced.

However, E.ON noted that National Grid was currently legally barred from introducing charging constraints on a locational basis.

15. The annual quantities (AQs) upon which payments to gas suppliers were based were set by reference to customers' meter readings. Suppliers were therefore incentivised to supply meter readings, but they did not always manage to provide readings for all their customers. A series of calculations were then made which first assessed meter readings on a seasonal basis and which were then adjusted to produce the AQ figure. Finally the gas supplied to a given area was allocated to each supplier on a pro rata basis. E.ON would normally expect to bill around [✂]% of its annual figure. Around [✂]% of the gas used in a given area would not be attributable to an individual supplier, and this would be then be allocated again on a pro rata basis to the suppliers in a given area. There were a number of ways in which the data used to calculate the AQ figure could be incorrect.

16. There was a project, Nexus, which would better align the calculations used in the gas and electricity settlement systems and which would remove the various issues with the apportionment of gas under the current system. E.ON welcomed these aspects of Nexus and considered that suppliers would still be incentivised to use data effectively. Nexus should be an improvement on the current system so long as all gas shippers acted in a fair and reasonable way. Once introduced, Nexus would allow for reconciliation of gas usage and gas billing on an individual customer basis. E.ON was becoming increasingly confident that Nexus would come into effect in the next 12 months.

17. E.ON noted that the introduction of smart meters would enable suppliers to obtain meter readings more efficiently, and there would therefore be pressure on them to use this information more effectively than at present.

18. E.ON was content for the introduction of half-hourly settlement for domestic customers to be supplier-driven, but it recognised that at some stage this initiative might require a mandate from government or the regulator to make sure it happened. The Nexus project and reforms to the electricity registration system would lead to a more centralised settlement system which would assist the introduction of half-hourly settlement.

19. Electricity customers had to bear significantly more social and environmental costs than gas customers, and this created a distortion of competition which affected products like electrical heating. One reason for this imbalance was that every household in the country had electricity but only around 23 million had gas.

Market power in generation

20. E.ON agreed with the inquiry group's preliminary assessment in its updated issues statement that participants in the generation market did not have individual or collective market power.

21. E.ON noted that its returns on its generating assets had been volatile over the past few years and had reduced substantially post the allocation of free carbon credits. E.ON recognised the overall shape of the CMA's analysis of returns on generation over the period 2008 to 2013. The financial crisis in 2008 had affected capacity in the market, and combined with changes in E.ON's generation portfolio, this had led to a reduction in its generation profitability. The free carbon regime had ended in 2013 and as a result E.ON, and it expected many of its competitors, would be announcing significant write-downs on its remaining plant. In E.ON's case that write-down would be [✂] for its UK business.

Liquidity

22. E.ON agreed with the inquiry group's preliminary assessment in its updated issues statement that the energy market was sufficiently liquid. Since 2007 E.ON had operated its generation and retail arms separately and was of the belief that there was sufficient liquidity for them to be run this way. E.ON used its trading business to hedge and shift risk from its retail business to its trading arm. On this basis, E.ON's retail business only carried volume risk and did not take price risk.

23. The transfer price from E.ON's trading arm to its retail business was based on [✂]. Following E.ON's planned split into separate generation and retail businesses, the trading business would remain with the generation business, and the retail business would then need to find its own way of accessing the market.

24. E.ON did not believe that it would suffer any competitive disadvantage from separating its businesses and did not think that its retail arm would suffer from any risk of foreclosure as a result. E.ON noted that its supply business required significantly more energy than its generation business currently produced. [✂].

Retail competition

Tariffs and pricing

25. [✂]

26. E.ON had one of the cheapest standard variable tariffs currently available, and had the lowest of the six large energy suppliers. The current differential between its standard variable and fixed tariff was 3%.

27. E.ON thought there were a number of factors why, in the energy market, fixed-price deals were cheaper than variable ones. [✂]

28. The current Retail Market Review (RMR) regime required E.ON to migrate customers at the end of their fixed tariff on to its cheapest standard variable product. E.ON currently only had one standard variable tariff. [✂]

29. E.ON considered that by having one of the lowest standard variable tariffs it [✂]. When E.ON had recently announced a reduction on its standard variable tariff, it made the headlines. However, E.ON had also introduced a one-year fixed product at the same time [✂].

30. E.ON's fixed tariff customers could opt in to receive price alerts which would let them know if E.ON released another offer of the same type as they were on so customers could see if they could get a better deal. [✂]

31. [✂]

32. [✂]

33. [✂]

34. [✂]

35. [✂]

36. E.ON had a campaign called 'Best Deal for You' through which it sought to engage with all its existing customers and encourage them to switch internally if it was in their best interests. It had also contacted its Economy 7 customers to check with whether that was the right tariff for them.

37. The RMR reforms had required the standard variable tariff to be the default tariff to which all customers returned after a fixed tariff period. E.ON had argued at the time that this might not be the correct approach, and a number of its customers were moved on to the standard variable tariff because their previous fixed tariffs had been discontinued or come to an end.

38. E.ON had reduced its standard variable tariff in December 2014. [✂]

39. E.ON suggested that the divergence between tariffs and forward-looking costs was not as great as Ofgem's Supply Market Indicator (SMI) view of costs would suggest. E.ON's concern was that Ofgem's calculation of regulatory

costs underestimated their impact and the true picture only became clear later, when supply companies published their financial results.

40. E.ON did not consider that the six large energy companies held market power over their standard variable tariff customers in part because these customers were not a homogenous group. There were those who were on or had just come off a fixed tariff (Group 1); there were some who were active switchers who for the moment were content to be on a standard variable tariff (Group 2); and there were those who had never switched, in some cases because they lacked the confidence to do so (Group 3). E.ON was not able to determine whether an individual customer fell into group 2 or 3. It argued that this meant that customers in Group 2 protected customers in Group 3, since it could not distinguish between them. [✂]

41. [✂]

42. [✂]

43. [✂]

44. It was not possible to reverse-engineer competitors' hedging strategies from publicly available information. The strategies appeared to fall within a very broad spectrum and it did not look as if there was convergence. E.ON would try to assess whether any of its competitors would go for a short hedge to try to gain a competitive advantage. It noted that during the recent price reductions, some of its competitors appeared to be less able to respond as they had bought gas to cover an extended period so that they could offer longer-term fixed price products. E.ON's position at the time had allowed it to reduce its prices.

45. For the past two years E.ON's primary focus had been to improve its customer service and its overall customer satisfaction rating. It noted that a supply company gaining large numbers of customers would need to further invest in its customer service operations to maintain its service quality. [✂]

46. Smaller suppliers should be able to keep growing and handle their growth if they manage their businesses well. They had the advantage of being exempt from a number of obligations until they reached a certain number of customers. Some of them were now spending more money on advertising and had developed strong brands. [✂]

47. [✂]

48. Whether smart meters would improve customer engagement across all types of standard variable customers depended on the causes of disengagement. If

the perceived hassle of switching was a major cause of disengagement, then the use of smart meters would help to address this problem as they could be used to facilitate next-day switching and improve the accuracy of information, eg meter reads, at the point of switching.

49. As well as making switching easier, smart meters would allow for more accurate billing and improve customers' experience when moving house. These sorts of improvements would help to give customers more confidence in the market as a whole. Smart meters would also allow customers to better understand how much energy they used and how they used it. E.ON already attempted to engage with its customers about energy saving, and smart meters and other smart devices (eg thermostats) would help to increase engagement in this way. Time-of-use tariffs and demand-response, which smart meters would help to enable, could potentially improve engagement as well, though it was noted that individual customers would not be able to respond to price signals until changes were made to the settlement system to allow for half-hourly settlement.

Environmental regulation

50. E.ON considered that the way that small suppliers were exempted from ECO and some other environmental and social obligations, such as the Warm Home Discount, until they had 250,000 customers, had affected the competition between small and large suppliers and affected small suppliers' ability to grow. It would be helpful if measures could be introduced, such as a buy-out mechanism or an auction system, which would mean that small suppliers could pay to meet their environmental obligations, rather than suddenly requiring them to invest in staff and expertise when they crossed the 250,000 customer threshold.

51. E.ON's view was that it would be fairer to the industry and consumers for environmental obligations, such as ECO, to be met from general taxation rather than have consumers pay through their bills. Consumers often did not understand how the environmental part of their overall bill was calculated or spent and paying for these obligations through general taxation would be less regressive than customers paying for them through their bills.

52. Increasing the level of the threshold to, say, 500,000 would not be the right thing to do. Instead, the thresholds should be removed and these regulations should apply to all small and large suppliers alike, but there should be ways for small suppliers to pay to outsource their compliance with the obligations.

53. E.ON believed that the above regulations meant that small suppliers with customer bases below the threshold derived a significant competitive

advantage over large suppliers. E.ON estimated that this advantage could be around £60 per customer. It noted that small suppliers had this advantage when seeking a high ranking on price comparison websites' (PCWs) best buy lists.

54. There were a number of other obligations which smaller suppliers were either exempt from or less burdened by, including administering feed-in tariffs and the Green Deal. Although the government often criticised the larger energy companies, it had also used them to solve problems and implement various initiatives, such as having to offer Power Purchase Agreements of last resort and Ofgem's Secure & Promote.

Ofgem's reforms to the retail market

55. When the energy industry was privatised, the expectation had been that the amount of regulation would decrease over time, and that consumer law and protection rules would be the main way that energy suppliers would be regulated. Instead, regulatory change had been layered on top of regulatory change, with the effect that companies like E.ON spent money and resources on dealing with regulation which could otherwise be used for innovation. The need to do this was reinforced by the fact that when companies put in place measures in order to comply with new regulations, if anything went wrong they were then fined by the regulator. Some of the regulations that had been introduced were good, but it was the layering upon layer that caused problems for the companies.

56. E.ON supported a move to a principles-based regulatory system rather than a rules-based one. While it would be necessary to have some rules to govern the retail market, E.ON considered that the current number could be reduced significantly, but that this might prove difficult for Ofgem to move from one regime to the other, given the number of conditions there currently were in place.

57. E.ON agreed with the principles that underpinned Ofgem's RMR reforms, ie transparency and fairness, but the way in which some of the reforms had been carried out had led to unintended consequences. For example, E.ON had previously had a tariff called Staywarm. Staywarm was compliant with the main part of RMR, but the linked regulation requiring customers at the end of a fixed-term contract to be migrated on to a standard variable product was incompatible with Staywarm. E.ON had withdrawn it. Staywarm had been a popular product with older people, as was E.ON's Age UK product that had cold weather payments which had to be removed following RMR.

58. RMR had restricted suppliers like E.ON from differentiating their products. It had heightened the focus on price rather than on other factors which also mattered to consumers. E.ON had no evidence that the RMR reforms had led to disengaged consumers becoming more engaged as it was too early to say. E.ON agreed with the principle that customers should be able to understand their bills and was supportive of moves to standardise terminology.

59. E.ON had managed to reduce its bills to one sheet of A4, and it was trying to keep them that size despite initiatives from Ofgem requiring more information to be added. E.ON's customers liked the shorter bill, which they felt was easier to understand.

60. E.ON had had a policy of trying to reward its loyal customers. RMR had removed the ability of suppliers to offer cash discounts and to reward customer loyalty, so E.ON had to instead launch a rewards scheme for all its customers, regardless of their tenure, [✂].

61. E.ON had dealt with the SLC 25A regulation, which prohibited suppliers from offering better deals to customers outside their 'legacy' areas than those within them, by putting in place a no-mains-gas discount for its in-area off-gas grid customers as well as a reduction to its Economy 7 pricing.

62. E.ON did not know whether Ofgem's recent letter confirming that it had no intention of reintroducing SLC 25A (which had officially expired some time ago) would see suppliers introducing discounts in their non-legacy areas. The perception of whether this practice was fair had to be considered, and even if Ofgem did not act, other bodies might raise concerns. E.ON was unsure whether the introduction of SLC 25A had affected competition on the standard variable rate as had been suggested; the end of doorstep sales might have been as, or even more, important a factor in terms of impact on competition.

63. Since Ofgem's letter, E.ON had not sought to reintroduce regional pricing on its standard variable tariffs and was not aware of any of its competitors doing so. Fixed tariffs had been exempt from SLC 25A [✂].

Interaction with consumers and trust in the energy market

64. E.ON had been the last of the six large energy suppliers to stop doorstep selling. E.ON considered that doorstep selling had been a useful way to reach groups of customers which could not be contacted by other means, eg those that were not online and did not use PCWs. E.ON had also used doorstep selling in its own 'legacy' areas. [✂] There were other ways of engaging customers other than the internet and PCWs, such as via organisations like Age UK.

65. [✂] E.ON only used PCWs accredited under Ofgem's Confidence Code. E.ON considered that customers should be able to trust PCWs but was unsure whether requiring all PCWs to include all tariffs was the best way of ensuring this. Whether PCWs were regulated and whether their charges and/or payments were transparent was also important. [✂]

66. E.ON had concerns about Ofgem's proposed method, known as personal projection, for assessing how much a consumer could save when switching, which presumed that when a customer's existing fixed deal ended they would move to a standard variable tariff. E.ON preferred a methodology which would use annual comparisons. The Ofgem proposal would inflate the apparent level of savings a customer could obtain and, worse, could lead to a customer ending up with an arrangement that was actually more expensive.

Microbusinesses and SMEs

67. E.ON did not make a distinction between its microbusiness and SME customers, and some of its microbusiness customers were handled by its Corporates business. It ran its SME business separately from its domestic retail business. It was able to distinguish between domestic customers and microbusinesses because customers would say that they were running a business and also because most businesses would want a fixed-price contract. The RMR regulations on tariff types did not apply to small businesses, so E.ON was able to have a discussion with each of its business customers about their needs and agree the type of contract which was appropriate for them.

68. E.ON had a range of fixed-price contracts which it offered to its SME customers. SME customers could vary greatly in their energy use [✂].

69. As far as transparency was concerned, E.ON noted that brokers were increasingly active in the SME market. E.ON itself had changed how it communicated with its SME customers, particularly around contract renewal. [✂]. E.ON had ceased rolling over SME customers in 2013.

70. [✂]

71. There were a wider range of types of third party intermediary (TPI) involved in the SME market than in the domestic market. The PCW model did not really exist in the SME market, but there were brokers which aggressively advertised online and looked to engage SMEs through this channel. At the other extreme there were thousands of 'one-man' sized brokers that accessed supplier prices through aggregators and which look to arrange contracts for customers from their own personal networks of businesses. In the middle

there were the brokers using call centres to cold-call small businesses. E.ON considered that on the whole brokers' involvement in the SME market was positive as it enabled SMEs to engage in the market and more easily compare prices, but it noted concerns about some brokers' behaviour and was in favour of increased regulation of their activities to protect customers. E.ON had developed its own code of practice for the brokers that sold its products.

72. E.ON had improved its customer service rating for its SME business and was now number two against the large suppliers. [✂]

73. [✂]

74. [✂] E.ON noted that its deemed and out-of-contract rates were published on its website.

75. [✂]

76. [✂]

Retail profitability

77. There were a number of reasons why E.ON's gross margins on domestic electricity had steadily increased since 2007. [✂]

78. [✂]

79. [✂]

80. Because E.ON was a large supplier which had been active in the industry for a number of years it had to deal with the complete range of customers, from those who liked to communicate online, gave regular meter readings and paid by direct debit, to those who regularly phoned its call centres or liked to pay quarterly, in cash, with the associated bad-debt risk. This meant that E.ON had to provide a range of ways for customers to contact it, and some of these systems were several years old and had evolved over time. New, smaller, suppliers would have more modern systems and might only deal with a narrower range of customers, which might mean their costs would be lower than E.ON's. The need E.ON had to deal with the administrative costs of all of the obligations etc would also be different to some smaller suppliers.

Regulatory framework

81. The codes which governed the UK energy industry were complex and even a large company like E.ON struggled to keep up with changes to them, including the European-wide codes which were also under development.

E.ON was involved with virtually every code across the value chain, while some smaller firms would be able to only focus on the codes that were relevant only to the part of the value chain in which they operated. E.ON did not think that simply reducing the number of codes would necessarily reduce complexity as having a single large code for electricity might require some companies to engage with elements they currently did not have to. The industry was complex, so it was not surprising that its governance codes were as well.

82. Having a number of codes each with its own governance arrangements could make it difficult to achieve changes to the overall system when changes to multiple codes were involved. However, over the past few years the codes' administrators had been working to better coordinate interactions between the codes. Code administrators were now working more closely with smaller parties to help them navigate the process for making changes. E.ON acknowledged that smaller parties might feel disadvantaged in engaging in the code modification process, as they did not necessarily have the resources or the depth of technical knowledge, but it noted that as well as the code administrators there were a number of consultants assisting smaller parties in this regard.

83. E.ON did not consider that the Six Large Energy Firms were able to dominate the various code governance panels. It argued that these panels were set up in a way which limited the influence of the large suppliers, as could be seen in the amount of representation that the large firms had in the various code panels. Consultants, some of whom were former employees of the large energy suppliers and other major parties like National Grid, acted as representatives of the smaller suppliers on the code panels.

84. Until the various arrangements governing the industry, such as settlement, were simplified, it would be difficult to simplify the codes themselves, and unless the industry was removed from the codes process altogether industry participants, large or small, would still need to engage with it regardless of who leads the process. E.ON noted that giving Ofgem a greater role in administering the codes would not necessarily increase the system's efficiency. As a result of its Significant Code Review, Ofgem had already acquired greater powers over this aspect of the industry than had originally been set up, and it was important to maintain a balance of powers/the checks and balances in the system. E.ON explained that a number of changes to the industry, such as Project TransmiT, had spent more time being considered by Ofgem than they had in the code modification process. Controversial changes to the industry would always take longer to implement than uncontroversial ones.

85. E.ON acknowledged that whilst it was easier for larger parties to cope with the codes process than smaller ones, it was not the case that the larger parties were trying to maintain the status quo, while the smaller parties tried to make changes. It was noted that the six large energy suppliers were evenly split on Project TransmiT and the electricity balancing significant code review. It really depended on each issue whether individual parties (smaller or larger) were in the same position as each other.

86. The fact that there were a number of codes meant that each one had its own collateral requirement, and parties had to handle different levels of exposure for each one. It would be helpful if these requirements could be brought together so that parties' exposure at any one point in time could be reduced.

In closing

87. E.ON considered that the introduction of smart meters would help to improve customer trust and improve engagement. It also believed that third party intermediaries and PCWs in the SME and domestic markets were important for consumer engagement and needed to be as transparent as possible. Innovation in dealing with customers in both the short and longer term was very important, and it was vital that the RMR regulations did not stifle innovation, particularly in respect of smart technology. E.ON did have concerns about the effect of regulation on innovation and the industry in general.