

CMA ENERGY MARKET INVESTIGATION

PROVISIONAL FINDINGS

RWE RESPONSE

A. INTRODUCTION AND STRUCTURE OF THIS RESPONSE

1. RWE notes the publication by the CMA on 10 July 2015 of its Provisional Findings Report ("PFs") in the Energy Market Investigation (the "Investigation"). This document provides RWE's formal response to the CMA's PFs. It should be read in conjunction with RWE's responses to certain Appendices to the PFs and to the CMA's Notice of Possible Remedies published on 7 July 2015 (the "Remedies Notice" or "RN") and RWE's Authorised Advisers' Confidential Submissions made in respect of the Disclosed Material (together "RWE's Response").
2. This document is structured as follows:
 - 2.1 Executive summary (Section B);
 - 2.2 Introductory remarks on the proper basis for the CMA's findings and certain key concerns on the CMA's overall approach (Section C);
 - 2.3 Response to the CMA's provisional findings relating to the wholesale energy markets and vertical integration (Section D);
 - 2.4 Response to the CMA's provisional finding of AECs relating to wholesale market rules (locational pricing and allocation of CfDs) (Section E and Schedule 1);
 - 2.5 Key aspects of the GB retail energy supply markets that the CMA appears to have misunderstood and which have an important impact on the CMA's provisional findings (Section F);
 - 2.6 Response to the CMA's provisional finding of an overarching feature of weak customer response and unilateral market power of suppliers in the domestic segment (Section G);
 - 2.7 Response to the CMA's provisional finding of an overarching feature of weak customer response and unilateral market power of suppliers in the microbusiness segment (Section H);
 - 2.8 Response to CMA's provisional finding of AECs relating to governance of the regulatory framework (Section I).
 - 2.9 Response to the CMA's profitability analysis and competitive price benchmarking in Appendices 10.3, 10.5 and 10.6 (the "Profitability Response") (Schedule 2).

B. EXECUTIVE SUMMARY

a. Introduction

3. RWE welcomes the CMA's provisional findings in relation to the operation of the wholesale energy markets and the impact of vertical integration, and acknowledges the thoroughness of the CMA's analysis in these areas.
4. RWE also agrees with certain significant aspects of the CMA's analysis in provisional findings across the wholesale and retail markets:
 - 4.1 In particular, RWE fully supports the CMA's provisional finding that the current system of uniform pricing for transmission losses creates a system of cross-subsidisation that distorts competition between generators and is likely to have both short- and long-run effects on generation and demand. We believe that the CMA should implement its proposed remedy as soon as is practicable. The CMA can feel confident as to the effectiveness and

proportionality of the proposed remedy given the extensive amount of work already available on this topic.

- 4.2 RWE agrees that one aspect of the energy markets that has not worked well is regulation, and that the lack of joined up policy making and regulation has harmed competition.
 - 4.2.1 RWE supports the need for greater regulatory robustness and transparency and calls on the CMA to support the concept RWE has put forward for an Office for Energy.
 - 4.2.2 RWE supports the need for regulation of the third party intermediaries that play such an important role in the domestic and SME segments. RWE calls on the CMA to require increased oversight of SME/microbusiness TPIs and domestic PCWs; in fact RWE believes that the CMA should go further and adopt formal regulation of both.
 - 4.2.3 RWE welcomes the CMA's provisional findings that SLC 25A and RMR simpler choices have distorted competition in the domestic segment.
5. There are however some provisional findings that RWE does not support. There are areas where RWE considers that the CMA's provisional findings are not properly grounded in the evidence, and further work is needed between now and the CMA's final report:
 - 5.1 The CMA's finding of weak customer response giving rise to supplier unilateral market power is not made out in respect of either the domestic or SME segments. In particular, the CMA has not properly established the extent of any disengagement and has assumed that all domestic SVT customers, and microbusinesses on widely defined 'default' products, are disengaged, which when assessed against the evidence is plainly not the case. RWE has serious concerns about the CMA's profitability and price benchmarking analysis, notably with regard to the calculation of ROCE, the inappropriate profit margin benchmarks used by the CMA, the analysis of efficiency and its impact on the price benchmarks established by the CMA, and the CMA's treatment of Centrica. As a result, many of the remedies under consideration by the CMA are entirely disproportionate to the extent of any AEC.
 - 5.2 There have been a number of developments in the retail markets over the period under review by the CMA, including some important changes that have taken place since the start of the Investigation, as well as others that are yet to take effect. These will not yet be fully reflected in the empirical evidence obtained by the CMA. The CMA seems to accept in places that it is unable properly to assess the impact of the changes. Yet the CMA fails to reflect this adequately in reaching its provisional findings. It will be very important that the CMA's remedies, in particular, take all these developments into account.
6. In the domestic segment, the CMA notes that the RMR simpler choices rules have restricted competition and choice, and we agree with this. Despite RMR simpler choices, we have seen the rapid growth of mid-tier and smaller suppliers and increased switching rates between SVT and non-standard tariffs, with significant increases even since the start of the Investigation which will not be reflected in the evidence obtained by the CMA. With the removal of the RMR changes, we fully expect the market to become even more competitive.
7. Looking forward, there are a number of changes that will enhance competition. In the domestic segment for example, these include, in particular, growth in smart products and time of use tariffs.
8. We highlight some of our key submissions in the following sections.

b. Domestic retail energy supply

i. CMA's provisional finding of AECs

9. Homogeneity as a fundamental barrier to engagement: Key to the CMA's finding of "weak customer response" and supplier UMP is the mischaracterisation of electricity and gas

supply as “homogenous” goods and the CMA’s assumption therefore that customers only care about price.

10. This is incorrect. There are a number of product features other than absolute price that customers value, and suppliers compete to differentiate themselves and innovate in various ways. The CMA’s survey clearly finds that in addition to price, many consumers value other elements when choosing their supplier, such as customer service, simplicity of tariff structures, tailored tariffs, supplier brand, the range of other services available such as boiler maintenance and whether a supplier provides smart meters. It is far from clear why the CMA argues that because price is important (though it is) other factors are not. The CMA fails to take this evidence into account and instead concludes inappropriately that suppliers offer a homogeneous product.
11. Evidence of customer engagement in practice: There is also ample evidence of customer engagement in practice, from high levels of internal and external switching, to the increasing use of online account management and measures taken by customers to manage their energy usage. For reasons we do not understand, the CMA has so far largely disregarded evidence it has seen of customer engagement in practice, including evidence from its own customer survey. For example, while the CMA provisionally concludes that “Customers have limited awareness of and interest in their ability to switch energy supplier...” this conclusion is starkly contradicted by the CMA’s own survey which finds that 89% of consumers are aware it is possible to switch supplier.¹ The CMA’s provisional finding of weak customer response – that a “material proportion” of customers are “fundamentally disengaged” – is not well founded and the actual barriers to engagement are very low.
12. It is certainly not appropriate therefore to regard all SVT customers (or all SVT customers who pay by standard credit) as disengaged. The evidence from the CMA’s customer survey cannot support a conclusion of disengagement on behalf of SVT customers as a whole and updated statistics in relation to switching (as just one of the measures of engagement) will show that they are, in the main, engaged. For those customers that RWE is unable to engage for whatever reason, as in any competitive market would be the case, such customers will in any event benefit from the competitive constraint on energy suppliers which arises by the vast majority of customers who do engage in a meaningful way and are fully aware that they can, should the need arise to switch supplier.
13. Price discrimination as evidence of supplier UMP: Unfortunately the CMA’s misconception of retail energy supply as “homogenous” also leads the CMA to regard price variation as evidence of supplier UMP. The discounts that exist are wholly consistent with the market being competitive. The existence of price discrimination must not be presumed to be evidence of UMP. In fact this kind of pricing is common to many competitive markets and can deliver customer benefits.
14. Profitability and pricing as evidence of UMP: Nor can the CMA reliably use the analysis it has undertaken with regard to profitability to support a conclusion of market power; a proper profitability analysis would show that suppliers are making only modest margins. The competitive benchmarks that the CMA adopts are unrealistic including the CMA’s assertion that customers are overpaying for their energy by some £1.2 billion per year; if suppliers’ revenues were £1.2 billion lower than they are, suppliers would be making losses and the industry would be unsustainable.
15. Impact of regulation: We accept the CMA’s provisional findings in relation to the regulatory framework having distorted competition through regulation that was focused too heavily on consumer protection and not sufficiently on competition. However, as noted above, we consider that the CMA currently understates the impact of the removal of those distortions on competition. This is important when considering whether remedies beyond the removal of the regulatory restrictions are required.

ii. CMA’s remedies under consideration

¹ Only 4% say incorrectly that they don’t believe it is possible and 6% responded that they did not know. See page 39, Figure 35, ‘Energy Market Investigation: A Report for the Competition and Markets Authority by GfK NOP’ (the “GfK Report”).

16. We explain above that we think the CMA has significantly overstated the level of disengagement in the domestic segment, and used flawed profitability analyses and price benchmarking to calculate supplier profitability and the extent of any 'overcharge'. As a result, we consider that certain of the remedies under consideration by the CMA are unnecessary and would be entirely disproportionate. However, as also noted above, we acknowledge that regulation has distorted competition, and as such we support remedies to end the distortion. We are also broadly supportive of a number of the remedies under consideration by the CMA aimed at improving customer engagement.
17. In particular, RWE has serious concerns about the possible implementation of a transitional safeguarding tariff and believes this to be unworkable. More importantly it would have serious adverse effects on competition, and is entirely disproportionate to the extent of the AEC that might exist. In this respect we agree with Prof. Littlechild and other former regulators, as well as Prof. Dieter Helm, all of whom have firmly rejected this.
18. A safeguarding tariff would not be effective in achieving the CMA's aims because it does not address the *cause* of any AEC from weak customer engagement. On the contrary, a safeguarding tariff would lead to reduced, not increased, consumer engagement as customers would perceive that they were being protected and be disincentivised from switching. Such an outcome would therefore be expected to reduce competitive pressure on suppliers.
19. Moreover, a safeguarding tariff will be difficult to set correctly. If it is set too high it will allow the market to over earn and will not serve its purpose; and if set too low it will force suppliers to increase non-regulated prices and/or trigger a strategic review.
20. In terms of the CMA's possible proposal for prioritising smart meters for prepayment customers, RWE believes this would not be practicable for us and more generally across the industry. Prioritising and successfully rolling out smart meters to domestic customers who currently have a prepayment meter will be challenging. This is due to the technical limitations in the communications infrastructure that have an impact on the functionality of the smart meter technology. For instance Home Area Network (HAN) solution will only work in 70% of properties until 2017 and HAN for flats is not expected until 2017. In addition the DCC will not have the full communications coverage at the start of the mass roll out and so will need to fit a traditional meter to keep customers on supply. Where these limitations affect prepayment customers, those customers would face practical barriers to accessing the benefits of smart meter technology. As a result a prepayment customer would have a poor customer experience and rather than facilitating engagement, prioritising roll out to prepayment customers before the technical issues are overcome could create barriers to engagement for them. An accelerated roll out to domestic customers having a prepayment meter will not therefore be an effective and comprehensive means of facilitating engagement amongst this group.
21. Instead of the above proposals, RWE believes that there are other measures that could be taken to improve engagement further, which are also under consideration by the CMA, including measures to unwind the regulatory distortions and more proactive (whilst proportionate) measures to engender greater confidence amongst consumers.
22. RWE considers that a package of remedies that includes the removal of the RMR simpler choices rules, the introduction of an independent PCW, Ofgem regulation of PCWs, together with suitable information remedies, perhaps in combination with other changes in the regulatory landscape (such as the planned changes to faster switching and a review of Ofgem's role) will be effective in achieving the CMA's aims and addressing the underlying causes of the AEC the CMA has identified.
23. As a result, including a safeguarding tariff or prioritisation of smart meters for prepayment customers in the CMA's package of remedies would make it more onerous than required and so would not be proportionate or, we believe, ultimately in the interests of energy consumers.
24. RWE wishes to emphasise that the introduction of a transitional safeguarding tariff would put the Government or regulator firmly in the role of setting prices for a large part of the

market and so would fundamentally undermine the longstanding approach in GB of aiming to have one of the most liberalised markets in the world.

25. Finally, although RWE does not consider further remedies are required, to the extent that the CMA is concerned about particular groups of consumers such as vulnerable customers, pending the rollout of smart meters there may be other transitional ways to protect such customers without jeopardising the competitiveness of the market, such as extending the Warm Homes Discount.

c. Microbusiness retail energy supply

i. CMA's provisional finding of AECs

26. RWE has observed in its review of the CMA's Provisional Findings that the CMA's analysis of the SME/microbusiness segment appears to lag behind the rest of its analysis, perhaps because the CMA has not yet appreciated that there are fundamental differences between the two segments and has assumed that it can simply read across many of its provisional findings from the domestic segment to the SME segment. In fact, whilst there are of course some commonalities, these segments are fundamentally different in many key respects. The read across by the CMA means the CMA overlooks important evidence of the competitiveness of the SME/microbusiness segment.
27. The CMA provisionally finds that SME customers face actual and perceived barriers to accessing and assessing information, arising from a lack of transparency and the role of TPIs.
28. In our view, negotiated prices are an important aspect of the SME market. The CMA recognises that there are some advantages, in terms of allowing a supplier to factor in credit risk and therefore avoid adverse selection issues, from a negotiated pricing model. Nonetheless the CMA believes that there is a lack of transparency as a result of the negotiated pricing model. We believe the CMA has underestimated the advantages of negotiated pricing. Which product is right for a customer, and what terms are offered to them, will depend on factors including business customer firmographic (e.g. business type, consumption, number of sites), customer need and preference with respect to channel, product features and benefits sought (e.g. fixed price, variable price, tracker product, level of standing charge, additional services sought e.g. bill frequency, energy management advice), complexity of metering arrangements currently used by the customer or sought by them, and the customer's credit rating. In light of this range of factors, negotiation allows the customer to choose the tailored product that is right for them and to obtain the best price and terms.
29. We agree that access to information is important, and customers can and do easily access the information they need to engage in the market. There are very high levels of awareness of contract end dates/when customers can negotiate or shop around. In the case of RWE's customers, those who are not on the cheapest product available to them are also told this. The evidence also shows that customers do shop around, both for themselves and through TPIs, and there are high rates of switching. RWE recognises that the effectiveness of the TPI market may be impacted by the minority of TPIs that have bad practices, and that this may affect levels of engagement, and considers therefore that proper regulation of the TPI market is an urgent priority.
30. RWE wishes to highlight that many of those SME/microbusiness customers that the CMA regards as disengaged by virtue of being on so-called 'default' tariffs have in fact engaged in the recent past, so it would be wrong automatically to regard them as disengaged. The CMA must also take account of the fact that their past engagement indicates that they could reengage at any time and this of itself acts as a competitive constraint.
31. Additionally, it is very important that the CMA takes proper account of the recent voluntary ending of auto-rollover by the largest SME/microbusiness retail energy suppliers, which we would expect to increase engagement. That said, we agree with the CMA that ending auto-rollover by only some suppliers purely on a voluntary basis would distort competition, and we would be supportive of a formal end to auto-rollover.

32. We do not consider that suppliers have UMP over their inactive customers. In the SME/microbusiness segment, as in the domestic segment, there is a see-saw pricing model, and as explained above in the section on domestic supply, the CMA would be misguided to assume that price discrimination is indicative of supplier UMP. The differences in prices between different product types observed by the CMA are again in part a reflection of the see-saw pricing model we describe above, and in part a reflection of the wholly different risks suppliers face, associated with different products offered by SME businesses.
33. The CMA comments on the significantly higher average profit margins in the SME segment than in the domestic or I&C segments. However, the CMA arbitrarily dismisses evidence in terms of the greater risks associated with supplying energy to SME/microbusiness customers. The CMA also fails to take account that margins have declined over the period reviewed. We have explained why we would not expect to see a return to the [CONFIDENTIAL] margins achieved in [CONFIDENTIAL] and [CONFIDENTIAL], and therefore looking at average margins across the period 2009 to 2013 will not give the CMA a realistic indication of the current state of competition in the SME energy market. As in the domestic segment, the competitive benchmarks that the CMA adopts are unrealistic and this can be illustrated most simply by the CMA's assertion that customers are overpaying for their energy by some £0.5 billion per year; RWE wishes to emphasise that if suppliers' revenues were £0.5 billion lower than they are, suppliers would be making losses and the industry would be unsustainable.

i. CMA's remedies under consideration

34. It is clearly evident that the CMA has failed to appreciate the differences between the domestic and SME segments when reviewing the remedies under consideration. The CMA will note from our comments above and our response to the RN that, in respect of the domestic segment, RWE is broadly supportive of many of the more sensible and measured remedies under consideration that are properly targeted at the underlying causes of an AEC. By contrast, some of these, and others that are seemingly aimed at making the SME segment more like the domestic segment, are wholly inappropriate for the SME segment. We explain above why negotiation can be very beneficial for business customers, allowing them to choose the tailored product that is right for them and to obtain the best price and terms. Some of the proposed remedies, such as those relating to price lists and PCWs, are not consistent with this feature of individual negotiation, and by discouraging or preventing negotiation, this will reduce rather than increase customer engagement. They could therefore have only limited use within the microbusiness segment for a subset of customers with very straightforward requirements.
35. RWE does consider that a package of remedies that includes a formal prohibition on auto-rollover, direct regulation of TPIS, and the provision by suppliers of clear product descriptions of all available products and information on how to obtain a tailored quote, will be effective in achieving the CMA's aims and addressing the underlying causes of the AEC the CMA has identified. However, as in the domestic segment and for all the reasons we set out in that section (which we do not repeat here), we consider that adding a safeguarding tariff to that package of remedies is unworkable, would have serious adverse effects on competition, is entirely disproportionate and not in the interests of consumers.

d. Gas and electricity metering and settlement

36. Gas: RWE accepts that the gas settlement system may not be optimal, but we consider that the concerns identified by the CMA will be largely addressed by implementation of Project Nexus. Implementation of Project Nexus should take place over an agreed timescale to go live on 1 October 2016.
37. As regards the CMA's concerns about incentives on shippers to place a higher priority on adjusting annual quantities ("AQ"s) down and delaying adjusting AQs up, we consider that this is a second order issue. Therefore, whilst we would support the introduction of mandatory monthly updates, we consider that it would make more sense that this should follow full implementation of Project Nexus and the smart meter roll out.
38. RWE considers that the gas meter inspection rules should be relaxed for all suppliers, and not only for Centrica, so that all suppliers are required to inspect gas meters every 5 years.

We consider that this would be the most effective and proportionate way of addressing the competitive advantage currently conferred on Centrica. In the longer term, we consider a risk-based approach should be developed.

39. Electricity: RWE accepts that the use of half-hourly consumption data to settle electricity will be a prerequisite for the widespread introduction of time of use tariffs, and that suppliers may not be able to encourage customers to change their consumption profile without the use of such data. However, the widespread introduction of time of use tariffs will only be feasible with the introduction of smart meters, and so it does not make sense to mandate the use of half-hourly consumption data before it is able to be used effectively.

e. Wholesale electricity market rules

40. RWE generally supports the CMA's provisional findings in respect of the wholesale electricity market rules and regulations.
41. RWE fully supports the provisional finding that the current system of uniform pricing for transmission losses is likely to result in significantly increased costs. Repeated cost benefit analyses of a locational losses scheme show an enhancement in customer welfare. Whilst the scale of benefits are uncertain, there is little doubt that Ofgem's conclusions in relation to the P229 (Proposed) remain valid under all reasonable analysis:
- 41.1 It increases cost reflectivity;
 - 41.2 There would be a decrease in losses and emissions;
 - 41.3 It more accurately reflects the impact of individual parties on transmission losses;
 - 41.4 It will improve the siting of generation and demand; and
 - 41.5 It addresses the cross subsidy in the current arrangements.
42. Given that the costs of implementing zonal losses are negligible, RWE considers that the CMA should implement its proposed remedy as soon as practicable.
43. As regards Contracts for Difference ("CfDs"), RWE agree with the CMA that the move from the Renewables Obligation to a more competitive allocation process is a positive step towards ensuring an efficient allocation of support. RWE also supports the CMA's provisional finding that the mechanism for allocating CfDs, whereby DECC may award CfDs directly to parties outside of a competitive process, may give rise to an AEC. In RWE's view, a competitive auction for CfDs is essential for any future allocation of low carbon contracts. RWE agrees also that DECC should undertake and consult (periodically) on a clear and thorough assessment before allocating technologies between pots and the CfD budget to the different pots. Additionally, to support effective competition in the short and long term, by protecting and preserving investor confidence, the overarching allocation framework should adopt a mechanistic approach, ensure major policy adjustments are absorbed with adequate lead times, and implement appropriate financial securities/Bid Bonds to ensure non-delivery and price volatility is minimised.

f. Governance of the regulatory framework and CMA's proposed remedies

44. RWE supports the CMA's provisional finding that there is a lack of robustness and transparency in regulatory decision-making, which increases the risk of policy decisions which are detrimental and have an adverse effect on competition, and that this constitutes an overarching feature giving rise to an AEC.
45. In this regard, we support the remedies under consideration by the CMA to promote robust and transparent decision making (more effective assessment of trade-offs between policy objectives and communication of impact of policies on prices and bills).
46. In particular it is essential for the CMA to consider the revision of Ofgem's statutory objectives and duties in order to ensure Ofgem promotes effective competition given the

detrimental impact Ofgem's measures have already had on competition over the relevant period.

47. RWE agrees with the CMA that financial reporting within the industry should be transparent, robust and should aim to build rather than detract from consumer confidence. This is an area where RWE will support and assist with the discussions in enhancing the information currently available. However, given the CMA's provisional finding that there are no fundamental issues with the operation and presence of vertical integration across value chains in the industry (which we support), there is no compelling need for significant changes to the current reporting framework and careful thought will be required in relation to the presentation of financial information on a segmental basis that is deeper than currently necessary under the CSS.
48. RWE believes that current reporting in the CSS provides considerable transparency in relation to the generation business, and highlights the main drivers of the supply business. The CSS is audited and prepared on the arm's length basis.
49. As regards codes, RWE considers that there is room for improvement of codes governance. RWE does not agree with the CMA's provisional finding however that the Six Large Energy Firms have limited incentives to promote and deliver policy changes. Nonetheless, RWE would be supportive of an independent codes adjudicator to decide on changes to codes. We would not support a remedy to grant Ofgem greater responsibility over developing and/or implementing code changes. Code changes should be managed by a single independent administrator, with uniform processes including a fixed maximum timetable for processing modification proposals, where the independent code adjudicator should take on the role currently carried out by Ofgem in relation to industry code modifications.

g. Conclusion

50. RWE supports the CMA's provisional findings in a number of areas. In particular, RWE is broadly supportive of the CMA's findings in relation to the operation of the wholesale markets, the impact of vertical integration, wholesale market rules and governance of the regulatory framework. On these issues, RWE commends the way in which the CMA has conducted its Investigation thus far and the thoroughness of the CMA's analysis and provisional findings on these issues.
51. In consequence, RWE is generally supportive of the remedies under consideration in these areas. In particular, RWE strongly advocates the need for a move to locational pricing of losses as soon as is practicable.
52. RWE considers that the CMA's analysis of the retail markets is less developed and that further work is needed between now and the CMA's final report. The CMA's provisional findings of weak customer response and supplier UMP in both the domestic and microbusiness segments are not supported by the evidence. The findings are based on certain key misconceptions and on a selective and sometimes inconsistent interpretation of the evidence.
53. The retail provisional findings are also based on evidence that is already out of date: the markets today are different to the markets even a year ago, and there is further positive change to come. So far, the CMA has not properly taken this into account and we hope that the CMA will take this opportunity properly to reflect on the developments.
54. Despite this, there are a number of domestic and microbusiness remedies under consideration that we support. We fully support regulatory changes including an end to RMR simpler choice and better regulation of domestic PCWs and microbusiness TPIs. We are not alone in calling for an end to RMR simpler choices, for which we note there is strong former regulator/academic support. We also support a number of the proposed remedies aimed at increasing customer engagement. We actively want to engage with our customers.
55. However, given that we do not think the CMA has properly demonstrated AECs of domestic or SME weak customer response/supplier UMP; given also that the CMA's provisional findings do not reflect current market conditions; and looking forward to the important

forthcoming developments, RWE considers that the introduction of a transitional safeguarding tariff would be entirely disproportionate and would seriously harm competition.

56. There will be much at stake for the GB energy markets and customers following the outcome of the CMA's Investigation. Therefore we would urge the CMA to reflect carefully on the valid concerns raised by RWE in relation to the CMA's provisional findings of weak customer response/supplier UMP in both the domestic and SME segments, and to address these in order that it can arrive at a final decision that is robust and supported by the evidence.

C. INTRODUCTORY REMARKS ON THE PROPER BASIS FOR THE CMA'S FINDINGS

57. There is much to commend about the way in which the CMA has conducted its Investigation thus far and about the thoroughness of the CMA's analysis and provisional findings on a number of issues (see in particular our comments in Section D and Sections E and I). There are other areas of the Investigation where we consider there is still considerable work to be done in order for the CMA to arrive at findings that are founded properly in the evidence and therefore robust and reliable; notably certain key areas of the CMA's analysis of the retail energy supply markets (see further our comments in Sections F, G and H).
58. The CMA is required to decide "*whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of goods or services in the United Kingdom or a part of the United Kingdom*".² In doing so, the CMA's benchmark is that of a "*well-functioning market*" and not an "*idealized, perfectly competitive market*".³
- 58.1 There are a number of respects in which the CMA appears to assess the GB energy supply markets not against the benchmark of a well-functioning market but against a perfectly competitive market. For example:
- 58.2 The CMA's gains from switching analysis, on which the CMA places great weight (to identify lack of customer engagement and supplier unilateral market power), seeks to identify the potential gains from switching to the cheapest tariff in the market (within a set of parameters). It treats any unexploited gains as evidence of weak customer response. This assumes that every customer has access to perfect information, cares only about price, and chooses to switch to the cheapest available tariff, irrespective of the non-price attributes of the tariff the customer has chosen.
- 58.3 The CMA's price benchmarking makes adjustments to both wholesale costs and indirect costs that assume a supplier could achieve significantly below industry average costs across its business. This is unrealistic. Firms face a number of real options to invest in different cost reduction projects and cannot simultaneously undertake all possible options to reduce costs. Without taking such differences into consideration, it is not appropriate to establish a 'competitive benchmark' based on better-than-average performance in all categories. In this regard, the CMA appears to adopt an unrealistic assumptions as to how a business would operate. Additionally, the CMA is particularly selective in its application of efficiency adjustments.
59. The CMA's analysis is influenced by its own preconceptions as to how the markets operate, and at times the CMA exhibits confirmation bias, i.e. the CMA interprets the evidence/its analysis in a way that confirms its own hypotheses. For example:
- 59.1 The CMA identifies material potential gains from switching, and attaches particular significance to the level of the gains available for what the CMA regards as homogeneous products.⁴ However, as we explain further below, the level of the gains is significantly overstated precisely because the CMA has treated electricity and gas supply as

² Section 134(2) of the Enterprise Act 2002.

³ CC3 (Revised), Guidelines for market investigations: Their role, procedures, assessment and remedies, page 11 paragraph 30.

⁴ PFs, Summary, page 6, paragraph 22; Summary, pages 25-27, paragraphs 112-117; Chapter 2, page 91, paragraph 2.254; Chapter 7, page 282, paragraph 7.184; Chapter 7, page 284, 7.188; Chapter 8, page 310, paragraph 8.74.

homogeneous products and has disregarded a number of important product characteristics and customer preferences. The CMA assumes that customers only value price, yet seems to accept elsewhere in its PFs, for example, when considering the impact of RMR, that product offerings from energy suppliers are not in fact homogenous.

- 59.2 In particular, the CMA's stance that products are homogenous⁵ sits uncomfortably with the evidence available to it on the impact of RMR which the CMA considers to have limited innovation.⁶ It is not clear how the CMA reconciles its view that innovation is important with its view that suppliers' products are homogenous and therefore prices should not vary as a result of either non-price attributes or tariff innovation. There simply cannot be product innovation in homogenous product industries.
- 59.3 On a related point, the CMA also assumes that there are no features of standard variable tariffs ("SVTs") that are likely to be attractive to customers or, for example, that paying by direct debit is necessarily more convenient than paying by standard credit and therefore preferable to all consumers, and these assumptions drive its provisional findings around customer disengagement.⁷
- 59.4 The CMA provisionally finds that suppliers are price discriminating as between SVT and non-standard customers, which the CMA considers is suggestive that they hold a position of unilateral market power over certain customer segments.⁸ At the same time the CMA provisionally finds that suppliers are able to exploit a position of unilateral market power, for example through price discrimination. RWE submits that the CMA's conclusion that price discrimination is evidence of unilateral market power sits uncomfortably with the CMA's conclusion that Ofgem's decision to ban price discrimination between regions (SLC 25A) contributed to a softening of competition on the SVT⁹ and is not fully appreciative of the 'see-saw' competitive dynamic. On the other hand, such a conclusion sits much more comfortably with modern mainstream economists' view of price discrimination – that prices are often not purely cost reflective even in highly competitive industries.
60. We would emphasise that it is important that the CMA reaches its conclusions based on a preponderance of the evidence. Whilst naturally, the CMA may conclude it is appropriate to attach more weight to some analyses/evidence than others, it ought to be possible to do so without being unduly selective in the evidence on which the CMA relies. The evidence should also be interpreted in a way that is consistent. For example:
- 60.1 We continue to have serious concerns about the weight the CMA places on its analysis of the return on capital employed ("ROCE") of the Six Large Energy Firms. The CMA notes that ROCE is the "*standard approach*" to measuring out-turn profitability,¹⁰ as it takes account of the capital required to operate the business, and the CMA uses ROCE as its preferred measure of profitability. As we have submitted on several occasions to the CMA, whilst it may be the CMA's standard approach, we do not believe that it is fit for purpose in this instance. RWE continues to have very serious concerns about the appropriateness of a ROCE analysis for an asset-light retail energy supply business, given the real difficulty in properly reflecting the value of all economic capital employed, which is needed in order to obtain a robust and reliable estimate of ROCE. The weakness in the ROCE analysis is demonstrated by the fact that an EBIT margin of only 3% (within the CMA's benchmark of 1-3%) would result in a ROCE of 23%, which is significantly above what the CMA calculates as the cost of capital; if nothing else, this inconsistency should cause the CMA to question its ROCE analysis.

⁵ PFs, Summary, page 6, paragraph 22; Summary, page 18, paragraph 82; Summary, page 27, paragraph 117; Chapter 4, page 111, paragraph 4.6; Chapter 4, page 136 paragraph 4.79; Chapter 7, page 236, paragraph 7.10.

⁶ PFs, Summary, page 31, paragraph 141; Summary, page 32, paragraph 143; Chapter 8, paragraph 8.245, page 354.

⁷ PFs, Summary, page 20, paragraph 90; Chapter 7, page 249, paragraph 7.66; Chapter 7, page 266, paragraph 7.122; Chapter 8, page 305, paragraph 8.48.

⁸ PFs, Summary, page 30, paragraph 135.

⁹ PFs, Summary, page 31, paragraph 141; Summary, page 32, paragraph 143; Chapter 8, page 354, paragraph 8.245.

¹⁰ PFs, Chapter 10, page 407, paragraph 10.9.

- 60.2 Further in relation to the CMA's profitability analysis, we have concerns that the CMA places weight on certain profit margin comparators whilst disregarding others, and has not explained the basis on which it accepts the views of certain third parties over those of the Six Large Energy Firms.
- 60.3 In the gains from switching analysis, the CMA uses the potential gains available to SVT customers as evidence that these customers are disengaged¹¹ and that suppliers have unilateral market power over them, whilst implicitly assuming that the potential gains from switching available to non-standard customers are consistent with a competitive market in which customers are engaged. This is inconsistent when the gains for SVT customers and non-standard customers differ by as little as £33. Moreover, RWE understands that the gist of the Confidential Submission made by its Authorised Advisers on the CMA's gains from switching analysis – following the Disclosure Room – is that the CMA's measured potential gains from switching do not differ very much between those who have, and those who have not, switched recently. Such a finding is consistent with RWE's submission that price differences (and so the CMA's measured potential gains from switching) arise in part because consumers value non-price attributes. However, such a finding appears wholly inconsistent with the CMA's primary thesis that engaged customers are price sensitive and so benefit from low prices while disengaged customers pay high prices and so would gain enormously from switching tariff.
- 60.4 There are also a number of instances on which the CMA relies on certain results from the GfK customer survey but fails to present (or otherwise fails to take into account) other results that present a conflicting view. There are also instances where the way in which the CMA presents the GfK results is liable to mislead. Furthermore, the relative weight the CMA places on its five measures of customer engagement is in places inconsistent for reasons that are not provided.
61. It is important that the CMA not only identifies any important limitations to the reliability or relevance of the evidence/analyses, but also that the CMA properly takes these limitations into account in reaching its conclusions and, where appropriate, explains how it will reconcile any data limitations. There are instances where the CMA's provisional findings are neither caveated by reference to data limitations nor explain what further steps the CMA will take. For example:
- 61.1 In its competitive price benchmarking, the CMA acknowledges in principle that suppliers may legitimately operate different business models, which may influence costs, and the CMA appears to acknowledge that by equating lower quartile costs with efficient costs without controlling for differences in the customer base, the CMA may over- or understate the potential for cost savings. Yet this acknowledgement is not taken into account in the CMA's provisional conclusions. Despite this major limitation, the results of the CMA's competitive price benchmarking are key to the CMA's provisional finding that suppliers have unilateral market power and are able to charge some customers prices that are not justified by costs. In its provisional conclusions, the CMA does not properly acknowledge that this finding is highly sensitive to the adjustments made in its competitive price benchmarking. We consider it important that the CMA revisit these adjustments.
- 61.2 There are a number of other instances where the CMA duly acknowledges concerns raised by the parties but does not properly take these into account when deciding how much reliance to place on the evidence/analysis in question (or does not propose any follow up work to resolve the limitations). In particular, when there is significant weight of argument and consensus amongst the parties, we query the reasons why the CMA would disregard them. As a result there is a significant risk that the CMA will reach conclusions that are not properly supported by the evidence.
62. It is not obvious to RWE that the outcomes measured by the CMA, and on which it relies for its findings for an AEC, flow from the causes of apparent disengagement that the CMA has identified.

¹¹ PFs, Chapter 8, page 310, paragraph 8.74.

D. WHOLESALE ENERGY MARKETS AND VERTICAL INTEGRATION

a. Wholesale market competition

63. RWE welcomes the CMA's provisional finding that there are no features of the wholesale gas markets that lead to an AEC.¹²
64. RWE also welcomes the CMA's provisional finding that electricity generators do not have unilateral market power.¹³
65. RWE agrees with the CMA's provisional finding that no single generator had the incentive to increase the wholesale price by a significant amount in a significant number of half-hour periods.¹⁴ RWE would add that it also does not have the *ability* to withdraw capacity in generation through the exercise of unilateral market power.
66. RWE agrees with the CMA's provisional finding that there is no evidence that the Six Large Energy Firms earned excessive profits from their generation businesses over the period 2009 to 2013 or that wholesale market prices were above competitive levels.¹⁵ The CMA provisionally finds that, between 2009 and 2013, returns were generally in line with or below the cost of capital.¹⁶ RWE agrees with this and would add that [CONFIDENTIAL]

b. Wholesale electricity market rules and regulations

67. RWE generally supports the CMA's provisional findings in respect of the wholesale electricity market rules and regulations.¹⁷
68. RWE supports the CMA's provisional finding that there would be no benefits to competition from a move from the current self-dispatch system to a more centralised system of dispatch.¹⁸ RWE considers that the current self-dispatch BETTA arrangements deliver significantly more efficiency and transparency in the determination of market prices than centralised dispatch and additionally that they deliver significantly greater efficiency compared with a model based on day ahead mandatory scheduling.
69. RWE supports the CMA's provisional finding that the current system of uniform charging for transmission losses distorts competition between generators and may lead to an AEC.¹⁹ RWE agrees with the CMA that the current system is likely to result in significantly increased costs, since the cross-subsidy inherent in the current system leads to plants generating when it might be more efficient for other plants to do so. RWE agrees also that the current system may lead to the inefficient location of plants. Consumers have incurred significant excess costs over the last 25 years and the proposed remedy should be implemented as soon as is practicable. See further Section E below.
70. RWE supports the CMA's provisional decision not to investigate further whether the absence of locational pricing for transmission constraints is a feature of the market that constitutes an AEC. As set out in RWE's response to the CMA's locational pricing working paper, RWE considers that proposals to manage constraints through market splitting or nodal pricing raise a number of complex economic interactions and potential unintended consequences

¹² PFs, Summary, page 8, paragraph 32; Chapter 4, page 120, paragraph 4.40; Chapter 4, page 143, paragraph 4.105.

¹³ PFs, Summary, page 9, paragraph 38.

¹⁴ PFs, Summary, page 9, paragraph 37; Chapter 4, page 139, paragraph 4.87.

¹⁵ PFs, Summary, page 9, paragraph 38.

¹⁶ PFs, Summary, page 9, paragraph 38; Chapter 4, page 139, paragraph 4.88; Chapter 11, page 440, paragraph 11.21.

¹⁷ PFs, Summary, pages 9-10, paragraphs 39-40; Chapter 5, pages 202-205, paragraphs 5.250-5.261.

¹⁸ PFs, Summary, page 10, paragraph 42; Chapter 5, page 149, paragraph 5.24; Chapter 5, page 150, paragraph 5.29; Chapter 5, page 151, paragraph 5.30.

¹⁹ PFs, Summary, page 11, paragraph 44; Summary, page 11, paragraph 45; Chapter 5, page 158, paragraph 5.58; Chapter 5, page 163, paragraph 5.77; Chapter 5, page 203, paragraph 5.252; Chapter 12, page 473, paragraph 12.2.

and RWE supports the CMA's decision not to investigate further locational pricing of transmission constraints.

71. RWE supports the CMA's provisional finding that the move to a single imbalance price will be positive for competition.²⁰ The CMA provisionally finds that, whilst it has not seen strong evidence in favour of a move to reserve scarcity pricing ("RSP"), there are insufficient grounds to consider that it is likely to lead to an AEC.²¹ RWE agrees with this. RWE believes that the introduction of reserve scarcity pricing is complementary to the capacity market and will lead to more efficient short-term price signals.
72. RWE supports the CMA's provisional finding that there are cogent arguments for introducing a capacity mechanism.²² Whilst RWE would be supportive of changes to rules that allow all providers of firm capacity to compete in the capacity market on equal terms, RWE does not disagree with the CMA's provisional finding that the design of the capacity market appears "*broadly competitive*".²³
73. As regards Contracts for Difference ("CfDs"), RWE agrees with the CMA that the move from the Renewables Obligation to a more competitive allocation process is a positive step towards ensuring an efficient allocation of support.²⁴ RWE also supports the CMA's provisional finding that the mechanism for allocating CfDs, whereby DECC may award CfDs directly to parties outside of a competitive process, may give rise to an AEC.²⁵ In RWE's view, a competitive auction for CfDs is essential for any future allocation of low carbon contracts; RWE agrees also that DECC should undertake and consult on a clear and thorough assessment before allocating technologies between pots and the CfD budget to the different pots. See further Section E below.

c. Vertical integration

74. RWE agrees with the CMA that there are some efficiencies resulting from VI which may be passed through to consumers and therefore supports the CMA's provisional finding that firms' VI structures do not give rise to an AEC.²⁶
75. See Section I below for our comments on the CMA's provisional finding that a lack of regulatory requirement for clear and relevant financial reporting concerning generation and retail profitability gives rise to an AEC.²⁷

E. WHOLESALE MARKET RULES PROVISIONAL FINDING OF AECs

a. Locational pricing

76. RWE fully supports the CMA's provisional finding that the current system of uniform pricing for transmission losses creates a system of cross-subsidisation that distorts competition between generators and is likely to have both short- and long-run effects on generation and demand.
77. We explain in this section why the CMA should implement its proposed remedy as soon as practicable and can be confident as to the effectiveness and proportionality of the proposed remedy given the extensive amount of work already available on this topic. This work in our view strongly supports the provisional findings and the proposed remedy.

²⁰ PFs, Chapter 5, page 169, paragraph 5.100.

²¹ PFs, Chapter 5, page 169, paragraph 5.100.

²² PFs, Summary, page 13, paragraph 55; Chapter 5, page 204, paragraph 5.257.

²³ PFs, Chapter 5 page 283, paragraph 5.166; Chapter 5, page 204, paragraph 5.257.

²⁴ PFs, Summary, page 14, paragraph 62; Chapter 5, page 188, paragraph 5.186.

²⁵ PFs, Summary, page 16, paragraph 68; Chapter 5, page 204, paragraph 5.260.

²⁶ PFs, Summary, pages 16-18, paragraphs 69-75; Summary, page 18, paragraph 79.

²⁷ PFs, Summary, page 44, paragraph 205; Chapter 11, page 455, paragraph 11.86; Chapter 12, page 478, paragraph 12.10.

The proposed remedy will be effective

78. Repeated cost benefit analyses of a locational losses scheme show that it results in enhanced customer welfare (see also Annex 1).²⁸ Whilst the scale of the benefits is uncertain, there is also little doubt that Ofgem's conclusions²⁹ in relation to the P229 (Proposed) remain valid under all reasonable analysis:
- 78.1 **It increases cost reflectivity** *"The P229 proposals would increase cost reflectivity and therefore allocate costs more appropriately";*
- 78.2 **There would be a decrease in losses and emissions:** *"The increased cost reflectivity of the P229 proposals should result in more efficient dispatch due to the cost signals allowing variable losses to be taken into account, leading to production cost savings, reduced losses and reduced emissions";*
- 78.3 **There is no disproportionate effect on any generator:** *"P229 more accurately reflects the actual impact of individual parties on transmission losses";*
79. **It will improve the siting of generation and demand:** *"All parties should face the costs of losses alongside the costs of carbon, fuel, land, labour, and in the long term this should promote competition overall";* and
- 79.1 **It addresses the cross subsidy in the current arrangements:** *"The P229 proposals would help to create a more level playing field for generators".³⁰*
80. Whilst further analysis may provide different views as to the magnitude of the P229 (proposed) benefits, we do not believe they would alter the conclusion that material benefits exist. We would also note that we are not aware of any parties arguing that the regulator's conclusions outlined above are not valid. In actual fact there are a number of factors which will influence net transmission losses, exacerbating the adverse effect on competition identified by the CMA and the benefits identified by Ofgem under P229. For example:

"These include: variations in zonal generation patterns, the level of Scottish exports to the E&W system, changes in interconnector net exports, the level of part loaded plant, the degree of geographic dispersal of plant and demand growth. In this case, it is the change in the geographical distribution of generation across the transmission network that is anticipated to have the greatest impact on future losses. In particular, with more generation connected on the periphery of the transmission network, power has further to travel to demand centres and existing local circuits will experience heavier loading. Both of these factors will culminate in higher losses (I²S). The expected continued change in generation

²⁸ See for example:

- **"The Welfare Effects of Locational Transmission Loss Factors in the British Wholesale Electricity Market"**, Prepared for RWE, 11 May 2015 Confidential submission to the CMA
- **"Cost Benefit Analysis of Modification Proposal P229: Changing to Zonal Seasonal Loss Factors"**, A report for Elexon by London Economics and Ventyx, October 2009 at https://www.elexon.co.uk/wp-content/uploads/2012/02/p229_proposed_cba_report_v1.01.pdf;
- **"P229 Cost Benefit Analysis: Additional scenarios"**, A report on a study for Ofgem, October 2010 at https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/lot-report-2_0.pdf ;
- **"What are the costs and benefits of zonal loss charging?"** Report prepared for Elexon by Oxera, June 2006 at https://www.elexon.co.uk/wp-content/uploads/2012/02/p198_cost_benefit_analysis_report_final.pdf
- **"The impact of average zonal transmission losses applied throughout Great Britain"**, Oxera report for Department of Trade and Industry, June 2003, at <http://www.oxera.com/Latest-Thinking/Publications/Reports/2003/The-impact-of-average-zonal-transmission-losses-ap.aspx>

²⁹ "Balancing and Settlement Code (BSC) P229: Introduction of a seasonal zonal transmission losses scheme", Ofgem decision letter, 28 September 2011, at https://www.ofgem.gov.uk/sites/default/files/docs/2011/09/p229-d_0.pdf (the Ofgem P229 Decision).

³⁰ Ofgem P229 Decision, pages 3-5.

*distribution is in part driven by, but not limited to, the connection of low carbon technologies*³¹

The proposed remedy is proportionate

81. The well-known (and rehearsed) arguments against the implementation of a zonal losses scheme can be summarised as:
 - 81.1 The cost and complexity of implementation;
 - 81.2 Distributional impact; and
 - 81.3 European legislation requiring locational pricing anyway.
82. We address each of these in turn.
83. As regards cost and complexity of implementation, as noted in our previous submission to the CMA, the Balancing and Settlement rules were designed to allow the implementation of a zonal transmission losses scheme.^{32 33} Therefore, it is reasonable to assume that a prudent operator would have designed its systems to allow for such a change to be easily implemented.
84. This view is fully supported by all cost benefit analyses on this topic which assumes that the transitional costs of implementing zonal losses are negligible. For example, the LE/Ventyx CBA³⁴ was based on total implementation costs estimates of £2.8 to £4.1 million across the whole industry (see Annex 2).
85. The implementation costs should be compared against the material benefits of a locational losses scheme (which range from £6.7 to £884 million, see Annex 1). In all modelled outcomes this is greater than 1.6 times the costs of implementation (return on investment), and could be more than 100 times the costs (return on investment). As Ofgem noted in its decision on P229, *"the implementation costs are low relative to the prospective benefits over 10 years"*.³⁵ Therefore, there is a clear and compelling case for implementation of a locational losses scheme.
86. As regards the distributional impact of a locational losses scheme, this has been highlighted as an argument against implementation. For example, Ofgem suggested under P229 that

³¹ National Grid Strategy Paper, National Grid's strategy paper to address Transmission Licence Special Condition 2K: Electricity Transmission Losses, November 2013, revised September 2014 at <http://www2.nationalgrid.com/UK/Industry-information/Electricity-system-operator-incentives/transmission-losses/> (the National Grid Losses Strategy).

³² For example in the "Ofgem Transmission Access and Losses" consultation document Ofgem stated the following: *"Ofgem believes that enduring arrangements for transmission losses should be designed to expose participants to the costs of locational marginal losses. We accept that this could be achieved in different ways. However, of the approaches considered in this document, we believe that Option 1, which involves adjusting participants' metered volumes using estimates of average zonal loss factors with a separate financial payment or levy to reflect the Difference between estimated marginal loss factor and the average loss factors used to adjust metered volumes, would best meet the objectives set out in Chapter 3. Under this approach, effective short term signals would be sent to all participants as to the costs of transmission losses. This approach also fits well with the framework for traded wholesale electricity markets established by NETA, since participants would have the opportunity to manage their exposure to the costs of transmission losses."*, Ofgem, May 2001, Page 83, Paragraph 6.2 at <https://www.ofgem.gov.uk/sites/default/files/docs/2001/05/3701---transmission-access-and-losses-under-neta---a-consultation-document--2205.pdf>

³³ Transmission Access and Losses Conclusions, Ofgem Factsheet 14, 25th February 2002: Includes the following: **"Scotland** These transmission access and losses proposals apply to England and Wales only. Reforms to the Scottish generation market are underway to create a British-wide Electricity Trading and Transmission Arrangements (BETTA). These reforms will bring more competition to this market, putting greater pressure on customer prices. They will also create a wider market for traditional and new renewable forms of Scottish electricity generation. As part of BETTA, new transmission access and losses arrangements will need to be extended to Scotland. At https://www.ofgem.gov.uk/sites/default/files/docs/2002/02/1097-factsheet0402_26feb.pdf

³⁴ London Economics/Ventyx report, page 24, see Annex 2.

³⁵ Ofgem P229 Decision, page 5.

"proposals have a large distributional impact, both between individual generators and between suppliers/consumers".³⁶ However, the distributional impact of a locational losses scheme only occurs to the extent that there is already a cross-subsidisation that exists.

87. Ofgem suggested that the *"potential adverse consequence of the high distributional impact might be justified by the longer-term benefit from a more efficient, cost reflective market".³⁷* It is our view that locational signals under a zonal losses scheme such as P229 (proposed) should be an integral part of a more economic and efficient electricity market. As we have noted, Ofgem concluded that P229 was both more cost reflective and efficient (see above) and as noted in this response, the consistent evidence from cost benefit analyses is that a locational losses scheme will provide long term benefits to customers.
88. Moreover, we are not clear as to why the CMA would wish to consider the distributional impact among one cohort of stakeholders, in this case generators, given the overwhelming evidence already set out that the benefits to the generality of customers will be materially positive under all conceivable scenarios.³⁸ The fact that one group of generator stakeholders loses out to another group of generator stakeholders by virtue of improving the economic signals in the design of the electricity market merely demonstrates the fact that cross-subsidies have persisted between these generators for some 25 years and not that such changes should not be implemented.
89. Further, as the CMA notes in Appendix 5.2, we would argue that given that this has been the direction of travel of many, many years³⁹ and is the most economically efficient outcome, it is reasonable to assume that such a change should have been considered in any investment since privatisation and indeed has been taken into account in significant strategic decisions taken by RWE.⁴⁰
90. European legislation requiring location pricing. In its decision on P229, Ofgem raised concerns that the debate at the European level over "market splitting" could *"create multiple price areas within a national system and implies 'locational' energy prices".⁴¹* Ofgem suggested that the benefits of the P229 proposals *"could be overtaken relatively quickly by some other scheme".* This contributed to their conclusion that *"implementation of P229 would not be consistent with good regulatory practice".*
91. We do not understand Ofgem's consideration of P229 in the context of European issues. There is no EU requirement in the network codes to address zonal transmission losses as part of "market splitting". Market splitting would result in different pricing zones, where zones are defined in relation to congestion on the transmission system, and where local prices reflect the conditions within these local markets (including the costs of transmission and losses). There is no reason why a locational losses scheme, perhaps based on P229 would be less compatible with market splitting than the status quo.

³⁶ Ofgem P229 Decision, page 6.

³⁷ Ofgem P229 Decision, page 6.

³⁸ The HMT Green Book indicates that distributional analysis should be a consideration in the appraisal and evaluation of proposals. The Green Book can be found at: <https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-government>.

³⁹ See for example:

- "Zonal Transmission Losses in the GB Electricity Market A Review of Statements by Ofgem and Others" 31 July 2006, Skyplex Consulting, at <https://www.ofgem.gov.uk/ofgem-publications/62046/17145-060731-review-070305.pdf> ; and
- Transmission Access and Losses, Ofgem, May 2001 at <https://www.ofgem.gov.uk/sites/default/files/docs/2001/05/3701---transmission-access-and-losses-under-neta---a-consultation-document--2205.pdf>.

⁴⁰ RWE and its predecessor companies took certain decisions to divest certain power stations that were influenced in part by the direction of travel associated with locational signals in the GB market. [CONFIDENTIAL]

⁴¹ Ofgem P229 Decision, page 6.

92. The Electricity Directive⁴² clearly establishes the national competences of the relevant National Regulatory Authorities with respect to transmission and distribution activities. There is no specific requirement with respect to the allocation of transmission losses under the Directive, and certainly no requirement to align transmission losses across member states (except to the extent that this affects cross border trading).
93. Specific transmission loss arrangements have been introduced for GB electricity interconnectors (where the loss factors have been set to 1)⁴³ and this seems to address the concerns expressed by Ofgem under P229 with regard to market splitting. Adopting this approach to any interconnection between regional markets would facilitate market splitting within GB. Furthermore, the current settlement arrangements with integrated transmission losses based on the Balancing and Settlement Code arrangements would remain integral to each regional market created as a result of market splitting.

The need for an Order

94. We recognise the history of locational transmission losses as outlined by the CMA. This torrid tale of code modifications, regulatory decisions, appeals and legal challenges illustrates that this is an issue that will not be resolved by bipartisan agreement under existing industry processes. Already, as a result of the current economically inefficient charging of transmission losses, consumers have incurred significant excess costs for 25 years as a result of industry inaction. That, in RWE's view, is 25 years too long and only a firm, timely and specific order from the CMA will start to resolve this issue.

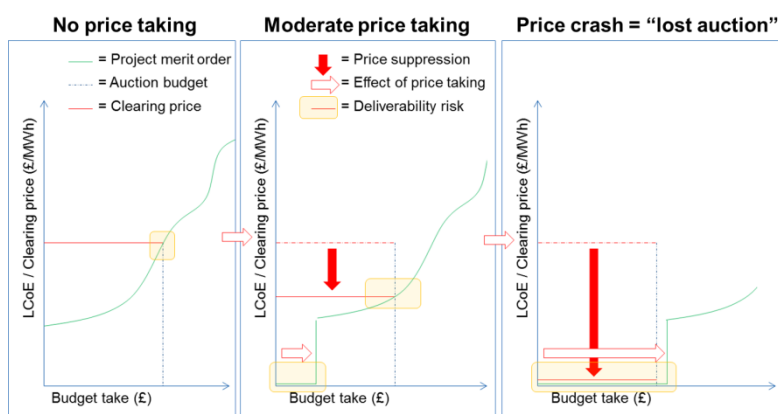
b. Contracts for differences

95. RWE welcomes the CMA's provisional finding that the recent allocation of CfDs on a non-competitive basis has led to the inefficient distribution of market support. RWE shares the CMA's concerns that DECC retains the power to award CfDs outside the auction process without sufficient constraints.
96. RWE supports the CMA's provisional finding that competitive allocation of CfDs is likely to be a more efficient means of providing support in most cases. We agree with the CMA that efficient outcomes are dependent on there being "*effective competition*". We therefore support the recommendation that DECC carry out a clear and thorough assessment of the impact of any proposal to use its powers to allocate CfDs outside a competitive process, which in our view should also be fully transparent. See further our response to the RN.
97. Having considered the results of the first CfD Allocation Round, we wish to highlight an issue that could potentially undermine effective competition in the medium term if left unaddressed in future auctions. We believe both technology pots exhibited "price taking" behaviour, i.e. where developers strategically bid below any realistic project price estimate. Such practice minimises allocation risk for the developer, but at the expense of price and deliverability risk. Such practice also leads to clearing price suppression, increased deliverability risks for other auction participants. See Figure E.b.1 below.

⁴² Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC.

⁴³ Balancing and Settlement Code (BSC) P278: Treatment of Transmission Losses for Interconnector Users, Ofgem decision letter, 1st May 2012, which states: "*We recognise that the modification proposal seeks to reflect the requirements of the recently transposed Third Package as it would align the UK treatment of interconnector links with the default position across Europe. Furthermore we note that it would facilitate the implementation of the EU Target Model as it would remove a potential obstacle to cross-border trade and therefore facilitate the development of a single European electricity market. Thus we consider that P278 would better achieve [BSC] Objective (e)*" at <https://www.ellexon.co.uk/mod-proposal/p278-treatment-of-transmission-losses-for-interconnector-users/>.

Figure E.b.1: Impact of price taking behaviour



98. Any price taking behaviour can lead to inefficient allocation through:
- 98.1 Non delivery – which undermines government environmental objectives and energy security;
- 98.2 Unpredictable auction price volatility – which undermines investor confidence.
99. Non delivery of CfDs will reduce the volume of low carbon secured through allocated public support, potentially to the extent that such reductions cannot be replaced in a timely manner, with the result that government objectives are undermined.
100. Auction price volatility will reduce developer ability to accurately forecast future allocation and price risk. Lowered investor confidence could result in risk 'premiums' being priced into future auctions, as well as lower liquidity of developers and/or projects leading to a loss of 'effective competition' in the medium term. This would increase auction clearing price and harm consumer interests.
101. Price taking behaviour occurred in the first CfD auction (See 2 solar PV projects which failed to sign offered CfDs) because there were insufficient protective measures, or penalties, in place to prevent or deter such practice. RWE believes adequate measures (e.g. Bid Bonds/Delivery Deposits) are required for future CfD allocation to guard against speculative bidding behaviour.
102. As regards the Renewables Obligation, we agree with the CMA's provisional view that the RO is unlikely to have a "material adverse effect on competition in future CfD competitive allocation rounds".⁴⁴
103. We agree with the CMA that "a central benefit of the move from ROCs to CfDs is....the level of support provided to low carbon generators". However RWE would highlight the further benefit of CfDs in providing price stabilisation, which enables continued investment in the future world of wholesale electricity prices that are not only more volatile, but are also significantly suppressed by virtue of "merit order effects" owing to large operational volumes of low marginal cost plant.

F. GB RETAIL ENERGY SUPPLY MARKETS: KEY MISCONCEPTIONS

104. There are a number of factual issues about the operation of the retail energy supply markets that the CMA appears to have misconstrued in its Provisional Findings, which have an important bearing on the CMA's provisional conclusions around the existence of AECs. It will be important that the CMA corrects these misconceptions.

⁴⁴ PFs, Chapter 5, pages 199-200, paragraph 5.235.

a. Nature of electricity and gas supply

No homogeneity

105. The CMA describes gas and electricity as “*homogenous good[s], in that the products themselves are unaffected by the choice of supplier, which means that customers are likely to attach a particular importance to the price of energy.*”⁴⁵
106. This assumption as stated is carefully worded. However, in other places the CMA goes beyond this carefully worded statement towards a position much closer to an incorrect assumption that product offerings from gas and electricity suppliers are homogenous.
- 106.1 For example the CMA discusses the causes of price variation and writes:
- “We observe that there is a wide range of tariffs and a striking variation in price level, particularly for a homogenous product.”*⁴⁶
- 106.2 In discussing the differences between domestic customers and SMEs the CMA writes in a manner that draws no distinction between the offerings from suppliers and the raw physical energy delivered to consumers:
- “There are a number of broadly similar characteristics of the retail supply of gas and electricity to SME customers (including microbusinesses) and domestic customers, such as (i) the same major suppliers, and (ii) the same fundamental characteristics concerning energy supply (eg homogeneity and traditional meters and bills)...”*⁴⁷
107. The CMA specifically concludes that homogeneity may act as a fundamental barrier to customer engagement,⁴⁸ so that it is key to a number of the CMA’s provisional findings. For example, the CMA finds that the unexploited gains of switching are high for a homogeneous product indicating a weak domestic customer response.⁴⁹ We therefore address this issue upfront. We return to it in Sections G and H.
108. RWE agrees, of course, that the actual gas or electricity supplied to the customer is unaffected by the choice of supplier and also that customers care about the price of energy. However, such observations certainly do not mean that the retail service associated with energy supply is itself a homogeneous product. Many retailers sell the same physical product (a specific book on a website for example) and yet retailers will manage to differentiate both their offer to customers and also their business strategies. In a fully competitive and liberalised retail energy market, suppliers can and will seek to differentiate their product offering for competitive advantage. The CMA appears to recognise this to some extent. For example, in looking at the nature of competition in the domestic retail energy markets, the CMA acknowledges that “*Households are also likely to place some value on other attributes of the supplier and/or tariff, including the convenience of the payment method and the quality of customer service offered by the supplier.*”⁵⁰ The CMA’s provisional findings in relation to the impact of RMR, i.e. that it has limited innovation,⁵¹ also seems to implicitly acknowledge the retail energy supply is not a homogeneous product. There cannot be product innovation in a homogeneous product industry.
109. In respect of the ‘fundamental barrier of homogeneity,’ RWE submits that:

⁴⁵ PFs, Chapter 7 page 234, paragraph 7.4.

⁴⁶ PFs, Chapter 2, page 90, paragraph 2.152.

⁴⁷ PFs, Chapter 3, page 104, paragraph 3.22

⁴⁸ PFs, Chapter 7, page 236, paragraph 7.13; Chapter 9, page 403, paragraph 9.112.

⁴⁹ PFs, Summary, page 26, paragraph 177; Chapter 7, page 285, paragraph 7.192; Chapter 8, page 291, paragraph 8.3.

⁵⁰ PFs, Chapter 7, page 234, paragraph 7.4.

⁵¹ PFs, Summary, page 31, paragraph 141; Summary, page 32, paragraph 143; Chapter 8, page 354, paragraph 8.245.

- 109.1 First, that the evidence the CMA relies upon to draw a connection between 'homogeneity' and a lack of customer engagement is unconvincing.
- 109.2 Second, that the evidence clearly shows that energy suppliers do not, as the CMA argues, provide homogenous product offerings.
- 109.3 Third, that the evidence of variation in prices across tariffs is not persuasive evidence of 'gains from switching' or more generally of there being a competition problem.
- 110. In respect of the first point, RWE submits that the CMA's reliance on evidence from the GfK customer survey to support an impact of product homogeneity on customer engagement is unconvincing:⁵²

"We have considered whether the survey sheds light on the potential impact of product homogeneity on customer engagement. Of those respondents who had never considered switching tariff, 14% said that they could not be bothered or it was too much effort, and 13% said they were not interested. Similarly, for those respondents who had never considered switching supplier, 15% said they could not be bothered or it was too much effort, and 14% said they were not interested. However (as discussed previously in relation to respondents' expressions of satisfaction as a reason for not considering switching), we note it is likely to be inherently difficult for respondents to answer the question, 'why have you not ever considered switching?'"

- 110.1 In fact, the CMA's survey evidence relied upon for this argument says absolutely nothing about the impact of product homogeneity on customer engagement. It simply says that of the customers who were aware they could switch but said they had never considered switching (less than 30%) just 14% said they could not be bothered or it was too much effort to consider switching while 13% said they were not interested. The survey cited by the CMA provides no evidence whatsoever as to the causes of such lack of interest and the CMA cannot rationally claim otherwise.
- 111. In relation to the second point, RWE first notes that the CMA has been provided with extensive evidence in respect of the impact of RMR which also clearly contradicts the the CMA's contention that suppliers' product offerings can properly be considered homogeneous. The CMA notes a range of practical impacts of RMR's simpler tariff rules on innovation⁵³ (one cannot have product innovation in homogeneous product industries) and, for example, the CMA notes Professor Waddams' testimony that *"one form of innovation – tailored products for different preferences and needs – was an obvious casualty of RMR rules."*⁵⁴ The CMA accepts such evidence, *"We consider that the restrictions imposed by the RMR four-tariff rule limits the ability of suppliers to innovate and provide products that may be beneficial to customers and competition"*⁵⁵ and similarly, CMA states: *"We note that some suppliers have used the roll-out of smart meters as a point of competitive differentiation from their rivals."*⁵⁶
- 111.1 The CMA draws on one aspect of the GfK customer survey in support of its view that energy is a homogeneous product, *"with 81% of respondents identifying factors related to 'cost/tariff/price/rate' as important to them"*.⁵⁷ The CMA states *"We understand price in this context to mean the average amount paid per kWh of gas and electricity..."*.⁵⁸ It is unclear on what basis the CMA has reached this understanding.

⁵² PFs, Chapter 8, pages 314-315, paragraph 8.86.

⁵³ PFs, Appendix 8.2, pages A8.2-16 to A8.2-17 paragraph 46.

⁵⁴ PFs, Appendix 8.2, page A8.2-17, paragraph 47(b).

⁵⁵ PFs, Chapter 8, page 354, paragraph 8.245.

⁵⁶ PFs, Chapter 7, page 240, paragraph 7.30.

⁵⁷ PFs, Chapter 8, page 314, paragraph 8.84.

⁵⁸ PFs, Chapter 7, page 236, paragraph 7.12.

- 111.1.1 RWE notes that survey respondents identified factors relating to 'cost/tariff/price/rate',⁵⁹ which potentially encompasses dimensions other than the price per kWh. The CMA does not seem to have explored what respondents meant by 'cost/tariff/price/rate' nor the importance customers might place on dimensions such as tariff structure (e.g. fixed term, fixed price, length of fix etc). This is a surprising omission given the significance of this issue to the CMA's provisional findings.
- 111.1.2 In giving this response, survey respondents were answering a question about what factors they considered when choosing a supplier; they were not being asked to rank the importance of those factors. When then asked about the *importance* of a range of factors, 'Cheap tariff rate' was the joint second most important factor (78%), equal to 'Simple/easy to understand tariffs' (78%), with customers regarding 'Good customer service' (83%) as the most important factor.⁶⁰
- 111.1.3 In fact, price is more important to some customers than to others; notably it is important to those who have shopped around or switched in the last year.⁶¹ The CMA has not sought to understand whether the relative importance of price and other product characteristics drives customers' switching behaviour.
- 111.2 RWE submits therefore that the CMA's survey evidence shows very clearly that the choices made by consumers are not made on the basis of price alone.
112. Further, paragraph 19 of Appendix 8.1 makes clear that a variety of other non-price attributes are also important for at least large subsets of consumers:
- "We also asked respondents how important pre-specified supplier attributes are to them. The following attributes were most frequently considered essential:
- (a) 32% rated good customer service essential;
 - (b) 29% rated simple/easy to understand tariffs essential;
 - (c) 28% rated cheap tariff rate essential;
 - (d) 23% rated payments based on actuals not estimated usage essential; and
 - (e) 20% rated tariffs tailored to their energy usage or circumstances essential."
- 112.1 In this respect, we also note that the CMA's focus on only those customers who say an attribute is "essential" very significantly underplays the significance of non-price attributes. Figure 31 of the GfK survey⁶², makes clear that, in addition to the 32% of respondents who consider good customer service to be essential a further 51% of respondents considered it "very important". We do not recite the evidence on other factors, but note that the survey evidence makes exceptionally clear that the proposition that energy suppliers' offerings are properly considered homogenous is simply and obviously inconsistent with the CMA's own survey evidence.

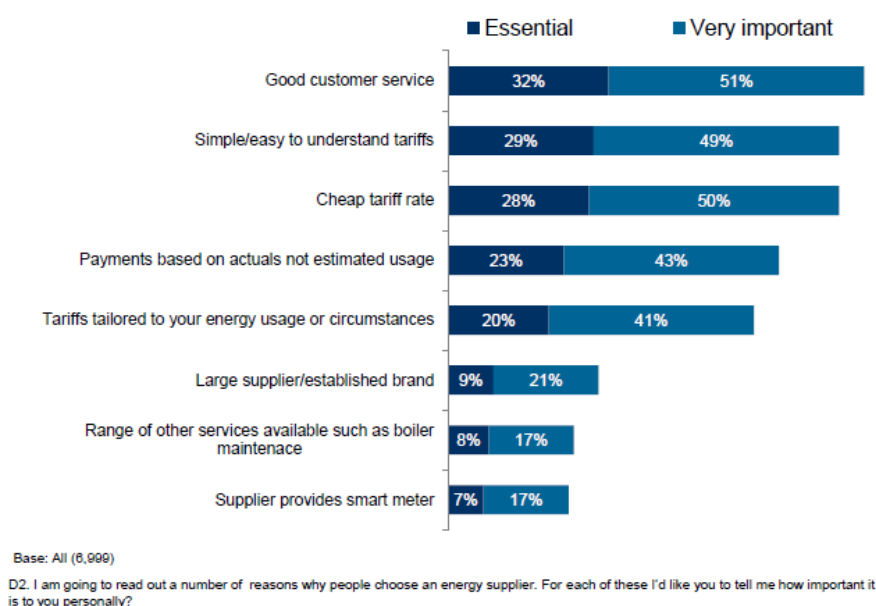
⁵⁹ PFs, Chapter 7, page 236, paragraph 7.11; Chapter 8, page 314, paragraph 8.84.

⁶⁰ PFs, Appendix 8.1, page A8.1-54, Figure 24.

⁶¹ PFs, Appendix 8.1, page A8.1-6, paragraph 18.

⁶² For completeness we do note that the figure itself is discussed at paragraphs 147-149 of PFs Appendix 8.1. Consistent with its approach at paragraphs 18-19 (and in stark contrast to the discussion in the GfK report discussion; see GfK Report, page 35, paragraph 90) the CMA makes no reference in its text to those who responded that a factor was "very important". Thus while for GfK the headline results from this question are summarized as "Good customer service (83% essential/very important), simple/easy to understand tariffs (78%) and cheap tariff rate (78%) were the three most important factors to customers." The CMA chooses to represent the results as less overwhelmingly contrary to its assertion in provisional findings that energy supplier offerings are homogenous, stating: "The following attributes were most frequently considered essential: (a) Good customer service – 32%. (b) Simple/easy to understand tariffs – 29%. (c) Cheap tariff rate – 28%....".

Figure 31: Importance of factors when considering a supplier – prompted rating



113. In respect of the third point, RWE submits that the CMA fails to recognise that competition may lead to variation in tariff design and price levels that are not indicative of a competition problem. Whilst the CMA notes in a footnote to Appendix 8.2 that, "*Price or margin discrimination is present in many industries and it is not, by itself, evidence that a market is not functioning well*"⁶³ the CMA's analysis and provisional findings disregard this bulwark of a conventional economic approach. In fact, price theory and practice make clear that price variation can be indicative of active competition in the real world.
- 113.1 This failure to appreciate that the products and services provided by energy suppliers are not homogeneous means that the CMA disregards almost entirely these other attributes in analysing the purportedly 'unexploited' gains from switching, and also that the CMA does not properly consider the implications for its analysis of the fact that pricing structures, such as those RWE previously described as 'see-saw' pricing can be actively desirable in driving competition between suppliers. This consideration is important in making the appropriate inferences from the CMA's gains from switching analysis. In particular, it makes clear that the existence of 'gains from switching' cannot properly be used to sustain evidence of a competition problem. Rather the CMA is only providing evidence establishing that prices vary; equating price variance with 'gains from switching' is a misnomer.
- 113.2 RWE submits that there is further evidence in the Provisional Findings pointing the CMA clearly to the conclusion that its 'gains from switching' are overstated. In particular, RWE submits that the CMA does not properly address the implications of its finding that its 'gains from switching' (price differences) are almost as high for those on non-standard tariffs as for those on SVTs.⁶⁴ The CMA's view is that high barriers to engagement result in unilateral market power over SVT customers. However, the CMA does not even begin to explain why non-standard customers, on the CMA's methodology, appear to have similar 'unexploited gains', even though they are known to have engaged recently in energy markets and have generally reported that search and switching were easy.
- 113.3 Moreover, RWE understands that the gist of the Confidential Submission provided by its Authorised Advisers on the CMA's gains from switching analysis – following the disclosure room – is that the CMA's measured potential gains from switching do not differ very much between those who have, and those who have not, switched recently. Such a finding is consistent with RWE's submission that price differences (and so the CMA's measured potential gains from switching) arise in part because consumers' value non-price attributes. However, such a finding appears wholly inconsistent with the CMA's primary thesis that

⁶³ PFs, Appendix 8.4, page A8.4-3, footnote 2.

⁶⁴ PFs, Chapter 2, page 91, paragraph 2.154; Chapter 7, page 284, Table 7.9.

engaged customers are price sensitive and so benefit from low prices while disengaged customers pay high prices and so would gain enormously from switching tariff.

- 113.4 Customers' choices of tariff will be driven in part by the sales and marketing efforts of suppliers and the CMA's analysis takes no account of the contribution that such sales and marketing efforts will have on tariff choice.
- 113.5 RWE considers that the CMA needs to accept that its current position on this point is wholly indefensible. The CMA should properly conclude that non-price attributes, tariff structures and indeed suppliers' sales and marketing efforts are each relevant to explain why the CMA observes price variation. That means its gains from switching analysis is finding evidence of price differences but is systematically overstating the true 'gains from switching' and does not constitute reliable evidence of a barrier to switching or engagement.

Price discounting

114. We have explained in previous submissions to the CMA and at a workshop held for the CMA in November 2014 how RWE sets the prices of its (domestic and SME) products. We do not repeat that in this response, save to highlight any key aspects that are relevant to the CMA's provisional findings. There is however one misconception regarding domestic pricing that we wish to address upfront, which is the application of discounts and premia. To be clear, RWE does not price its SVT at a premium to its non-standard products; rather its non-standard products are priced at a discount to its SVT.
- 114.1 In the CMA's analysis, the CMA calculates a percentage difference between SVT and non-standard revenues as a percentage of the revenues from the discounted non-standard tariffs.⁶⁵ This implies that revenues from non-standard tariffs reflect the base price and that SVTs are priced at a premium to this, which is not correct. The CMA seems to acknowledge elsewhere in the PFs that the Six Large Energy Suppliers offer *discounted* non-standard tariffs, for example, in Appendix 7.3 *Pricing Strategies of the Six Large Energy Firms*, CMA writes in respect of RWE: "*Throughout the period RWE's cheapest tariffs were online tariffs with discounts...*".⁶⁶
- 114.2 Substantively, the CMA does not consider the implications of discounting for customer acquisition for its gains from switching analysis. Suppliers offer discounted non-standard tariffs, since these are permitted within the constraints of RMR simpler choices, whereas they are restricted in their ability to discount on SVT; suppliers need to find a way to compete on price to acquire customers notwithstanding the constraints imposed by regulation. Discounting to acquire customers is a normal business activity and non-standard tariffs have a different cost stack and are priced to compete in broker tables. However, it is normal that not all customers will switch to the cheapest tariffs in the market. The CMA fails to recognise this. According to the CMA's analysis in PFs, the existence of 'gains from switching' is an indication of problematic incentives to switch.⁶⁷ This is incorrect. In fact it is indicative of a market in which suppliers discount to acquire customers, and in which not all customers switch to the cheapest discounted tariffs.

b. Retail energy supply business hedging practices

115. RWE notes that a number of references have been made to supply business hedging practices throughout the PFs; in particular, it is relevant to the CMA's competitive price benchmarking analysis and its cost pass-through analysis. RWE is concerned however that the CMA has not fully understood, in particular, the diversity of hedging approaches and the benefit of these under different market conditions. The CMA also appears not to fully accept why hedging is perfectly rational (and pro-competitive) for a profit-maximising retail energy supplier. As a result, the CMA's competitive price benchmarking analysis assumes that all suppliers could achieve wholesale costs that are below the average out-turn costs

⁶⁵ PFs, Chapter 6, page 6, paragraph 23; Summary, page 20, paragraph 91; Chapter 2, page 90, paragraph 2.151; Chapter 7, page 249, paragraph 7.67; Chapter 7, page 264, paragraph 7.115; Chapter 7, page 271, paragraph 7.139; Chapter 8, page 337, paragraph 8.170.

⁶⁶ PFs, Appendix 7.3, page A7.3-3, paragraph 8.

⁶⁷ PFs, Summary, pages 26-27, paragraph 117.

(and, in one part of the analysis, that incurred wholesale costs should be benchmarked against spot market prices). And the CMA's cost pass-through analysis uses an inappropriate measure of expected wholesale costs in its Part A analysis.

Diversity of hedging approaches and their benefits under different market conditions

116. We set out here RWE's view of commodity hedging to manage different commodity risks deriving from various customer contracts. The following table provides a high level summary of different product types that RWE hedges across its Domestic and SME supply businesses, with a summary of RWE's assessment of the commodity risks the particular product bestows on the business and the relevant hedging methodology used to mitigate this risk.

Segment	Customer product	Resultant commodity risk for supply business	RWE's view of least risk hedge methodology
Domestic	Standard variable tariff (SVT)	[CONFIDENTIAL]	[CONFIDENTIAL]
Domestic	Fixed tariff (varying lengths)	[CONFIDENTIAL]	[CONFIDENTIAL]
SME	Negotiated price fixed term tariff	[CONFIDENTIAL]	[CONFIDENTIAL]
SME	Flexible tariff	[CONFIDENTIAL]	[CONFIDENTIAL]
SME	Deemed tariff	[CONFIDENTIAL]	[CONFIDENTIAL]
SME	Default tariff	[CONFIDENTIAL]	[CONFIDENTIAL]

117. It is important to note that the above product suite for RWE's Domestic supply business is defined by the current competitive environment, which is to say products focused on variable and fixed tariffs, with the degree of variation limited by the 'four tariff rule' element of RMR simpler choices. Other product types, such as green/environmental tariffs may require a different approach to commodity hedging.
118. It is also important to note that other hedging strategies can be followed. If, however the above table summarises RWE's view of the least risk approach to hedging commodity risk. Exclusive of 'complex risks', addressed below, even with wholesale market hedging undertaken, the above approaches still contain risks for RWE's supply business, particularly around variations in customer demand due to uncertainty of customer retention, and timing risks between a customer signing a contract, and the hedging of the underlying commodity risk taking place and the uncertainty of weather outside seasonal norms.
119. The following paragraphs expand on the above hedging approaches in a little more detail, including some explanation of why RWE considers these approaches to be optimal.

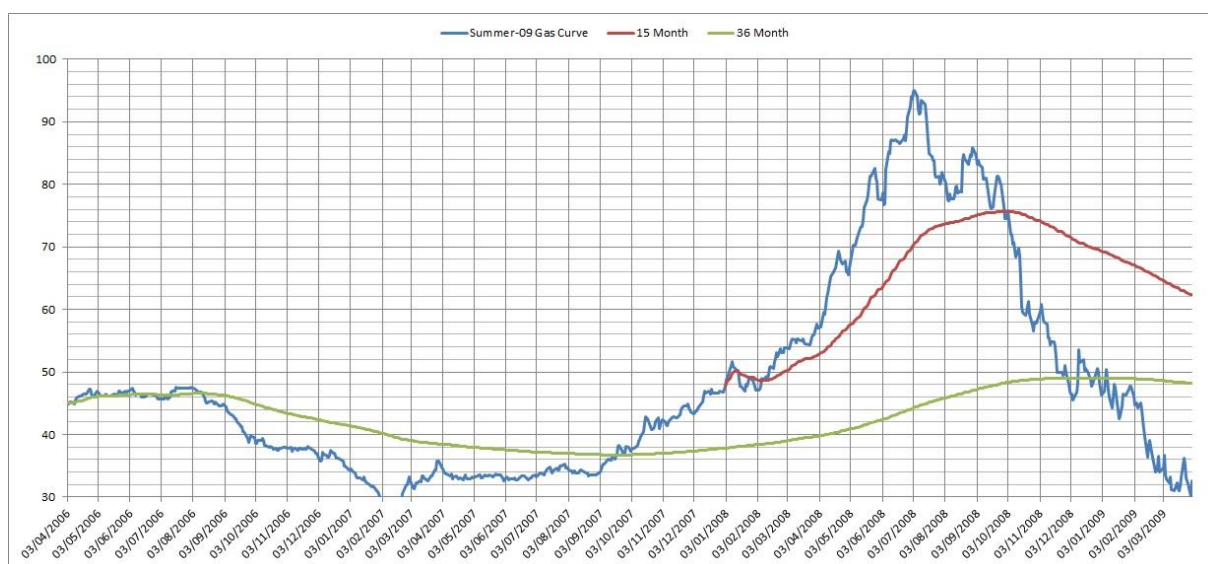
Approach to hedging for Domestic SVT tariff customers

120. RWE notes that in Appendix 10.5, the CMA assesses the hedging decisions of the Six Large Energy Firms in managing their exposure to commodity prices for SVT customers by reference to the hedging approaches of mid-tier and small suppliers (in particular, by using mid-tier supplier commodity costs as verification of lower quartile Six Large Energy Firms' costs as an appropriate benchmark). Generally, the key differential between mid-tier suppliers and the Six Large Energy Firms is the hedging tenor used for commodity hedging, with mid-tier hedging timeframes tending to be of shorter tenor. RWE is particularly

concerned by this analysis as the CMA seems to draw conclusions at various points that the shorter hedging profile is always a more effective choice, predominantly through looking at the wholesale strategy over the last five years.⁶⁸

121. It is instructive to consider the fact that for major parts of the period under review by the CMA, the predominant wholesale market direction has been one of falling wholesale commodity prices. Particularly significant is the scale of the falls during the period from 2008 to 2010. The size of price movements up or down will have a large impact on the variability of performance of different hedging strategies. Due to the large price movements during this time, the performance of different hedging strategies will be very variable. During this time, the mid-tier suppliers' demand position was growing significantly while their hedging tenors will have been relatively short. The result of this is that the mid-tier suppliers would have achieved lower commodity costs as a result of these particular dynamics. In an analogous rising market this would not have been possible.
122. Figures F.b.1 shows the evolution of benchmark summer gas contracts for the three years ahead of delivery:

Figure F.b.1, summer 2009 gas curve



123. Figure F.b.1 (summer 2009 gas curve) shows that the shorter hedging profile ends up being significantly higher in cost than the longer profile.
124. Due to the periods of falling wholesale market prices during the period of review, it appears that the CMA considers that shorter hedging profiles for customers on non-fixed tariffs are to be preferred to longer hedging profiles. RWE presents some analysis below based on real world market prices that illustrates that this would not have proven to be the case in all market conditions. The most effective hedging strategy for low commodity costs is of course entirely dependent on the dominant wholesale market trend over which hedging is undertaken. Unfortunately, only with the benefit of hindsight do we actually know how wholesale market prices will evolve.

Figure F.b.2



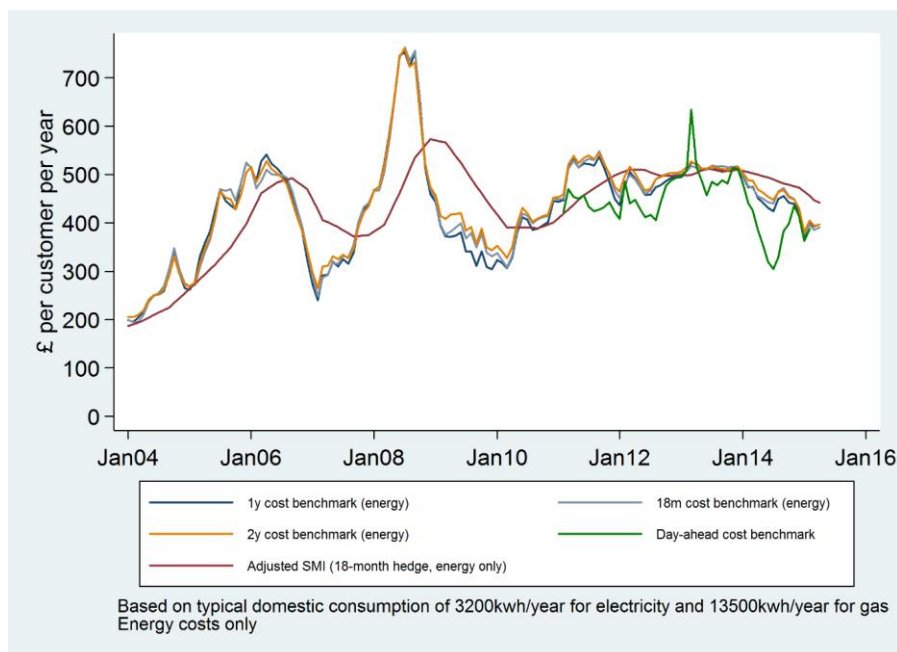
125. Figure F.b.2 above shows the evolution of wholesale market gas price for customer supply over 2015, from 2012 until the end of 2014. As can be seen in the above graph, a wholesale market with falling prices will benefit a short hedge path in terms of commodity cost most quickly, while the longer hedge paths will see declining average commodity cost more slowly.

Figure F.b.3



126. Figure F.b.3 above shows the evolution of wholesale market price from Figure F.b.2, inverted, to show the effect of rising prices rather than falling prices. As can be seen from the chart, the longer hedge timeframes will react to rising prices less quickly than short term hedge profiles.

127. The above figure illustrates that different hedging strategies will perform more or less well depending on the evolution of wholesale market prices.
128. As supply businesses will generally want to retain their customers, and will be conscious that price is a key factor for customer satisfaction, they have to be able to balance customer preference for protection from rising wholesale costs (which implies a longer hedging tenor) with customer preference for lower wholesale market prices to be passed through during time of falling wholesale prices (which implies a shorter hedging tenor).
129. To always achieve the best possible commodity price, a supply business would need to be able to accurately forecast wholesale price development in advance, and thus choose the optimum hedging profile. As it is not possible for supply businesses to predict forward wholesale market movements, it is not possible for the optimum hedging strategy to be known for all timeframes in advance.
130. Whilst it may be envisaged that a supply business may decide to use a longer or shorter profile to manage its commodity cost based on its knowledge of customer preference for price stability or price variability, RWE believes that the combined overall requirements of a reasonable degree of both customer tariff certainty and supply business cost certainty make the spot market price scenario used as one of the benchmarks in Appendix 10.5 an unrealistic scenario.
131. [CONFIDENTIAL]
132. RWE refutes the implications of Appendix 10.5 paragraph 28 that the choice to hedge over a longer timeframe is associated with customer inactivity. The argument incorrectly assumes that the Six Large Energy Firms are choosing to hedge in this way because customers are generally inactive. [CONFIDENTIAL] A hedging timeframe that meets these needs for customers in terms of relative prices and reduced volatility will be attractive to customers.
133. The CMA's analysis in Figure 1 of Appendix 7.2 is perhaps helpful to make tangible the significant importance of hedging to supply businesses. Figure 1 shows that under the CMA's 1 year cost benchmark, costs for a supply business would be expected to have varied from around £250 per customer per year in 2007 to more than £700 per customer per year in 2008 before subsequently falling back to around £300 in 2009. This magnitude of year-on-year change would amount to a huge variation in costs per customer for any business. By contrast, a firm following an 18 month benchmark hedge profile, while still experiencing considerable volatility in costs per customer, experiences considerably less volatility in per customer cost. RWE submits that if in 2009 one energy supply business had genuinely experienced and priced on the basis of energy costs of £700 per customer while other rival suppliers costs were experiencing and pricing on the basis of expected costs of only £450, the consequences for the high cost supplier would have been catastrophic. Energy supply businesses are acting rationally when they hedge.



Approach to hedging for Domestic fixed term contract customers

134. RWE notes that in Appendix 8.4, paragraph 53, the CMA states that *"Each of the Six Large Energy Firms, with the exception of British Gas, have different strategies for purchasing energy for their SVTs and fixed-term tariffs... This means expectations in relation to future energy costs are likely to differ between SVTs and fixed-term tariffs"*.
135. Such a conclusion is ambiguous. It is correct that the two strategies expose customers to different levels of wholesale cost volatility. A customer on a fixed term tariff will not be exposed to adverse wholesale cost volatility for the life of the fixed term. If a supplier has hedged the non-SVT contract in a back-to back manner, the supplier will also not be exposed to adverse wholesale market risk on that contract. However, in a rising wholesale market the commodity cost of a *sequence* of non-SVT contracts hedged in a back-to-back manner will rise faster than the commodity costs for SVT contracts if they are hedged on a long tenor. The converse is true in a falling wholesale market.
136. As set out in the table above, the commodity risk between SVT and fixed-term tariffs for a supply business is different. One is an exposure risk compared to other suppliers' costs of commodity for SVT, which accrues incrementally over time, while the other is an immediate exposure to the commodity price which has been used in setting the fixed-term contract price. This is why hedging is undertaken differentially under a risk minimising strategy. A hedging strategy which sought to make directional bets (take risk), based on a view of future wholesale market direction, would be a risk taking, rather than risk managing, strategy.
137. Absent any forward view of commodity price, the least risk view is to immediately dispose of the commodity risk associated with a fixed-term contract. The CMA seems to acknowledge this in Appendix 8.4, paragraph 55.
138. The CMA also considers that *"our provisional view is that there are no reasons to expect that downside risks associated with purchasing energy costs are inherently and systematically higher in the provision of SVTs as compared with fixed-term, fixed rate tariffs."*⁶⁹ In respect of RWE at least, this would seem to fundamentally misunderstand the way in which it hedges its requirements for its SVT and non-standard tariffs. In both a rising and a falling wholesale market, RWE faces additional risk associated with purchasing wholesale energy for its SVT:

⁶⁹ PFs, Chapter 8, page 339, paragraph 8.181.

138.1 [CONFIDENTIAL] and whilst RWE can *in principle* change its price to reflect a rise in wholesale price, in practice, as the CMA identifies, price changes take place infrequently, meaning that in a rising wholesale market RWE may have to bear a higher cost until such time as it can put through an SVT price increase; indeed there are significant menu costs (in the region of [CONFIDENTIAL]) associated with each SVT price increase which restrict RWE's ability to put through frequent price changes. The CMA largely accepts the presence of such menu costs, at least in respect of price increases.⁷⁰ Similarly, if wholesale prices fall, suppliers face (political, media and/or regulatory) pressure to reduce SVT prices even if the falling wholesale prices have not yet fully filtered through to the supplier; they also risk losing SVT customers to (their own or other suppliers') non-standard tariffs which can respond more quickly to falling wholesale prices, meaning that they risk having to sell back hedged SVT volumes at a loss.

138.2 [CONFIDENTIAL]

Approach to hedging fixed-term SME products (Fixed product)

139. The SME market is focused on individually negotiated contracts, where the wholesale risk position materialises as a contract is signed with a customer. Typically, a customer is quoted a price including a current live view of wholesale market prices, whereby if they then accept and sign that contract, the business is immediately exposed to the price quoted in the signed contract versus the current wholesale market price. [CONFIDENTIAL]

140. Contracts sold to SME customers on a fixed-price fixed-term basis will not in general be for the volume of, or the term, that is available in the wholesale market. Therefore any differences result in additional risk for suppliers.

141. For these reasons, any alternative approach would not be a risk minimising strategy.

Approach to hedging SME products with short notice periods (Flexible, Deemed and Default products)

142. Although these products have different customer types and overall have very different risk profiles for the business, they each present similar risks for a supply business from a commodity perspective as they all have short timeframes in which a customer can leave the business, meaning the supply business assessment of commodity position for any customer is subject to significant volume uncertainty.

143. In light of the above risks, RWE employs [CONFIDENTIAL]

144. A supply business retains commodity risk on such contracts as there is uncertainty about whether a customer will remain on supply for the period over which a commodity purchase has been made. If a customer leaves during that period, then the supply business is left with a long commodity position. The potential commodity cost risk manifests itself as the difference between the initial purchase price and the price at which any residual commodity exposure has to be sold back into the market.

145. Hedging such a risk is extremely difficult for a business to manage; in fact, due to wholesale commodity market clip sizes and tenor, it is not directly possible, and the supply business retains some residual risk in almost all cases.

146. RWE notes that the CMA has provided limited analysis into SME hedging techniques employed by supply businesses. RWE considers it is similarly important for the CMA to understand the complex set of risks faced in managing such customer positions.

147. In all the above scenarios, [CONFIDENTIAL]

148. As such a large percentage of a customer bill is made up of commodity cost, and as a result of wholesale market volatility, not hedging commodity positions for customers can leave a

⁷⁰ See e.g. PFs, Appendix 7.2, pages A7.2-3 and A7.2-18, paragraphs 11 and 51.

supply business with a risk to the tune of hundreds of millions of pounds. Such a risk is likely to be an existential threat to many supply businesses.

149. As mentioned above, a supply business also faces other 'complex risks', such as Swing risk and Shape risk, which are also managed by RWE's supply business in a variety of ways and can be hedged by supply businesses. [CONFIDENTIAL]

Why it is rational for a retail energy supplier to engage in hedging of wholesale energy costs

150. *Reducing its cost of capital:* A firm which hedges and otherwise manages to reduce the riskiness of its earnings may reduce its cost of funding.
151. *Menu costs:* Other things equal, firms with significant menu costs prefer not to change their prices too frequently. This in turn can provide an incentive to smooth cost changes by hedging. The CMA has acknowledged that there may be significant menu costs⁷¹ (costs of changing prices, such as the costs of updating the billing systems, informing customers, or reputational costs).
152. *Consumer risk aversion:* The CMA recognises that hedging of retail energy wholesale costs may be "(efficiently) absorbing short-run cost movements that risk-averse customers do not like."⁷² RWE agrees with the CMA when it notes that⁷³ "the risk associated with the cost of energy is likely to be important to some customers". The CMA goes on to argue that is the case particularly for those "for whom the cost of energy is a high proportion of their disposable income. For such customers, an energy tariff that provided certainty over the price might be preferred to one in which the price was highly volatile, even if the latter was, in expected terms, slightly cheaper."⁷⁴ Without hedging, shocks affecting wholesale energy costs would be transmitted to customers to a greater extent. Hedging allows a supplier to provide a more valuable offering to consumers than that available from a supplier that does not hedge. Suppliers that hedge need only move their prices slowly over time which is in the interests of customers who are risk averse (and also who would otherwise experience higher prices as a result of additional menu costs being incurred).
153. Whilst RWE's SVT price varies over time, it changes infrequently (slightly more than once (1.4 times) per year on average during the period 2004 to 2014), and when it changes, the extent to which it does so is relatively modest. Over this period, the annualised percentage volatility of RWE's SVT has been 8.5% for electricity and 11.9% for gas (based on a monthly series of averaged SVT prices), which compares favourably to the annualised percentage volatility of wholesale energy prices of 32.8% for electricity and 36.2% for gas (based on a monthly series of wholesale prices created from the monthly contract prices achieved with a one month linear hedge profile). [CONFIDENTIAL]
154. The literature on the economically efficient provision of insurance provides us with the result that if customers are more risk averse than their retail energy supplier, it will be economically efficient for the firms to 'insure' their consumers against the risk of energy price variation – and be compensated for doing so by way of charging a (insurance) premium. In the presence of uncertainty, differences in the degree of risk aversion generate gains from trade, as customers are willing to pay more than the supplier's cost incurred to avoid the risk.⁷⁵

⁷¹ PFs, Appendix 7.2, page A7.2-3, paragraph 11.

⁷² PFs, Appendix 7.2, page A7.2-3, paragraph 11.

⁷³ PFs, Appendix 7.2, pages A7.2-3 - A7.2-4, paragraph 12.

⁷⁴ PFs, Appendix 7.2, pages A7.2-3 - A7.2-4, paragraph 12.

⁷⁵ According to J.W. Pratt (1964), *Risk aversion in the small and in the large*, *Econometrica*, 32, 122-136, agents who are more risk averse are always willing to pay more for insurance than someone who is not. As Shavell (2009), *Economic analysis of accident law*, *Harvard University Press* (p. 122) observes, this implies that it is possible "for the more risk averse to pay the less risk averse or the risk neutral to assume the risk, so as to leave both better off in terms of expected utility."

155. Moreover, as the hedging and the provision of insurance involves transactions costs, it is more efficient for the retail energy suppliers to perform the hedging than for customers on an individual basis. This can be shown by way of an analogy with the financial sector: Diamond (1984) develops a theory of financial intermediation whereby delegation to an intermediary is optimal, as it avoids costly duplication of individual efforts and is subject to increasing returns to scale.⁷⁶ Outreville (1997) applies these insights to the insurance market and, if one interprets the insurer as playing the role of Diamond's intermediary, suggests that there is merit in taking a similar approach in viewing the hedging services provided by energy suppliers.⁷⁷
156. *The cost of financial distress (or even bankruptcy)*: The CMA recognises that the 'closed' position will affect a supplier's profit but does not discuss the ramifications of this insight.⁷⁸ By not hedging, a supplier would acquire extremely large 'open' positions, as a result of which it is exposed to significant market risk. In particular, if forward prices for energy increase drastically within a short period of time, and one or several rival suppliers have hedged (part of) their costs, so that they do not have to adjust their prices significantly, the only way for the unhedged supplier to remain competitive is by absorbing the higher energy procurement cost in its profit-and-loss account. The literature on corporate risk management argues that firms can benefit from hedging market risks, because excessive volatility increases the expected costs of financial distress and can lead to suboptimal investment.⁷⁹
157. *Firm risk aversion*: If a firm or its shareholders are risk averse, clearly that can provide an incentive to hedge.
158. *Strategic motives*: The academic literature has also developed a variety of models wherein firms can have an incentive to hedge even if not risk averse. The reasoning is typically that hedging activities today change firms' marginal incentives tomorrow.

G. DOMESTIC SEGMENT PROVISIONAL FINDING OF AECs

159. The CMA has provisionally identified an "overarching feature of weak customer response"⁸⁰, which it considers gives rise to an AEC and gives suppliers a position of unilateral market power with regard to their inactive customer base:
- 159.1 The CMA considers that there are a number of barriers to engagement, including the fundamental nature of electricity and gas supply (product homogeneity and issues associated with traditional meters)⁸¹, barriers to accessing and assessing information⁸² and

⁷⁶ P. Diamond, 'Financial intermediation and delegated monitoring,' *The Review of Economic Studies*, 51(3), 393-414 (p. 393).

⁷⁷ J.-F. Outreville, *Theory and practice of insurance*, Kluwer Academic Publishers (p. 134).

⁷⁸ PFs, Chapter 7, page 275, paragraph 7.155.

⁷⁹ See, e.g., H. Bessembinder and M.L. Lemmon (2002), '[Equilibrium pricing and optimal hedging in electricity forward markets](#),' *Journal of Finance* 57 (3), 1347-1382 (p. 1353). On the basis of a large literature on corporate hedging, the authors emphasise that "firms can benefit from hedging market risks, because excessive volatility increases the expected costs of financial distress and can lead to suboptimal investment." The articles cited include C. Smith and R. Stulz (1985), 'Determinants of firm's hedging policies,' *Journal of Financial and Quantitative Analysis*, 20, 391-405; R. Stulz (1990), 'Managerial discretion and optimal financing policies,' *Journal of Financial Economics*, 26, 3-28; K. Froot, D. Scharfstein, and J. Stein (1993), 'Risk management: Coordinating corporate investment and financing policies,' *Journal of Finance*, 48, 1629-1658. According to this literature, "companies in the power industry are likely to benefit from reducing the risk of their cash flows. The extreme volatility of wholesale power prices implies that even well-capitalized power firms may have power price exposures sufficiently large that adverse price changes could lead to corporate default or bankruptcy."

⁸⁰ PFs, Summary, page 29, paragraph 128; Chapter 8, page 331, paragraph 8.156; Chapter 8, page 342, paragraph 8.195; Chapter 8, page 366, paragraph 8.300.

⁸¹ PFs, Summary, page 28, paragraph 123; Chapter 7, page 237, paragraph 7.19;

⁸² PFs, Summary, page 28, paragraph 124; Chapter 8, page 322, paragraph 8.111; Chapter 8, page 367, paragraph 8.301.

barriers to switching,⁸³ as well as specific barriers that apply to prepayment customers.⁸⁴ The CMA argues that a material proportion of customers are fundamentally disengaged.⁸⁵

- 159.2 The CMA considers that this overarching feature of weak customer response allows suppliers to charge certain customer segments prices that are higher than can be justified by costs.⁸⁶
- 159.3 The CMA relies heavily on the results of its gains from switching analysis, both to evidence weak customer response and to use price discrimination as evidence of supplier unilateral market power. The CMA points to certain results from the GfK customer survey as indicating low levels of customer engagement and the existence of barriers to search and switching.
- 159.4 The CMA relies on its analysis of supplier profitability, and its benchmarking of supplier pricing, to support its finding of AECs and to assess the extent of any overcharge.
- 160. RWE disagrees with a number of the CMA's provisional findings:
 - 160.1 RWE believes that the actual barriers to engagement in this market are very low.
 - 160.2 As regards the fundamental characteristics of energy supply, we consider that the CMA is incorrect in respect of the first of these (homogeneity) and overstates the "fundamental" nature of the second (traditional meters) and, as a result, misconstrues them as "fundamental" barriers to engagement:
 - 160.2.1 Suppliers' product offerings to consumers in this market are not homogeneous (see Section F above).
 - 160.2.2 Traditional meters do introduce some complexity for firms that must be managed, and for customers in ensuring that they provide access for meter readings, but the CMA offers no credible evidence that the complexity introduced by the use of traditional meters creates a barrier to engagement. Customers do not need to interact with their meters other than to collect occasional meter readings. Customers can find all the information required to switch tariff or supplier on their bill, and the evidence from the GfK survey is that customers who have switched recently have found it easy to find information about their existing tariff/usage.⁸⁷ In Appendix 8.2, the CMA concludes that "*The RMR has not been in place long enough for us to be able to assess with full confidence its overall impact on consumer and engagement*".⁸⁸ RMR of course includes a variety of measures in relation to information on and simplicity of bills. The CMA does not explain how it can reconcile on the one hand its inability to evaluate the impact of recent reforms to the provision of information to consumers and yet at the same time conclude that there is a 'fundamental' barrier to engagement that arises from traditional meters.
 - 160.3 Search and switching barriers in this market are in fact very low, and we consider that the CMA materially overstates the extent of any barriers.

⁸³ PFs, Summary, page 28, paragraph 126; Chapter 8, page 326, paragraph 8.133; Chapter 8, page 367, paragraph 8.301.

⁸⁴ PFs, Summary, page 28, paragraph 127; Chapter 8, page 329, paragraph 8.145; Chapter 8, page 368, paragraph 8.301;

⁸⁵ PFs, Chapter 8, page 314, paragraph 8.82.

⁸⁶ PFs, Chapter 8, page 342, paragraph 8.194.

⁸⁷ "Energy Market Investigation: Technical Report on a survey conducted for the Competition and Markets Authority by GfK NOP." ("GfK Technical Report"), Appendix B, question E25e: 73% of those who switched in the last year and shopped around in the last 3 years found the overall task of shopping around to be very/fairly easy.

⁸⁸ PFs, Appendix 8.2, page A8.2-22, paragraph 64.

- 160.4 The lack of any significant barriers to engagement is evidenced by the high levels of engagement actually seen in the market.
- 160.4.1 [CONFIDENTIAL] of our domestic customer accounts joined RWE within the last three years; and every year a significant proportion of customer accounts leave RWE for another supplier or transfer to a different RWE tariff ([CONFIDENTIAL] on average, between 2008 and 2015, [CONFIDENTIAL]). Whilst switching supplier and tariff are far from the only measures of engagement, even on these measure alone, our own experience is that there are high levels of engagement. Additionally, [CONFIDENTIAL] of RWE domestic customer accounts now have online billing, [CONFIDENTIAL] in 2013, and compared with around [CONFIDENTIAL] in 2009. 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, and in 2014, Energy Tracker was viewed over [CONFIDENTIAL] times by customers;
- 160.4.2 High levels of engagement can also be seen from the GfK survey evidence obtained by the CMA, despite the fact that the GfK survey presents only a partial picture as it focuses overly on measures of engagement related to switching between suppliers. We are concerned that the CMA relies on selected results from the GfK survey (some of which the CMA interprets in a way that is misleading) to evidence a lack of engagement, whereas in fact the GfK survey provides material evidence that there are good levels of engagement. See further our Authorised Advisers' Confidential Submissions.
- 160.5 We consider that the proportion of customers that are less engaged is relatively small, such that they benefit from the competitive constraint imposed by the majority who do engage. Additionally, the group of less engaged customers is not static and any customer can become engaged at any time through a variety of triggers such as moving home. RWE believes, therefore, since suppliers cannot identify any customer as permanently disengaged they must treat all customers as if they already engage in the market (or could do at any time).
- 160.6 As the CMA notes, Ofgem has recently taken steps to improve switching processes and to reduce switching times, meaning that switching timescales reduced from 5 weeks to the mandated 21 days at the end of 2014, and some suppliers have adopted the voluntary 17 day time period. Ofgem has announced its decision to introduce reliable next-day switching by 2019.⁸⁹ The recent and forthcoming reductions in switching times can be expected to reduce any barriers to engagement that may persist. A further significant consideration in terms of proportionality, as the CMA will no doubt be well aware, is that there is a point at which intervention to remove residual minor switching barriers is not good economic policy since the incremental costs of intervention do not provide sufficient incremental benefits for consumers and, instead, result in higher prices as a result of the greater regulatory costs.
- 160.7 We do not consider that the CMA's gains from switching analysis can be relied on as evidence of weak customer response:⁹⁰ not only are the gains clearly overstated, but the CMA's approach would falsely detect a competition problem in most competitive markets. The CMA should recognise that price differences are the norm in competitive markets and, as a result, the existence of a price difference (in the CMA's language, a 'gain from switching') is not of itself an indicator of lack of engagement or an uncompetitive market.
- 160.8 RWE has submitted to the CMA that this is a market characterised by see-saw pricing. See-saw pricing is common to many markets, is not necessarily problematic, and can and does deliver customer benefits. The CMA acknowledges in places⁹¹ that there is see-saw pricing, but it does not properly consider the implications of this finding for the rest of its analysis. Based on the CMA's provisional findings on this issue, if the CMA applied its gains from switching analysis to any industry which used discounts to acquire customers (as many

⁸⁹ PFs, Chapter 8, page 323, paragraph 8.115-8.116.

⁹⁰ PFs, Summary, page 25, paragraph 111; Chapter 7, page 285, paragraph 7.192.

⁹¹ See e.g. PFs, Chapter 7, page 268, paragraph 7.131.

competitive industries do), then the CMA would inevitably diagnose the existence of switching incentives and incorrectly consider this an indication of a competition problem.

- 160.9 Moreover, in relation to observed price differences, there is a danger therefore that the CMA is effectively making the same conceptual mistake that the CMA criticises Ofgem for when Ofgem introduced SLC 25A. The CMA criticises Ofgem for distorting competition by banning price discrimination⁹² but then simultaneously considers that price differences which are not purely cost reflective are evidence of price discrimination, inevitably leading to customer detriment.⁹³ As the SLC 25A debate made clear, competition policy has typically refused to take a stance against discounts because there is a very serious risk of dis-incentivising (or even prohibiting) discounting in a market which would be to the detriment of competition and consumers.
- 160.10 The CMA has not to date made a convincing case supporting its concerns about see-saw pricing. The CMA accepts it should consider whether prices were, on average, above the competitive level. This pricing structure means that it is wrong to look at the prices at one end of the see-saw without at the same time considering the prices at the other end. They are interrelated. Moreover, suppliers need to pay attention to the level of discount, as if it is set at a level that is too high, it will result in persistent churn and attrition of the customer base paying normal prices, and thus reduced profits, whereby customers are acquired on discounted products and the discounts are funded essentially by the revenues received from customers once those customers have reverted to normal prices (undiscounted) levels.

a. There is no overarching feature of weak customer response

161. The CMA considers that there is an overarching feature of weak customer response, resulting from fundamental barriers to engagement.⁹⁴
162. RWE disagrees with this. Before addressing the barriers to engagement identified by the CMA, and the levels of engagement in practice, we consider the measures of engagement identified by the CMA.

i. The CMA has construed 'engagement' too narrowly

163. The CMA considers that customer activity can be measured by choice of tariff, choice of payment method and choice of supplier.⁹⁵
164. We do not agree that customer activity can be measured along these dimensions since the CMA's measures of 'activity' are, in fact, aspects of product design/supplier identity. In particular, we do not believe that such measures should be over-interpreted and we note that customers who are happy with their tariff and supplier may not be very 'active'. We note in particular that customers who have transitioned onto SVT with their existing supplier will, on the CMAs measure of activity, be automatically be judged inactive. Yet we know that 25% of customers on SVT have been with their supplier for less than one year.
165. RWE does accept that product attributes may be correlated with some measures of customer activity, but since consumers have different characteristics and therefore have different preferences, it is by no means the case that customers on one particular tariff or payment type should be automatically considered inactive.

⁹² PFs, Summary, paragraph 150, page 33; Chapter 7, page 245, paragraph 7.52; Chapter 7, page 255, paragraph 7.90; Chapter 8, page 334, paragraph 8.165; Chapter 8, pages 355-356, paragraph 8.251; Chapter 8, page 356, paragraph 8.254; Chapter 11, page 447, paragraph 11.51.

⁹³ PFs, Summary, page 30, paragraph 135; Chapter 8, page 342, paragraph 8.195; Chapter 12, page 475, paragraph 12.6,.

⁹⁴ PFs, Summary, page 29, paragraph 128; Summary, page 30, paragraph 135; Summary, page 38, paragraph 175; Chapter 8, page 331, paragraph 8.156; Chapter 8, page 342, paragraph 8.195; Chapter 8, page 366, paragraph 8.300; Chapter 8, page 368, paragraph 8.302; Chapter 9, page 402, paragraph 9.111; Chapter 10, page 406, paragraph 10.1; Chapter 10, page 435, paragraph 10.361; Chapter 12, page 474, paragraph 12.4; Chapter 12, page 476, paragraph 12.8.

⁹⁵ PFs, Summary, page 20, paragraph 88; Chapter 7, page 248, paragraph 7.62.

166. In addition, RWE consider that it is not clear why the CMA has chosen only these three particular measures of activity. Other measures of activity could include, for example, the use of online billing and use of consumption tracking tools.
167. In addition, in our view, whilst the CMA considers 'choice of tariff' as a measure of activity, the CMA effectively regards being on an SVT as an indicator of disengagement.⁹⁶ In considering choice of tariff, the CMA does not address at all the evidence of switching between tariffs (for a customer who may choose to remain with the same supplier) as an indicator of engagement, which we consider to be a key omission.

Choice of tariff

168. The CMA regards the SVT as the "default tariff – ie the tariff energy customers will pay if they have not made an active decision to change tariff."⁹⁷
169. We do not agree that SVT should be regarded as a default tariff. The CMA notes that in 2014, 71% of electricity customers and 69% of gas customers of the Six Large Energy Firms were on the SVT.⁹⁸ It is incorrect simply to assume that all of these customers have defaulted onto the SVT and have not made an active choice of tariff. The CMA itself acknowledges that 25% of these customers (on standard credit and direct debit) have been on the SVT with the same supplier for a year or less.⁹⁹ In fact the figure rises to 37-39% when considering customers who have been on the SVT with the same supplier for two years or less.¹⁰⁰ The CMA also acknowledges that these customers "may have been acquired by the supplier on the SVT."¹⁰¹ Despite this, and without any evidence as to whether or not customers have actively chosen to be on the SVT, the CMA treats the SVT as a default tariff throughout its analysis. In fact, the CMA seems to reach a point where it uses 'disengaged customers' and 'SVT customers' interchangeably in its analysis and conclusions when these two groups of customers are clearly not the same.
170. It is true that for RWE, [CONFIDENTIAL]. However, the fact that in 2014, [CONFIDENTIAL] and [CONFIDENTIAL] of electricity and gas acquisitions respectively¹⁰² were onto RWE's SVT ([CONFIDENTIAL] and [CONFIDENTIAL] if excluding prepayment customers) indicates that for some customers, it is an active choice to be on an SVT. This is supported by the fact that, according to the CMA's own analysis, for certain others of the Six Large Energy Firms, there were still substantial proportions of acquisitions onto the SVT for non-prepayment customers.¹⁰³ The fact that some customers choose this as an acquisition tariff implies that a proportion of existing customers also actively choose to remain on an SVT.
171. There can be reasons for this. For example, some consumers may believe wholesale costs may fall and therefore prefer a product where the tariff automatically adjusts periodically instead of a fixed tariff where some activity is required if wholesale prices do fall. Additionally, prior to 2013, there were a variety of fixed non-standard tariffs that were priced at a premium to SVT, and it is very clear that a cheaper SVT should not be regarded as a 'default' tariff for disengaged customers.
172. It is not correct therefore to regard the SVT as a default tariff and to assume that SVT customers have not made an active choice of tariff. The CMA's findings in this regard seem

⁹⁶ PFs, Summary, page 20, paragraph 88; Chapter 7, page 248, paragraph 7.62.

⁹⁷ PFs, Summary, page 20, paragraph 90; Chapter 7, page 249, paragraph 7.66; Chapter 7, page 264, paragraph 7.115.

⁹⁸ PFs, Chapter 7, page 250, paragraph 7.68.

⁹⁹ PFs, Chapter 7, page 251, paragraph 7.72; Chapter 7, page 280, paragraph 7.176.

¹⁰⁰ PFs, Chapter 7, page 251, Table 7.1.

¹⁰¹ PFs, Chapter 7, page 251, paragraph 7.72.

¹⁰² PFs, Chapter 7, pages 265-266, Tables 7.7 and 7.8 – unredacted version commented on by RWE during putback process.

¹⁰³ PFs, Chapter 7, page 266, paragraph 7.121.

to be swayed by the CMA's own preconception that SVT is a 'default' tariff and not by evidence as to whether customers regard it as such.

173. In 2014, [CONFIDENTIAL] of RWE's SVT customers left RWE for another supplier or transferred to a different RWE tariff. Over the last five years from 2010, the proportion of customer accounts on SVT has [CONFIDENTIAL] (and in absolute terms from [CONFIDENTIAL] customer accounts), and this [CONFIDENTIAL]. These metrics would indicate that it is not correct to regard SVT as a 'default' tariff as the CMA does¹⁰⁴ and clearly it cannot be assumed, as the CMA appears to, that all SVT customers are disengaged.
174. Additionally, as noted above, whilst the CMA purports to regard 'choice of tariff' as a measure of engagement, in fact the CMA appears to make a straight distinction between SVT and non-standard tariffs.¹⁰⁵ The CMA is not actually considering whether customers have *chosen* to be on their current tariff, but is simply assuming that SVT customers have *not* made such a choice.

Choice of payment type

175. Similarly, the CMA assumes that direct debit offers greater convenience and standard credit is a default payment type, and therefore assumes that any customers making an active choice would choose to pay by direct debit,¹⁰⁶ which again appears to be based on the CMA's own preconceptions and is not necessarily the case. In fact in paragraph 116 of the PFs, the CMA acknowledges that there are likely to be some customers who have an active preference for paying by standard credit, and are likely to assign some value to this payment method.
176. The CMA considers that since *"paying by standard credit appears to be correlated with several indicators of inactivity...[this] suggests that those who pay by standard credit may have a greater propensity to be inactive than those who pay by direct debit."*¹⁰⁷ However, the CMA has not sought to investigate whether customers choose to pay by standard credit, despite noting that *"the flexibility of timing of payment available to those who pay by standard credit may be of real benefit to the cash-constrained."*¹⁰⁸ Instead, the CMA is relying on *other* indicators of inactivity to evidence that paying by standard credit is of itself a sign of inactivity, and then seems to treat all customers who pay by standard credit as inactive.¹⁰⁹
177. Moreover, as regards the CMA's claim in relation to the patterns it finds in Figure 7.7, RWE notes that these patterns are showing no more than the fact that electricity and gas entrants have a greater proportion of customers on direct debit than incumbent suppliers. Such a pattern could be observed for a variety of reasons including differences in customer mix, different pricing structures and different business strategies as between the Six Large Energy Firms and the comparator entrants. The CMA does not explore alternative explanations for the patterns it observes. Due to the small supplier exemption, suppliers with less than 50,000 customers are not required to offer all payment types. Initially new entrants offered only direct debit tariffs, which explains why (even as they have grown) they have a large proportion of direct debit customers.
178. In our experience, whilst RWE agrees that direct debit offers convenience benefits to many customers, a significant minority of customers choose to pay by standard credit. [CONFIDENTIAL] Paying on receipt of bill can give customers greater flexibility and control

¹⁰⁴ E.g. PFs, Chapter 7, page 258, paragraph 7.97; Chapter 7, page 280, paragraph 7.177.

¹⁰⁵ E.g. PFs, Summary, page 20, paragraph 91; Chapter 7, page 249, paragraph 7.66;

¹⁰⁶ PFs, Chapter 7, page 237, paragraph 7.15; Chapter 7, page 252, paragraph 7.75; Chapter 7, pages 253-4, paragraph 7.82.

¹⁰⁷ PFs, Chapter 7, pages 253-4, paragraph 7.82.

¹⁰⁸ PFs, Chapter 7, pages 253-4, paragraph 7.82.

¹⁰⁹ PFs, Chapter 7, page 250, paragraph 7.70; Chapter 7, page 253, paragraph 7.82; Chapter 7, page 254, paragraph 7.83; Chapter 7, page 258, paragraph 7.96.

over payment, which they may favour over the effort and expense saved through paying by direct debit.

179. As the CMA notes, the GfK survey finds that 15% of standard credit customers have switched supplier within the last three years;¹¹⁰ whilst this is lower than the proportion of direct debit customers who have switched (30%),¹¹¹ it is a clear indication that at least this 15% are not inactive and furthermore (since they have changed supply yet remain on a standard credit tariff) it would indicate that they have actively chosen to pay by standard credit. If these customers have chosen to move supplier and still to pay by standard credit, it stands to reason that a proportion of customers who have not switched supplier have also chosen to pay by standard credit.
180. The CMA considers that "*Prepayment...is not generally a choice on the part of the customer: all customers on prepayment meters must pay by prepayment.*"¹¹² However, as for standard credit customers, the CMA appears to have assumed this is the case without any clear evidence of this. We would note that:
- 180.1 [CONFIDENTIAL] of our prepayment customers are debt-free, which may indicate that paying the prepayment allows them successfully to budget for their energy requirements.
- 180.2 A prepayment customer could choose to have their meter replaced. We do not charge customers who have been with us for more than a year or vulnerable customers.
- 180.3 Even if a customer has not actively chosen to pay by prepayment, this does not necessarily indicate any lack of engagement; as noted above, prepayment customers are no less likely to have switched suppliers than customers on other payment types. Therefore we do not consider that paying by prepayment ought of itself to be regarded as an indicator of a lack of engagement, although we acknowledge (as noted above) that owing to technical constraints a prepayment customer may have fewer tariff choices available without changing their meter.

Choice of supplier

181. RWE acknowledges that rates of switching between suppliers have declined since 2008, and this results in part from the distortion of competition resulting from SLC 25A and RMR simpler choices. However, RWE has also experienced a significant increase in internal switching in recent years, and it is surprising that the CMA does not take into account internal switching as an indicator of engagement (see comments above on 'choice of tariff'). As regards length of tenure, as at June 2015, [CONFIDENTIAL] of RWE's customer base has been with RWE for less than a year and [CONFIDENTIAL] for less than two years.

ii. There are no significant barriers to engagement

182. The CMA identifies three potential barriers to engagement: the fundamental characteristics of energy consumption, barriers to accessing and assessing information, and barriers to acting on information (either as a result of perceived or actual barriers to switching) or, for pre-payment customers, as a result of the technological limitations on pre-payment meters.¹¹³
183. The CMA considers that the first of these barriers to engagement, those due to the fundamental characteristics of energy consumption, are "*fundamental*" or "*intrinsic and irreducible properties of energy*".¹¹⁴ RWE disagrees with this. RWE considers that the CMA

¹¹⁰ PFs, Chapter 7, page 254, paragraph 7.83; Chapter 8, page 293, paragraph 8.10, Chapter 8, page 307, paragraph 8.55.

¹¹¹ PFs, Chapter 8, page 307, paragraph 8.55; Appendix 8.1, page A8.1-4, paragraphs 10; Appendix 8.1, page A8.1-16, paragraph 60; Appendix 8.1, pages A8.1-31 to A8.1-32, paragraph 100.

¹¹² PFs, page 21, paragraph 94; Chapter 7, page 252, paragraph 7.76; Chapter 8, page 307, paragraph 8.57.

¹¹³ PFs, Summary, page 28, paragraphs 123-127; Chapter 8, pages 332-333, paragraph 8.157; Chapter 8, page 367, paragraph 8.301.

¹¹⁴ PFs, Chapter 8, page 333, paragraph 8.158.

has mischaracterised the fundamental characteristics of energy consumption. As regards barriers to search and switching, RWE considers that in practice these are very low and will be further reduced by Ofgem's interventions for faster switching. RWE does consider that for some customers there may be a perception of barriers, but RWE does not consider that this operates as a significant barrier to engagement.

184. RWE also considers that, to the extent that there is any perceived barrier to engagement, this can be resolved by some of the informational remedies under consideration by the CMA and/or by the proper regulation of PCWs; see further RWE's response to the RN.
185. RWE has structured its response in relation to barriers to engagement so as to follow the stages of engagement identified by the CMA in Figure 8.7.

Stage 1: awareness of ability to switch/considering switching

186. The CMA refers to the results of the GfK customer survey which, according to the CMA, show that "36% of respondents either did not think it was possible or did not know if it was possible to change one (or more) of the following: tariff; payment method or supplier"¹¹⁵
187. RWE would note that a great majority of customers (89%) thought that it was possible to switch suppliers.¹¹⁶
188. Furthermore it is misleading to point to the 36% figure (customers who either did not think it was possible or did not know if it was possible to change **one (or more)** of the following: tariff; payment method or supplier) to support a lack of awareness of ability to switch/failure to consider switching. This figure will include customers who, for example, knew it was possible to switch supplier and payment type, but did not know they could switch tariff etc. These consumers clearly have some awareness of their options, such that a lack of awareness should not be regarded as a barrier to engagement.
189. Of the customers who have never considered switching tariff, or those that have never considered switching supplier, in each case 41% said they were satisfied with their existing tariff or supplier respectively.
190. The CMA considers that two fundamental characteristics of energy consumption "*might help to explain the apparently widespread lack of engagement in and understanding of the domestic retail energy markets*": the homogeneous nature of gas and electricity, and the role of traditional meters and bills.¹¹⁷
191. We note that the CMA says these "*might help to explain*", which would indicate that the CMA has not reached a view, on the balance of evidence, as to whether in fact these do explain any purported lack of engagement. Yet in reaching its provisional findings, the CMA treats these supposed characteristics, and in particular the "*homogenous nature of gas and electricity*" as if they do explain the lack of engagement found by the CMA.
192. As regards the homogeneous nature of gas and electricity, see our comments in Section F above. Retail energy supply products are not homogeneous, and in any case the CMA has presented no evidence that homogeneity is a "*fundamental barrier*" to engagement.¹¹⁸
193. The CMA notes, with a view to assessing potential remedies, "*First, that some of these features are the result of the intrinsic and irreducible properties of energy. Secondly, that there will be other less tangible factors driving the behaviour of different consumers.*"¹¹⁹ We do not repeat our comments made in relation to the first point (see Section F above). As regards the second point, it is important that the CMA properly identifies what is driving

¹¹⁵ PFs, Summary, page 20, paragraph 89; Chapter 7, page 249, paragraph 7.64; Chapter 8, page 292, paragraph 8.6; Chapter 8, page 312, paragraph 8.77.

¹¹⁶ PFs, Chapter 8, page 312, paragraph 8.77 (see footnote 413).

¹¹⁷ PFs, Chapter 8, page 314, paragraph 8.82.

¹¹⁸ PFs, Chapter 8, page 310, paragraph 8.75 (footnote 412).

¹¹⁹ PFs, Chapter 8, page 333 paragraph 8.158.

customer behaviour not only in the context of identifying suitable remedies but also in ensuring it has properly identified the existence and extent of an AEC. So far we do not think the CMA has properly done this.

194. As regards traditional meters, there is no evidence to suggest they are a fundamental barrier to engagement; the arrangements around traditional metering are longstanding and were no different prior to the relevant period, and in paragraph 95 of the PFs the CMA notes that prior to 2008 switching was higher (so using switching as a measure of engagement, traditional meters do not appear to present any real barrier). RWE would note that customers are provided with clear and sufficient information as to their energy consumption and their tariff so as to allow them easily to identify whether they are on the best tariff for them (see paragraph 160.2.2 above). The high rates of switching between suppliers and tariffs (see further below), together with the overall decline in energy consumption over time, evidences that large numbers of customers are using this information and traditional meters do not operate as a 'fundamental' barrier. In any event, RWE agrees with the CMA that the introduction of smart meters will significantly enhance the level of information available to customers about their own consumption.¹²⁰ RWE considers additionally that there are further informational measures that could be taken prior to the full rollout of smart meters to facilitate customer search; see further our response to the RN (remedy 9).

Stage 2: access to information

195. The CMA's provisional view is that customers face actual and perceived barriers to accessing and assessing information arising from the complex information in bills and the structure of tariffs, and lack of confidence in and access to PCWs by certain categories of customer.¹²¹
196. We consider that there are very low barriers to accessing and assessing information and that the CMA overstates the difficulties of accessing and assessing information.
- 196.1 Based on the Ofgem RMR baseline and year one surveys, around three-quarters of customers found it easy to decide which deal to switch to, easy to find the information they wanted and easy to understand the information they found.¹²²
- 196.2 The results of the GfK survey similarly show that 65% found the overall task of shopping around easy (very or fairly easy), and more than three-quarters found finding out about their own energy usage and finding out about other suppliers easy (very or fairly easy).¹²³
197. We accept that for *some* customers there may be a *perceived* barrier, but we do not consider that this barrier is borne out in practice by those who do shop around. As explained above and further in our response to the RN, we consider that any perceived barriers will be largely addressed once reforms to PCW Confidence code have had time to embed and smart meters are introduced, and can also be addressed prior to the rollout of smart meters by certain of the informational remedies under consideration by the CMA.
198. Suppliers are required to provide a wide range of information on bills and in annual statements, giving customers easy access to information on their consumption and on whether they are on the supplier's cheapest tariff, which they can use to decide whether to switch tariffs or shop around between suppliers. Additionally, the CMA fails to consider the role of sales and marketing activity in providing information to customers and thereby reducing search costs, even though it describes such activities as "*a central function of an energy retailer*".¹²⁴ By way of example only, RWE provides free sales calculator

¹²⁰ PFs, Chapter 2, page 97, paragraph 2.177; Chapter 8, page 316, paragraph 8.92; Chapter 8, page 367, paragraph 8.301; Chapter 9, page 383, paragraph 9.45; Chapter 12, page 474, paragraph 12.5; Chapter 12, page 477, paragraph 12.9.

¹²¹ PFs, Chapter 8, page 315, paragraph 8.87; Chapter 8, page 315, paragraph 8.89; Chapter 8, page 316, paragraph 8.92; Chapter 8, page 317, paragraph 8.96; Chapter 8, page 318, paragraph 8.98; Chapter 8, page 320, paragraph 8.106; Chapter 8, page 322, paragraph 8.111.

¹²² PFs, Appendix 8.2, page A8.2-5, Table 1.

¹²³ GfK Report, page 51, Figure 46.

¹²⁴ PFs, Chapter 7, page 240, paragraph 7.27.

comparisons via telephone and its website, which inform prospective customers how much (if anything) they would save by switching to RWE offers; these are bespoke to the customer's circumstances (current supplier(s), kWh level(s), postcode, payment method(s), fuel, tariff etc).

199. As regards the complexity of comparing tariffs, it has been recognised by Ofgem that standing charges have efficiency benefits;¹²⁵ and the CMA also correctly notes in its assessment of RMR that simpler choices rules have led some lower consumption customers, some of whom will have been on low income, to pay more, and also led to the removal of some niche products valued by customers for both price and non-price elements.¹²⁶ There is therefore clearly a balance to be achieved between simplifying products so that customers understand them, and maintaining sufficient flexibility to allow suppliers to compete, to recover fixed/variable costs in an equitable manner and to devise products that best meet customers' needs.
200. Currently, the RMR simpler tariff rules go too far in terms of simplification, and they restrict competition between suppliers in terms of both price and non-price factors (see further below). However, in light of the simplification that has taken place, it cannot be said that complexity of comparing tariffs operates as a barrier to search, and the evidence supports that this is not a barrier to search.
201. RWE supports the CMA's provisional finding that TPis such as PCWs can significantly reduce search and switching costs for domestic customers by providing an easy means to gain personalised quotes.¹²⁷ RWE agrees that PCWs are an important driver of competition and customer engagement, helping customers to make informed decisions about switching energy supplier and facilitating smaller suppliers to enter and expand on the market. Furthermore, the increasing use of PCWs and the fact that the majority of customers using a PCW 'multi-home' is an indicator of high levels of engagement in the market.¹²⁸
202. As set out in our UIS response and our response to the remedy 6 of the RN, we believe customers should be able to search and obtain information on other features such as term length, fixed versus variable in terms of price and length and energy efficiency, to enable them to make informed decisions and increase their understanding of energy costs in order to reduce their consumption. As also noted in our response to the UIS, 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.
203. Ofgem's Confidence Code (as amended) will undoubtedly be helpful in ensuring that trust and transparency is improved, and in our view, these could be further improved by direct regulation of PCWs. Whilst it is too soon to comment on the full impact of the Code, we would note that a key success has been to ensure that all accredited PCWs display tariffs, prices and savings in the same fashion, meaning that the consumer is reassured that they will see the same consistent pricing across any number of PCWs. We comment further in our response to the RN.
204. The CMA notes the rapid expansion in the use of PCWs and RWE agrees with this.¹²⁹ RWE's proportion of its total gains through the PCW channel has risen from [CONFIDENTIAL] in 2009 to [CONFIDENTIAL] in 2015. We consider that the CMA understates the impact of likely continued growth in PCWs.
205. As the CMA identifies, "*the internet has significantly reduced search and comparison costs in recent years*".¹³⁰ We accept that information might not be as easily available to the

¹²⁵ Ofgem, *The Retail Market Review – Implementation of Simpler Tariff Choices and Clearer Information*, Decision dated 27 August 2013, page 13, paragraph 2.13.

¹²⁶ PFs, Summary, page 31, paragraph 142; Chapter 8, page 354, paragraph 8.244.

¹²⁷ PFs, Summary, page 28, paragraph 125; Chapter 8, page 320, paragraph 8.103.

¹²⁸ PFs, Appendix 8.3, page A8.3-22, paragraph 81.

¹²⁹ PFs, Chapter 7, page 263, paragraph 7.110.

¹³⁰ PFs, Chapter 8, page 317, paragraph 8.94.

small proportion of customers without access to the internet, and that this may make these customers less likely to engage in the markets. However, we would note that even for customers without internet access, there is no barrier to accessing or assessing information; in the domestic energy segment, there are a number of PCWs who will provide information over the telephone for those customers who cannot or choose not to use the internet. For example, uSwitch has in-house and outsourced telesales partners and offers a mirror service to that offered to a consumer visiting the uSwitch website. RWE also receives telesales switches from a number of other major PCWs, again all offering the same full market comparison as their websites. (We would note that however that telesales made by PCWs are not subject to the Confidence Code.) Additionally, customers can and do call suppliers to discuss tariffs: RWE received around [CONFIDENTIAL] inbound sales calls in 2014.

206. Collective switches have been run by local councils and other public organisations in conjunction with PCWs, and they target customers who may be less engaged or less likely to switch. For example, Martin Lewis's MoneySavingExpert collective (Cheap Energy Club) appears to target and encourage customers who have not switched previously. uSwitch's telesales partners target new customers that have used the site for a different service such as mobile phone or financial service and targets customers who previously might not have considered switching their energy supply. As noted above however, PCW telesales services are not covered by the Ofgem Confidence Code; and they might more effectively address any barriers to engagement if they were covered by it and customers could have greater trust in them.

Stage 3: ability to act on information

207. The CMA focuses on two particular purported barriers to switching: erroneous transfers and uncertified meters. The CMA also addresses specific constraints it considers to exist in the case of pre-payment customers.¹³¹
208. The CMA provisionally finds that there is *"some evidence indicating that the process of searching for an alternative supplier and switching has been problematic for some customers. However, the perception of the complexity and burden of the process is worse than the reality, which may further dissuade domestic customers from shopping around and/or switching."*¹³²
209. RWE considers that the barriers to switching are low. The fact that the CMA homes in on two specific issues which affect a minority of customers is perhaps of itself an indication of the ease with which most customers can switch domestic energy supply, as a result of numerous changes in recent years.

Erroneous transfers

210. The CMA provisionally finds that erroneous transfers have the potential to cause material detriment to those who suffer from them.¹³³ RWE agrees that there is detriment to a customer who suffers an erroneous transfer.
211. However, as regards the CMA's provisional finding that erroneous transfers may impact customers' ability to switch as well as their perception of switching,¹³⁴ we would note that erroneous transfers affect only a small percentage of all transfers ([CONFIDENTIAL] of RWE's acquisitions) and the CMA has presented no evidence that an erroneous transfer operates as a barrier to switching for other customers (or indeed that they operate as a

¹³¹ PFs, Chapter 8, page 322, paragraph 8.112.

¹³² PFs, Summary, page 28 paragraph 126; Chapter 8, page 326, paragraph 8.133.

¹³³ PFs, Chapter 8, page 325, paragraph 8.125; Chapter 8, page 333, paragraph 8.157(ii)(c); Chapter 8, page 368, paragraph 8.301(c); Chapter 12, page 475, paragraph 12.5(c).

¹³⁴ PFs, Chapter 8, page 325, paragraph 8.125; Chapter 8, page 333, paragraph 8.157(ii)(c); Chapter 8, page 368, paragraph 8.301(c); Chapter 12, page 475, paragraph 12.5(c).

barrier for a customer who has previously experienced an erroneous transfer, although we accept that this may be the case).

212. Additionally, the CMA does not take full account of Ofgem's recent changes which will reduce concerns around erroneous transfers. The quicker switching changes introduced in 2014 have moved all responsibility for the transfer to the gaining supplier and have improved the process.

Uncertified meters

213. RWE considers that the current derogation applicable to Centrica distorts competition. As set out in our response to the RN (remedy 4b), RWE consider that an effective remedy would be, initially, for all suppliers to benefit from the derogation applicable to Centrica; and subsequently for a move towards a risk-based approach (see remedy 4b).

Prepayment meters

214. The CMA provisionally finds that prepayment meters place technical constraints on customers from engaging fully in the market, which contributes to such customers facing higher costs and a more limited choice of tariffs.¹³⁵ The CMA considers therefore that prepayment meters reduce customers' ability and incentive to engage in the market and search for better deals.¹³⁶
215. RWE acknowledges that there is a more limited choice of tariffs available to prepayment customers; suppliers have a specific number of tariff slots with the vending providers, making it difficult for them to change tariffs for prepayment meters, as there are a limited number of slots across the industry. The problem is exacerbated by the RMR simpler choices rules, which restrict the number of tariffs a supplier can offer and also prohibit cashback and other non-cash incentives such as vouchers, which was previously an effective means of offering discounts to prepayment customers. Therefore, relaxing the RMR simpler choices rules may result in more options for prepayment customers, as it would give suppliers the freedom to offer cashback and other non-cash incentives, notwithstanding the technical constraints on increasing the number of tariffs. The introduction of smart meters, at the appropriate time, will remove the technical barriers associated with prepayment meters and, in with the move from traditional to smart meters, is expected to further promote engagement by prepayment customers.
216. We would note that there is an additional cost to RWE of serving prepayment customers. In order not to disadvantage these customers, whom RWE accepts are more likely to be financially constrained, RWE sets its prepayment SVT at the same level as its standard credit SVT, notwithstanding that SLC 27.2A would permit RWE to apply a payment type differential to reflect the higher costs of serving prepayment customers.
217. In any case though, the evidence from the GfK customer survey, which the CMA notes, is that prepayment customers are no less likely to have switched supplier,¹³⁷ so the limited choice of tariffs would appear not to operate as a fundamental barrier to engagement.
218. It is unclear to us in this regard why the CMA appears to disregard levels of switching between supplier as an indicator of engagement, and there is a danger in the CMA drawing conclusions based on selective measures of engagement. We acknowledge that the GfK survey shows lower levels of engagement on measures other than switching between suppliers. However, it would be particularly concerning for the CMA to rely heavily elsewhere on whether customers have switched supplier in the last three years, and in relation to prepayment customers to give less weight to this indicator of engagement.

¹³⁵ PFs, Summary, page 28, paragraph 127; Chapter 8, page 329, paragraph 8.145; Chapter 8, page 333, paragraph 8.157(d); Chapter 8, paragraph page 368, 8.301(d), paragraph 12.5(d).

¹³⁶ PFs, Summary, page 28, paragraph 127; Chapter 8, page 329, paragraph 8.145; Chapter 8, page 333, paragraph 8.157(d); Chapter 8, page 368, paragraph 8.301(d); Chapter 12, page 475, paragraph 12.5(d).

¹³⁷ PFs, Chapter 8, page 297, paragraph 8.22.

iii. There is significant evidence of customer engagement in practice

219. The CMA provisionally finds that the number of “*fundamentally disengaged customers is substantial*”.¹³⁸
220. We disagree with this:
- 220.1 The CMA has neither explained what it means by, nor evidenced the existence of, a substantial number of customers who are “*fundamentally disengaged*”.¹³⁹
- 220.2 We explain above that the CMA has inferred that certain customer characteristics or choices indicate disengagement (notably, customers on SVT and customers who pay by standard credit), based on its own preconceptions, when in fact the CMA has no evidence that all such customers are disengaged and has not sought to find out whether these customers are exhibiting an active choice or disengagement.
- 220.3 The evidence from the GfK customer survey and *inter alia* evidence from the market of rates of switching between suppliers and tariffs in fact indicates that there is a good level of customer engagement in the market. Furthermore, RWE is disappointed that the CMA has interpreted and presented selected results from the GfK customer survey in a way that is misleading.
- 220.4 The CMA’s gains from switching analysis, which according to the CMA shows material unexploited gains that evidence a lack of engagement, is not only unreliable but the CMA’s interpretation of the results is unsupported.
- 220.5 Although the CMA appears to acknowledge in principle that engagement is not binary and that there are degrees of engagement along various dimensions of choice, in practice, the CMA seems to have interpreted the evidence in a binary way, often disregarding indicators of engagement wherever there exist *any* indicators of disengagement.

The GfK survey shows significant customer engagement

221. The CMA points to the GfK survey as providing “*material evidence of domestic customers’ lack of understanding of, and engagement in, retail energy markets.*”¹⁴⁰ The CMA appears to have been highly selective in the way in which it has interpreted the results of the survey. The CMA states that:
- “(a) 36% of respondents either did not think it was possible or did not know if it was possible to change one (or more) of the following: tariff; payment method **or** supplier;
- (b) 34% of respondents said they had never considered switching supplier;
- (c) 56% of respondents said they had never switched supplier, did not know it was possible **or** did not know if they had done so; and
- (d) 72% said they had never switched tariff with an existing supplier, did not know it was possible, **or** did not know if they had done so.”¹⁴¹ (emphasis added)
222. RWE considers that, on the contrary and notwithstanding the limitations in survey design, the GfK survey shows high levels of customer engagement. The GfK survey results show that:

¹³⁸ PFs, Chapter 7, page 258, paragraph 7.98.

¹³⁹ PFs, Chapter 7, page 258, paragraph 7.98.

¹⁴⁰ PFs, Summary, page 20, paragraph 89; Chapter 7, page 249, paragraph 7.64.

¹⁴¹ PFs, Chapter 7, page 249, paragraph 7.64.

- 55-59% of customers had compared prices once or twice in the last three years¹⁴²;
- Two thirds of customers who had switched in the past three years stated that they were likely to switch in the future¹⁴³;
- Nearly half (44%) of all customers have exercised their option to switch suppliers;¹⁴⁴
- A great majority of customers (89%) thought that it was possible to switch suppliers;¹⁴⁵
- Nearly half (43%) of all customers have been contacted by a different supplier from their current one, suggesting that the customer switch to the other supplier;¹⁴⁶ and
- Only 10% of customers who switched in the last three years thought switching was difficult.¹⁴⁷

223. The GfK survey also clearly demonstrates 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%)¹⁴⁸ even though, according to the GfK survey, customers appear to trust other energy suppliers (27%)¹⁴⁹ less than they trust these other service providers (mobile phone network providers (43%), banks offering current accounts (52%)).¹⁵⁰ In addition, a significant proportion of customers who shopped around and then decided not to switch, did not switch because after comparing tariffs they were either happy with their existing tariff, were confident they were on the right deal or did not think they would save enough to make it worth switching – a process that is generally considered to be straightforward.

224. Furthermore, the CMA has quoted from the results of the GfK customer survey in a way that is misleading. We refer to our comments in paragraph 188 above about the 36% figure calculated by the CMA. Similarly, the 72% (customers who had never switched tariff with an existing supplier, did not know it was possible, or did not know if they had done so) will include customers who have never switched tariff with an existing supplier but knew it is possible to do so and/or may even have switched between suppliers. Again, these customers may not only have some awareness of their options but may have shown clear signs of engagement. Therefore it would not be correct to rely on this figure to support a lack of understanding of, and engagement in, retail energy markets.

Correlation between different dimensions of engagement (as identified by the CMA)

225. The CMA considers that *“there is a degree of correlation between different dimensions of inactivity. For example, those on an SVT are more likely than those on non-standard tariffs: to be on a single fuel tariff; to pay by standard credit; and to be supplied by the historical incumbent.”*¹⁵¹

¹⁴² GfK Customer Survey Tables, Table 461.

¹⁴³ GfK Report, page 22, Figure 22.

¹⁴⁴ GfK Report, page 24, paragraph 73.

¹⁴⁵ GfK Report, page 39, Figure 35.

¹⁴⁶ GfK Technical Report, Appendix B, question E2(c).

¹⁴⁷ GfK Report, page 70, Figure 65.

¹⁴⁸ GfK Report, page 15, Figure 10.

¹⁴⁹ GfK Report, page 2, paragraph 9.

¹⁵⁰ GfK Customer Survey Tables, Tables 959 and 973.

¹⁵¹ PFs, Chapter 8, page 292, paragraph 8.5.

226. We do not agree that these product characteristics are suitable indicators (or dimensions) of engagement. Customers may have an active preference for, for example, payment type or whether a tariff is variable or not. Even if these product characteristics were indicators of inactivity, the correlation between these factors means that they cannot be considered one at a time. In its analysis, the CMA has made no attempt to disentangle any alleged effects on engagement or gains from switching that flow from, for example, being on an SVT, from the effects on engagement that flow from correlated factors. Such an approach would only be valid if there were no correlation between factors, but this assumption appears very unlikely to be the case. See our Authorised Advisers' Confidential Submissions for further details.
- 226.1 We explain above why we do not consider that customers on SVT or those paying by standard credit are necessarily disengaged.
- 226.2 Additionally, it does not make sense automatically to regard single fuel customers as disengaged. Around 4 million UK homes are off the gas grid. The fact that they are on a single fuel tariff cannot be taken as an indication of inactivity. Others may have actively chosen their other fuel tariff. The CMA does not address either issue.
- 226.3 As for a customer who is served by the incumbent supplier, we acknowledge that if that customer has never searched or considered switching either supplier or tariff, this *may* indicate a lack of engagement; however, many customers who are currently served by an incumbent supplier will have switched either or both, or searched and decided to stay with their existing arrangements (for reasons such as service, brand or price), and it would be wrong automatically to treat these customers as inactive. We note that based on the GfK survey, customers with an incumbent supplier are no more or less likely to have switched tariffs with their existing supplier.¹⁵²

Customer demographics

227. The CMA is looking at demographic factors on a 'one-by-one' basis. The demographic factors highlighted by the CMA are likely to be correlated. For example, a customer with no qualifications will reasonably be more likely to have a lower income. In its analysis, the CMA has made no effort to disentangle any alleged effects on engagement that flow from one demographic factor from the effects that flow from correlated demographic factors. This means that the CMA's analysis provides only limited insight as to which factors determine whether a customer is on SVT, whether they are engaged and the impact on potential gains from switching. See our Authorised Advisers' Confidential Submissions for further details.
228. The CMA finds, based on the GfK survey, that respondents aged 65+, those with a disability and/or those on the PSR are no more or less likely to have switched tariff with their existing supplier; and that a lower proportion of customers on the PSR are on an SVT.¹⁵³ We would make the following comments:
- 228.1 This would seem to highlight the danger in relying on specific results from the GfK customer survey, without considering the results in the round. On the one hand, the CMA finds that customers aged 65+ are less likely to have switched supplier in the last three years,¹⁵⁴ and on the other they are no more or less likely to have switched tariffs.¹⁵⁵ Both measures of engagement are relevant. Wherever possible the CMA should ensure it has taken into account all relevant measures. This might not always be possible given flaws in the GfK survey design, but the CMA clearly must take into account all measures covered by the survey. Furthermore, it should reflect properly on the survey's limitations (notably the survey's lack of collection of evidence on within supplier tariff switching) when seeking to interpret its evidence base.

¹⁵² PFs, Appendix 8.1, pages A8.1-32 – A8.1-33, paragraph 103.

¹⁵³ PFs, Chapter 8, page 292, paragraph 8.13; Chapter 8, pages 292-293, paragraph 8.15.

¹⁵⁴ PFs, Chapter 8, page 293, Figure 8.1; Chapter 8, page 293-294, paragraph 8.10.

¹⁵⁵ PFs, Chapter 8, page 294, paragraph 8.13.

- 228.2 Additionally, the demographics that the CMA has identified as being more likely to be associated with disengagement do not necessarily drive the gains from switching (and the CMA regards the latter as evidence of disengagement), and this would seem to be inconsistent with a finding that customer demographics determine levels of engagement.¹⁵⁶
- 228.3 The CMA provisionally finds that three suppliers (including RWE) take steps to encourage PSR customers to move onto more favourable tariffs.¹⁵⁷

iv. The CMA's gains from switching analysis cannot be relied on as evidence of weak customer response

229. We refer to our comments in Section F.b by way of preliminary remarks on certain key limitations to the CMA's gains from switching analysis.
230. The CMA points to the "*significant gains from switching that went unexploited by domestic energy customers over the period [2012 to 2014]*"¹⁵⁸ as providing evidence of weak customer engagement, given in particular the levels at which (according to the CMA's analysis) they are available, and that they relate to purportedly homogeneous goods that constitute a significant proportion of household expenditure.
231. RWE does not consider that the results of the CMA's gains from switching analysis are reliable and in any case RWE disagrees with the CMA's interpretation of them. We acknowledge that the CMA has made some adjustments to its methodology to reflect, in particular, parties' authorised advisers' Disclosure Room Reports; but nonetheless, the fundamental issues identified at the outset of the Investigation remain. See further our Authorised Advisers' Confidential Submissions:
- 231.1 The switching scenarios presented by the CMA do not properly reflect customer preferences; they rely on the assumption that only price (in p/kWh) is relevant for customers and as a result they overstate the potential gains from switching. The CMA states that the most important tariff characteristic for customers is likely to be the price (in p/kWh)¹⁵⁹ but provides no evidence that other characteristics are unimportant. RWE submits that customers do not only care about price. As described earlier in this report, RWE considers that the CMA's survey evidence and its evidence in relation to RMR suggest that customers' choices are driven by more than price alone. If so, then the CMA's 'gains from switching' reflect (at least in part) the value of the differences in product attributes and are not realistic potential gains from switching.
- 231.2 Although the CMA has considered a range of switching scenarios, ranging from (S1) changing tariff but keeping supplier and payment type, to (S5) changing supplier, tariff type and payment method, the CMA focuses almost entirely on the results of scenarios S4b and S5 which by design suggest the largest gains from switching. This is despite the concerns raised by RWE and others that, particularly in the more liberal scenarios, the CMA was not properly reflecting customer preferences.
- 231.3 The results of the analysis assume zero opportunity costs associated with search and switching. Whilst search and switching costs are low, to assume perfect search at all times is inconsistent with the obligation on the CMA to apply a benchmark of a "*well-functioning market*". This is one of a number of examples of the CMA assuming an "*idealized, perfectly competitive market*".
- 231.4 In any case the existence of potential gains from switching does not of itself necessarily indicate a competition concern and is a feature that is present in many markets. The CMA itself acknowledges that "*gains from switching are likely to be present in most markets*" but considers that "*we attach particular significance to the fact that they are available at such*

¹⁵⁶ PFs, Appendix 8.1, page A8.1-35, paragraph 114.

¹⁵⁷ PFs, Chapter 8, page 295, paragraph 8.16.

¹⁵⁸ PFs, Chapter 8, page 299, paragraph 8.30.

¹⁵⁹ PFs, Chapter 8, page 303 paragraph 8.42.

*levels for domestic gas and electricity customers (which are homogenous goods and constitute a significant proportion of household expenditure)."*¹⁶⁰

- 231.5 The CMA's reasoning is self-serving. It is precisely because the CMA has treated domestic gas and electricity supply as homogeneous products in which only the absolute price (p/kWh) matters, and other customer preferences/product characteristics (such as, *inter alia*, payment type and payment type sub-families, tariff structure, properly sub-divided length of fix, non-cash discounts) do not matter, that the CMA identifies savings at the level it does. The CMA then uses these inflated savings as evidence of concerns of significant levels of unexploited gains in a market for homogeneous goods.
232. The CMA also appears to place particular weight on the gains from switching analysis partly because it considers gains are higher for potentially more vulnerable consumers (low income, renters, those in receipt of Warm Homes Discount).¹⁶¹ However, this is inconsistent with the CMA's own finding in Appendix 8.1 that demographics do not make a material difference to gains.¹⁶²
233. Furthermore, the CMA's provisional conclusion that the existence of material potential savings provides evidence of weak customer engagement is inconsistent with the other evidence available to the CMA.¹⁶³ Without prejudice to our other submissions on the CMA's gains from switching analysis, we would urge the CMA to consider the results of its gains from switching analysis in the round, along with the results of its GfK customer survey and other evidence such as evidence of internal and external switching. The GfK customer survey in fact evidences high levels of engagement (see our comments above). We also refer above to the other evidence that there are high levels of engagement in the domestic segment.
234. We address in the following sections certain specific findings of the CMA. See also our Authorised Advisers' Confidential Submissions.

Non-standard tariffs

235. The CMA does not find that non-standard customers are disengaged or that competition is lacking in that segment. However, the CMA provisionally finds that "*while the gains for those on non-standard tariffs are substantially below those on SVTs, there were still appreciable gains to be made for those on non-standard tariffs.*"¹⁶⁴ We consider the existence of gains from switching for non-standard customers is consistent with customers making an active choice in a competitive market, and taking into account both price and non-price factors to find the tariff that is right for them. The CMA partially accepts this.¹⁶⁵
236. In the alternative, it may be that some non-standard customers have switched tariff, but did not consider switching supplier, as the CMA also notes ("*while active in the sense of having chosen a tariff, some customers may not be fully engaged in the sense of having fully considered the option of switching supplier.*")¹⁶⁶ The CMA seems to accept that a customer who switches tariffs but does not fully consider switching supplier, whilst according to the CMA is not "fully" engaged, is not disengaged.
237. An important feature of the gains from switching analysis is the CMA's result that the 'gains from switching' for customers on SVT are found to be only on average £34 more than the reported 'gains from switching' for customers on non-standard tariffs.¹⁶⁷ Competition for

¹⁶⁰ PFs, Summary, pages 26-27, paragraph 117; Chapter 7, page 285, paragraph 7.192; Chapter 8, page 310, paragraph 8.74.

¹⁶¹ PFs, Summary, page 27, paragraph 119.

¹⁶² PFs, Appendix 8.1, page A8.1-35, paragraph 114.

¹⁶³ PFs, Chapter 8, page 301, paragraph 8.35.

¹⁶⁴ PFs, Chapter 8, page 303, paragraph 8.43.

¹⁶⁵ PFs, Chapter 8, pages 304-305, paragraph 8.47.

¹⁶⁶ PFs, Chapter 8, pages 304-305, paragraph 8.47.

¹⁶⁷ PFs, Appendix 7.4, page A7.1-15, paragraph 44.

non-standard tariffs is, as the CMA acknowledges, intense and since non-standard tariffs are acquisition products, by definition those on non-standard tariffs must have engaged. RWE submits therefore the fact that the CMA is finding that there is almost as many 'gains from switching' (i.e., in truth, price variance) to be made for non-standard tariffs as it finds for SVTs strongly suggests that, in reality, some of the price variance observed for both SVT and non-SVT customers results from consumer preferences for non-price factors, returns from sales and marketing activities and/or differences in the costs of serving different customer segments who are attracted to different tariffs or types of tariff.

238. RWE submits that it is simply not credible for the CMA to maintain the position that there are systematically high search and switching costs among those individuals who have recently engaged in choosing a non-standard tariff given that its position is flatly contradicted by the CMA's survey results where a significant majority of individuals who have actively searched found search and switching easy (as noted above, 65% found the overall task of shopping around very/fairly easy; additionally, 83% of those who switched in the past three years found it to be very/fairly easy¹⁶⁸). Yet, to explain its findings that there are such apparently high gains from switching available to people who have recently engaged and chosen non-standard tariffs, the CMA would need to believe that such search and switching costs are large even among engaged customers who say they found search and switching easy.
239. RWE further submits that a far simpler explanation of the observed price variance – one that is consistent with the CMA's survey evidence – is that in reality customers do care about aspects of the product's attributes in addition to price (see paragraph 112 above), the brand or reputation of their supplier and/or that they respond to marketing and sales activities, so that, as a result, these factors should be expected to be reflected in the prices the CMA observes (which then drive the gains from switching the CMA purports to find). For all the reasons set out in this response and previous submissions to the CMA, RWE believes that the CMA is not justified in putting such emphasis on its gains from switching analysis. To come to a properly reasoned judgement the CMA must accept that, in reality, the CMA's gains from switching analysis simply measures the extent of price variance across tariffs including the price variance which results from causes that have nothing to do with search and switching costs or weak customer response.
240. The fact that the gains from switching do not equate to inactivity, but to the potential importance of a range of other factors, is also demonstrated by the survey evidence that shows gains from switching available to customers who have searched or switched in the last year, who presumably the CMA consider to be active. See further our Authorised Advisers' Confidential Submissions.
241. At the very least (and putting aside any outstanding methodological concerns we may have) the CMA should focus on the difference in savings between SVT and non-standard customer groups rather than the absolute level of price differences (since these will be correlated with consumer preferences for product attributes).

SVT attributes

242. Whilst the CMA seems to acknowledge that "*it is still possible in principle that customers are choosing not to switch from an SVT because of beneficial non-price attributes that it has*",¹⁶⁹ the CMA summarily rejects this possibility without any evidence as to whether or not this is the case. We refer above to the evidence that in practice some customers choose to be on an SVT.
243. The CMA goes on to consider that "*If a customer were to adopt a **simple strategy** of buying the market's cheapest fixed tariff and then switching at the end of the term to the market's cheapest fixed tariff prevailing at that time, there would be no volatility within the term of the tariff, but potentially a significant jump (up or down) at the end of the tariff's term.*"¹⁷⁰ It is the CMA's assessment that this is a simple strategy, but this fails to take account of

¹⁶⁸ GfK Technical Report, Appendix B, question E43.

¹⁶⁹ PFs, Chapter 8, page 305, paragraph 8.48.

¹⁷⁰ PFs, Chapter 8, page 305, paragraph 8.50.

customer preferences and that customers may consider the available savings not worthwhile and/or choose not to switch on an annual basis for this reason. RWE believes that this is another example of the CMA basing its analysis on a theoretical notion of a perfect market.

Exit fees

- 243.1 The CMA considers that customers may value tariffs that do not have exit fees.¹⁷¹ We agree that the existence or otherwise of exit fees is a feature that customers will take into account in deciding whether a tariff is right for them. This is a factor we consider the CMA does not properly reflect in its gains from switching analysis and which may explain some of the price variation between tariffs which may drive apparent the gains from switching.
- 243.2 The CMA estimates that 53% of fixed-term fixed-price tariffs are subject to exit fees; its justification for not taking these into account is that *"Customers on the SVT do not face exit fees and it is these customers who are estimated to have the most to gain from switching."*¹⁷² However, the CMA appears to misunderstand the point made by RWE; it is precisely because SVT customers generally do not face exit fees and fixed tariff customers often do that the CMA is overstating the gains available to SVT customers. Whilst it is correct that SVT customers would not have to pay an exit fee to switch tariffs, the fact that the tariff the CMA proposes they should switch to has an exit fee should be taken into account when calculating what the real potential 'gain' is from switching. See further our Authorised Advisers' Confidential Submissions.

Payment method

244. The CMA acknowledges that *"Payment method is a further potential dimension of choice to which customers may assign value."*¹⁷³ We agree with this. We welcome the acknowledgement by the CMA that *"some customers who currently pay by standard credit may do so because they value the flexibility over the timing of payments it affords them."*¹⁷⁴ However, the CMA implies that this is a minority of customers and that for most customers on standard credit, this is not an active choice (the CMA repeats an assumption made elsewhere that *"paying by direct debit offers greater convenience to the customer than paying by standard credit"*¹⁷⁵; the CMA also relies on the fact that standard credit customers are most likely to be with the incumbent gas and electricity supplier as indicating a greater propensity to be inactive).¹⁷⁶ We would urge the CMA not to make such presumptions as to whether or not customers on standard credit have made an active choice of payment type. See also our comments in paragraphs 176 to 180.3 above about customers choosing standard credit and prepayment.

v. Impact of recent and forthcoming changes

245. We refer above to some of the recent and forthcoming changes in the domestic segment that can be expected to improve customer engagement, including the provision of clearer information on bills, the growing use of PCWs and the recent implementation of the PCW Confidence code, the recent and forthcoming changes to bring about faster and more accurate switching, and the rollout of smart meters.
246. Some of these are changes that have already started to have a positive impact on customer engagement. For example, the GfK survey and the Ofgem RMR baseline and year one surveys all indicate that customers have easy access to the information they need to shop around; the continuing rapid growth of the mid-tier and smaller suppliers, and RWE's own internal and external switching figures, indicate that customers are increasingly engaged.

¹⁷¹ PFs, Chapter 8, page 306, paragraph 8.51.

¹⁷² PFs, Appendix 7.4, page A7.4-13, paragraph 38.

¹⁷³ PFs, Chapter 8, page 306-307, paragraph 8.53.

¹⁷⁴ PFs, Chapter 8, page 308, paragraph 8.56.

¹⁷⁵ PFs, Chapter 8, page 306, paragraph 8.53.

¹⁷⁶ PFs, Chapter 8, page 307, paragraph 8.55.

However, these changes will not yet be fully reflected in the evidence collected by the CMA, and the CMA should ensure it properly takes this into account. In its PFs, whilst the CMA indicates its awareness of the changes, the CMA does not properly reflect these changes (or the limitations in the evidence available to the CMA) in reaching a provisional finding of weak customer response.

247. Similarly developments such as the rollout of smart meters are expected to have a significant positive impact on customer engagement in the near future, and this of course will not be reflected in the evidence collected by the CMA.
248. In addition of course, significant change will continue to result from the continuing growth and increasing scale of the competitive constraint from small and mid-tier suppliers. Small suppliers will continue to have cost advantages (via exemptions) over the Six Large Energy Firms, which makes them artificially stronger competitors by design.
249. And finally the CMA will need to take proper account throughout its analysis of changes to regulation, both in terms of the removal of restrictions of competition resulting from measures such as SLC 25A and RMR simpler choices, and also the expected positive impact of measures such as the development of smarter markets.
250. In considering the extent of any AEC and the proportionality of any remedies, the CMA will need to take proper account of all these developments.

b. Suppliers do not have unilateral market power over any part of the customer base

251. The CMA considers that weak customer response confers upon suppliers unilateral market power over their inactive customer base, which is manifested through price discrimination and charging prices to some customers that are higher than can be justified by costs.¹⁷⁷
252. RWE disagrees with this:
 - 252.1 First, in reaching such an assessment for the position going forwards the CMA has not taken full account of all of the changes outlined in paragraphs 245 to 249.
 - 252.2 Second, in making this judgement the CMA wrongly assumes that price discrimination is indicative of a competition problem, whereas in fact it can give rise to customer benefits. In this regard, additionally, the CMA does not properly weigh the evidence of competition over SVT customers or the protection afforded by active customers to less active customers.
 - 252.3 Third, the CMA's assessment of profitability is fundamentally flawed. The CMA's evidence suggests that there were no (or very small) excess out-turn profits (e.g. domestic margins measured at 3.3% while, according to the CMA, margins in the range of 1-3% would appear to provide a guide to competitive EBIT)¹⁷⁸ and CMA's "inefficiency" explanation for excess profitability is implausible. In light of low overall margins (and profitability that, on a proper assessment, is not excessive) we fundamentally disagree that prices charged by RWE are higher than can be justified by costs. There are no excess profits.

i. Evolution of price competition over time

There has been significant growth of the smaller/mid-tier suppliers

253. The period under review by the CMA has been characterised by the substantial growth of the smaller/mid-tier suppliers, and a change to the way in which suppliers compete on

¹⁷⁷ PFs, Summary, page 29, paragraph 128; Summary, page 30, paragraph 135; Summary, page 38, paragraph 175; Chapter 8, page 313, paragraph 8.81(f); Chapter 8, pages 331-332, paragraph 8.156; Chapter 8, page 342, paragraph 8.195; Chapter 8, pages 366-367, paragraph 8.300; Chapter 8, page 368, paragraph 8.302; Chapter 10, page 406, paragraph 10.1; Chapter 10, page 435, paragraph 10.136; Chapter 12, page 474, paragraph 12.4; Chapter 12, page 475, paragraph 12.6.

¹⁷⁸ PFs, Chapter 10, page 434, paragraph 10.130-10.131.

price, resulting from changes to the regulatory regime and the increasing competitiveness of the market.

254. The CMA acknowledges that there has been a rapid expansion in the market shares of suppliers outside of the Six Large Energy Firms, which has resulted in falling levels of market concentration.¹⁷⁹ We agree with this. Specifically, the CMA documents the fall in concentration measured by HHI of approximately five hundred points in gas (from 2,450 to 1,950) and by around three hundred points in electricity (from 1,800 to 1,500) over the last four years alone so that – on conventional competition policy thresholds – the industry is already markedly less than highly concentrated. There is every reason to expect that concentration will continue to fall rapidly over the next few years. As the CMA notes, in two out of three of RWE’s incumbent regions, it is no longer the largest supplier.¹⁸⁰ Within the last 4 years, each of the former incumbent electricity suppliers has seen its market share in electricity in its incumbent region decrease (decreases in market share range between 4% and 14%; RWE’s share has decreased by [CONFIDENTIAL]).
255. In RWE’s view, the CMA does not properly take this into account in assessing conditions of competition and, in particular, the ability of each of the Six Large Energy Firms to exercise unilateral market power in respect of any part of their customer base. The CMA also does not properly take into account the impact on price competition of small supplier exemptions (see further below).
256. The CMA notes that over the last year, “*virtually all of the tariffs offered by these suppliers were below the average SVT of the Six Large Energy Firms.*”¹⁸¹
257. We have previously submitted that RWE’s non-standard tariffs are normally priced at a discount to its SVT and that this is a pricing model adopted not only by the rest of the Six Large Energy Firms but across the industry (for example, RWE understands that First Utility has over 1.5 million customers, of whom 15% are on SVTs). It is evident also that the mid-tier suppliers are in a phase of growth and acquisition, and we would expect them to acquire customers predominantly onto discounted non-standard products (as RWE does – see above). In light of this, it is not surprising that most of their tariffs are acquisition tariffs priced at below the average SVT of the Six Large Energy Firms. This is a function of the see-saw pricing model operated across the industry (see further below).
258. We note that a number of mid-tier suppliers’ SVTs are priced above the average SVT of the Six Large Energy Firms, indeed some are priced significantly higher which would suggest that for some or all of the mid-tier suppliers considered by the CMA, the discount between their SVT and non-standard tariffs may be significantly greater than it is for any of the Six Large Energy Firms. Indeed, our understanding¹⁸² is that First Utility currently offers a discount of 19% on its cheapest tariff (at Ofgem’s medium user consumption level) compared to its SVT which is higher than many of the larger suppliers; and Extra Energy offers a discount against its SVT of over 20%. The CMA has not commented on this.
259. As regards average revenues of the mid-tier suppliers, the CMA’s results, which are largely redacted, appear to be mixed. The CMA refers to some mid-tier suppliers that, in 2014, earned average revenues for electricity and gas that were lower than the average of the Six Large Energy Firms,¹⁸³ but also refers to at least one mid-tier supplier whose average revenues for electricity and gas were close to and, in some cases, exceeded the average of the Six Large Energy Firms.¹⁸⁴ (It is unclear why the average is the appropriate benchmark for such comparisons – instead of the lowest price of one of the Six Large Energy Firms – since the CMA alleges that all of the Six Large Energy Firms have unilateral market power but does not suggest the same is true of the mid-tier and smaller suppliers. In addition, it

¹⁷⁹ PFs, Summary, page 22, paragraph 97.

¹⁸⁰ PFs, Chapter 7, page 261, paragraph 7.105.

¹⁸¹ PFs, Chapter 7, page 273, paragraph 7.148.

¹⁸² As at 10 July 2015.

¹⁸³ PFs, Summary, pages 39-40, paragraph 183; Chapter 7, page 273, paragraph 7.149.

¹⁸⁴ PFs, Chapter 10, page 429, paragraph 10.105.

is unclear to RWE why the CMA has used a different period here than that used for the rest of its profitability and pricing analysis, of 2009 to 2013.)

260. The CMA notes that these results and differentials highlighted by the CMA “*may reflect in part the impact of compositional factors, including differences in the location of suppliers’ customers...and differences in the proportion of customers using particular types of payment methods.*”¹⁸⁵ We agree with this. However, the CMA fails to note that additionally, the difference in revenues will reflect *inter alia* the difference in product mix between the Six Large Energy Firms and mid-tier suppliers, and will not take account of the different cost base associated with SVT and non-standard products (see our comments further in this Section).

The CMA’s cost pass-through analysis significantly overstates any widening of the gap between SVT prices and underlying costs

261. The CMA provisionally finds that the evidence it has reviewed “*appears to be consistent with a potential weakening of competition over the SVT over time, and particularly from 2009, as the gap between the SVT and underlying costs appears to widen.*”¹⁸⁶
262. We consider that the CMA’s methodology is flawed and therefore overstates any widening of the gap. However, we do consider that there may be some widening of the gap to reflect the return from unsustainable margins towards the beginning of the period to more sustainable margins by the end, and resulting from the dampening of competition caused by SLC 25A.
- 262.1 Whilst the CMA has adjusted its methodology to some extent in response to the submissions of various parties, we continue to have serious concerns about the way in which the CMA has determined expected costs and the selective manner in which the CMA has relied upon the results of its analysis. In particular, the methodology: does not account for differences in the hedging approaches deployed for SVT and non-standard products, respectively; ignores the fact that the pricing of SVT and non-standard products [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 price – which can, for example, arise because average revenues (per unit of power/gas) will be higher in low volume out-turn years all else equal because consumers’ average unit costs will be affected by standing charges. All of these effects are fundamental to a proper analysis in a competition investigation of this nature.
263. Appendix 7.2 presents the CMA’s analyses, which consists of two parts:
- 263.1 The first part (Part A) assesses the Six Large Energy Firms’ *tariff*-setting behaviour and the extent to which changes in short-term (monthly) “marginal” costs correlates with those decisions; and
- 263.2 The second part (Part B) assesses the relationship between longer term changes in actual (incurred) costs and actual (realised) *unit revenues* (“prices”).¹⁸⁷
264. The CMA’s finding of a ‘widening gap’ appears to rely heavily on the results of the analysis performed in Part A, despite the CMA’s own acknowledgement that “*Part A uses stylised monthly prices and costs [that] are not a comprehensive source for the assessment of the levels of costs, and so gross margins,*”¹⁸⁸ and despite recognising that “*the one-year*

¹⁸⁵ PFs, Chapter 10, page 429, paragraph 10.110.

¹⁸⁶ PFs, Chapter 7 page 276, paragraph 7.161.

¹⁸⁷ PFs, Appendix 7.2, pages A7.2-3 - A7.2-4, paragraph 12.

¹⁸⁸ PFs, Appendix 7.2, page A7.2-4, paragraph 13.

forward-looking cost benchmark departs from each firm's cost outlook in one way or another."¹⁸⁹

265. In Part A of Appendix 7.2, the CMA sets out to assess how monthly changes in (what it deems to represent) expected marginal costs are passed through to prices. The CMA considers that the measures it employs are "*sufficiently robust for assessing the relative movements of costs and prices*"¹⁹⁰, despite acknowledging that:
- 265.1 Monthly forecast cost measures (to the extent that they are available at all) may lack precision and are in some cases produced on a different basis by each firm;
- 265.2 Firms may be (efficiently) absorbing short-run cost movements that risk-averse customers do not like;
- 265.3 There may be significant menu costs (costs of changing prices, such as the costs of updating the billing systems, informing customers, or reputational costs);
- 265.4 The cost measures used in Part A are not a comprehensive source for the assessment of the levels of costs (and, hence, gross margins);
- 265.5 There are several other factors suppliers take into account when setting prices, including their hedging contracts;
- 265.6 There have been a number of regulatory changes throughout the period of analysis, which may have affected the way suppliers price their products.¹⁹¹
266. In light of the sheer number and materiality of those caveats (as put forward by the CMA itself), the CMA cannot credibly rely on its Part A analysis.¹⁹²
267. In addition, in respect of the CMA's chosen pricing measure in Part A, RWE notes that the CMA considers its pricing measure¹⁹³ – a simple average of the Six Large Energy Firms' SVT bills – is informative and relevant for Part A. The CMA argues it would not be appropriate to use an average price weighted by market share (of the form proposed in paragraph 40(b)) on the grounds that the weights would change over time and so this may make comparisons across time harder. In this respect, RWE does not consider the CMA's position is ultimately convincing since the CMA could easily choose weights which are constant over time and which nonetheless reflect suppliers market shares more convincingly than using weights equal to one.
268. By contrast, Part B uses annual data and more comprehensive measures of all direct cost items, and so can be used to assess the levels of gross margins and the relationship between costs and prices over the longer term. The widening of the gap seems to be much less pronounced, if it is discernible at all.¹⁹⁴
269. The CMA lists the numerous criticisms that the parties had levelled at the Part A type analysis previously presented in the Cost pass-through working paper,¹⁹⁵ and then claims that they are addressed by the CMA's analysis in Part B.¹⁹⁶ However, since the CMA has

¹⁸⁹ PFs, Appendix 7.2, page A7.2-27, paragraph 79.

¹⁹⁰ PFs, Appendix 7.2, page A7.2-4, paragraph 13.

¹⁹¹ PFs, Appendix 7.2, page A7.2-3 - A7.2-6, paragraphs 11-20.

¹⁹² The CMA states that its "analysis does not seek to form a view of how each of these factors interact", but the interaction of these factors (and, possibly, even others) in relation to the determination of prices cannot be merely glossed over the way in which the CMA does. PFs, Appendix 7.2, page A7.2-5, paragraph 16.

¹⁹³ PFs, Appendix 7.2, page A7.2-13, paragraph 40(a).

¹⁹⁴ PFs, Appendix 7.2, page A7.2-24, Figure 7. In addition, Footnote 37 on page A7.2-23 states: "For electricity, the compound growth rate is 5.2% for revenue and 4.7% for direct costs. For gas, the compound growth rate is 5.4% for revenue and 5.8% for direct costs."

¹⁹⁵ PFs, Appendix 7.2, pages A7.2-28 - A7.2-29 paragraph 80.

¹⁹⁶ PFs, Appendix 7.2, page A7.2-29, paragraph 81.

relied almost entirely on Part A and has, to a large extent, arbitrarily ignored Part B, these criticisms have not in fact been properly addressed. It is unclear to RWE why the CMA has given so little weight to Part B and has continued to rely on Part A despite the serious criticisms raised by the parties.

270. The most fundamental (but not the only) limitation to the CMA's Part A analysis (see further paragraph 262 above) is that both of its measures of expected wholesale costs (which are a supplier's most significant direct cost item) fail to take account of suppliers' actual hedging strategies. The CMA explains the failure to take account of firms' hedging strategies by saying that the one-year forward-looking benchmark *"does not involve any assumptions about the hedging decisions that should or could have been made by all firms in the market. Adopting a firm's hedging strategy or a stylised hedging strategy would produce a benchmark that would bias the analysis to the benefit of one or a few firms."*¹⁹⁷ In respect of the latter point, RWE accepts it would change the CMA's cost benchmark, but notes that the CMA's focus is in considering industry wide averages, so that the sense in which individual firms would benefit is not clear; all firms costs would move up or down depending on the choices being made. Moreover, it does not follow that it is appropriate to use a benchmark that is not correct for any of the firms to which it is applied. This would seem to indicate a failure on the part of the CMA to understand the importance of hedging and how firms hedge their wholesale energy costs (see further our comments in Section F above).
- 270.1 The widening of the gap between SVT prices and cost benchmarks identified by the CMA¹⁹⁸ is likely to be less pronounced if the CMA allows (as it should) for longer term hedging strategies. This can be seen to some extent as between the two cost benchmarks used by the CMA, with the widening less pronounced with the CMA's adjusted SMI which (whilst flawed) at least allows for some hedging of wholesale costs. See further our Authorised Advisers' Confidential Submissions.
- 270.2 The CMA does not properly acknowledge that it is perfectly rational (and pro-competitive) for a profit-maximising retail energy supplier to engage in hedging of wholesale energy costs. Additionally, the CMA seems to misunderstand the differences between suppliers' hedging strategies (and that these are likely to differ for SVT and non-standard products). See further our comments in Section F.b.
271. The CMA's analysis is based on a flawed claim that, in principle, only the energy cost that the supplier expects to incur in purchasing the remaining expected volume (the 'open' position) should matter in terms of the way in which a retail supplier sets its prices, whereas the cost that the supplier has already incurred for future delivery by purchasing some of the expected volume in advance (the 'closed' position), e.g., through hedging contracts, should be deemed irrelevant.¹⁹⁹
272. The CMA provisionally finds that SVT price changes (both price increases and price decreases) have generally been less frequent and smaller in magnitude than the movements in the one-year benchmark and appear to lag changes in the benchmark.²⁰⁰
- 272.1 It is unsurprising that price changes have been less frequent. RWE typically changes its SVT prices once or twice a year (1.4 times on average over 2004 to 2014):
- 272.1.1 There are significant menu costs (in the region of [CONFIDENTIAL]) so that changing prices involves significant cost to suppliers, particularly when prices are increasing, as the CMA seems to acknowledge.²⁰¹
- 272.1.2 Additionally, the increased media and political comment and intervention in relation to SVT price changes (vastly greater than that which is prompted by

¹⁹⁷ PFs Appendix 7.2, page A7.2-27, paragraph 79.

¹⁹⁸ PFs, Summary, page 32, paragraph 149; Chapter 7, page 276, paragraph 7.160.

¹⁹⁹ PFs, Chapter 7, page 275, paragraph 7.155; Appendix 7.2, pages A7.2-5 – A7.2-6, paragraphs 18-19.

²⁰⁰ PFs, page 276, paragraph 7.160(a).

²⁰¹ PFs, Appendix 7.2, page A7.2-3, paragraph 11(b); Appendix 7.2, page A7.2-18, paragraph 51(a).

non-standard changes) 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.

- 272.1.3 Indeed the failure by Government and others properly to explain the reason behind price changes and the increasing contribution of policy and network costs (which the CMA seems to acknowledge) 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 SVT prices cannot readily be changed frequently and [CONFIDENTIAL] in order to avoid the political and media implications which impact customer perception.
- 272.1.4 [CONFIDENTIAL] As a result, as the CMA identifies, RWE typically is forced to [CONFIDENTIAL]
- 272.2 There are also a number of reasons why, based on the CMA's analysis, SVT price changes would be expected to lag changes in forward looking costs. This may in part reflect hedging of wholesale energy costs by suppliers, which the CMA has not properly taken into account in its Part A analysis – we refer to our comments in Section F.b above, which we do not repeat here. Additionally, given that price changes take place infrequently, it is natural that a price change will lag the change in underlying expected costs.
273. The CMA also observes that the cheapest one-year fixed tariffs appear to have followed its expected cost measures more closely than the SVT.²⁰² Again, this is entirely unsurprising. Whereas suppliers can only put through SVT price changes infrequently resulting in a natural lag between changes in expected costs and price, by contrast, suppliers are able to launch non-standard tariffs quickly, therefore can more quickly reflect changes in underlying expected costs.
274. The CMA touches on its Part B analysis in provisionally finding that “*net margins for the sale of electricity and gas to domestic customers were relatively low in 2007 and 2008 and have increased thereafter, although there is no obvious trend from 2010 to 2013.*” The CMA also finds that “*Average gross margins earned by the Six Large Energy Firms from sales of gas and electricity to the domestic customers have not shown a clear trend over the period 2007 to 2013.*”²⁰³ However, the CMA does not seem to place any weight or draw any conclusions from this, even to sense check whether the results of its Part A analysis are correct, despite the fact that the CMA's Part B analysis, which is based on actual data (in stark contrast to the largely hypothetical Part A analysis), does not support the CMA's Part A analysis. We refer to our Authorised Advisers' Confidential Submissions, which extend the CMA's Part B analysis to a longer timeframe, and show that there is in fact some widening of the gap for gas only, consistent with unsustainably low margins in the earlier part of the period and the impact of SLC 25A on fuel type differentials.
275. The CMA identifies that average (nominal) electricity prices rose by 24% and gas prices by 27% over the period 2009 to 2013.²⁰⁴ RWE welcomes the acknowledgement by the CMA that for electricity, the main drivers of price increases have been the costs of social and environmental obligations and network costs.²⁰⁵ We set out below in this section our comments on the impact of policy interventions on competition and pricing.
276. 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. See further our comments in this section in relation to cost pass-through and profitability.

²⁰² PFs, Chapter 7, page 277, paragraph 7.163.

²⁰³ PFs, Chapter 7, page 279, paragraph 7.171.

²⁰⁴ PFs, Chapter 2, page 88, paragraph 2.145.

²⁰⁵ PFs, Chapter 2, page 89, paragraph, 2.147.

ii. Price discrimination is not indicative of a competition problem

277. The CMA relies on evidence of price discrimination between SVT and non-standard tariffs as evidence of market power, and the CMA assumes that price discrimination produces negative outcomes. The CMA finds that there is a wide range of tariffs and a "*striking variation*" in price level, "*particularly for a homogenous product*", and that the range appears to have widened over the past 12 months.²⁰⁶
278. RWE does not agree with the CMA's provisional findings in this regard.
279. RWE does not dispute that there is an element of price discrimination in the retail energy supply markets. However, the CMA has failed to demonstrate why this raises any competition concern. The CMA appears to imply that the presence of price discrimination suggests suppliers hold a position of unilateral market power, but the CMA has not shown that this is the case.²⁰⁷ In reality, price variation and price discrimination are features of many competitive markets and from an economic point of view are often considered to be efficient/pro-competitive. RWE has previously submitted to the CMA a number of remarks in relation to the role and importance of price discrimination in driving competition in response to the CMA's consideration of SLC 25A. We do not repeat those submissions here, beyond noting that we wrote in that paper that:

"npower agrees with the CMA that the economic literature suggests the effects of a ban on price discrimination are ambiguous. However, the economic literature identified by the CMA does emphasise that a ban has the potential to harm consumers. In particular, the economic literature on price discrimination proposes that:

- *Price discrimination can result in extended access to the market, with additional customer groups being served, due to greater ability of suppliers to target these customer groups with lower prices²⁰⁸;*
- *Price discrimination can allow for the efficient volumes to be provided to customers and efficient recovery of fixed costs²⁰⁹; and*

²⁰⁶ Specifically, the CMA finds that (PFs, Chapter 7, page 269, paragraph 7.134):

Up to the end of 2012 there were many non-standard variable tariffs, which offered some of the cheapest rates, and fixed and capped rate products were often sold at a premium; and that with the introduction of RMR, fixed rate products have taken the place of non-standard variable products as the cheap acquisition product. However, over the last year, the "*disparity between the SVT and the cheapest non-standard products offered by the Six Large Energy Firms as increased...as they have begun to compete more vigorously with the mid-tier suppliers in the non-standard space.*"

The CMA calculates (PFs, Chapter 8, page 336, paragraph 8.168) that from mid-2013 to March 2015, just over 40% of discounted fixed-tariffs (which we assume means fixed price and fixed term) were priced at a discount of 10% or more on the SVTs. Similarly, the CMA identifies material gains from switching for SVT customers under scenario S1 of its gains from switching analysis.

The CMA also calculates (PFs, Chapter 7, pages 337-338, paragraph 7.184) that for all the dual fuel customers of the Six Large Energy Firms, average potential gains from switching externally to any tariff offered were equivalent to 14% of the average bill (equivalent to about £160 a year) (and that standard credit SVT customers could have saved an average of 22% by switching tariff and/or supplier and payment method, or 14% while keeping their current payment method; whilst direct debit SVT customers could have saved 15% by switching tariff and/or supplier).

²⁰⁷ PFs, Chapter 8, page 341, paragraph 8.193.

²⁰⁸ This can be seen in the monopoly literature, which whilst not directly relevant to the energy market, we nevertheless view as informative. See Schmalensee, R., (1981), Output and Welfare Implications of Monopolistic Third-Degree Price Discrimination, *The American Economic Review* 71(1), pp. 242-247. Varian also suggests that a necessary condition for price discrimination to be welfare enhancing is that it expands market output. Varian, H. P., (1985), Price Discrimination and Social Welfare, *The American Economic Review* 75(4), pp. 870-875.

²⁰⁹ See for example, Ramsey, F. (1927) "A contribution to the Theory of Taxation", *Economic Journal*, pp. 47-61. And Baumol, W. J., and D. F. Bradford (1970), Optimal Departures from Marginal Cost Pricing, *American Economic Review* 60 (June), pp. 265-283.

- Price discrimination in oligopoly markets can potentially benefit consumers through increased competition^{210 211.}
280. We believe such observations have relevance in response to the CMA's PFs. In particular, they make clear that the CMA cannot legitimately presume price discrimination is an indication of a problematic degree of market power, as it currently appears to.
281. Additionally, the CMA does not properly weigh the evidence of competition over SVT customers or the protection afforded by active customers:
- 281.1 The CMA accepts that firms monitor each other's SVT prices and that SVT prices track each other fairly closely over time,²¹² but the CMA does not properly take into account this competition and seems to assume that firms compete only in relation to non-standard tariffs.
- 281.2 The CMA also seems to acknowledge that significant numbers of customers on SVT have engaged recently (see our comments above) but does not properly take into account the competitive constraint which derives from their likelihood of re-engaging. As noted above, in 2014, [CONFIDENTIAL] of RWE's SVT customers left RWE for another supplier or transferred to a different RWE tariff. In 2015 (to June 2015), [CONFIDENTIAL] of all losses suffered by RWE were from [CONFIDENTIAL]. Furthermore, as RWE does not know which of its customers are going to leave or transfer onto another npower tariff, RWE does not differentiate in the SVT it charges. 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 SVT are not 'locked in' and there are no barriers to them switching to a fixed term product with RWE or switching to another supplier. Therefore, to the extent there are less engaged SVT customers, they benefit from the competitive constraint imposed by more active SVT customers.
- 281.3 On a related issue, the CMA also does not take proper account of the constraint imposed on SVT by non-standard pricing. 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. Prices for SVT and non-standard products are [CONFIDENTIAL]
282. In RWE's view, any increased discounts over the last 12 to 18 months have been driven by:
- 282.1 An increasingly competitive market (see for example our comments above about the rapid expansion of the smaller suppliers);
- 282.2 RMR simpler choices rules that effectively prohibit cash discounts on the SVT, thereby forcing suppliers to offer discounted non-standard tariffs in order to acquire customers; and
- 282.3 [CONFIDENTIAL]
283. We have previously emphasized that the CMA's gains from switching analysis inappropriately assumes consumers do not have preferences for product attributes. If this were true then we would not observe active customers choosing to be on SVT and we would expect to find that those on SVT have much larger gains from switching than those customers who are currently on non-standard tariffs. The CMA's results however are not consistent with this. In particular while the CMA finds that *"For all the dual customers of the Six Large Energy Firms, average potential gains from switching externally to any tariff offered were equivalent to 14% of the average bill (equivalent to about £160 a year) over*

²¹⁰ The benefits from this competition could be both in terms of lower prices and increased product differentiation (consumer choice) from the suppliers' ability to launch targeted products.

²¹¹ Intuitively, whilst a single firm is always better off being able to offer a range of prices, we note that the economic literature has emphasised that the same need not be true in strategic situations. In some circumstances, limiting the opportunities for competition, for example, through uniform prices can be beneficial to firms, to the potential detriment of consumers.

²¹² PFs, Chapter 7, page 267, paragraph 7.127.

the period."²¹³ It also finds that the difference in the gains from switching for those on non-standard and those on SVT are nothing like of this order of magnitude. Instead the CMA finds that *"the average difference [in gains from switching] amounts to around £34 per customer per year."*²¹⁴ This evidence does not support the CMA's provisional finding that the Six Large Energy Firms are exploiting unilateral market power over disengaged customers on SVT. Alternatively, the CMA's provisional findings are currently hugely overstating the extent of any concern.

Revenues across SVT and non-standard products

284. The CMA finds that over the period 2011 to 2014, average revenue per kWh from the SVT was around 10% and 13% higher than average revenue from non-standard tariffs for electricity and gas respectively across the Six Large Energy Firms.²¹⁵
285. We do not consider that a comparison of average revenues across tariff types is meaningful, since this does not take account of differences in direct or indirect costs (see further below), nor differences that might result from differences in consumption between SVT and non-standard customers.²¹⁶
286. 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, like many other markets, being characterised by an introductory (or 'see-saw') pricing model – see our comments above.

Differences in underlying costs

287. The CMA considers the extent to which price differences can be explained by differences in costs.
288. As regards wholesale costs, which are the largest individual cost item:
- 288.1 The CMA notes that *"To the extent to which the Six Large Energy Firms have different purchasing strategies for their SVTs and fixed-term tariffs, their expectations in relation to future energy costs may differ between SVTs and fixed-term tariffs."*²¹⁷ As the CMA is aware, RWE adopts different wholesale energy purchasing strategies for its SVT and non-standard tariffs. The CMA goes on to say that *"our comparison of various forward-looking energy cost benchmarks and a stylised 18 months hedging strategy in Appendix 7.2 shows that no cost indicator results in systematically higher or lower expectation of wholesale costs."*²¹⁸ See our comments above and see our Authorised Advisers' Confidential Submissions on the benchmarks used by the CMA in Appendix 7.2; none reflect the hedge profile RWE uses for its products.
- 288.2 The CMA considers that *"our provisional view is that there are no reasons to expect that downside risks associated with purchasing energy costs are inherently and systematically higher in the provision of SVTs as compared with fixed-term, fixed rate tariffs."*²¹⁹ In respect of RWE at least, this would seem to fundamentally misunderstand the way in which

²¹³ PFs, Summary, page 6, paragraph 22.

²¹⁴ PFs, Appendix 7.4, Annex G, pages A7.4-52 - A7.4-53, paragraph 5.

²¹⁵ PFs, Summary, pages 20-21, paragraph 91; Chapter 2, page 90, paragraph 2.151; Chapter 7, pages 249-250, paragraph 7.67.

²¹⁶ Furthermore, as noted above, it is misleading to present the percentage difference between SVT and non-standard revenues as a percentage of the revenues from the discounted non-standard tariffs. This implies that revenues from non-standard tariffs reflect the base price and that SVTs are priced at a premium to this, which is not correct. As the CMA seems to acknowledge elsewhere, the Six Large Energy Suppliers offer discounted non-standard tariffs.

²¹⁷ PFs, Chapter 8, page 338, paragraph 8.178.

²¹⁸ PFs, Chapter 8, page 338, paragraph 8.179.

²¹⁹ PFs, Chapter 8, page 339, paragraph 8.181.

it hedges its requirements [CONFIDENTIAL]. See further our comments in Section F.b above.

289. The CMA's finding on this issue also disregards the "*fundamental differences between standard variable and fixed-term tariffs*" which the CMA sets out at paragraphs 56 to 61 of Appendix 8.4 but then seems to ignore without any clear reasoning why.
290. As regards indirect costs, RWE considers that there are likely to be differences in the costs associated with SVT and non-standard customers. Even if only comparing direct debit dual fuel tariffs (as the CMA does in paragraph 8.183), RWE still considers that costs associated with SVT are likely to be higher than costs associated with non-standard tariffs, as a result of social tariff costs and complex metering costs which are more likely to be associated with SVTs, and the fact that non-standard customers are more likely to manage their accounts online which results in lower costs for RWE. In any case, it is unclear why in paragraph 8.183 the CMA compares indirect costs only of direct debit dual fuel SVT and non-standard tariffs, whereas in the remainder of this section the CMA seems to compare SVT and non-standard costs more generally regardless of fuel type or payment method.
291. The CMA provisionally finds that "*there are significant disparities in the tariffs charged by the Six Large Energy Firms that cannot be fully explained by differences in cost*"²²⁰ and that RWE is one of the suppliers that offered a greater number of tariffs at a discount of more than 10%.²²¹ RWE agrees that the differences between its SVT and non-standard tariffs are not *fully* explained by differences in unit costs. However, there is a difference in costs that the CMA has failed to recognise. As RWE has explained at length in previous submissions and in its hearing (see also above), [CONFIDENTIAL]. The level of discount RWE has offered is reflective of the intense competitive pressure it has faced and RWE submits that the CMA should be decidedly hesitant to regulate away discounting. In addition, RWE submits that the CMA needs to be careful in making such observations since overhead costs must be paid for, but economic realities mean they cannot be recovered across different product types in a simple formulaic, perhaps proportionate, manner – and furthermore economic theory suggests that economic efficiency is often best served if they are not.²²²
292. Whilst the CMA acknowledges that the Six Large Energy Firms position their fixed-term tariffs as acquisition and retention products,²²³ the CMA infers that this is inconsistent with a competitive market. The CMA provisionally finds that "*suppliers are charging some customer segments prices that are higher than can be justified by costs, which suggests that they enjoy a position of unilateral market power over certain customer segments*" (emphasis added).²²⁴ We comment further below and in our Profitability Response (see Schedule 2); see also our Authorised Advisers' Confidential Submissions on Appendices 8.4 and 10.5.

iii. Profitability in the segment is not excessive

293. The CMA seeks to assess the potential level of detriment arising from the AEC it has provisionally identified of weak customer response giving rise to supplier unilateral market power over what it claims is an inactive customer base.²²⁵
294. As a preliminary remark we would note that the CMA has not been able to properly assess profitability of the domestic segment because of limitations in the data held by the Six Large Energy Firms. Even if this were possible, we would have fundamental concerns about the methodology adopted by the CMA to assess profitability and to devise a suitable benchmark.

²²⁰ PFs, Chapter 8, page 340, paragraph 8.186.

²²¹ PFs, Chapter 8, page 340, paragraph 8.187.

²²² See the economic theory of 'Ramsey' pricing.

²²³ PFs, Chapter 8, page 341, paragraph 8.193.

²²⁴ PFs, Chapter 8, page 342, paragraph 8.194.

²²⁵ PFs, Summary, page 29, paragraph 128; Summary, page 30, paragraph 135; Summary, page 38, paragraph 175; Chapter 8, page 331, paragraph 8.156; Chapter 8, pages 36-37, paragraph 8.300; Chapter 9, pages 402-403, paragraph 9.111.

We set out in this section our overall comments on the CMA's profitability as well as comments on any specific analysis carried out relating to domestic segment. In Section H we focus on comments on the CMA's provisional findings relating to microbusiness profitability; however, our overarching comments apply equally to the CMA's microbusiness profitability analysis. Please see also our response to the Appendices to Chapter 10 and our Authorised Advisers' Confidential Submissions.

The CMA's ROCE analysis of out-turn profits is fundamentally flawed

295. The CMA notes that ROCE is the "*standard approach*" to measuring out-turn profitability, as it takes account of the capital required to operate a business,²²⁶ and uses ROCE as its preferred measure of profitability. It remains RWE's view that whilst this may be the CMA's standard approach, it is not fit for purpose in this instance. RWE continues to have very serious concerns about the appropriateness of a ROCE analysis for an asset-light supply business.
296. The CMA asserts that it "*recognises the need to ensure that all capital employed by firms is identified and included in our analysis*".²²⁷ However, the CMA has only included assets that meet its criteria for recognition. Further, the CMA notes a number of limitations in its analysis that, together, raise serious questions over the robustness of its analysis. The CMA is also extremely selective in the elements of capital employed that it recognises. It has not taken account of parties' submissions regarding material other elements of capital employed, particularly notional capital as well as others.
297. As regards notional capital, the CMA continues not to include it in capital employed, and instead assumes firms would manage certain business risks through a fee arrangement.²²⁸ In so doing, the CMA has failed to acknowledge RWE's views that:
- 297.1 Notional capital is equity and debt capital rather than cash and cash equivalents;
- 297.2 Business risks cannot be removed by engaging with a trading intermediary through a fee arrangement (as applied by the CMA) and adopting "efficient" operating processes used by independent suppliers; and
- 297.3 Independent suppliers hold significantly more risk and the probability of their default is high, the costs of which, to customers (both directly and through any supplier of last resort provisions), could be significant if a firm the size of one of the Six Large Energy Firms were to default.
298. The CMA provisionally finds that the ROCE of the Six Large Energy Firms over the period 2009 to 2013 averaged 28%, which was substantially above the cost of capital over the period which is estimated by the CMA at 10%.²²⁹ The CMA finds that four of the Six Large Energy Firms earned an average ROCE between them of 44%²³⁰ (between three and six times the CMA's estimate of the level of profits that would provide a reasonable level of return)²³¹; whereas two of the Six Large Energy Firms (including RWE) made combined losses. We also note that profitability is lower if the full period (2007 to 2013) is considered.
299. The CMA finds that returns were variable over the period, which the CMA attributes to "*factors including temperature related revenue and cost impacts*".²³² As far as RWE is aware, the CMA has not sought to identify the cause of this variability and has simply assumed that it relates to temperature related impacts. In RWE's view, this volatility year

²²⁶ PFs, Chapter 10, page 407, paragraph 10.9.

²²⁷ PFs, Appendix 10.3, page A10.3-8, paragraph 20.

²²⁸ PFs, Appendix 10.5, page A10.5-27, paragraph 88.

²²⁹ PFs, Chapter 10, page 414, paragraph 10.33.

²³⁰ PFs, Summary, pages 38-39, paragraph 179; Chapter 10, page 414, paragraph 10.33; Chapter 10, page 433, paragraph 10.126.

²³¹ PFs, Chapter 10, page 415, paragraph 10.35.

²³² PFs, Chapter 10, page 415, paragraph 10.36.

on year and between firms is an indication of the inherent unreliability of a ROCE assessment of an asset light business for which insufficient adjustments have been made to properly reflect all capital employed – see further our Authorised Advisers’ Confidential Submissions. The CMA seeks to deal with this variability by using a five year average; however, simply averaging the results fails to address their unreliability.

300. The CMA considers that the results of its analysis are not very sensitive to inaccuracies or differences in assumptions.²³³ RWE disagrees with this. We refer further to Profitability Response (see Schedule 2) and our Authorised Adviser’s Confidential Submission. In particular:

300.1 The CMA’s comment that its measures of firms’ capital employed would have had to increase by approximately £10 billion to bring the ROCE down to the cost of capital for the four of the Six Large Energy Firms assumes that all firms should be limited to earning the cost of capital.²³⁴ This is incorrect, and contradicts the CMA’s own guidelines, which state that “*a competitive market would be expected to generate significant variations in profit levels between firms and over time*”.²³⁵ In real markets, profits vary across firms depending on their relative success or failure in either improving their product offering, in their sales and marketing efforts or in managing their costs (including by managing the risks they face) to achieve relative advantage compared to other firms in the industry. Economics suggest that firms remaining active in a market should expect to make profits but it certainly does not suggest that in competitive markets every firm should earn a return that is equal to its cost of capital as the CMA indicates in its provisional findings. Rather, economics suggests only that the *marginal* firm in a competitive industry should not expect to persistently make positive economic returns.²³⁶ As the CMA’s chief economist has previously described:

“The theory predicts that the marginal firm in long-run equilibrium earns zero economic profits, but firms with lower costs will earn positive economic profits.”²³⁷

300.2 The CMA notes also that the trading fee would have to increase by several hundred per cent in order to bring the ROCE down to the cost of capital for the four suppliers that made returns in excess of this.²³⁸ Again, the CMA assumes that all firms should be limited to earning the cost of capital. Additionally, the CMA is wrong to focus on one element of the ROCE calculation, and does not take into account that it has significantly underestimated the value of capital employed. Notwithstanding this, [CONFIDENTIAL].

The results are materially driven by a single supplier

301. The CMA has not properly considered that its key findings are materially driven by the financial performance of Centrica alone.

302. The CMA uses *inter alia* the results of its profitability analysis to support its finding of an AEC that the Six Large Energy Firms have unilateral market power *vis-a-vis* their purportedly inactive customer base. However, a simple breakdown of the CMA’s own results shows that its finding of excess profitability may, to a material extent, be driven by a single firm which has the largest market share, Centrica.

²³³ PFs, Chapter 10, pages 415-416, paragraph 10.38.

²³⁴ PFs, Chapter 10, page 415, paragraph 10.38(a).

²³⁵ CC3 (Revised), Guidelines for market investigations: Their role, procedures, assessment and remedies, page 28, paragraph 117.

²³⁶ For academic papers where this statement is heavily relied upon see for example the “free entry” literature following Berry, S. (1994) “Estimation of a model of Entry in the Airline Industry” *Econometrica*, Journal of the Econometric Society, p.999-917. See also the CMA’s chief economists published article making the same point: http://ecp.crai.com/ecp/assets/CRA_DP9.pdf.

²³⁷ See page 4, Professor R. Lind and Dr. M. Walker “The (mis)use of profitability analysis in competition law cases” Available from http://ecp.crai.com/ecp/assets/CRA_DP9.pdf.

²³⁸ PFs, Chapter 10, pages 415-416, paragraph 10.38(b).

303. As the CMA notes, “[~~§~~] earned more than half of the combined profits in excess of the cost of capital.”²³⁹ Notwithstanding our view that the CMA’s profitability analysis is flawed, based on our analysis of Table 10.1, we find that the weighted average ROCE of the Six Large Energy Firms excluding [~~§~~] from 2009 to 2013 is just [~~§~~], compared with the average including [~~§~~] of [~~§~~]; and over the longer period of 2007 to 2013, this would be lower than [~~§~~]. See further our Authorised Advisers’ Confidential Submissions.

Inconsistency between the CMA’s ROCE and margin analysis

304. The CMA concludes that “different sources of evidence on profitability and prices give broadly consistent results”.²⁴⁰ We disagree. The CMA states that “margins in the range of 1 to 3% would appear to provide a reasonable guide for what is required to cover efficient levels of capital employed and operating costs” and acknowledges that out-turn domestic margins are only 3.3%.²⁴¹ It also notes that the competitive EBIT margin implied by its ROCE analysis is 1.3%.²⁴² If a margin of 3.0% is considered reasonable, based on the CMA’s analysis this would imply that a ROCE of 23% is reasonable. This inconsistency implies that the CMA has significantly understated capital employed in its ROCE analysis, which supports our view (as set out in previous submissions) that this is the case.²⁴³ RWE has on occasions emphasised that it is extremely difficult to make an accurate assessment of the economic capital employed in a business of this nature.

The CMA’s profit margin benchmarking is highly selective

305. As per our previous submissions to the CMA, in light of the fundamental concerns we have about any ROCE analysis of retail energy supply, RWE is supportive in principle of a profit margin benchmarking analysis and considers that more weight should be placed on this than on any ROCE analysis.
306. However, we are disappointed that that CMA continues to consider as suitable comparators the margins of mid-tier suppliers and margins on I&C customers,²⁴⁴ both of which we consider to be clearly unsuitable. Whilst we welcome the CMA’s consideration of other regulatory precedents²⁴⁵ (which we discuss further below) we are disappointed also that the CMA has dismissed a number of other potentially useful comparators²⁴⁶ without seeking to assess whether it could make any necessary adjustments or whether at least it might use a broad range of benchmarks as a sense check as to whether profitability in the retail energy sector is excessive. See further our Profitability Response (Schedule 2) and our Authorised Advisers’ Confidential Submissions.

Margins earned by mid-tier suppliers

307. The CMA appears to place weight on the margins earned by mid-tier suppliers.²⁴⁷ The CMA is wrong to confuse the “greenfield” mid-tier firms with the “brownfield” business of the Six Large Energy Firms. In our response to the CMA’s (non-published) working paper on the assessment of profit margin comparators for the competitive benchmark in retail energy supply, we explained that mid-tier suppliers are not an appropriate benchmark because significant differences exist between these firms and the Six Large Energy Firms in terms of life cycle, risks, costs, strategy and operational practice. We also raised a number of

²³⁹ PFs, Chapter 10, page 416, paragraph 10.40.

²⁴⁰ PFs, Summary, page 20, paragraph 90.

²⁴¹ PFs, Chapter 10, page 434, paragraph 10.131.

²⁴² PFs, Chapter 10, page 428, paragraph 10.101.

²⁴³ RWE also provides its comments in relation to the CMA’s evidence on gains from switching in paragraphs 229 to 244 above, and in paragraphs 261 to 274 above provides its views on the CMA’s cost pass-through analysis. RWE does not believe that the CMA’s results paint a consistent picture once the CMA adopts appropriate methodologies and affords appropriate weight to the full set of evidence available to it.

²⁴⁴ PFs, Chapter 10, page 424, paragraph 10.79.

²⁴⁵ PFs, Appendix 10.6, page A10.6-3, paragraph 7(a).

²⁴⁶ PFs, Chapter 10, page 424, paragraph 10.78.

²⁴⁷ PFs, Chapter 10, page 427, paragraph 10.98.

more specific concerns with using the margins of mid-tier suppliers as a comparator. Whilst much of the detail is redacted in the published PFs, making it difficult to assess whether any of these concerns have been taken into account, on the face of it they do not appear to have been:

- 307.1 The CMA continues to focus on gross margins,²⁴⁸ which RWE does not consider to be appropriate. As explained in our response to the CMA's profit margin comparators working paper, it is at the EBIT margin level that the competitive level of profitability needs to be determined. This is because there is a theoretical link between the opportunity cost of capital and EBIT, which does not extend easily to gross margins. Assessing profitability at the gross margin level fails to take into account all relevant acquisition costs. A firm may have low relative gross margins but relatively higher EBIT margins, or vice versa. This is because firms compete on both prices and costs and will adopt different strategies to attract customers.
- 307.2 The CMA has sought to explain why it considers that gross margins are more appropriate than EBIT margins, pointing in particular to "*disproportionately large customer acquisition costs*" and "*Upfront investments in staff costs and facilities*" as well as exemptions from environmental obligations.²⁴⁹ We agree that new entrants need to incur this expenditure, and that small suppliers derive a disproportionate benefit from the ECO exemption in particular. One approach the CMA proposes to overcome this is to compare the margins of the Six Large Energy Firms and the mid-tier excluding costs to acquire ("EBITC2A").
- 307.3 We do not consider, however, that EBITC2A would adequately control for all these differences, notwithstanding the weaknesses of its analysis that the CMA itself identifies. This is due to the additional sources of material differences in the costs incurred and risks faced between the Six Large Energy Firms and the mid-tier firms. For example, differences in customer mix and the absence of a legacy customer base would also be likely to materially affect mid-tier firms' costs to serve. Mid-tier firms also do not face the same operational, cost and risk impacts that arise from the corporate and institutional backgrounds of the Six Large Energy Firms. The CMA appears to assume that some of these limitations on comparability are not relevant or imply that mid-tier firms' margins would be lower.
308. We previously expressed concerns that, by relying on the results of only two mid-tier suppliers, the CMA may have been overly selective in its choice of comparators. RWE submitted that, if the CMA was minded to consider the profitability of the independent suppliers, the results of all independent suppliers should be factored into the determination of a competitive margin. It is unclear to us to what extent, if at all, the CMA has taken this into account.
309. The CMA seems to have preferred the views of independent suppliers as to what is a reasonable (gross margin and) EBIT margin,²⁵⁰ over the view of the Six Large Energy Firms, without explaining why it has done so. Furthermore, the CMA considers this to represent an "*aspirational margin*"²⁵¹ without providing any evidence for its views.
310. The CMA also does not consider that the customers served by the Six Large Energy Firms have materially higher systematic risk such as would justify higher returns than those of the independent suppliers.²⁵² The CMA, however, has not taken into account that the Six Large Energy Firms have a higher proportion of SVT customers relative to the independents suppliers. As explained in paragraph 138 above, [CONFIDENTIAL]

²⁴⁸ PFs, Chapter 10, pages 424-425, paragraphs 10.82-10.86; page 426, paragraphs 10.92-10.93; Chapter 10, page 427, paragraph 10.98.

²⁴⁹ PFs, Chapter 10, page 424, paragraph 10.82.

²⁵⁰ PFs, Chapter 10, pages 425-427, paragraphs 10.86 and 10.98-10.99.

²⁵¹ PFs, Chapter 10, page 425, paragraph 10.88; Chapter 10, page 426, paragraph 10.93.

²⁵² PFs, Chapter 10, page 425, paragraph 10.91.

Margins on industrial and commercial customers

311. We continue to have concerns about the CMA's use of EBIT margins on I&C customers as a competitive benchmark for margins in the rest of the supply business.²⁵³ The CMA notes the concerns raised by the parties *"that I&C was a less risky business due to having more scope for cost pass-through, less shaping risk, and lower bad debt costs."*²⁵⁴ The CMA dismisses these concerns without any real consideration of them.²⁵⁵
- 311.1 In relation to bad debt, the CMA simply says *"we note that I&C is likely to be more correlated with the economy than is domestic supply, but possibly less so than SME. On balance, it was not clear to us that bad debt risk was clearly lower in I&C than for the combined SME and domestic business, such as would justify a lower margin on I&C."*²⁵⁶ It is not clear to us from the PFs that the CMA has carried out any analysis of relative bad debt levels of the different segments so as to have any evidential basis on which to assess relative bad debt and it is not evident that the CMA has sought to assess whether bad debt is solely influenced by the economy or whether SME customers, by virtue of the risks inherent in operating a small business, might present a greater bad debt risk irrespective of changes to the economy. [CONFIDENTIAL]
- 311.2 As regards the other concerns identified by the CMA, the CMA simply dismisses these without any clear explanation.²⁵⁷

Regulatory margins

312. The CMA dismisses regulatory precedents in Northern Ireland and New South Wales because *"we were not persuaded that the cost structure of Power NI or the NSW suppliers was sufficiently comparable to that of GB suppliers to enable a like-for-like margin comparison. Since, for an asset-light business, the required margin is sensitive to small absolute changes in capital employed, this latter point is important."*²⁵⁸ It is surprising that the CMA has simply dismissed these potential comparators on this basis – seemingly without attempting to identify any necessary adjustments – yet the CMA places such weight on its ROCE analysis which is subject to the same limitations.²⁵⁹ The CMA cannot credibly maintain such an inconsistent approach to developing different pieces of available evidence, at least not if it is to reach a conclusion that is robust and supported by the evidence.
313. The CMA also considers that regulatory margins should not be seen as a lower bound for the competitive margin.²⁶⁰ We disagree. We would expect regulated retail supply businesses to have lower margins than the competitive margin for retail energy supply, due to lower risks and regulatory safeguards around financial viability.

iv. The CMA's competitive price benchmarking sets an unrealistic benchmark

314. The CMA considers that its analysis provides an illustration of price levels in a better functioning, but not necessarily perfectly competitive, market.²⁶¹ It is not clear to us how this follows from the adjustments the CMA describes which in fact seem aimed at identifying price levels in a perfectly competitive market.²⁶² In particular, the adjustments assume that suppliers can achieve better-than-average performance across multiple cost

²⁵³ PFs, Chapter 10, pages 426-427, paragraph 10.94-10.96; Chapter 10, page 427, paragraph 10.100.

²⁵⁴ PFs, Chapter 10, page 426, paragraph 10.94.

²⁵⁵ PFs, Chapter 10, page 426, paragraph 10.94.

²⁵⁶ PFs, Chapter 10, page 426, paragraph 10.94.

²⁵⁷ PFs, Chapter 10, page 426, paragraph 10.94.

²⁵⁸ PFs, Chapter 10, page 427, paragraph 10.97.

²⁵⁹ PFs, Chapter 10, page 425, paragraph 10.91.

²⁶⁰ PFs, Chapter 10, page 427, paragraph 10.97.

²⁶¹ PFs, Chapter 10, pages 416-417, paragraph 10.43.

²⁶² PFs, Chapter 10, pages 416-417, paragraph 10.43.

categories, which is wholly unrealistic. Management time is expensive and has opportunity costs. Put another way, firms face real options to invest in different cost reduction projects and cannot simultaneously undertake all possible options to reduce costs in all categories. Therefore, just as the CMA accepts that there may be causality between indirect costs categories²⁶³ (see our comments below), the same applies at the more aggregated level between direct costs and indirect costs. Therefore it is not appropriate to establish the “competitive benchmark” based on better-than-average performance in multiple categories.²⁶⁴

315. In particular, the benchmarks the CMA uses for wholesale costs (lower quartile costs of the Six Large Energy Firms and the average of the two firms trading standard products (RWE and EDF),²⁶⁵ are inappropriate. Achieving lower than average wholesale costs in the long term is unrealistic, and the CMA’s assertions rely on the benefit of hindsight. Firms hedge to limit price volatility, but wholesale costs vary between firms because each one uses a different hedging strategy. Exogenous market movements will affect each strategy differently and result in different out-turn cost. Ex post evaluations may suggest that certain procurement strategies result in lower costs. This is not true from an ex ante perspective. Due to the exogenous movements, if a company adopts a particular static hedge profile, it cannot expect to achieve lower costs than the average cost of other static hedging strategies.
316. Further, based on the way in which RWE operates in the wholesale markets, the results of the CMA’s profitability analysis of the generation businesses of the Six Large Energy Firms does not suggest that the wholesale costs incurred by the retail businesses of these firms exceeded competitive levels. The CMA found that the returns of the generation operations of the Six Large Energy Firms between 2009 and 2013 were generally in line with or below the cost capital,²⁶⁶ and its provisional view was that wholesale market prices were not above competitive levels. Based on the way in which RWE npower procures its energy in the wholesale market, if the CMA found that wholesale prices were not above competitive levels, this also implies that the wholesale costs incurred by energy retailers were not above competitive levels. This suggests that it is not appropriate to set a benchmark level for wholesale costs that is lower than the out-turn wholesale costs.
317. The CMA says that in addition to using the wholesale costs of two of the Six Large Energy Firms as a benchmark, the CMA also used a ‘lower quartile’ scenario.²⁶⁷ The CMA’s justification for that is that “*the mid-tier suppliers tended to have wholesale costs that were below or at the lower quartile of the larger firms, despite their small scale.*”²⁶⁸ There are again a number of flaws with this – see further our Profitability Response (Schedule 2).
318. First, the CMA appears not to have understood the different way in which wholesale costs are hedged for SVT and non-standard products:
 - 318.1 As the CMA has identified, the majority of customers of the Six Large Energy Firms are on SVT²⁶⁹; [CONFIDENTIAL]. The majority of the customers of the mid-tier suppliers, by contrast, are on non-standard products; [CONFIDENTIAL]. See further our comments in Section F.b above.
 - 318.2 Whilst RWE does not have full insight as to how the others of the Six Large Energy Firms or (save for Utility Warehouse) the mid-tier firms meet their wholesale energy needs, RWE would expect this to differ as between SVT and non-standard products. This means that it

²⁶³ PFs, Chapter 10, page 421, paragraph 10.61(b).

²⁶⁴ PFs, Chapter 10, page 418, paragraph 10.51; Chapter 10, page 419, paragraph 10.56; Chapter 10, pages 419-420, paragraph 10.58.

²⁶⁵ PFs, Chapter 10, page 419, paragraph 10.58.

²⁶⁶ PFs, Summary, page 9, paragraph 38.

²⁶⁷ PFs, Chapter 10, page 419, paragraph 10.58.

²⁶⁸ PFs, Chapter 10, page 418, paragraph 10.50.

²⁶⁹ PFs, Chapter 10, page 373, paragraph 9.15.

is not appropriate to use the wholesale costs of the mid-tiers (purchased primarily for non-standard products) as a benchmark for the Six Large Energy Firms.

319. Second, many of the mid-tier firms entered the market or grew rapidly around the period 2009 and 2010, and would have been purchasing energy at the prevailing market price during the growth period. The Six Large Energy Firms, however, would have hedged into longer term positions, and paid higher prices as a result of the significantly higher prices observed in 2008.
320. Third, there are likely to be significant differences in the tariff mix within the Six Large Energy Firms. For example, SSE has an estimated 10% of non-standard customers,²⁷⁰ whereas our own portfolio of non-standard customers would be approximately [CONFIDENTIAL]. The CMA has failed to control for different product mix of the Six Large Energy Firms within its wholesale benchmarking.
321. RWE notes that there may be a wide range of reasonable outcomes in costs. This means, if the CMA continues to proceed with wholesale cost benchmarking, it needs to be careful not to establish a single benchmark that could contribute towards the CMA making a false positive finding of excessive profitability. RWE considers that the most reasonable benchmark would be the average of the Six Large Energy Firms' wholesale costs, calculated in each year of the Relevant Period.
322. RWE considers that there are a number of serious shortcomings in the CMA's benchmark of indirect costs per customer.²⁷¹ The CMA's analysis is simplistic and its misunderstandings and flawed analysis lead it to select an inappropriately low benchmark that implies that most operators have been inefficient. The principal problems are that: (i) the CMA does not acknowledge or take account of other drivers of indirect costs per customer that are outside firms' control; (ii) the CMA does not control for volume; and (iii) the CMA's judgement of the cost efficiency that a "reasonably efficient"²⁷² firm could be expected to achieve is wholly unrealistic and based on a selective assessment of very limited evidence. The CMA should also consider points made in the Confidential Submissions of RWE's Authorised Advisers regarding its comparison of the indirect cost ratios of the Six Large Energy Firms with mid-tier firms' indirect costs.
323. RWE infers from the CMA's choice of benchmarks for debtors and creditors that it believes that firms with even average debtor balances and/or average creditor balances may have managed their working capital inefficiently. The CMA presents no evidence to support such an assumption. RWE considers that this benchmark is entirely inappropriate as there are a multitude of underlying drivers of variations in working capital balances between firms, many of which are outside firms' control and the CMA has not made any attempt to identify or control for these drivers in determining its benchmark.
324. RWE further considers that the CMA's reasoning for selecting its benchmark for fixed assets²⁷³ is flawed and is at odds with the CMA's own stated approach to profitability analysis. This is firstly because a period of sustained investment in fixed assets would imply that a firm was previously operating aged and therefore highly depreciated assets which would understate the long run typical value of fixed assets per customer and, secondly, because the nature of fixed asset investments over time will naturally give rise to substantial variations between firms in the value of fixed assets per customer.
325. The CMA explains it has allocated capital employed as between segments.²⁷⁴ This is inconsistent with its previously stated approach for ROCE, where it considers it was impractical to do so, and it sought to avoid "*any arbitrary allocations of capital employed*

²⁷⁰ Bernstein analyst report, 22.06.15, 'SSE: The Calm Before the Storm Reiterate Underperform', page 5, exhibit 5.

²⁷¹ PFs, Chapter 10, page 420, paragraph 10.58.

²⁷² PFs, Chapter 10, page 416, paragraph 10.43.

²⁷³ PFs, Chapter 10, page 420, paragraph 10.58.

²⁷⁴ PFs, Chapter 10, page 420, paragraph 10.60.

between different customer types".²⁷⁵ We would comment that the costs of acquiring customers are likely to be higher for SME/microbusiness customers than for domestic customers, and we consider that the CMA's allocation is likely to understate these and therefore understate the capital employed by our SME business.

326. The CMA notes two 'general limitations' on its benchmarking analysis.²⁷⁶ In fact these are fundamental limitations that call into question the whether the CMA's analysis is meaningful:
- 326.1 The first is that the CMA acknowledges that *"Suppliers may legitimately operate different business models, for example by targeting different customer groups, which may influence costs. By equating lower quartile costs with efficient costs without controlling for differences in the customer base, we may overstate or understate the potential for cost savings."*²⁷⁷ A supplier's business model is key to its costs, in particular its wholesale energy costs, which as the CMA notes elsewhere make up the largest single cost item.²⁷⁸ As we explain above, [CONFIDENTIAL]
- 326.2 The second is that the CMA's analysis *"relies on cost allocations being reasonably consistent across the Six Large Energy Firms, at least in the categories that we have focused on. For example, if the variability in certain cost categories is due to differences in cost allocation rather than efficiency, then our analysis may overstate the potential for cost savings."*²⁷⁹ In fact the issue is not just one of allocation between cost categories, although we agree that this would impact on the CMA's analysis. As noted above, just as the CMA accepts that there may be causality between indirect costs categories (see our comments below), the same applies at the more aggregated level between direct costs and indirect costs and it is not appropriate to establish the "competitive benchmark" based on better-than-average performance in all categories.
327. The CMA dismisses these concerns. *"Those suppliers with higher than average levels of indirect costs told us that they recognised that they were inefficient and were working to improve cost efficiency. This suggests to us that the differences in indirect costs are primarily the result of differences in efficiency and not merely as a result of differences in business models or cost allocation."*²⁸⁰ [CONFIDENTIAL] However, as RWE has previously explained, it does not consider that [CONFIDENTIAL]. As RWE noted in its response to the CMA's working paper on profit margins analysis, the differing corporate and institutional backgrounds and evolution of the Six Large Energy Firms meant that they were at different stages in their lifecycle and had different operating models and associated cost bases at the start of, and during, the period. Further, RWE considers that some variation in the performance of firms is to be expected in a competitive market because some strategies and projects will succeed and some will result in losses or low levels of profitability. As with the previous analysis published by the CMA, we observed a real [CONFIDENTIAL].
328. The CMA concludes that the *"analysis provides an indication that the total level of profits in excess of the cost of capital that firms have earned over the period may be higher than that indicated by the ROCE analysis based on out-turn costs."*²⁸¹ We disagree with this conclusion because the ROCE analysis already significantly overstates profitability. The CMA then compounds the issue by applying a crude allocation across segments and applying unrealistic and unreasonable wholesale and indirect cost benchmarks that do not reflect how the suppliers operate their businesses.²⁸²

²⁷⁵ See *CMA Analysis of retail supply profitability – ROCE (Version for RWE)*, 17 April 2015, page 4, paragraph 7; and PFs, Appendix 10.3, page A10.3-3, paragraph 7.

²⁷⁶ PFs, Chapter 10, pages 420-421, paragraph 10.61.

²⁷⁷ PFs, Chapter 10, pages 420-421, paragraph 10.61(a).

²⁷⁸ PFs, Chapter 7, page 239, paragraph 7.22.

²⁷⁹ PFs, Chapter 10, page 421, paragraph 10.61(b).

²⁸⁰ PFs, Chapter 10, page 421, paragraph 10.62.

²⁸¹ PFs, Chapter 10, page 421, paragraph 10.64.

²⁸² PFs, Chapter 10, page 421, Table 10.3.

329. In light of the fundamental concerns with the CMA's methodology identified above (and explained in more detail in our Profitability Response (see Schedule 2) and our Authorised Advisers' Confidential Submissions) we reject the CMA's provisional conclusions that prices may have exceeded benchmark levels by 5% for domestic and 14% for SME over the period 2009 to 2013.²⁸³
330. The CMA considers that *"This analysis indicates that those suppliers who had made economic losses over the period (...) had done so because of inefficient levels of indirect costs, and not because their prices were below the competitive level."*²⁸⁴ We disagree with this. The CMA has made adjustments for *inter alia* what it regards as inefficiency, as a result of which the CMA finds that prices were above the competitive level. However, this finding is based on a flawed benchmarking of efficiency, and therefore is itself flawed.
331. The CMA also appears to have been inconsistent in presenting its findings on the extent to which prices were above benchmark levels. In paragraph 10.65 it explained that prices for domestic gas and electricity exceeded benchmark levels by 5%. However, in paragraph 10.69 it explained that the *"average domestic customer paid approximately [...] 3% [...] more per year than might have been the case had markets functioned more effectively."*

Wholesale spot scenario

332. The CMA calculates that, had suppliers purchased energy on the spot markets rather than purchasing forward, competitive benchmark domestic electricity prices would have been around 12% lower than actual prices, and SME electricity prices around 27% lower.²⁸⁵ It is unclear the extent to which the CMA places any reliance on this analysis. RWE considers that a scenario based on the spot market is entirely infeasible, and should be disregarded as a benchmark.
333. On an *ex ante* basis, the wholesale energy market is uncertain and it is impossible to know with certainty whether the spot or forward price will be higher at a future delivery point. It is therefore not appropriate to draw trends from an *ex post* evaluation on data that had such uncertainty on an *ex ante* basis. This is especially the case for short time horizons. A clear example of this, as identified by a number of other firms, is that out-turn spot prices were higher than out-turn future prices for the 2005 to 2008 period. Our analysis presented in Figures F.b.2 and F.b.3 above shows that in a market of falling prices, spot prices will be lower than hedged prices,²⁸⁶ but in a market of rising prices, spot prices will be higher.
334. Additionally, the CMA fails to consider the reduction in risk (i.e. reduced price volatility) for suppliers and customers when using forward purchasing strategies. Forward prices typically have a small premium built into forward curve which represent the convenience yield for having removed price risk ahead of time. While this comes at a small cost, there is an offsetting reduction in risk for market participants. The reduction in risk has a value for suppliers and consumers which the CMA fails to attribute. See our comments in Section F.b above explaining why suppliers engage in hedging of wholesale energy costs.
335. The CMA seems to acknowledge that there are benefits in moderating risk through hedging, although it considers that the justification for hedging in relation to variable tariffs (i.e. SVT) is less apparent than for fixed price tariffs.²⁸⁷ [CONFIDENTIAL]; as the CMA acknowledges in its cost pass-through analysis,²⁸⁸ domestic retail price changes tend to be infrequent and tend to take place only if changes to underlying costs reach a certain minimum level.

²⁸³ PFs, Chapter 10, page 422, paragraph 10.65.

²⁸⁴ PFs, Chapter 10, page 422, paragraph 10.68.

²⁸⁵ PFs, Chapter 10, page 423, paragraph 10.75.

²⁸⁶ When based on a static hedge strategy.

²⁸⁷ PFs, Chapter 10, page 423, paragraph 10.74.

²⁸⁸ PFs, Appendix 7.2, pages A7.2-9 – A7.2-10, paragraph 28.

v. The CMA does not fully take account of the impact of regulation

336. The CMA has not taken full account of the effects of the regulatory environment in its assessment of UMP (see our comments in paragraph 15 above). For example the CMA concludes that RMR has reduced the number of tariffs and stifled innovation, and has softened price competition between PCWs,²⁸⁹ but does not consider the impact of the simpler choices rules on price competition between suppliers. The CMA finds profits increased post 2009²⁹⁰ which is consistent with regulation distorting competition, rather than an increase in profit arising as a result of UMP. The CMA also does not fully take account of the positive changes to regulation, such as the introduction of the PCW Confidence Code, the formal relaxation of SLC 25A (which needs time to take effect), the removal of auto-rollover for domestic customers in 2013 and forthcoming changes to settlement, and the positive impact on competition that these will have. See further our response to the RN.

Impact of RMR

337. The CMA provisionally finds that whilst the purpose of RMR was to promote customer engagement, *"some of the RMR measures restrict the behaviour of suppliers and constrain the choice set for consumers in a way that may have an adverse impact on competition and consumer welfare."*²⁹¹ The CMA notes that whilst the measures have not been in place long enough to fully assess their impact, *"the evidence in hand at this stage is not particularly encouraging."*²⁹² The CMA finds that there are few signs that customer engagement is improving materially and the CMA doubts that the four-tariff rule will have a benefit on engagement in the long term.²⁹³ We agree that RMR, despite its positive intentions, has dampened competition. In our view, not only has RMR failed to increase customer engagement, it has also constrained price and non-price competition between suppliers. As the CMA accepts, in accordance with RWE's previous submissions, RMR has resulted in the Six Large Energy Firms withdrawing a number of tariffs and discounts and changing tariff structure.²⁹⁴
338. We welcome the statement by the CMA that it agrees with much of what the Six Large Energy Firms said in relation to the adverse impact of the RMR rules on innovation.²⁹⁵
339. The CMA provisionally finds that the impact of the RMR rules on price competition between suppliers is less clear, since *"price competition now takes place in the fixed-term, fixed-rate space where many tariffs are priced at a sizeable discount to SVTs."*²⁹⁶ We disagree; not only has RMR effectively prevented suppliers offering discounts on their SVTs (except under limited exceptions to the prohibition on cash discounts), RMR also effectively prevents suppliers from targeting offers at different customer groups, for example low/no standing charge tariffs aimed at low consumption customers and low unit rate tariffs aimed at high consumption customers. By preventing PCWs from negotiating special or exclusive tariffs with suppliers, RMR has additionally limited price competition between suppliers through the PCW channel.

SLC 25A

340. The CMA provisionally finds that it is likely that SLC 25A contributed to a softening of competition on the SVT.²⁹⁷ In line with our previous submissions, we agree with this. The

²⁸⁹ PFs, Chapter 8, page 355, paragraph 8.247.

²⁹⁰ PFs, Chapter 8, page 347, paragraph 8.214.

²⁹¹ PFs, Chapter 8, page 353, paragraph 8.242.

²⁹² PFs, Chapter 8, page 353, paragraph 8.243.

²⁹³ PFs, Chapter 8, page 353, paragraph 8.243.

²⁹⁴ PFs, Chapter 8, page 354, paragraph 8.244.

²⁹⁵ PFs, Chapter 8, page 354, paragraph 8.245.

²⁹⁶ PFs, Chapter 8, page 354, paragraph 8.246.

²⁹⁷ PFs, Chapter 8, page 355, paragraph 8.251.

CMA also provisionally finds that, since Ofgem has confirmed that SLC 25A is no longer in force, it does not currently lead to an AEC.²⁹⁸ Whilst we agree with this, we would note that the impact of SLC 25A remains very relevant to the CMA's assessment of whether there are features of the market that give rise to an AEC; the competitive conditions that prevailed from 2009 until at least the end of 2014 will have been affected by SLC 25A, whereas any softening of competition caused by SLC 25A can be expected to reverse now that SLC 25A has been unequivocally revoked. However, in light of the uncertainty since the formal expiration of SLC 25A until the CMA's clarification in December 2014, more time may be needed until there is a return to full competition and SLC 25A fully ceases to have an effect on the market.

PCW Confidence Code

341. The CMA provisionally finds that the amended Confidence Code which took effect in March 2015 and requires PCWs to present all tariffs, whether or not fulfillable, as a default, does not give rise to an AEC.²⁹⁹ We do not disagree with this. We are supportive of the Confidence Code and only deal with PCWs that comply with the Confidence Code. We consider also that the CMA has not fully taken account of the positive impact on customer trust and engagement that can be expected to result from this. That said, as set out further in our response to RNS, a greater rebuilding of trust could be achieved through direct regulation of PCWs and other TPIs, especially if PCWs are given access to more data, i.e. via ECOES.

Small supplier exemptions

342. The CMA's provisional view is that there is a legitimate rationale for providing some degree of exemption, without which, the cost of delivering any scheme would fall disproportionately on small suppliers, and that the current exemptions are not likely to be market distorting.³⁰⁰ We note that we do not think the CMA has taken full account of brokerage and also the possibility of small suppliers entering into bilateral contracts for the provision of obligation measures.
343. Whether or not the CMA considers that small supplier exemptions give rise to an AEC, it is important that the CMA properly takes into account the impact that they have on price competition. We do not think the CMA has done this. The small supplier exemptions give the small suppliers (and the mid-tier suppliers, to the extent that they were small suppliers for part of the period under review by the CMA) a price advantage. When analysing prices of the Six Large Energy Firms and the small or mid-tier suppliers, as the CMA does in its competitive price benchmarking and (by implication) in its gains from switching analysis, the CMA should take into account this price advantage.

c. Gas and electricity settlement

Gas settlement

344. The CMA provisionally finds that the current system of gas settlement is a feature of the market that gives rise to an AEC through the inefficient allocation of costs and the scope for gaming.³⁰¹ The CMA is concerned that Project Nexus, whilst likely to address most of the inefficiencies, is too slow and does not address the incentives on shippers to place a higher priority on adjusting AQs down and delaying adjusting AQs up.³⁰²
345. RWE accepts that the gas settlement system may not be optimal, but we consider that the concerns identified by the CMA will be largely addressed by implementation of Project

²⁹⁸ PFs, Chapter 8, page 356, paragraph 8.254.

²⁹⁹ PFs, Chapter 8, page 357, paragraph 8.261.

³⁰⁰ PFs, Chapter 8, page 366, paragraph 8.299.

³⁰¹ PFs, Chapter 8, page 360, paragraph 8.273.

³⁰² PFs, Chapter 8, page 360, paragraph 8.273.

Nexus. Implementation of Project Nexus should take place over an agreed timescale to go live on 1 October 2016.

346. As regards the CMA's concerns about incentives on shippers to place a higher priority on adjusting AQs down and delaying adjusting AQs up, we consider that this is a second order issue. Therefore, whilst we would support the introduction of mandatory monthly updates, we consider that it would make more sense that this should follow full implementation of Project Nexus and the smart meter roll out. In the meantime, RWE would, however, be supportive of suppliers having the ability to submit monthly meter readings and for this information to be used in the settlement of industry charges.

Electricity settlement

347. The CMA provisionally finds that the absence of a firm plan for moving to half-hourly ("HH") settlement for domestic electricity customers and of a cost-effective option of elective half-hourly settlement is a feature of the market that gives rise to an AEC.³⁰³ RWE accepts that the use of half-hourly consumption data to settle electricity will be a prerequisite for the widespread introduction of time of use tariffs, and that suppliers may not be able to encourage customers to change their consumption profile without the use of such data. However, the widespread introduction of time of use tariffs will only be feasible with the introduction of smart meters, and so it does not make sense to mandate the use of half-hourly consumption data before it is able to be used effectively. See further our response to the RN.
348. Additionally, we consider that HH settlement will need to reflect wider changes to the market and suppliers should be able to innovate to provide solutions to customers that want demand side response without necessarily being forced to use HH settlement. Given that smart will be a crucial enabler for HH settlement, suppliers must be given time to roll this out first, therefore migration to HH should be after mass rollout of smart i.e. post 2020. As we explain in RWE's response to the RN, we believe the primary focus should first be on educating customers in using smart to ensure customer engagement. Forcing customers into providing access to their HH data and onto time of use tariffs too early will compromise DECC's strategic aims for smart metering rollout. Time must also be given to ensure that the data is sufficiently robust before migrating to HH, in order to avoid additional cost and delay to the detriment of customers.
349. More work is also required to ensure that the smart meter specification is aligned with HH settlement requirements. For reasons set out in our response to the RN, the CMA's argument for HH to deal with demand side response is not robust. Given all these factors such a project will require well resourced project management with a design authority. Finally it should be recognised that there are fundamental differences between domestic and microbusiness customers, so any remedy to address the above issues should adequately reflect this – see further our comments in the following Section H.

H. MICROBUSINESS SEGMENT PROVISIONAL FINDING OF AEC

a. The SME segment is fundamentally different to the domestic segment

350. As a preliminary remark, RWE would note that the CMA seems to assume that there are a number of broad similarities between the domestic and SME segments, and therefore the CMA simply reads across much of its analysis of the domestic segment when looking at the SME/microbusiness segment.³⁰⁴ This is not appropriate. Whilst there are of course some commonalities, there are a number of fundamental differences between the segments that go beyond the "key differences" the CMA has identified. It is also not instructive to distinguish between customer differences and supply differences, since the two are closely interrelated.
351. RWE's experience is that the microbusiness segment is a highly competitive and dynamic segment as reflected by the diversity of suppliers and of businesses, customer preferences,

303 PFs, Chapter 8, page 363, paragraph 8.286.

304 PFs, Chapter 9, page 371, paragraph 9.8.

the role played by Third Party Intermediaries and the strong indicators of customer engagement.

352. As the CMA acknowledges, there are over 30 active suppliers of each of gas and electricity in the SME segment,³⁰⁵ and that this number is continuing to grow.³⁰⁶ 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.
353. That said, in respect of the smallest SME consumers (by consumption), we note the CMA's finding that Centrica is the largest supplier of both electricity and gas, with a market share of 40% in gas that is around 4 times larger than the next largest suppliers.³⁰⁷ It is important that the CMA considers the impact on competition of Centrica's strong market position.
354. In RWE's view the CMA understates the extent of the differences between domestic customers and microbusinesses. RWE agrees with a number of the differences between domestic and microbusiness and domestic customers identified by the CMA: it is right that they do not only vary (from domestic customers) by the amount of energy they consume;³⁰⁸ that there are no concerns about 'vulnerable' microbusinesses;³⁰⁹ and that only a minority of SMEs use both mains electricity and gas.³¹⁰ However, whilst it is correct, for example, that some microbusinesses spend similar amounts to domestic customers, it is unhelpful to look at microbusinesses in this way, since even those microbusinesses consuming a comparable amount of energy to a domestic customer will represent a diverse range of businesses with differing customer preferences and characteristics, and their energy intensity will differ from one customer to the next. Additionally, microbusiness consumption is theoretically unlimited, since a business with very high consumption and/or turnover would classify as a microbusiness if it has less than 10 employees.
355. These differences in customer characteristics and preferences are reflected in the products offered to SMEs and microbusinesses.
356. Whereas domestic tariffs (both SVT and non-standard tariffs) are available to any customer (usually subject to meeting very basic eligibility criteria), SME products are typically bespoke to each customer, whether or not the terms and conditions are negotiated as between the supplier and customer. As regards the CMA's terminology when describing "tariffs" available to microbusinesses,³¹¹ RWE would comment that these are not tariffs but are products. Each product has different features and benefits, for a very wide range of customers with different needs and circumstances. Which product is right for a customer, and what terms are offered to them, will depend on factors including:
- 356.1 Business customer firmographic, e.g. business type, consumption, number of sites;
- 356.2 Customer need and preference with respect to channel, product features and benefits sought, e.g. fixed price, variable price, tracker product, level of standing charge, additional services sought e.g. bill frequency, energy management advice;
- 356.3 Complexity of metering arrangements currently used by the customer or sought by them, e.g. commercial AMR/Advanced metering that they may already have (which may not be

³⁰⁵ PFs, Chapter 9, page 374, paragraph 9.19.

³⁰⁶ PFs, Appendix 9.1, pages A9.1-6 – A9.1-7, paragraph 15.

³⁰⁷ PFs, Appendix 9.1, pages A9.1-10 – A9.1-11, paragraph 24.

³⁰⁸ PFs, Chapter 9, page 372, paragraph 9.11.

³⁰⁹ PFs, Chapter 9, page 372, paragraph 9.12.

³¹⁰ PFs, Chapter 9, page 372, paragraph 9.13.

³¹¹ PFs, Chapter 9, pages 376-378, paragraph 9.28.

inter-operable), traditional metering or SMETS compliant true SMART meter, in some instances separate MOP metering arrangements; and

- 356.4 The credit rating of the customer's business.
357. The fact that microbusinesses can negotiate with suppliers to tailor these products to their specific energy requirements and their risk profiles results in a substantial benefit to both customers and suppliers. RWE welcomes the CMA's recognition that there are some advantages, in terms of allowing a supplier to factor in credit risk and therefore avoid adverse selection issues, from a negotiated pricing model.³¹² However, RWE would reiterate that these advantages are significant and provide important benefits for customers, particularly those with good credit ratings, in terms of ability to negotiate lower prices. Additionally, for example, a customer with a very high consumption and turnover (which would still classify as a 'microbusiness' if it has under 10 employees) may wish to agree a new contract 6 months in advance in order to have greater certainty over its medium-long term finances, and will need to negotiate with a supplier in order to do so.
358. We note that RWE's new Flexible product does not fully meet the CMA's definition of "evergreen". It is a fixed price contract but is neither a fixed term contract nor an auto-rollover contract (in responses to CMA microbusiness data requests we had classified this product as an 'evergreen' product, which was the closest of the CMA's definition, but it is not a variable price product insofar as the price is fixed for a year). Under the Flexible product, the customer is offered a fixed price for 12 months but can leave at any time upon 30 days' notice or can enter into a new fixed term contract at any time. It is important that the CMA recognises the differences between this product and an auto-rollover product.
359. The CMA correctly identifies that bad debt is a more substantial issue for suppliers in the SME segment.³¹³ We would note though that the bad debt risk for SMEs arises not only because of the risk of SMEs going out of business (which we agree is a real risk for SMEs). There is significant market churn both between suppliers and between properties making SME debt a substantial issue for suppliers, particularly with the shift from longer to shorter term contracts. During their time on supply a number of our customers will face significant cash flow issues at one or more points during their financial year which will put pressure on their ability to service their energy debts. This, coupled with issue of high rates of failure among start-ups and the greater incidence of phoenix companies, poses a significant challenge to suppliers.
360. As regards the regulation of microbusinesses, we agree with the CMA's finding that it is generally less prescribed than in the domestic markets, which the CMA considers is "*partly a reflection of the degree of political and media interest. News about domestic energy bills tends to attract a high level of public interest. In contrast, microbusiness energy supply has a lower profile, although there have been instances of high-level political activity in this area.*"³¹⁴ Whilst we agree that the degree of political and media interest is likely to have contributed to the excessive and inconsistent regulation applied to the domestic sector, we consider that the lighter touch regime applicable to microbusinesses results not from a lack of political and media interest but rather is a reflection of the fundamental differences between the segments. In our review, most of the microbusiness regulations introduced have worked in the interests of customers, providing microbusinesses with important protections whilst allowing suppliers the freedom to compete on price, quality and product innovation. There are, however, aspects of regulation that work less well and mean that competition might not be as effective as it could be and we would urge the CMA to address these. These include the regulation (or lack thereof) of TPIs, the inconsistent regulatory approach to auto-rollover (see further below), and certain specific regulatory obligations that go beyond what is required or justified.
361. As regards costs and prices, it is not meaningful to carry out a comparison of unit revenues across the domestic and SME segments given the different cost structures of these

³¹² PFs, Appendix 9.1, page A9.1-29, paragraph 85.

³¹³ PFs, Chapter 9, page 374, paragraph 9.18.

³¹⁴ PFs, Chapter 9, page 375, paragraph 9.24.

businesses and the key differences between tariffs offered to domestic customers and products tailored to SME customers.

b. There is no overarching feature of weak customer response

362. The CMA has provisionally identified an “*overarching feature of weak customer response*”, which it considers gives rise to an AEC and gives suppliers a position of unilateral market power with regard to their inactive microbusiness customer base.³¹⁵
363. The CMA considers that customers have limited awareness and interest in switching as a result of the fundamental characteristics of the SME retail energy market, specifically product homogeneity and issues associated with traditional meters.³¹⁶ In addition, the CMA considers that customers face actual and perceived barriers to accessing and assessing information, in particular as a result of a lack of transparency and the way in which TPIS operate.³¹⁷ The CMA argues that a material proportion of customers are fundamentally disengaged.³¹⁸
364. RWE disagrees with aspects of the CMA’s provisional findings. RWE considers that there is weak evidence of disengagement of microbusiness customers. The CMA seems to accept that there are higher levels of engagement (and broader measures of engagement) than exist in the domestic market,³¹⁹ but nonetheless simply reads across its provisional conclusions in relation to domestic weak customer response to reach very similar provisional conclusions in relation to microbusiness customer response. As set out in Section G, we do not consider that there is weak customer response even in the Domestic segment, but it is incumbent on the CMA to ensure it has a robust evidence base, independent on any views it has on the domestic market, to support any conclusions of weak customer response among microbusinesses. RWE does not believe that there is any such evidence base.
365. Additionally, the CMA will need to (but currently does not) recognise and take account of important recent changes in the segment, including the ending of auto-rollover by the largest suppliers and a range of regulatory changes that can be expected to drive even greater customer engagement. The CMA says it recognises that the regulatory developments are recent and not properly reflected in the data available to it,³²⁰ but in practice, this limitation does not seem to be reflected in the CMA’s provisional finding of weak customer response giving rise to supplier UMP. For instance, since the end of auto-rollover in November 2014, RWE has seen [CONFIDENTIAL] customers move onto the new Flexible product. Of these, every month around [CONFIDENTIAL] have moved onto a [CONFIDENTIAL], [CONFIDENTIAL] have left RWE for another supplier. These are customer who would otherwise have been locked into another contract for a year under auto-rollover.

i. There are no significant barriers to engagement

The CMA has misconstrued the fundamental characteristics of energy supply to SMEs

366. As regards the fundamental characteristics of energy supply, we consider that the CMA misunderstands the first of these (homogeneity) and overstates the ‘fundamental’ nature

³¹⁵ PFs, Chapter 9, page 402, paragraph 9.111.

³¹⁶ PFs, Chapter 9, page 403, paragraph 9.112(a).

³¹⁷ PFs, Chapter 9, page 403, paragraph 9.112(b).

³¹⁸ PFs, Chapter 9, page 402, paragraph 9.111.

³¹⁹ PFs, Chapter 9, page 379, paragraph 9.35; Chapter 9, pages 380-381, paragraphs 9.38 and 9.41; Chapter 9, page 383, paragraph 9.44.

³²⁰ PFs, Appendix 9.1, page A9.1-17, paragraph 41.

of the second (traditional meters) and, as a result, misconstrues them as 'fundamental' barriers to engagement:

- 366.1 Suppliers' product offerings to consumers in this market are not homogeneous (see Section F above). In the SME/microbusiness segment, products are tailored to individual customers' characteristics and preference and reflect the negotiated nature of the SME segment. See paragraph 356 where we explain the factors that will determine which product is best for a customer and the terms that are offered to them. The CMA does not even seek to address whether SME/microbusiness energy supply products are homogeneous, but simply reads this across from its (incorrect) assumptions in the domestic segment.³²¹
- 366.2 The CMA offers no credible evidence that the complexity of traditional meters is a barrier to engagement and results in weak customer response. We explain above that not all SME/microbusiness customers have traditional meters. Even in the case of traditional meters, we see no evidence that these operate as a barrier to engagement. We address this in more detail in our domestic response in Section G, and many of the same considerations apply in respect of SME/microbusiness customers with regard to the use of traditional meters.

Lack of published prices is not a barrier to engagement

367. The CMA provisionally finds that customers face actual and perceived barriers to accessing and assessing information, arising from a lack of transparency and the role of TPIs.³²²
368. We agree that microbusinesses' access to information and ability to assess that information is important. However, this does not necessarily require "transparency" of the kind that exists in the Domestic segment. All markets, including highly competitive ones, require consumers to take actions to compare their current supplier with a potential new one. Indeed, some auctions for example are competitive precisely because participants do not have transparency. Thus there is no universal automatic link between transparency and effective competition.
369. As set out in our response to the UIS, the information required by microbusinesses to ensure they are on the product that is right for them is readily available. A customer can obtain a quotation from RWE over the telephone or on our websites in about 30 minutes, meaning that a microbusiness can obtain quotes from multiple suppliers in a relatively short amount of time. A microbusiness can also use a TPI to search on its behalf (see further below).
370. The CMA makes three arguments in relation to transparency:
- 370.1 First, the CMA argues that a lack of transparency may mean customers are less likely to search;³²³
- 370.2 Second, the CMA is concerned that searchers will be in a weaker bargaining position and therefore would achieve worse outcomes in the negotiations;³²⁴
- 370.3 Third, the CMA is concerned that microbusinesses may not be aware that there may be better deals available and therefore they are less likely to search.³²⁵
371. RWE does not believe that any of these arguments is convincing.

³²¹ PFs, Chapter 9, pages 403-404, paragraph 9.112.

³²² PFs, Summary, page 37, paragraph 172; Chapter 9, page 386, paragraph 9.59; Chapter 9, pages 387-8, paragraph 9.65; Chapter 9, pages 403-404, paragraph 9.112; Chapter 12, pages 477-478, paragraph 12.9.

³²³ PFs, Chapter 9, pages 387-388, paragraph, 9.65; Chapter 9, pages 403-404, paragraph 9.112.

³²⁴ PFs, Chapter 9, pages 383-394, paragraph 9.48.

³²⁵ PFs, Chapter 9, pages 387-388, paragraph, 9.65; Chapter 9, pages 403-404, paragraph 9.112.

- 371.1 In respect of the first and second arguments, RWE has already noted that price discovery is not a costly process – it involves a phone call. If, as the CMA submits, having a rival quote in hand is helpful for negotiations then the low cost of obtaining a competitive quotation strongly suggests that a lack of published prices need not operate as a barrier to engagement.
- 371.2 In respect of the third argument, first, we would note that the CMA does not appear to have considered any evidence that customers on so-called ‘default’ products are unaware that there are better deals available.
- 371.3 In any event, RWE notes that in relation to the significant majority of customers on a Fixed contract, 60 days prior to the point of Fixed contract expiry RWE writes to them to set out their options. The renewal letter specifically sets out:
- 371.3.1 The customer’s current contract price and consumption;
- 371.3.2 A reminder that our Fixed contract is *“Our most competitive plan, offering greater budget certainty and leaving you to run your business with peace of mind.”* (It also tells them about our Variable contract.)
- 371.3.3 It tells them *“If you do nothing, we’ll change your account to our Flexible business energy plan, a contract with a price that we’ll fix for 12 months, which you can end by giving us 30 days’ notice at any time.”*
- 371.4 As regards the relatively small minority of customers on our Deemed or OOC³²⁶ products, 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. This letter says *“Please call us – we’d like to help you pay less. At the moment, you’re on out of contract rates for your electricity. These are probably higher than the contract rates we could offer you. But if you call us and switch to a Fixed or Variable business energy plan, we can make sure you’re getting the best deal from us that suits your needs.”*
- 371.5 Therefore it should be very evident to RWE’s customers on Flexible, Deemed and OOC products that there may be better deals available. RWE considers that the idea that a lack of transparency itself would mean that customers may be less likely to try to switch supplier or tariff is not convincing.

Third party intermediaries

372. The CMA considers that one way of overcoming a lack of transparency is to receive assistance from an intermediary.³²⁷ Whilst we do not consider there is any lack of information available from suppliers, we agree that TPIs can certainly help to promote the dissemination of information. The 1,000 plus TPIs that act on behalf of suppliers or customers have stimulated competition in the market and can provide customers with a very useful service. The CMA notes that new suppliers have relied heavily on TPIs for growth,³²⁸ which we consider to be further evidence that TPIs serve SME/microbusiness customers well.
373. The CMA notes that the smallest businesses may be less likely than large businesses to use a TPI as their main source of information.³²⁹ We would note that this does not necessarily mean that they do not use TPIs, since this may still mean that smaller businesses that also approach suppliers directly have consulted or obtained some information from a TPI. In any case, we do not consider that the smallest businesses have any difficulties in accessing TPIs. As the CMA notes, *“the 2014 survey for Ofgem reported that only 15% of microbusinesses and small businesses said that they had not been contacted by a TPI in*

³²⁶ RWE’s “Default” product meets the CMA definition of “OOC” (PFs, Chapter 9, pages 376-378, paragraph 9.28(b)(iii)) and is referred to as OOC to avoid confusion with the CMA’s broader definition of “default”.

³²⁷ PFs, Chapter 9, page 384, paragraph 9.52.

³²⁸ PFs, Appendix 9.1, page A9.1-31, paragraph 93.

³²⁹ PFs, Chapter 9, page 384, paragraph 9.53.

the past year”, and “The 2014 survey also suggested that there had been an increase in approaches by brokers.”³³⁰

374. The CMA also notes that many smaller customers appear to distrust TPIs.³³¹ RWE recognises that the effectiveness of the TPI market may be impacted by the minority of TPIs that have engaged in bad practices, and that proper regulation of the TPI market is an urgent priority. We share the concerns expressed by the CMA about the lack of transparency of TPI commission payments and that this is not well understood by customers, and that TPIs may have incentives to present offers that are not the most advantageous for customers.³³² RWE would note however that for the large majority of customers who use TPIs, it is a positive experience (80% are satisfied), which would support that those TPIs that deal fairly with customers can provide a very valuable service.³³³
375. As regards the draft code of practice for non-domestic TPIs developed by Ofgem, RWE would reiterate that this issue has been under consideration by Ofgem for close to 4 years and Ofgem currently proposes to wait for the outcome of the CMA investigation and take into account the CMA’s findings in relation to TPIs. Ofgem’s proposals do not go far enough: direct regulation of the TPI market is required. RWE would urge the CMA to take immediate action and we refer further to our response to the RN.

Price comparison websites

376. The CMA provisionally finds that there is “*very limited availability of PCWs for business energy customers*”. The CMA considers that there “*may be*” demand for online price comparison services in the SME sector and, whilst the CMA notes arguments made about the complexity of the SME segment, the CMA considers that the development and promotion of a non-domestic energy PCW would not be “*impossible*”.³³⁴
377. RWE agrees that the complexity of customer demand and preferences and the variety of products on the market mean that PCWs have struggled to establish themselves in the business customer marketplace. However, we do not consider that the lack of PCWs results in any barrier to engagement.
378. We comment above on the important role played by TPIs and we do not repeat those comments here. TPIs provide two key benefits that PCWs would not:
- 378.1 First, TPIs allow for negotiation, which is such a key feature of this segment. The CMA acknowledges that Fixed term contracts offer the possibility of negotiation with a supplier or through a TPI, and that a PCW is unable to provide negotiated prices, but considers that “*this may not matter as much for smaller customers (for example if their energy needs are likely to be simpler than larger businesses)*”.³³⁵ This is not only inconsistent with the CMA’s other findings with regard to microbusiness, since it implies that it does not matter if they do not get the best price; it also misunderstands the market as it is not necessarily the case that microbusinesses’ energy needs will be simpler than those of a large business.
- 378.2 Second, they are a ‘push’ channel, reaching out to customers who are not necessarily actively seeking a new product/supplier, but who are open to competitive offers. PCWs, by contrast, are a ‘pull’ channel, providing information only to those customers who are already researching the market.

³³⁰ PFs, Chapter 9, pages 384-385, paragraph 9.54.

³³¹ PFs, Chapter 9, pages 384-385, paragraph 9.54.

³³² PFs, Appendix 9.1, pages A9.1-37 – A9.1-38, paragraphs 120-122; Appendix 9.1, page A9.1-39, paragraph 128.

³³³ PFs, Appendix 9.1, page A9.1-39, paragraph 107.

³³⁴ PFs, Chapter 9, Chapter 9, page 386-7, paragraphs 9.60-9.63.

³³⁵ PFs, Appendix 9.1, page A9.1-44, paragraph 147.

379. Therefore, whilst there may be a place for PCWs (see further our response to the RN), we do not consider that they are necessary, nor that they provide the benefits available from a (well run) TPI.

The (formal) end of auto-rollover should improve engagement

380. The CMA notes that the largest energy companies have gradually withdrawn auto-rollover in favour of 'notice' or 'evergreen' contracts.³³⁶ However, the CMA has some continuing concerns about auto-rollover in the SME market, *"that they reduce the customer's window to engage with choosing an energy tariff, and prevent switching outside that window"*.³³⁷ The CMA notes also that *"Many smaller suppliers continue to offer auto-rollovers, which may to some extent give those suppliers an unfair competitive advantage"*.³³⁸ RWE shares the CMA's concerns. In addition to providing these suppliers with an unfair competitive advantage, it leaves microbusiness customers in a position where they may not know upon entering into a contract whether they will be auto-rolled over upon expiry.
381. The CMA notes that the removal of auto-rollover resulted from informal pressure from Ofgem and the government,³³⁹ and absent regulation or legislation formally prohibiting it, auto-rollover could be reintroduced. Whilst RWE does not envisage reintroducing auto-rollover, RWE agrees that a suitable regulatory or legislative prohibition on auto-rollover is by far preferable to the current uncertain position.
382. The CMA notes that for suppliers that have ended auto-rollover, their customers on replacement products are no longer locked into their supplier during the replacement contract terms.³⁴⁰ As regards the products that replaced auto-rollover products, the CMA notes that *"If the customer's ability to terminate the contract during the replacement contract term increases those customers' engagement during that term, then competition could operate more effectively and may lead to lower prices on default products, and increased competition on acquisition and/or retention products more generally."*³⁴¹ Understandably, the CMA has limited evidence on this because the change is so recent.
383. We agree that the end of auto-rollover is likely to increase customers' engagement during the term of their replacement contract. RWE notes that the CMA's evidence on tariff types in Figure 9.4³⁴² is data from April 2013 so that the move away from auto-rollovers (since 2013) will not yet be fully reflected in the CMA's data.
384. We note that, although the CMA considers that the ending of auto-rollover may increase engagement,³⁴³ and notwithstanding that the CMA does not yet have firm information on the impact of the end of auto-rollover,³⁴⁴ nonetheless the CMA provisionally concludes that there is weak customer engagement and supplier unilateral market power.³⁴⁵ It is essential that the CMA properly takes into account the expected impact of a significant recent change in the SME segment, or at least that the CMA properly reflects on the limitations of the evidence available to it.

ii. There is significant evidence of customer engagement in practice

³³⁶ PFs, page 373, Chapter 9, paragraph 9.17.

³³⁷ PFs, page 395, Chapter 9, paragraph 9.79.

³³⁸ PFs, pages 395-396, Chapter 9, paragraph 9.80.

³³⁹ PFs, page 373, Chapter 9, paragraph 9.17; Chapter 9, pages 375-6, paragraph 9.23.

³⁴⁰ PFs, Chapter 9, page 396, paragraph 9.83.

³⁴¹ PFs, Chapter 9, page 396, paragraph 9.83.

³⁴² PFs, Chapter 9, page 380, Figure 9.4.

³⁴³ PFs, Chapter 9, page 381, paragraph 9.39.

³⁴⁴ PFs, Appendix 9.1, page A9.1-59, paragraph 202.

³⁴⁵ PFs, Chapter 9, pages 402-403, paragraph 9.111.

385. RWE welcomes the acknowledgement by the CMA that there is a spectrum of engagement.³⁴⁶ The CMA acknowledges that on some measures, engagement is higher than in the domestic segment.³⁴⁷ Nonetheless the CMA considers that the level of engagement by some microbusinesses is low, and that “outcomes appear to be significantly worse for customers who do not engage and end up of default tariffs”.³⁴⁸
386. RWE considers that generally there are good levels of engagement by SME/microbusiness customers. (We address the CMA’s provisional findings on outcomes in the sections that follow.) This is evidenced by, *inter alia*, high levels of switching and contract search.
387. RWE considers also that there are high levels of customer satisfaction amongst SME/microbusiness customers and RWE welcomes the acknowledgement by the CMA that customers staying with a supplier for a long time could be the result of satisfaction not inactivity³⁴⁹ and that choosing not to switch supplier may be a positive decision by a customer rather than a sign of disengagement.³⁵⁰
388. RWE notes though that despite the acknowledgement by the CMA about customer satisfaction, when considering time spent with current supplier as a possible indicator of disengagement, the CMA does not seek to assess whether a customer has remained with a supplier because the customer is satisfied. The CMA simply assumes that a customer who remains on any of what it regards as ‘default’ products is disengaged.³⁵¹

The CMA’s indicators of engagement are too restrictive

389. The CMA considers that indicators of engagement include type of tariff, degree of switching in the past year, contract search activity and the effect of regional incumbency.³⁵² As in its analysis of the domestic segment, we consider that the CMA has construed the indicators of engagement too narrowly.

The CMA overstates the level of disengagement by customers on so-called ‘default’ products

390. The CMA considers that spending more than “transitory periods” on what it terms “default” products indicates a possible lack of engagement.³⁵³
391. As a preliminary remark, we would comment that the CMA’s ‘default’³⁵⁴ products are a collection of quite different products over which the CMA has done varying degrees of analysis. The CMA has done very little analysis in relation to the products that replace auto-rollover or in relation to the Tariff product for legacy customers; and the CMA seems to acknowledge the valuable purpose served by Deemed and OOC³⁵⁵ and that these apply to small numbers of customers.³⁵⁶ Despite this, the CMA lumps these products all together and reaches a very broad conclusion of weak customer response and supplier unilateral market power.³⁵⁷
392. As regards customers on RWE’s Flexible product, RWE disagrees that these are ‘transitory’ products and it would be incorrect to regard customers who spend any significant time on

³⁴⁶ PFs, Chapter 9, page 379, paragraph 9.35.

³⁴⁷ PFs, Appendix 9.1, page A9.1-18, paragraph 44.

³⁴⁸ PFs, Chapter 9, page 383, paragraph 9.46.

³⁴⁹ PFs, Chapter 9, page 379, paragraph 9.34.

³⁵⁰ PFs, Appendix 9.1, page A9.1-22, paragraph 56(b).

³⁵¹ PFs, Chapter 9, pages 379-380, paragraph 9.36.

³⁵² PFs, Chapter 9, page 379, paragraph 9.35.

³⁵³ PFs, Chapter 9, pages 379-380, paragraph 9.36.

³⁵⁴ PFs, Chapter 9, pages 379-380, paragraph 9.36.

³⁵⁵ PFs, Chapter 9, page 399, paragraph 9.94.

³⁵⁶ PFs, Chapter 9, page 397, paragraph 9.85.

³⁵⁷ PFs, Chapter 9, pages 402-403, paragraph 9.111.

RWE's Flexible product as showing signs of disengagement (and not to distinguish at all between this product and an auto-rollover product). These customers will all have been acquired onto RWE's Fixed product, which is an acquisition product and customers on this product must be regarded as engaged. In the SME segment as in the domestic segment, suppliers operate a ('see-saw') pricing model of offering introductory discounts, [CONFIDENTIAL]; a customer who transfers onto a non-discounted Flexible product following the end of their discounted acquisition product should not, without more robust evidence, be regarded as disengaged.

393. As regards Deemed and OOC products, the CMA acknowledges that these products only apply to a minority of customers (6% of electricity customers and 7% of gas customers across the Six Large Energy Firms).³⁵⁸ Nonetheless the CMA is concerned that "*many customers who use these tariffs stay on them for a substantial period of time.*"³⁵⁹ The CMA continues to refer to data from 2013, based on which Ofgem noted that the median duration of microbusiness customers' stay on Deemed and OOC terms was over one year, and the median for "most of" the Six Large Energy Firms was over 300 days.³⁶⁰ We do not recognise this figure amongst our own Deemed and OOC customers. As explained below customers typically stay on these products for only a limited period of time.
394. RWE agrees, in principle, that its Deemed and OOC products are intended to be transitory products. [CONFIDENTIAL] RWE would urge the CMA to consider carefully what is an appropriate transitory period and not to ignore other forms of engagement by these customers during this period.
395. As the CMA is aware, OOC products apply to SME customers who have terminated their contracts.³⁶¹ By definition³⁶² a customer who has terminated its contract should not be regarded as inactive. The CMA should consider that the customer's engagement in the recent past is highly relevant and indicates that the customer may re-engage at any time. Of the [CONFIDENTIAL], and we obviously cannot know how many of these ([CONFIDENTIAL]) may be in contact with other suppliers and/or TPIs.
396. As regards Deemed products, typically these apply when a business moves into new premises and the supplier previously serving those premises inherits the customer;³⁶³ unsurprisingly, for some businesses, sorting out an energy supply contract might not be their most pressing concern, and an initial decision to use the existing supplier to the premises should not be taken as an indicator of disengagement.

There are high levels of contract search activity

397. RWE agrees with the CMA's view that "*Customers may display a degree of engagement by considering whether to change their contract, even if they do not end up switching.*"³⁶⁴ According to a survey carried out for Ofgem by BMG (the "BMG survey") referred to by the CMA, half of businesses with one to nine employees had looked into switching supplier or changing their contract within the past year. This provides further evidence of the high levels of customer engagement in the microbusiness sector.³⁶⁵ We note that, according to the BMG survey, only around a quarter of owner-operator businesses (with no employees) have never considered switching (though it is unclear whether they have never considered switching or whether they have not done so in the last year);³⁶⁶ more evidence would be required before this could be taken as indicating a lack of engagement rather than a positive

³⁵⁸ PFs, Chapter 9, page 397, paragraph 9.85.

³⁵⁹ PFs, Chapter 9, page 397, paragraph 9.86.

³⁶⁰ PFs, Chapter 9, page 397, paragraph 9.87.

³⁶¹ PFs, Chapter 9, pages 376-378, paragraph 9.28(b)(iii).

³⁶² Save in the case of a contract terminated in error by a TPI, which we address below.

³⁶³ PFs, Chapter 9, pages 376-378, paragraph 9.28(b)(ii).

³⁶⁴ PFs, Chapter 9, page 381, paragraph 9.41.

³⁶⁵ PFs, Chapter 9, page 381, paragraph 9.41 – BMG Research (2015), Micro and small business engagement in energy markets (report for Ofgem).

³⁶⁶ PFs, Chapter 9, page 381, paragraph 9.41.

choice to remain with their existing supplier. In any event, we would note that a relatively small proportion of the very smallest businesses fall into this category.

398. We consider however that it is too restrictive to regard as engaged only those customers who have shopped around within the last year. Since RWE's acquisition Fixed contracts are typically entered into for a period of 1 to 3 years – and a customer on a Fixed contract by definition is engaged – a customer who has shopped around more than a year ago could well still be properly regarded as engaged.
399. RWE also notes that there are high levels of awareness by customers of contract end dates and when they can negotiate. The Ofgem 2013 survey showed that only 13% of microbusinesses on fixed term contracts did not know or were unsure when their contract ended and almost two-thirds of microbusinesses knew when they could start renegotiating their contract or give notice of termination.³⁶⁷ This is consistent with RWE's experience of a highly engaged customer base.

There are high rates of switching

400. According to the BMG survey, 20% of businesses with one to four employees and 24% of businesses with five to nine employees switched supplier in the past year.³⁶⁸ Furthermore a survey carried out for Ofgem in 2013 (the "2013 Ofgem survey") found that 69% of those who had not switched within the last year were satisfied with their current supplier.³⁶⁹ The CMA notes that switching amongst microbusinesses is comparable to the switching rate among small business insurance customers³⁷⁰ and that the reported switching rate for microbusinesses increased between the two surveys carried out for Ofgem in 2013 and 2014.³⁷¹
401. The CMA appears also to acknowledge that switching within the last year might not be a suitable measure since many SME contracts are longer than one year (over 70% of acquisition contracts),³⁷² but does not take this into account in reaching a provisional finding of weak customer response.

402. [CONFIDENTIAL]

The CMA's assessment of regional incumbency is not meaningful

403. In order to assess whether suppliers' higher share of supply in their incumbent areas might be a sign of a lack of engagement, the CMA has looked at the proportion of customers on evergreen tariffs in and out of area, since "*customers who had remained on the same tariff since privatisation would be on these tariffs.*"³⁷³ We do not think this analysis is meaningful or that the CMA can derive anything from it.
- 403.1 In the data supplied by RWE to the CMA, "evergreen" covers the following products: Variable [CONFIDENTIAL], Flexible (our new product launched in 2014 to replace our auto-rollover product; covering [CONFIDENTIAL] of electricity customers and [CONFIDENTIAL] of gas customers) and Tariff (the product available only to electricity customers who have not moved supplier since we acquired them at privatisation and remain on open-ended contracts; covering [CONFIDENTIAL] of electricity customers).

³⁶⁷ PFs, Appendix 9.1, page A9.1-25, paragraph 67.

³⁶⁸ PFs, Chapter 9, pages 380-381, paragraph 9.38(a).

³⁶⁹ PFs, Appendix 9.1, page A9.1-22, paragraph 56(b) - The Research Perspective and Element Energy (2013) Quantitative research into non-domestic consumer engagement in, and experience of, the energy market (report for Ofgem).

³⁷⁰ PFs, Chapter 9, pages 380-381, paragraph 9.38(d).

³⁷¹ PFs, Chapter 9, pages 380-381, paragraph 9.38(e).

³⁷² PFs, Appendix 9.1, page A9.1-22, paragraph 56.

³⁷³ PFs, Chapter 9, page 382, paragraph 9.43; Chapter 9, pages 401-402, paragraph 9.107.

- 403.2 By definition, our Tariff product only applies to electricity customers in our incumbent regions. There is no out of area equivalent to this product. Therefore, an analysis that shows that *"All five of the former electricity incumbents supplied a greater proportion of their microbusiness volumes through evergreen tariffs in their home regions compared with other areas"*³⁷⁴ is not comparing like with like; it is comparing completely different products. If the CMA wishes to make a proper comparison of the in and out of area weighting of evergreen products, it should use as its sample only those products that are available in and out of area.

c. Suppliers do not have unilateral market power over any part of the customer base

i. Price discrimination is not indicative of a competition problem

404. The CMA has concerns about higher prices it observes in relation to so-called 'default' tariffs.³⁷⁵
405. RWE would comment that the SME segment, like the domestic segment, operates based on an introductory (or 'see-saw') pricing model. The price variation the CMA observes results from this pricing model. We refer to our comments in Section F.b.2 as to why this is not indicative of a competition problem and can in fact bring customer benefits, and we do not repeat these here.
406. In fact the CMA implicitly acknowledges that see-saw pricing can result in benefits, in its comments on auto-rollover: *"If the change in rollover type means that customers are staying with the supplier for less time on average, or paying a relatively high price for less time on average, then that may make customers less attractive to acquire or renegotiate with, and acquisition and/or renewal prices may be less keen."*³⁷⁶ Yet the CMA does not properly reflect this either in its provisional findings in relation to supplier unilateral market power, or in its consideration of possible remedies (see further our response to the RN).

Pricing of auto-rollover (or replacement) products

- 406.1 The CMA comments that, having looked at the average prices paid by customers since suppliers (including RWE) discontinued auto-rollover, its analysis suggested that customers who had moved onto a supplier's replacement product were not seeing better prices as a result of the removal of the auto-rollover terms.³⁷⁷ [CONFIDENTIAL]
- 406.2 We would note also that there are additional risks for us associated with this product, over and above those associated with our rollover product, since any customer may leave at any time.³⁷⁸ In this regard, we do not agree with the CMA's finding that the additional uncertainty associated with a contract that a customer can leave at any point is not a substantial cost.³⁷⁹
- 406.2.1 A third party campaign could target our entire Flexible customer base (i.e. not only those whose contracts are due to expire) at any given time.
- 406.2.2 [CONFIDENTIAL]

³⁷⁴ PFs, Chapter 9, page 382, paragraph 9.43.

³⁷⁵ PFs, Chapter 9, pages 379-380, paragraph 9.36.

³⁷⁶ PFs, Appendix 9.1, page A9.1-60, paragraph 207.

³⁷⁷ PFs, Chapter 9, pages 396-397, paragraph 9.83.

³⁷⁸ We need to be able to factor attrition rates into our approach to the wholesale purchase of energy, but as yet do not have enough historic enough so as to be able to do this. Additionally, we expect that customers will be most likely to leave (or enter into a new Fixed contract with us) when wholesale prices are falling and lower priced offers become available on the market, leaving us with the risk of needing to sell back wholesale energy in a falling market.

³⁷⁹ PFs, Appendix 9.1, page A9.1-61, paragraph 210.

406.2.3 [CONFIDENTIAL]

406.2.4 In any event, because RWE competes actively to acquire and retain customers, RWE must constantly ensure that its prices across all products are competitive.

406.3 [CONFIDENTIAL]

Pricing of Deemed and OOC products

407. The CMA recognises that *"Deemed and OOC tariffs are special cases. They provide a valuable function by giving customers continuous access to energy, even when a contract is not in place. Given the nature of these tariffs, they have certain costs which are higher than other tariffs (especially bad debt)."*³⁸⁰ The CMA notes also only a small proportion of customers are on these products and many customers spend only a short period of time on them. The CMA says that it has not attempted to assess whether prices are fully cost-justified.³⁸¹ However, despite these findings, which RWE supports, the CMA reaches a provisional finding of weak customer responses that seems to include Deemed and OOC products, which does not reflect at all the limitations to the CMA's analysis or the mixed nature of its findings.³⁸²
408. The CMA provisionally finds that *"Taken together, these factors suggest that although customers on deemed and OOC tariffs are paying high prices, the increment above other tariff types is partly cost-justified, and a relatively small number of customers are on these tariffs. However, we do not believe that competition can be working effectively to constrain these tariffs, given that some microbusiness customers do remain on them for a considerable period of time despite significantly cheaper tariffs being available."*³⁸³
409. The CMA expects any competitive constraint on the pricing of Deemed or OOC products to be weak, illustrated by the fact that the price for these products is significantly higher than for other product types.³⁸⁴ The CMA has provisionally found *"considerable variation"* in the prices paid by SMEs; in particular, that rollover tariffs were 29-36% higher than retention tariffs for electricity and 25-28% higher for gas;³⁸⁵ Deemed tariffs were 68-82% higher than retention tariffs for electricity and 70-116% for gas.³⁸⁶
410. We do not accept that there is weak competitive constraint on our pricing. As explained earlier in this section, the prices of our products are interlinked:
- 410.1 As the CMA acknowledges, Deemed prices are subject to a licence condition which states that they must not be unduly onerous.³⁸⁷ We set our Deemed prices [CONFIDENTIAL].
- 410.2 As regards OOC pricing, the particular risk associated with OOC customers comes from the fact they have taken the active step of terminating their contract with us, meaning we expect them to leave at any time (and we reemphasise in this context the very short period for which customers typically stay on an OOC product).
411. The CMA also notes that Deemed prices vary considerably between suppliers and, whilst the CMA would not expect the riskiness of Deemed customers to vary significantly between suppliers, it also notes that there are large differences in write-off rates.³⁸⁸ The CMA also observes a tendency for suppliers with higher write-off rates to charge higher deemed

³⁸⁰ PFs, Appendix 9.1, page A9.1-71, paragraph 244.

³⁸¹ PFs, Appendix 9.1, page A9.1-71, paragraph 245.

³⁸² PFs, Chapter 9, pages 402-403, paragraph 9.111.

³⁸³ PFs, Chapter 9, page 399, paragraph 9.96.

³⁸⁴ PFs, Chapter 9, page 397, paragraph 9.84.

³⁸⁵ PFs, Summary, pages 6-7, paragraph 25; Chapter 2, page 93, paragraph 2.159.

³⁸⁶ PFs, Summary, pages 6-7, paragraph 25; Chapter 2, page 93, paragraph 2.159.

³⁸⁷ PFs, Chapter 9, pages 377-378, paragraph 9.28(b)(ii).

³⁸⁸ PFs, Chapter 9, page 399, paragraphs 9.92-9.93.

prices, which suggests that differences in prices may partly be justified by differences in bad debt.³⁸⁹

ii. Profitability in the segment is not excessive

The CMA fails to take account of greater risks associated with supplying SME (rather than domestic or I&C) customers and recent trends in profitability

412. The CMA observes that average SME EBIT margins (8.4%) were noticeably higher than Domestic (3.3%) or I&C (2.0%) margins over the period 2009 to 2013.³⁹⁰
413. As explained in our response to the UIS, RWE would note that the EBIT margin of its SME segment over the last three years has averaged [CONFIDENTIAL]. In 2014, RWE's SME EBIT margin was [CONFIDENTIAL], which was [CONFIDENTIAL] the average EBIT margin across the Six Large Energy Firms as calculated by the CMA. [CONFIDENTIAL]
- 413.1 [CONFIDENTIAL]
- 413.2 Structural industry change: The inclusion of contract end dates on bills puts customers in a strong position to regularly review and negotiate their contracts. During 2013, triggered by pressure from the Government, all of the large players in the SME market (including the Six Large Energy Firms and Opus Energy) decided to cease auto-rollover of their SME customers, further improving the customer position. We are surprised that, having taken this step, Ofgem has decided that it will not intervene to remove this practice from the rest of the market. As a result of the position that Ofgem has taken, SME/microbusiness customers who elect to switch to smaller suppliers may be unaware that they will continue to be auto-rolled. As set out in our response to the RN, RWE would support a ban on the use of auto-rollover that is applicable to all suppliers, which we consider would be in the interests of customers.
- 413.3 The average margins shown by the CMA over the relevant period are not margins RWE would expect to be able to achieve in the current competitive climate, although RWE would not consider them to be excessive.
414. The CMA rejects parties' submissions that SME margins were higher because of *inter alia* bad debt risk.³⁹¹ The CMA speculates that SME customers could be disconnected for non-payment.³⁹² The CMA has not sought to assess the bad debt risk associated with supply to an SME business. We would note that the ability to disconnect SME customers who do not pay their bills does not prevent bad debt from arising. At the point of disconnection, the supplier will already have incurred the bad debt. The CMA accepts parties' submissions that SME (and I&C) businesses are likely to be more exposed to the economic cycle than domestic customers.³⁹³ However, the CMA considers that "*the scale of the margin differential between domestic and SME is sufficiently large that it was implausible that it could be explained by differences in costs or risks that we had not already taken account of.*"³⁹⁴ We have not seen any evidence that the CMA has sought to take account of these differences; the CMA appears simply to have presumed that bad debt risk is not intrinsically higher for SME customers.
415. We note the CMA's observations that margins were generally higher in gas than electricity, and that the CMA considers that this is driven by Centrica's higher margins.³⁹⁵ We submit in Section G above that the CMA should consider the extent to which retail profitability is

³⁸⁹ PFs, Chapter 9, page 399, paragraphs 9.94.

³⁹⁰ PFs, Chapter 2, page 92, paragraph 2.157; page 388, Chapter 9, paragraph 9.66; Chapter 10, page 409, paragraph 10.16; Chapter 10, page 434, paragraph 10.130.

³⁹¹ PFs, Chapter 10, page 409, paragraph 10.17.

³⁹² PFs, Chapter 10, page 409, paragraph 10.17.

³⁹³ PFs, Chapter 10, page 409, paragraph 10.17.

³⁹⁴ PFs, Chapter 10, pages 409-10, paragraph 10.18.

³⁹⁵ PFs, Chapter 10, page 410, paragraph 10.19

driven by Centrica's market power and should consider profitability across the Six Large Energy Firms excluding Centrica; we would reiterate this in respect of the SME/microbusiness segment.

416. Additionally, as regards any comparison between the domestic and SME segments, we would note that the period over which the CMA has analysed margins (2009 to 2013) includes years in which RWE's domestic margin was [CONFIDENTIAL] than RWE would consider [CONFIDENTIAL] and years in which RWE's SME margin was higher than RWE [CONFIDENTIAL]. Therefore, over and above any other differences between the two segments, [CONFIDENTIAL].

The CMA's comparison of margins across product types is not like-for-like

417. The CMA compares gross margin across Deemed/OOC products against gross margin for retention products.³⁹⁶ Gross margins on retention products are not an appropriate comparator. The CMA acknowledges that a comparison of gross margins does not take account of differences in indirect costs, in particular bad debt associated with Deemed and OOC customers.³⁹⁷ The CMA calculates that bad debt write-offs could explain some (but in most cases not all) of the difference in gross margins between Deemed and retention products (and between Deemed and OOC products).³⁹⁸ We agree that, for RWE, differences in bad debt write-offs will account for some of the difference; we refer to our submissions above as to the additional volume risk associated with Deemed and OOC customers who can (and do) leave at any time.

RWE does not make higher margins on its smallest customers

- 417.1 The CMA identifies higher average revenues (in £/MWh) and gross margin for smaller business customers compared with larger ones.³⁹⁹ We have previously commented on why making comparisons of revenues across consumption bands on a £/MWh basis is entirely inappropriate, since any such comparison cannot take account of the costs that do not vary directly by consumption or product type (e.g. customer service costs), and will necessarily be misleading.⁴⁰⁰
- 417.2 It is also misleading to compare gross margins across consumption bands, since this ignores the fact that RWE would not expect indirect costs to vary in direct proportion to consumption. The implication is that gross margins can be misleading measures of relative earnings across consumption groups.
418. We welcome the provisional finding by the CMA that, although the CMA found the highest average revenues and gross margins for customers the CMA classified as small micro-businesses, other evidence suggests that this does not translate into higher profits or NPVs and that the differences in prices and gross margins may be explained by indirect costs which are incurred on a per customer basis, especially metering, customer service and marketing.⁴⁰¹
419. The CMA has provisionally found some indications that "*supplying medium microbusinesses may be more profitable than supplying larger SMEs*" (but that the evidence on this point is not conclusive)⁴⁰². However, the CMA notes that: for electricity except for rollover contract, and for gas except in the case of Centrica rollover contracts, differences in per customer costs could broadly explain the differences in margins.⁴⁰³ We would comment that, as the CMA is aware, the largest suppliers have ceased the practice of auto-rollover, meaning that

³⁹⁶ PFs, Chapter 9, page 397, paragraph 9.88; page 398, Chapter 9, Table 9.1.

³⁹⁷ PFs, Chapter 9, page 398, paragraph 9.90.

³⁹⁸ PFs, Chapter 9, pages 398-399, paragraph 9.91.

³⁹⁹ PFs, Chapter 9, page 389, paragraph 9.70.

⁴⁰⁰ Letter dated 12 June 2015 from Eversheds to the CMA accompanying RWE's microbusiness PFs putback response.

⁴⁰¹ PFs, Chapter 9, page 400, paragraph 9.99-9.100.

⁴⁰² PFs, Chapter 9, page 401, paragraph 9.105.

⁴⁰³ PFs, Appendix 9.1, pages A9.1-74 - A9.1-75, paragraphs 258-262.

any issues associated with auto-rollover cannot be expected to persist except amongst those smaller suppliers that still engage in this practice.

Margins in and out of area

420. The CMA provisionally finds higher gross margins on evergreen products in home regions compared with other regions, especially for the smallest microbusinesses.⁴⁰⁴ As noted above, the 'Tariff' product which is only for customers who have been with their supplier since privatisation and have not switched tariffs, is only relevant in the supplier's home region, therefore it is not possible to compare gross margins in home and other regions: in comparing 'evergreen' gross margins, the CMA is effectively comparing (for RWE) combined margins across Tariff, Flexible and Variable products in our home region against Flexible and Variable products in our other regions. This is clearly not a like for like comparison. See our comments above about comparison of evergreen price in and out of area.
421. We welcome the provisional finding by the CMA that suppliers are not systematically receiving significantly higher gross margins on other tariff types in their home regions compared with elsewhere.⁴⁰⁵

d. Gas and electricity settlement

422. Please see our response in paragraphs 347 to 348 above. As for domestic, we consider that HH settlement for SME/microbusiness customers should follow the rollout of smart meters. Additionally, we would note that the benefits of HH settlement for SME/microbusiness customers are comparatively lower than they are for domestic customers, since these business customers generally have less ability to change their consumption behaviour to take advantage of the benefits of time of use products.

I. GOVERNANCE OF THE REGULATORY FRAMEWORK PROVISIONAL FINDING OF AECs

a. Effective communication on the impact of policies and policy trade-offs

423. The CMA notes that clearer communication around the costs and benefits of proposed and existing policies would increase the transparency of the information available and improve the quality of the public debate and policy decision making and that that a new independent institution might help achieve this.
424. We share the CMA's views that more effective assessment and clarity in communication of the interaction between policies and the trade-offs between policy objectives will assist in building transparency and accountability and result in more effective formulation of sustainable policies.
425. We believe there is a strong case for a new institutional role to provide independent scrutiny of the impact of DECC's programme and in particular on the interactions and trade-offs between policies. We also believe that a balanced scorecard, which could be used to track changes in key metrics as they respond to policy, regulatory and market changes, could usefully summarise and provide clarity on the UK's performance across its energy priorities.
426. We believe the impartiality of the institution entrusted with this role will be central to its success in enhancing trust and clarity in the market. In our view a new independent institution will be required. See further our response to the RN.

b. Ofgem's duties and independence

427. We share the CMA's view that the changes to Ofgem's duties under the Energy Act 2010 (EA10) constrain Ofgem's ability to promote competition by making the promotion of effective competition secondary to a requirement to protect the interests of consumers interests as a whole. This concern is exacerbated further by the lack of any key definition

⁴⁰⁴ PFs, Chapter 9, pages 401-402, paragraphs 9.106-9.107.

⁴⁰⁵ PFs, Chapter 9, page 402, paragraph 9.108.

and metric in meeting the objective of consumer protection and the wider concerns about policy trade-offs with security and sustainability. Specifically, measures taken in the name of 'fairness' between different customer groups or to further other policy objectives inevitably come at the expense of other groups of customers. The only way to properly appraise the costs and impacts of such measures is against the likely competitive outcomes in the absence of such interventions. The required transparency and accountability is best delivered with a primary objective to deliver competitive outcomes wherever possible and for those policy decisions which modify competitive outcomes (e.g. to cross-subsidise specific customer groups) to be made in a transparent and accountable fashion against a competitive benchmark.

428. We share the CMA's concerns that institutional pressure from DECC on Ofgem to implement particular policies reduces transparency and accountability and we agree that there should be greater clarity in the exercise of policy measures to ensure that the costs to customers – or particular groups of customers – are transparent and justifiable. In our view, greater clarity and rigour around 'trilemma' policy trade-offs and giving Ofgem a primary focus on the promotion of competition, including a right and duty for Ofgem to comment on all DECC's policies that are likely to affect competition in the supply of electricity and gas, will go a long way to ensuring that policy interventions that deviate from competitive outcomes are properly identified, appraised and justified as such.
429. We are less confident about the effectiveness of measures to "air disagreements" when taken in isolation from the clarification and strengthening of Ofgem's powers in respect of competition. While disagreements between Ofgem and DECC will no doubt continue to arise from time to time, a shared preference for the avoidance of 'washing dirty laundry in public' is likely to mean that informal means for resolving disagreements will continue to prevail over formal and public fora for airing differences of views. Nor is any such measure likely to avoid the implied or explicit threat to legislate to solve the 'problem' (or to require Ofgem to solve the problem). It is for this reason that the primary focus should fall on ensuring genuine independence for Ofgem and the primacy of its duties and powers in promoting competition and the transparent appraisal of measures which lead to deviations from competitive outcomes. Effectively anchoring one side of the debate to the delivery of competitive outcomes is, in itself, the best means to ensure that policies which seek to modify competitive outcomes are clearly identified, properly appraised and transparent to customers. See further our response to the RN.

c. Framework for financial reporting

430. RWE agrees with the CMA that financial reporting within the industry should be transparent, robust and should aim to build rather than detract from consumer confidence. This is an area where RWE will support and assist with the discussions in enhancing the information currently available.
431. However, given the CMA's provisional finding that there are no fundamental issues with the operation and presence of vertical integration across value chains in the industry (which we support), there is no compelling need for significant changes to the current reporting framework and careful thought will be required in relation to the presentation of financial information on a segmental basis that is deeper than currently necessary under the CSS.
432. RWE believes that current reporting in the CSS provides considerable transparency in relation to the generation business, and highlights the main drivers of the supply business. The CSS is audited and prepared on the arm's length basis.
433. RWE's reporting:
- 433.1 Aligns with the scope of the market (generation, supply for domestic and supply for non-domestic);
- 433.2 Is market orientated, including wholesale costs at point of delivery and RWEST contracts made at market prices;
- 433.3 Aligns to the licence structure; and

- 433.4 Is not just limited to the CSS (RWE also reports on an IFRS and UK GAAP basis).
434. RWE supports reporting based on P&L as an indicator of profitability. However, RWE does not support further allocation of balance sheets between segments, which would result in too arbitrary an allocation. Further allocation would also require a number of material adjustments to be made to calculate economic capital employed.
435. As a company operating in a liberalised market, RWE would not expect to have to submit regulated accounts. In addition, RWE believes that firms' management should be able to make decisions on the granularity of internal reporting required to run a business. Further granularity in reporting would take the business beyond what is considered strategic/competition sensitive confidential information.
436. RWE considers that CSS reporting should be the standard requirement for all suppliers regardless of size. With respect to information for individual policy making, RWE believes government should be able to request any supplementary information, for disclosure in consultation processes or as and when required. Furthermore, RWE considers that ex-post policy costs could be shown on the face of bills.

d. Industry codes

437. We agree with the CMA that the codes address the technical complexity of the industry, especially in electricity, and that the codes should stay up to date through a process of modification which requires expertise. We agree with the CMA that this is a burden and believe that the respective actors behave according to good governance and that the process does not favour any particular type of participant. We agree that the code modification process is not sufficient in its own right to drive long term major changes, nor should it be – rather it enables the underpinning detail to be addressed. We believe that inefficiency of long term outcome, particularly in the design and implementation of strategic programmes like Nexus, is caused not by the code governance process but by shortcomings in the adjudication process above the codes. We do not agree that parties have limited incentive to innovate and do believe that the governance process is fit for purpose in resolving disputes. We agree that Ofgem's role in practice has not always been effective and that in addition its competing duties have acted to impede or distort code development; therefore we do not consider that Ofgem should be given greater powers to initiate and manage code changes, which could compromise its impartiality in relation to the modification process. See further our response to the RN.

SCHEDULE 1

Annex 1: Zonal Transmission Losses Welfare analysis

"The Welfare Effects of Locational Transmission Loss Factors in the British Wholesale Electricity Market", Prepared for RWE, 11 May 2015, Confidential submission to the CMA

Updated Welfare Analysis

RWE has provided a report prepared by NERA/Imperial College that estimates the welfare benefits expected to arise from the allocation of losses on a zonal basis. This study supports earlier findings that there would be a material benefit to customers from such a change. Whilst the study only looked at short-run effects and is therefore likely to be an under-estimate of the benefits, the NPV of introducing seasonal loss factors is found to be approximately £880M for consumers. This demonstrates that even in its simplest form (using seasonal loss factors based on P229) a zonal losses scheme improves efficiency and a further development of using half hourly loss factors could increase the benefit to customers to £1,590M NPV.

Therefore, based on previous analysis as well as the updated study provided by NERA/Imperial College, we support the introduction of a seasonal loss factor methodology based on P229 at the earliest opportunity (we recommend April 2017 to allow suppliers to prepare adequately) and for the industry then to consider further incremental improvements.

Table 1
Welfare Impact of Introducing Zonal TLMs for Generators
(2014 £ million, NPV to 2030)⁷

	Welfare Impact - 2016 - 2030 (2014 £Mn)	
	Seasonal TLMs	Hourly TLMs
Impact on Consumers		
Power Purchase Costs (inc. capacity payments)	-798	-1,675
Low Carbon Subsidies	77	265
Constraints	-56	-51
Losses	-108	-129
Total	-884	-1,590
Power Sector Costs		
Generation Costs (excluding TNUoS)	142	121
Import Costs	-297	-257
Constraints	-56	-51
Losses	-108	-129
Total	-318	-315

Source: NERA/Imperial. Note, all NPVs are calculated between 2016 and 2030 at a real discount rate of 3.5%, following the HM Treasury Green Book. Impact per consumer is an annual benefit. Increases in costs are shown in red whilst decreases are shown in black.

"Cost Benefit Analysis of Modification Proposal P229: Changing to Zonal Seasonal Loss Factors", A report for Elexon by London Economics and Ventyx, October 2009

Table 5-4: CBA - Reference Scenario with high and low WACC estimates - without NOx and SOx (£ millions)			
		Annual Discounted CBA (million £)	
Year	Annual CBA (million £)	Low WACC (3.5%)	High WACC (5.2%)
2011	2.87	2.77	2.72
2012	6.94	6.47	6.26
2013	6.25	5.62	5.35
2014	4.84	4.21	3.94
2015	3.56	2.99	2.75
2016	4.66	3.78	3.42
2017	3.47	2.72	2.42
2018	8.82	6.67	5.83
2019	8.34	6.08	5.23
2020	10.47	7.38	6.24
Totals		48.68	44.15
Discounted Demand Side-Benefits		1.82	1.68
Total (including Discounted Demand-Side Benefits)		50.50	45.83
<i>Source: LE/Ventyx</i>			

Table 5-5: CBA - Reference Scenario with high and low WACC estimates - with NO_x and SO_x (£ millions)

		Annual Discounted CBA (million £)	
Year	Annual CBA (million £)	Low WACC (3.5%)	High WACC (5.2%)
2011	17.98	17.36	17.07
2012	63.81	59.50	57.54
2013	34.55	31.11	29.58
2014	33.49	29.12	27.23
2015	42.10	35.34	32.50
2016	28.75	23.30	21.07
2017	25.95	20.31	18.06
2018	31.72	23.97	20.96
2019	33.83	24.69	21.23
2020	33.27	23.44	19.83
Totals		288.14	265.07
Discounted Demand Side-Benefits		1.82	1.68
Total (including Discounted Demand-Side Benefits)		289.96	266.75
<i>Source: LE/Ventyx</i>			

"P229 Cost Benefit Analysis: Additional scenarios", A report on a study for Ofgem, October 2010 at https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/lot-report-2_0.pdf

Table 12 CBA – Redpoint Reference scenario

Year	Production cost savings (£mn)	Implementation costs (£mn)	Ongoing costs (£mn)	Annual CBA (£mn)	Annual discounted CBA (£mn)
2011/12	-5.26	-3.85	-0.16	-9.27	-8.88
2012/13	11.85		-0.16	11.69	10.72
2013/14	10.27		-0.16	10.12	8.89
2014/15	6.75		-0.16	6.59	5.54
2015/16	7.07		-0.16	6.91	5.57
2016/17	8.78		-0.16	8.62	6.65
2017/18	8.65		-0.16	8.49	6.28
2018/19	8.38		-0.16	8.22	5.82
2019/20	5.35		-0.16	5.20	3.52
2020/21	5.71		-0.16	5.55	3.60
Total					47.71

Table 13 CBA with SO₂ and NO_x emissions – Redpoint Reference scenario

Year	Change in SO ₂ emissions (£mn)	Change in NO _x emissions (£mn)	Annual CBA (£mn)	Annual discounted CBA (£mn)
2011/12	3.87	17.01	11.60	11.11
2012/13	-3.81	10.02	17.90	16.41
2013/14	-1.16	10.64	19.60	17.22
2014/15	2.47	9.04	18.10	15.22
2015/16	2.04	7.33	16.28	13.11
2016/17	2.56	8.36	19.54	15.08
2017/18	2.56	9.45	20.50	15.15
2018/19	4.02	14.43	26.67	18.87
2019/20	5.72	20.11	31.03	21.03
2020/21	4.82	17.28	27.65	17.94
Total				161.14

“What are the costs and benefits of zonal loss charging?” Report prepared for Elexon by Oxera, June 2006 at https://www.elexon.co.uk/wp-content/uploads/2012/02/p198_cost_benefit_analysis_report_final.pdf

Table 8.1 Scenarios of future benefits of AZTL to 2015/16 (£m)

	Central	Demand	Gas	Seasonal
Assumed annual benefits				
Generation redispatch	2.9	6.4	6.0	8.9
Demand response	0.6	0.9	0.5	0.7
Assumed annual operating costs	0.3	0.3	0.3	0.3
Assumed implementation costs	2.0	2.0	2.0	2.0
NPV of future benefits to 2015/16	20.8	49.0	43.0	65.6

Source: Oxera.

Table 8.2 Scenarios of future benefits of AZTL to 2020/21 (£m)

	Central	Demand	Gas	Seasonal
Assumed annual benefits				
Generation redispatch	2.9	6.4	6.0	8.9
Demand response	0.6	0.9	0.5	0.7
Relocation of generation (from 2015/16)	10.6	9.8	7.3	10.6
Assumed annual operating costs	0.3	0.3	0.3	0.3
Assumed implementation costs	2.0	2.0	2.0	2.0
NPV of future benefits to 2020/21	64.8	103.0	86.1	129.3

Source: Oxera.

The impact of average zonal transmission losses applied throughout Great Britain, Oxera
report for Department of Trade and Industry, June 2003

Table 9.1: Scenarios of Future benefits of AZTL (£m)

	High	Medium	Low
<i>Assumed annual benefits</i>			
Generation redispatch	1.29	0.74	0.19
Demand response	0.25	0.19	0.13
Relocation of generation (from 20010/11)	10	4	1
<i>Proportion of above benefits assumed to be offset by change in other costs (%)</i>	25%	25%	25%
<i>NPV of future benefits to 20/19/20, net of offsetting cost increases</i>	55.50	24.38	6.67

Source: Oxera

Annex 2: P229 Implementation Costs

Table 3-1 : P229 Assessment Phase Impact Assessment Responses

Company	Implementation Period	Estimate
International Power Mitsui	10 Working Days	N/A
Total Gas & Power	6-9 Months	N/A
ScottishPower	8 Months	£200,000
E.ON UK	9 Months	N/A
EDF ENERGY	12 Months	£300,000 - £600,000
Western Power Distribution	Minimal	N/A
GDF Suez Energy UK	6-9 Months	£150,000
RWE Trading GmbH	Minimal	N/A
Drax Power Limited	12 Months	N/A
British Energy Trading & Sales Ltd	9 Months	£100,00 - £300,000
Centrica	Minimal	< £10,000

Source: Elexon

Table 3-2 : Distributor Cost Estimates of P229 Implementation

	Low Estimate	High Estimate	Mid-Point Estimate
Cost per MW	£35.78	£51.97	£43.88
Total	£2,791,761	£4,055,164	£3,423,463

Source: LE/Ventyx

SCHEDULE 2

RESPONSE TO APPENDICES 10.3, 10.5 AND 10.6

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CMA ENERGY MARKET INVESTIGATION

NOTICE OF POSSIBLE REMEDIES

RWE RESPONSE

INTRODUCTION

1. RWE has provided a detailed written response to the Provisional Findings ("PFs") published by the CMA on 10 July 2015 in its Energy Market Investigation ("Investigation"), and RWE's written response has included a schedule (the "Profitability Response"), containing detailed commentary in relation to the CMA's PFs in relation to profitability and competitive price benchmarking which RWE considers to be flawed in several important respects. RWE's Authorised Advisers have also made Confidential Submissions on Disclosed Materials relating to several aspects of the CMA's analysis (the "Confidential Submissions").
2. This document responds to the CMA's Notice of Possible Remedies ("RN"), but should be read in conjunction with our response to PFs (including our Profitability Response) and our Authorised Advisers' Confidential Submissions. The CMA should consider the entirety of that response in setting the context for this document, but RWE would highlight in particular that it does not consider that the CMA can properly use the analysis of profitability that it has so far undertaken as a basis from which to consider the imposition of some of the more significant and intrusive remedies which are contemplated in the RN, such as the introduction of a safeguard tariff.
3. Our response to the RN is structured as follows:
 - 3.1 In the Overview section we comment on the adverse effects on competition ("AECs") that the CMA has provisionally identified, and summarise RWE's views in relation to those AECs. Where our view of the relevant AECs differs from that of the CMA, we remind the CMA of the main points of difference between us. We also comment on the packages of remedies (including a number of those which have been put forward by the CMA in its RN) which we consider will provide an effective means to address the AECs that the CMA has provisionally identified.
 - 3.2 In the Individual Remedies section, we provide comments individually on each of the remedy options that the CMA considers might be effective in addressing the identified AECs. We cover relevant customer benefits, where appropriate, within the substance of each individual remedy response. Where remedies encompass the microbusiness segment as well as the domestic segment of retail supply, we comment separately in relation to each segment. Separate commentary has been provided in recognition of the fact that the issues affecting the two segments, and therefore the potential impact of the proposed remedies on those two segments, will differ. It is imperative that the CMA considers the proposed remedies and their potential impact on the microbusiness and domestic segments separately in order to ensure that remedy proposals are proportionate.
 - 3.3 In the final section we touch briefly on those remedy options that the CMA has considered but is not currently minded to pursue. RWE notes that, as the CMA is not minded to pursue those remedies at this time, RWE has only provided high level comments. However, should the CMA's position change, RWE reserves the right to comment further.

OVERVIEW

4. We deal in turn with each of the AECs / remedy areas identified by the CMA.

Locational Pricing for Transmission Losses

5. The CMA has provisionally found that the absence of locational pricing for transmission losses is a feature of the wholesale electricity market in Great Britain that gives rise to an AEC, as it is likely to distort competition between generators and to have both short- and long-run effects on generation and demand.

6. RWE agrees with the CMA's provisional finding that the current system of uniform pricing for transmission losses creates an AEC. In our response to PFs on this issue, we emphasise that there have been repeated cost benefit analyses which show that a locational losses scheme results in enhanced consumer welfare, with material benefits ranging from £6.7 million to £884 million. We also highlight the need, after 25 years of debate, to act swiftly and decisively with a specific Order from the CMA, to put an end to this AEC.
7. To address such concerns the CMA has proposed remedy 1, the introduction of a new standard condition to electricity generators', suppliers', interconnectors', transmission, and distribution licences to require that variable transmission losses are priced on the basis of location in order to achieve technical efficiency.
8. RWE agrees that the introduction of an appropriate standard licence condition for electricity generators' suppliers', interconnectors', transmission and distribution licences in this respect would provide an effective and proportionate remedy to the AEC the CMA has identified, provided it were appropriately specified.
9. In its detailed response on remedy 1, RWE has provided a number of specific comments in relation to the remedy proposal and, in particular, a specific suggestion for how the CMA could draft such a licence condition to ensure its timely implementation. RWE does not believe that other remedies are required to address this AEC.

Mechanisms for allocating CfDs

10. The Group has provisionally found that the mechanisms for allocating CfDs are a feature of the wholesale electricity market in Great Britain giving rise to an AEC through increasing the risk of inefficient allocation of financial support to generation capacity and which adversely impacts competition.
11. RWE welcomes the CMA's recognition of the AEC which results from there being no obligation on DECC (i) to carry out a clear and thorough impact assessment on the allocation of CfDs when this happens outside a competitive process, and (ii) to monitor regularly and justify the allocation of budgets between the different pots for different technologies.
12. To remedy these concerns the CMA has proposed:
 - 12.1 Remedy 2a – DECC to undertake and consult on a clear and thorough impact assessment before awarding any CfD outside the CfD auction mechanism; and
 - 12.2 Remedy 2b – DECC to undertake and consult on a clear and thorough assessment before allocating technologies between pots and the CfD budget to the different pots.
13. RWE supports these remedies as appropriate solutions, however it submits that in order for them to be effective solutions to the AEC identified, it will be important that the remedies include an obligation on DECC, imposed by primary legislation, to carry out this analysis in a transparent way which justifies the outcome. This would ensure that the consultations are carried out in a robust and fully transparent manner, including through public consultation. In addition, there should be an obligation on the Secretary of State to take into account the results of these consultations.
14. RWE also notes that it cannot currently see any circumstances which may merit non-competitive allocation. Even where there are exceptional circumstances, for reasons of industrial policy or wider market failures, a robust analysis of the circumstances should still be carried out to assess whether allocating CfDs outside of the auction process can be justified. Additionally, given the demonstrated risk to consumer interests posed by non-competitive allocation, RWE believes that the factors considered in any such process, and weighting of such factors, should be constant across all projects (whatever the technology).

RMR (simpler choices)

15. The CMA has provisionally found that the 'simpler choices' component of the Retail Market Review rules (including the ban of complex tariffs, the maximum limit on the number of

tariffs that suppliers will be able to offer at any point in time, and the simplification of cash discounts) is a feature of the markets for the domestic retail supply of electricity and gas in Great Britain that gives rise to an AEC through reducing retail suppliers' ability to innovate in designing tariff structures to meet customer demand, in particular, over the long term, and by softening competition between PCWs.

16. RWE considers the CMA rightly recognises that the ability of suppliers to innovate in designing tariff structures to meet customer demand has been hampered by the simpler choices regulations, and that price competition between PCWs has also been softened. RWE's response to the PFs makes clear that it believes the CMA has understated the impact of RMR on price competition between suppliers. In RWE's view, the restriction in the number of tariffs not only limited the options in terms of which tariffs suppliers could launch, but also limited the ability of suppliers to target and trial products at different customer groups, thereby weakening price competition.
17. RWE believes that increasing the number of tariffs and other incentives allowed will enable suppliers to design innovative tariff structures to meet customer demand, thereby increasing customer choice and stimulating competition between suppliers and PCWs alike. RWE is strongly of the view that relaxing these constraints will intensify both engagement and competition in the retail energy market. RWE therefore believes that remedy 3 would be effective in addressing any concerns the CMA may continue to have that a lack of engagement giving suppliers a level of unilateral market power over their inactive customers, as well as directly addressing the provisional AEC relating to the distortion of competition brought about by RMR.
18. Further, RWE also believes that the CMA's PFs of an AEC arising from reduced ability to innovate should inform its analysis in relation to gains from switching, where in effect the CMA has inappropriately discarded as irrelevant non-price factors based on a view that electricity and gas are homogeneous products.

The Domestic Market

19. The CMA has provisionally found that a combination of features of the markets for domestic retail supply of gas and electricity in Great Britain give rise to an AEC through an overarching feature of weak customer response which, in turn, gives suppliers a position of unilateral market power concerning their inactive customer base which they are able to exploit through their pricing policies or otherwise. These features are said to act in combination to deter customers from engaging in the domestic retail gas and electricity markets, to impede their ability to do so effectively and successfully, and to discourage them from considering and/or selecting a new supplier that offers a lower price for effectively the same product.
20. RWE does not consider that the CMA has produced convincing evidence to support a provisional finding of an AEC of weak customer response, or that there is evidence of the existence or ability to exploit unilateral market power.
21. RWE does not accept the CMA's contention that weak customer response (to the extent it can properly be evidenced by any of the features identified by the CMA) gives suppliers a position of unilateral market power concerning inactive customers, or the contention that suppliers have the ability to exploit such a position. In this respect RWE makes the following high-level remarks – each developed more fully in our response to PFs:
 - 21.1 First, the CMA has overstated the level of any disengagement.
 - 21.2 Second, the CMA has failed to recognise the fact that suppliers are unable to differentiate in their pricing between customers who are 'engaged' and customers who are 'disengaged'. The pricing model operated by RWE (and others) is one in which discounts are offered in order to acquire customers, with a view to retaining some of those customers for a period on non-discounted prices.
 - 21.3 Third, to the extent there is price discrimination, it is not between engaged and disengaged customers, but rather a "see-saw" pricing mechanism that is used in many competitive

markets. RWE makes its discounted prices available to existing customers as well as new ones, and very large numbers of customers transfer tariff to take advantage of that position.

- 21.4 Fourth, the “gains from switching” analysis undertaken by the CMA is unsupportable.
- 21.5 Fifth, a finding of exploitation of unilateral market power is completely at odds with a properly drawn analysis of profitability.
- 22. In summary, RWE does not believe the CMA’s provisional AEC finding is currently well founded in reliable evidence. That said, RWE does, of course, recognise that some customers may have difficulties accessing and assessing information and RWE would be supportive of the introduction of appropriate measures to reduce these difficulties.

Limited awareness of and interest in the ability to switch energy supplier arising from fundamental characteristics of the domestic retail gas and electricity supply markets

- 23. The CMA provisionally finds that customers have limited awareness of and interest in their ability to switch energy supplier, which arises in particular from the following fundamental characteristics of the domestic retail gas and electricity supply markets:
 - 23.1 the homogeneous nature of gas and electricity which means an absence of quality differentiation of gas and electricity and which may fundamentally affect the potential for customer engagement in the markets; and
 - 23.2 the role of traditional meters and bills, which give rise to a disparity between actual and estimated consumption. This can be confusing and unhelpful to customers in understanding the relationship between the energy they consume and the amount they ultimately pay.
- 24. The CMA considers that these fundamental characteristics may particularly affect certain categories of customer (e.g. those who are elderly, live in social and rented housing or have relatively low levels of income or education) who the CMA believes are less likely to have considered engaging than others.
- 25. RWE fundamentally disagrees that customers have limited awareness of and interest in their ability to switch energy supplier. **The CMA’s own customer survey indicated that 89% of customers were aware of their ability to switch.** Nor does RWE agree with the CMA’s characterisation of gas and electricity as homogeneous. Whilst the underlying energy is the same whoever supplies it, this misses the point that suppliers can and do seek to differentiate their offerings in relation to the characteristics of their energy products, brand, tariff structures, quality of service, range of ancillary services, etc. The CMA’s customer survey reflects customers’ interests in a whole series of factors of this nature¹.
- 26. In relation to the CMAs consideration of the impact of traditional meters, RWE notes that the industry is spending £11.1 billion on the introduction of smart meters over the next 5 years. Smart meters will enable customers to engage with their energy usage and provide suppliers with the opportunity to deliver innovative services to customers.
- 27. To the extent that the CMA progresses with its finding that there is an AEC, RWE considers that the following package of remedies would be effective and proportionate in addressing this feature during the period before smart meters are fully rolled out:
 - 27.1 RWE believes that remedy 3 – removal of the simpler choices elements of RMR – will enable targeted discounts and offers and encourage the provision of differentiated products and services, and so increase quality differentiation between energy suppliers. In addition the introduction of smart meters will address the role currently played by traditional meters.
 - 27.2 RWE proposes that the CMA should consider relaxing some of the constraints from RMR on how information is provided to consumers in bills. In particular, RWE npower’s customer research and feedback indicates that whilst customers are receptive to some of the information required by RMR (such as cheapest tariff), customers are being overloaded with

¹ Provisional Findings, Appendix 8.1, page A8.1-54, Figure 24.

information that is confusing and which may disengage them. Some of the information which is most useful to customers has been relegated to page 2 of the bill. RWE's work with the Behavioural Insights Team (BIT) and Ofgem, as referred to in RWE's response to remedy 9, has already provided helpful evidence on how to improve communication, and will continue to do so.

- 27.3 Finally, RWE believes that remedy 10 – measures to prompt customers on standard variable tariffs – may also help address this concern. In particular, RWE does recognise that there is spectrum of engagement across consumers on SVT and that some of those consumers may benefit from additional prompts to engage. In principle, RWE supports measures to improve engagement through customer prompts, provided these are done in an efficient and effective manner, recognising customer preferences for certain communication channels and for not being overburdened with information. More detailed proposals are provided in RWE's response to remedy 10.

Actual and/or perceived barriers to accessing and assessing information as a result of the complex information provided in bills and the structure of tariffs

28. The CMA has provisionally found that certain customers face actual and perceived barriers to accessing and assessing information arising, in particular, from the complex information provided in bills and the structure of tariffs, which combine to inhibit the value-for-money assessments of available options, particularly on the part of customers that lack the capability to search and consider options fully (in particular, those with low levels of education or income, the elderly and/or those without access to the internet).
29. RWE believes that the CMA has overstated the extent of the challenges consumers face. While RWE agrees that more could be done to help certain customers to access and assess information, and it would be supportive of measures which will facilitate this, RWE does not believe that this feature alone is sufficient to make a provisional finding of AEC.
30. RWE notes the CMA's concerns regarding the complexity introduced by the structure of tariffs. As a first remark, RWE agrees with the CMA's observation that standing charges (or pre-RMR multi-tier unit rates) do have some potential benefits for low volume customers that the CMA should take into account in its overall assessment. The price differentiation allowed under multi-tier tariffs (or those with standing charges) constitute a relevant customer benefit since they typically serve to reduce the price paid by some customers.
31. RWE considers that the CMA's concerns will be addressed by a combination of remedy 3 (since the removal of RMR 'simpler choices' would allow suppliers to compete by offering and marketing simpler tariff structures for particular subsets of customers), and also by careful development of an appropriate remedy 9. In particular, if RWE's suggestions under remedy 9 were adopted, they would change the way in which some information is presented in bills in order to reduce complexity.

Actual and/or perceived barriers to accessing and assessing information as a result of a lack of confidence in and access to PCWs by certain categories of customers

32. The CMA has provisionally found that certain customers face actual and perceived barriers to accessing and assessing information arising, in particular from a lack of confidence in, and access to, price comparison websites (PCWs) by certain categories of customers, including the less well-educated and the less well-off.
33. RWE agrees with the CMA when it notes, in respect of this concern, that alternative forms of third party intermediaries (TPIs), such as collective switching schemes, may become increasingly important for such customers.
34. RWE notes in its response to remedy 10 that it is vitally important that the regulatory framework supports digital innovation, since RWE npower views digital channels and services as increasingly important for driving engagement, and providing customers with the information and tools to take control of their energy usage and costs. Some of the RMR rules, such as those regarding the Product End Notice, constrain RWE's ability to innovate and engage in a digitised manner to satisfy the expectations of RWE npower's customers.

35. RWE considers that 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. Providing PCWs with more access to customer data, either via ECOES or MiData, could improve the switching process and facilitate ongoing customer engagement. RWE notes Ofgem's recent reconsideration of the confidence code and, with the increased access to customer data, RWE believes that it is essential that PCWs are regulated in order to protect customer data and continue to build trust and encourage engagement in the market. Ofgem's Confidence Code (as amended) will undoubtedly be helpful in ensuring that trust and transparency is improved, and in our view, these could be further improved by direct regulation of PCWs. In order that PCWs can further drive competition in the market, under remedy 3 we would support PCWs being permitted to agree exclusive deals with suppliers; we note that this would require changes to the Confidence Code and in our response to the RN we also set out the other provisions we consider are required in order to provide customers with trust and simplicity in using PCWs.
36. RWE agrees with the CMA that confidence in price comparison websites can be improved by adopting remedy 6, the introduction of an Ofgem independent comparison service for domestic and microbusiness customers.
37. RWE also notes (in its response to remedy 4a) that when PCWs are provided with access to MiData, this should be sufficient for current tariff types to facilitate ongoing engagement in the market. In the future, when the market moves to more complex tariffs, specifically time of use tariffs, then in order to provide a quote that is accurate for each individual customer, it may be necessary to understand usage down to the half-hourly interval. RWE notes that there is provision within the roll-out of smart meters to allow customers access to 24 months of daily read data. In addition, in response to remedy 4a RWE agrees that PCWs should be able to access customer data at a later date to provide an updated view on the potential savings available, but only if a customer has specifically provided ongoing permission.
38. In terms of access to the internet by those who are less well-educated and/or less well-off, RWE considers that digital exclusion is an important government policy concern. In this respect RWE notes the recent emphasis on digital exclusion by government² which aims to significantly reduce the number of people lacking digital capability by 25% by April 2016 and then to reduce the number of people offline by 25% every two years. It is not clear to RWE that digital exclusion is a concern that is properly addressed through intervention in the energy market specifically.
39. RWE also believes that remedy 3 should allow energy suppliers to negotiate exclusive arrangements with PCWs which will allow them to differentiate their offerings and so increase their incentive to actively market their services. Removing, clarifying and simplifying some of the rules around discounts, bundles, incentives and loyalty rewards will also increase engagement.

Actual and/or perceived barriers to switching from uncertified meters and the experience of erroneous transfers

40. The CMA provisionally concludes that customers face actual and/or perceived barriers to switching, such as where they have uncertified meters or experience erroneous transfers which have the potential to cause material detriment to those who suffer from them. The CMA considers that erroneous transfers may thereby impact customers' ability to switch as well as their perception of switching.
41. RWE considers that the actual barriers to switching are in fact very low. This can be seen from the fact that the specific actual or potential barriers to switching that the CMA has identified in relation to remedies 4a and 4b appear very modest in character. The concern around uncertified meters applies to a very small fraction of meters (according to the CMA's PFs around 1% of transfers), and the extent of concerns from erroneous transfers is clearly

² See <https://www.gov.uk/government/publications/government-digital-inclusion-strategy/government-digital-inclusion-strategy>.

also not a widespread concern. More generally, RWE believes that the lack of switching barriers are clearly evidenced by the high levels of engagement actually seen in the market.

42. To the extent that the CMA maintains its PFs, RWE agrees with the CMA that this is again an area where the introduction of smart meters should in the fullness of time help bring improvements. In addition, RWE notes that concerns of switching barriers for consumers will be reduced by Ofgem's proposed introduction of one-day switching.
43. In respect of remedy 4a – measures to address barriers to switching by domestic customers, and remedy 4b – removal of the exemption for Centrica on two-year inspection of gas meters, in order to address a barrier to switching:
 - 43.1 In relation to uncertified meters, RWE notes that while the roll-out of smart meters should address the feature of uncertified electricity meters, this is not the primary driver of the smart meter programme and consideration must also be given to rolling out smart meters in a way which promotes cost efficiencies to the benefit of all customers³. Thus RWE believes that the current roll-out plans will address any issue the CMA has identified with respect to uncertified electricity meters, in an appropriate timeframe and that no further measures are necessary.
 - 43.2 In relation to Dynamic Teleswitched (DTS) meters RWE considers that the replacement of DTS meters with new smart metering technology, along with the development of technical systems and processes that the industry is currently undertaking to ensure interoperability, should remove the barriers to switching that customers with these metering arrangements currently face. However, RWE also considers that this is only part of what is required to tackle the barriers to switching for customers with DTS meters. In order that such customers are able to take full advantage of products that take account of new smart capabilities, suppliers need to be able to develop and offer a more extensive range of tariffs than are currently allowed under the RMR four-tariff rule. As a result RWE supports remedy 3.
 - 43.3 RWE npower believes that PCWs should be given access to the ECOES database in order for them to facilitate the switching process for customers. However, RWE npower believes that if they are granted access to ECOES then Ofgem should regulate the PCWs to prevent bad practice, protect customer data and to ensure the supplier is not held responsible if incorrect data is submitted by the PCW.
 - 43.4 In relation to penalties for delays in switching, RWE notes that the industry is already working with Ofgem, DECC and consumer groups to implement a Switching Guarantee for Domestic customers, and compensation for delayed switching is being discussed as part of that Guarantee.
 - 43.5 RWE npower acknowledges the desire from Government, DECC, the Treasury and Ofgem to move to next day switching. It is important that the implementation of next day switching delivers meaningful benefits and protection for all customers. RWE npower is currently working with industry partners and stakeholders, through the auspices of Energy UK, to understand how the complexities associated with next day switching can be resolved.
 - 43.6 In relation to barriers to switching for those in rented accommodation, RWE npower does not at this time have a clear idea of what would be the most practicable and effective remedies to increase engagement beyond the application of remedy 3 and the introduction of smart meters. However, in its detailed response to remedy 4a, RWE makes a number of suggestions which it considers are potentially worthy of further study by the CMA.
 - 43.7 Remedy 4b proposes the removal of the exemption for Centrica on two-year inspection of gas meters by amending the current Licence Condition arrangement so that all parties move to a similar and equivalent derogated position to that of Centrica. RWE npower considers

³ It must also be understood that industry discussions and developments have resulted in a change to the recertification regime. These changes focus on a risk-based approach whereby suppliers are obligated to ensure meters are recertified dependent on the individual risk of meter inaccuracy. This "in service testing" approach will look at samples of meter types to establish an overall risk of inaccuracy of a certain meter population rather than assume that from a certain date all meters in that category will need to be recertified.

that the current derogation arrangements distort competition and that, in the short-term, this remedy would be effective at removing that distortion. That said, RWE npower believes that it is necessary to await the outcome of Ofgem's current consultation into future state model options for a revised Metering Inspection Regime, before determining whether this remedy is warranted and proportionate.

Weak response of customers with pre-payment meters

44. In relation to prepayment meters, the CMA provisionally finds that these place technical constraints on customers on such meters from engaging fully with the markets, and reduce customers' ability and incentive to engage in the markets and search for better deals. The CMA considers that prepayment meters therefore contribute to such customers facing higher costs and a more limited choice of tariffs. In remedy 5, the CMA considers introducing a requirement that energy firms prioritise the roll-out of smart meters to domestic customers who currently have a prepayment meter.
45. RWE agrees that customers on prepayment meters have a more limited choice of tariffs. However, RWE agrees with the CMA when it *"expect these problems to be partly addressed with the full roll-out of smart meters and, in the intervening period Ofgem has recently published a report setting out measures to address the limited availability of tariffs for prepayment customers."*
46. Furthermore, the CMA's proposed remedy 3 should remove one of the principal causes of this limitation, and allow choice for prepayment customers to be expanded.
47. In relation to remedy 5, while RWE considers that smart meters are an important enabler in helping customers to engage with their energy usage and they offer suppliers the opportunity to deliver innovative services to customers, RWE considers that prioritising and successfully rolling-out smart meters to domestic customers who currently have a prepayment meter would not be practicable. The reasons are discussed in RWE's detailed response to remedy 5 and are due to current technical limitations in the communications infrastructure that have an impact on the functionality of smart meter technology. Where those limitations affect prepayment customers, those customers would face practical barriers to accessing the benefits of smart meter technology. The most cost effective approach for customers is a density led approach. RWE considers that cost advantages in achieving density in rolling out smart meters may be put at risk if the CMA were to prioritise the rollout of smart to pre-payment customers. This may increase the overall costs of the programme to all customers.

Remedies which RWE considers clearly disproportionate

48. For the reasons given in response to remedy 11 RWE considers that a safeguard tariff would be counterproductive, ineffective and disproportionate, not least because of the significant adverse effects it would have.

The Microbusiness Market

49. The CMA has provisionally found that a combination of features of the markets for retail supply of gas and electricity to SMEs in Great Britain give rise to an AEC through an overarching feature of weak customer response from microbusinesses which, in turn, gives suppliers a position of unilateral market power concerning their inactive microbusiness customer base which they are able to exploit through their pricing policies or otherwise. These features act in combination to deter microbusiness customers from engaging in the SME retail gas and electricity markets, to impede their ability to do so effectively and successfully, and to discourage them from considering and/or selecting a new supplier that offers a lower price for effectively the same product.
50. In RWE's view there are fundamental differences between the microbusiness and domestic segments of the retail market. Yet as we point out in our observations on PFs, the CMA treats the two segments as substantially the same. The CMA has essentially copied and pasted its weak customer response AEC from domestic to microbusiness without supportable reasons for doing so. Consequently, RWE does not consider that the CMA has produced evidence to support a provisional finding of an AEC of weak customer response,

or that there is reliable evidence of the existence, or ability on the part of suppliers to exploit, unilateral market power.

51. RWE rejects the CMA's contention that weak customer response (to the extent it can properly be evidenced by any of the features identified by the CMA) gives suppliers a position of unilateral market power concerning inactive customers, and the contention that suppliers have the ability to exploit such a position. First, the CMA has overstated the level of any disengagement. Second, a finding of ability to exploit unilateral market power is completely at odds with a properly drawn analysis of profitability.
52. In summary, RWE cannot accept the CMA's overall provisional AEC finding of weak customer response. It does, however recognise that aspects of TPI conduct and the continuation of auto-rollover in some quarters can be expected to be detrimental to engagement, and so RWE would be supportive of appropriate measures to regulate TPIs and to ensure auto-rollover is brought to a halt across the market as a whole.
53. In what follows, we discuss in turn each of the CMA's features contributing to its overall feature of weak customer response.

Limited awareness of and interest in the ability to switch energy supplier arising from fundamental characteristics of the domestic retail gas and electricity supply markets

54. The CMA provisionally finds that customers have limited awareness of and interest in their ability to switch energy supplier, which arises in particular from the following fundamental characteristics of the markets for retail energy supply to SMEs:
 - 54.1 the homogeneous nature of gas and electricity which means an absence of quality differentiation of gas and electricity and which may fundamentally affect the potential for customer engagement in the markets; and
 - 54.2 the role of traditional meters and bills, which give rise to a disparity between actual and estimated consumption. This can be confusing and unhelpful to customers in understanding the relationship between the energy they consume and the amount they ultimately pay.
55. RWE fundamentally disagrees that customers have limited awareness of and interest in their ability to switch energy supplier. Products offered by suppliers in the microbusiness segment are far from homogenous. The CMA has failed to appreciate the nature of the market and the fact that this is one in which products are tailored and priced to meet the needs of customers on a bespoke basis, reflecting the heterogeneity of the customer base.
56. Moreover, the CMA has produced limited evidence on engagement, and what evidence it does produce not only notes higher levels of engagement than exist in the domestic market, but also notes positive signs of increased switching between suppliers. The CMA remains concerned that 'some' microbusinesses "*appear to show limited engagement*" but does not identify who those microbusinesses are. Instead it wrongly bundles together different types of customer and labels them as being on 'default' tariffs. It suggests that spending more than transitory periods on these tariffs could be "*a sign of a possible lack of engagement*". It fails to note, for example, that [CONFIDENTIAL]. It would be completely unsupportable to assert that these customers should be considered to be inactive. There is no basis for the CMA properly to draw a conclusion that microbusiness customers are not engaged.
57. Further, RWE does not consider that the CMA has so far offered any evidence whatsoever to suggest that the fact that bills can have a disparity between actual and estimated consumption give rise to either a limited awareness of, or interest in, the ability on the part of microbusinesses to switch energy supplier.
58. However, in respect of traditional meters, RWE agrees with the CMA's view that the roll-out of smart meters over the next five years may have a potentially significant positive impact on engagement, and clearly will address any role being played by traditional meters in this regard. In addition, smart meters will enable a different approach to billing so that there should no longer be any disparity between actual and estimated consumption.

59. To the extent that the CMA does consider that the remedies are appropriate in the interim period before smart meters are fully rolled out, RWE considers that its proposals in respect of remedies 6, 7, 9 and 10 would constitute an effective and proportionate remedy. We discuss remedies 6 and 7 in more detail below, but first briefly comment on remedies 9 and 10.
60. RWE describes in its response to remedy 9 that it believes that the CMA's concerns in relation to customer engagement and ease of accessing and comparing offers would be resolved through the adoption of a common framework that would assist customers with evaluating the key elements of energy contracts, such as:
 - 60.1 Clarity on any costs that may be passed through and the circumstances in which this could happen. As a specific example SSE is understood to pass through FiT and EMR charges and to provide estimates of these costs for the first year of a contract only. (The CMA should note that npower contracts are fully inclusive of those charges with no pass-through).
 - 60.2 Arrangements at contract end e.g. renewal process, roll/non-roll, and notice periods and the product type that customers exit onto.
 - 60.3 Confirmation of any consumption information used to quote, to check it is comparable.
 - 60.4 Product features and benefits that are included or excluded e.g. metering, billing, account management, and web service.
 - 60.5 Discounts or premiums applied e.g. dual fuel, direct debit and other arrangements.
61. RWE envisages this taking the form of a standard method of calculating the annual cost of supply based on a reasonable estimate of the consumption likely to be used by the customer, with clear flagging of any terms that are relevant to that estimate e.g. inclusive or exclusive of other costs and pass-through (we believe that it is in the interests of microbusinesses that all costs should be inclusive, where reasonable). This could also include a checklist, prepared by Ofgem, and retail energy suppliers would be obliged (via a licence modification) to cover each item on the checklist as part of the sale.
62. In addition, in relation to remedy 10, RWE agrees that retail energy suppliers should take reasonable steps to prompt customers who are on 'default' tariffs to engage in the market. Our view is that these prompts should take place through a customer's preferred means of contact (including SMS and email, as well as hard copy letters and bills), as this is more likely to prompt action by the customer, although the use of digital means will necessitate the collection of email addresses and mobile phone numbers, as well as keeping those contact details up to date.

Barriers to accessing and assessing information arising from the non-publication of tariffs

63. The CMA has provisionally found that customers face actual and perceived barriers to accessing and assessing information arising, in particular, as a result of a general lack of price transparency concerning the tariffs that are available to microbusinesses, which results from many microbusiness tariffs not being published; a substantial proportion of microbusiness tariffs being individually negotiated between customer and supplier; and the nascent state of PCWs for non-domestic customers (although it acknowledges that transparency may be improving with the introduction of online quotes and PCWs).
64. RWE does not accept that microbusiness customers face actual or perceived barriers to accessing and assessing information. They are targeted constantly by suppliers and over 1,000 TPIs seeking to offer them different / better / cheaper products. RWE communicates regularly with customers highlighting options for them to consider to enable them to access better deals. The lack of published prices is not a barrier to engagement. Microbusinesses are able readily to obtain multiple quotes for supply, and – as businesses – are able readily to ascertain which offer best suits their needs. As far as TPIs are concerned, however, RWE acknowledges that there have been some cases of bad practice which will have reduced customer trust, and RWE would certainly consider that the lack of transparency as regards commissions, and a lack of alignment in some cases between the interests of the customer and the interests of the TPI, could mean that customers are denied the information they

need in order to make fully informed choices. RWE therefore agrees that aspects of TPI conduct constitute a feature which can properly be regarded as an AEC. RWE would not regard this feature as leading necessarily to weak customer response, however.

65. In summary, RWE considers that the CMA has significantly overstated the significance of these concerns in the SME market. In particular, RWE believes that negotiated deals are a necessary and beneficial feature of the market for many business customers, enabling them to find and agree supply contracts and services that are tailored to their specific needs at lower prices.
66. If the CMA does proceed with its PFs despite RWE's submissions, RWE considers that an effective and proportionate response to the concerns the CMA identifies would involve a package of remedies which draws on remedy 6, remedy 7a, remedy 7b and RWE's suggestions in relation to remedies 9 and 10 described above.
67. In relation to remedy 6, RWE supports the CMA's aim of improving the way in which microbusiness customers⁴ engage with the market easier and more transparent. It considers that while a PCW that covered all products and microbusiness customers would not be practicable, a 'benchmark' PCW, which provides details of a small number of simple products, would in principle be possible for a subset of business customers having straightforward requirements, for example single sites with simple metering, those that have consumption that is similar to that of domestic customers, and those who are willing to accept the limitations in features and benefits inherent in a comparison of simple products.
68. RWE believes that in considering proportionality and appropriate scope of remedy 6, it will be very important for the CMA to consider the potential adverse effects. In particular RWE submits the CMA should consider:
 - 68.1 How best to avoid the situation whereby a (say) low risk customer adopts a tariff available on the PCW which is more expensive than the tariff which would be available once a supplier had collected more information on the telephone; and
 - 68.2 The additional costs of operating products which are designed for supply via PCWs. In particular, RWE notes that the simple products of this nature may need to be created by suppliers specifically for this purpose, for example, a fixed rate product of one, two or three years' duration with a start date within a week of the quotation.
69. As a result of the potential adverse effects of a version of remedy 6 which is drawn too widely, RWE considers that it is important that the design of the remedy is such that customers have the choice of whether, or not, to use PCWs and an ability to continue to agree deals directly with energy suppliers, or indirectly through other third parties if they so wish.

Barriers to accessing and assessing information arising from TPIs

70. In addition, the CMA has provisionally found that customers face actual and perceived barriers to accessing and assessing information arising because of the role of TPIs, in relation to which:
 - 70.1 A number of complaints have been made by non-domestic customers to various official bodies concerning alleged TPI malpractice, which may have reduced the level of trust in all TPIs and discouraged engagement more generally (although this situation may improve if Ofgem implements a code of practice for non-domestic TPIs that is currently in draft form); and
 - 70.2 The CMA has noted a lack of transparency as well as the existence of incentives not to give non-domestic customers the best possible deal. It is concerned that customers are not aware of this and therefore do not take steps to mitigate it (for example, by consulting more than one TPI or seeking other benchmark prices). It considers this is exacerbated by

⁴ RWE notes that some of its I&C customers currently fall within the CMA's broad definition of "microbusiness".

the lack of easily available benchmark prices, and the fact that many tariffs are not published.

71. RWE considers that TPIs play an important role in the business energy market. TPIs advise customers on a range of offers, taking into account the customer's attributes and product features (described in more detail in the response to remedy 6), so that the customer is able to find a deal that suits their needs. Around [CONFIDENTIAL] of our [CONFIDENTIAL] SME/microbusiness customer acquisitions come through TPIs.
72. In addition, RWE's experience is that the majority of TPIs are reputable and offer a fair range of products and prices. However, we recognise that some TPIs may be influenced by the commission that they can earn per sale, which can vary between suppliers and can also include incentives based on margin or total number of sales achieved. RWE accepts that, in general, the extent of searches undertaken and the commission that TPIs earn is not visible to the customer, and may mean that whilst the customer gets a good deal, it may not reflect the best price possible, as the TPI is balancing finding a saleable price with optimising its own commission earnings.
73. There are, in addition, documented examples of poor practice in the TPI market, and customers have no means of assuring themselves as to the reputability of a broker that they may be dealing with, other than personal recommendation from peers or through affinities some TPIs may have with a trade association whom the microbusiness may trust.
74. RWE understands why, in principle, the CMA considers that a remedy like remedy 7a would have positive effects by increasing price transparency. RWE considers that a variant of remedy 7a could be practicable if:
 - 74.1 its scope were limited to a subset of simple products, in the same way as we have outlined in respect to remedy 6;
 - 74.2 customers were able to retain an option to call suppliers to negotiate on price and terms & conditions; and
 - 74.3 the price lists only apply to customers with straightforward requirements (e.g. single sites, consumption similar to domestic, etc.) so that list prices would not be available to all customer types to transact on.
75. RWE considers that a more effective remedy (that would make comparisons between suppliers easier) would be to require retail energy suppliers to provide clear product descriptions of all available products, with information on features and benefits, terms and conditions, and even who the product may benefit, on their websites. This could be accompanied by information on how to obtain a tailored quote, which could be fulfilled in a number of ways:
 - 75.1 by calling the supplier;
 - 75.2 via a TPI where appropriate; and
 - 75.3 possibly on-line for some simple products.
76. RWE also believes that the adoption of its proposed common framework checklist (as described in the response to remedy 9) would also assist sales agents and TPIs when researching the best deal for a customer.
77. Finally, RWE also considers that the direct regulation of the services offered by TPIs is warranted and would, in particular, be an effective and proportionate way of increasing customer's confidence in TPIs, as described in our detailed response to remedy 7b.

Auto-rollover and weak customer response

78. Some microbusiness customers are on auto-rollover tariffs (where customers are signed up for an initial period at a fixed rate, with an automatic rollover for a subsequent fixed period

at a rate they have not negotiated with no exit clause), and are given a narrow window in which to switch supplier or tariff, which may limit their ability to engage with the markets. The CMA identifies auto-rollover tariffs as a feature which may limit the ability of microbusinesses to engage.

79. Although this practice has been ceased by the Six Large Energy Firms, RWE would support the CMA's observations that its continuation by other suppliers could give them a competitive advantage, and would contend that engagement by customers could be threatened if there is uncertainty or confusion as to what will happen at the end of their contract term. Moreover, RWE does consider that – as a matter of contractual fairness – companies should not be allowed to roll customers onto a fixed duration contract without customers' explicit consent. Our view is that where the customer has not specifically re-contracted, then they should be able to leave on giving 30 days' notice.
80. Therefore RWE supports remedy 8 and we consider it essential for protecting customers' interests at contract renewal. In addition, RWE accepts that this remedy would be effective in allowing microbusiness customers greater opportunity to engage.

Remedies that would clearly be disproportionate

81. For the reasons given in response to remedy 11 RWE considers that a safeguard tariff would be counterproductive, ineffective and disproportionate, not least because of the significant adverse effects it would have.

Remedies in relation to gas settlement

82. The CMA has found that the current system of gas settlement is a feature of the markets for domestic and SME retail gas supply in Great Britain that gives rise to an AEC through the inefficient allocation of costs to parties and the scope it creates for gaming, which reduces the efficiency and, therefore, the competitiveness of domestic and microbusiness retail gas supply.
83. The CMA goes on to note that Project Nexus is likely to address most of the current inefficiencies in the gas settlement system identified, but is concerned at the slow pace of the implementation, the lack of a deadline and the fact that some players might have been adversely affected by these delays. Moreover, the CMA is concerned that the incentives that shippers face to place a higher priority on adjusting AQs down and delaying adjusting AQs up will still be present after Project Nexus is implemented. As a result, the CMA suggests remedy 12a – Requirement to implement Project Nexus in a timely manner.
84. RWE accepts that the gas settlement system may not be optimal, but considers that the concerns identified by the CMA will largely be addressed by Project Nexus, which RWE is keen to see implemented in a timely manner.
85. Indeed RWE is supportive of Project Nexus and is investing considerably in the delivery of internal systems to support it. We are disappointed by the delay and have taken steps including raising industry code modifications to attempt to ensure that it is delivered to the revised date of the 1st October 2016 and that there is no further slippage. Despite our disappointment in the delay we believe this is necessary in order to deliver a fully functioning solution. To suggest any further interim change prior to full delivery would, in our view, further risk the industry Nexus delivery.
86. RWE does, however, support the introduction of a remedy requiring go-live with core functionality on 1 October 2016, as this would help to ensure there is no further slippage in delivery.
87. The CMA proposes to introduce remedy 12b – introduction of a new licence condition on gas shippers to make monthly submissions of Annual Quantity updates mandatory. The aim of such a remedy is to reduce shippers' incentives to game the settlement system through the timing of AQ adjustments. However RWE believes these incentives to be a second order issue.

88. Therefore RWE does not believe that it is necessary to include remedy 12b in a package of remedies since, although the AQ process for Small Supply Points is outdated, Project Nexus (which is due to be implemented on 1 October 2016) will enable and incentivise more frequent meter read submissions and provide the opportunity for AQs to be updated on a rolling monthly basis. Additionally a new Gas Performance Assurance Framework (PAF), due to be implemented alongside Project Nexus, will strengthen the governance around meter reads and AQs, including through the potential for financial penalties to be imposed against shippers who fail to perform in this area. Thus, whilst RWE would support the introduction of mandatory monthly updates in due course, it considers that this would most effectively be implemented after implementation of Project Nexus, and after the roll-out of smart meters, when this can be undertaken remotely.
89. In summary, RWE considers therefore that the introduction of a new licence condition on gas shippers to make monthly submissions of AQ updates mandatory would be a disproportionate response to an issue that is already being addressed through Project Nexus and the Gas PAF. As noted above, however, RWE does support the introduction of a remedy requiring go-live with core functionality on 1 October 2016, as this would help to ensure there is no further slippage in delivery.
90. RWE would, however, be supportive of suppliers having the ability to submit monthly meter readings and for this information to be used in the settlement of industry charges.

Remedies in relation to half hourly settlement

91. The CMA considers the absence of a firm plan for moving to half-hourly settlement for domestic and certain SME electricity customers, and of a cost-effective option of elective half-hourly settlement, is a feature that gives rise to an AEC in the domestic and SME retail electricity markets through the distortion of suppliers' incentives to encourage their customers to change their consumption profile, which overall reduces the efficiency and, therefore, the competitiveness of domestic retail electricity supply.
92. RWE accepts that the use of half-hourly consumption data to settle electricity will be a prerequisite for the widespread introduction of time of use tariffs, and that suppliers may not be able to encourage customers to change their consumption profile without the use of such data. However, the widespread introduction of time of use tariffs will only be feasible with the introduction of smart meters, and so it does not make sense to mandate the use of half-hourly consumption data before it is able to be used effectively.
93. RWE believes it is essential that there is greater clarity of regulatory goals and that change is coordinated on an industry wide basis across all aspects of codes and licence regulation if we are to avoid significant sunk costs and poor customer experience.
94. RWE believes that the plan for moving to half-hourly settlement, and associated milestones timetable must be pragmatic and deliverable across the market, taking account of the scale of direct change and enabling change that may be needed, and the capacity of customers to accept such change and of the market to deliver it. An example of direct change would be the installation of smart meters or changes to billing and systems to use such meters. An example of enabling change would be changes to industry 'Change of Measurement Class' processes so they are capable of processing the likely volume of transactions we will see, or changes to customer permission requirements to allow half-hourly polling of consumption information without need for explicit consent.
95. In respect of the SME/microbusiness segment, additionally we would note that the benefits of half-hourly settlement for customers are comparatively lower than they are for domestic customers, since these business customers generally have less ability to change their consumption behaviour to take advantage of the benefits of time of use products, which further supports that a premature move to HH settlement would be disproportionate.

Remedies in relation to lack of robustness and transparency in regulatory decision-making

96. The CMA has provisionally found a combination of features of the wholesale and retail gas and electricity markets in Great Britain that give rise to an AEC through an overarching

feature of a lack of robustness and transparency in regulatory decision-making which, in turn, increases the risk of poor policy decisions which have an adverse impact on competition. The CMA identifies these features as:

- 96.1 the lack of a regulatory requirement for clear and relevant financial reporting concerning generation and retail profitability;
- 96.2 the lack of effective communication on the forecasted and actual impact of government and regulatory policies over energy prices and bills;
- 96.3 Ofgem's statutory objectives and duties which, in certain circumstances, may constrain its ability to promote effective competition; and
- 96.4 the absence of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making and implementation can be addressed transparently.
- 97. RWE agrees that there are problems with a lack of robustness and transparency in regulatory decision making which, in turn, increases the risk of poor policy decisions and that these problems together give rise to an AEC. RWE has been public in its call for an independent Office of Energy to facilitate a more effective assessment of trade-offs between policy objectives and shine a light on the impact of these trade-offs in the context of dealing with the trilemma. However, as regards the specific features identified by the CMA which go to make up the overall AEC, RWE's support for the CMA's provisional finding comes with a number of caveats, described in respect of each feature below.
- 98. RWE considers that whilst resolving disagreements between DECC and Ofgem over policy decision making and implementation may be helpful, the most important issue is actually ensuring genuine independence for Ofgem and anchoring Ofgem's primary duties and powers in the promotion of competition and the transparent appraisal of measures which lead to deviations from competitive outcomes, so that it becomes possible to identify clearly, and make transparent following appraisal, policies which may alter or blunt competition.
- 99. The rest of this section discusses each of the specific four features identified in turn.

Lack of a clear and relevant financial reporting concerning generation and retail profitability

- 100. In relation to remedy 14, RWE agrees with the CMA that financial reporting within the industry should be transparent, robust and should aim to build rather than detract from consumer confidence. This is an area where RWE will support and assist with the discussions in enhancing the information currently available.
- 101. However, given the CMA's provisional finding that there are no fundamental issues with the operation and presence of vertical integration across value chains in the industry (which we support), there is no compelling need for significant changes to the current reporting framework and careful thought will be required in relation to the presentation of financial information on a segmental basis that is deeper than currently necessary under the CSS. RWE believes that current reporting in the CSS provides considerable transparency in relation to the generation business, and highlights the main drivers of the supply business. The CSS is audited and prepared on the arm's length basis.

The lack of effective communication on the impact of government and regulatory policies over energy prices and bills

- 102. RWE shares the CMA's views that there needs to be a more effective assessment of the trade-offs between energy policy objectives and communication to a wide audience of the impact assessments relating to policy proposals, and the interactions between policies and policy trade-offs. RWE believes that this would assist in building greater transparency and accountability as well as facilitating more effective formulation of sustainable policies going forward.

103. In relation to remedy 15, RWE considers that there is a strong case for the introduction of a new institutional role of an independent 'Office of Energy' which would be tasked with providing impartial information about the industry, the market and the impacts of policies. The Office of Energy would provide independent scrutiny of the impact of DECC's programme and in particular evidence on the interactions and trade-offs between policies. We also believe that a balanced scorecard, particularly with respect to the energy trilemma, which could be used to track changes in key metrics as they respond to policy, regulatory and market changes, could usefully summarise and provide clarity on the UK's performance across its energy priorities.
104. RWE believes the impartiality of the institution entrusted with this role will be central to its success in enhancing trust and clarity in the market. In our view a new independent institution will be required. Further discussion is provided in our detailed response to remedy 15.

Ofgem's statutory objectives and duties

105. The CMA has provisionally found that changes made in the Energy Act 2010 to Ofgem's statutory objectives and duties may have led Ofgem to carry out inefficient trade-offs between competing objectives, which in turn might have led to decisions that adversely impact competition. The CMA proposes in remedy 16, to make a recommendation that Ofgem's statutory objectives and duties be revised in order to increase the emphasis on Ofgem's responsibility to promote competition as a primary objective.
106. RWE agrees with the CMA's view that the changes to Ofgem's objectives and duties under the Energy Act 2010 (EA10) constrain Ofgem's ability to promote competition by making the pursuit of competition secondary to the protection of consumer interests.
107. RWE also considers that a fresh look at Ofgem's powers and duties to sharpen the focus on promoting competition might be warranted in the light of the CMA's wider observations on the regulatory framework and potential institutional solutions. Specifically, as we highlight in our responses to remedy 15 above and remedy 18 below, we envisage new roles for an 'Office of Energy' to appraise the effectiveness and trade-offs between various DECC policies, and an 'Independent Code Adjudicator' to decide on code modification proposals. These parallel initiatives would further help to focus Ofgem's role on the economic regulation of the monopoly networks and the effective operation of the competitive generation, retail and wholesale markets. If the CMA recommends changes along these lines, corresponding changes to Ofgem's duties and responsibilities might be required to ensure clarity and consistency on the allocation of duties and responsibilities between the institutions.

The absence of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making and implementation can be addressed transparently

108. The CMA has considered the independence and overlap of DECC's and Ofgem's roles. It noted that DECC has a number of direct and indirect powers which it can exercise to influence Ofgem's function and operation. However, the CMA is concerned that, in the absence of such formal powers for DECC to direct Ofgem to implement a specific change, DECC may exert institutional pressure on Ofgem by saying it will act to address a certain issue in the event that Ofgem does not itself act to address the issue in question. We consider that the use of such an informal approach – if it encourages Ofgem to implement changes that it would not pursue in the absence of such pressure – risks harming transparency and the independence of regulation.
109. RWE shares the CMA's concerns that "institutional pressure" from DECC on Ofgem to implement particular policies reduces transparency and accountability and we agree that there should be greater clarity in the exercise of policy measures to ensure that the costs to customers – or particular groups of customers – are transparent and justifiable. In our view, greater clarity and rigour around trilemma policy trade-offs (under remedy 15) and giving Ofgem a primary focus on the promotion of competition (remedy 16) will go a long way to ensuring that policy interventions that deviate from competitive outcomes are properly identified, appraised and justified as such.

110. RWE considers that Ofgem should have the right and duty to comment on all DECC's policies which are likely to affect competition in the supply of electricity and gas. Those views should take place in the context of an impact appraisal of such measures. Moreover, Ofgem should have the right to seek a formal direction to implement any decision or policy which is likely to deliver outcomes which deviate from those expected to result from the operation of effective competition.

Remedies in relation to code administration

111. The CMA has provisionally found a combination of features of the wholesale and retail gas and electricity markets in Great Britain that are related to industry code governance and which give rise to an AEC through limiting innovation and causing the energy markets to fail to keep pace with regulatory developments and other policy objectives. These features are as follows:
- 111.1 parties' conflicting interests and / or limited incentives to promote and deliver policy changes; and
 - 111.2 Ofgem's insufficient ability to influence the development and implementation phases of a code modification process.
112. RWE supports overall the CMA's PFs of an AEC arising in relation to code governance. The modification process is not sufficient in its own right to drive long term major changes. However, RWE does not agree that the parties to the codes have limited incentive to innovate, and considers that the governance process for resolving disputes is fit for purpose. RWE considers that a crucial contributory factor to the problems that the CMA has provisionally identified in relation to codes is that of shortcomings in the adjudication process above the codes.

Recommendation to DECC to make code administration and/or implementation of code changes a licensable activity

113. In relation to remedy 18a, RWE believes that making code administration a licensable activity would lead to positive change particularly if service provision of the role was subject to competitive tender for a defined period. This would incentivise the administrators to improve their performance and service offering (including through improved compliance with the licence obligations) to prove their worth for the next tender period.
114. RWE believes that the administration of codes across the industry, managed by a single over-arching codes administrator with the adoption of high level uniform governance arrangements across all codes, could bring more benefits than having a number of separately licensed code administration entities.

Granting Ofgem more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes

115. RWE believes that the AEC does not turn on the ability (or inability) of Ofgem itself to influence development and implementation of code modification. In relation to remedy 18b, RWE does not believe that Ofgem should be granted more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes. While Ofgem has significant industry experience, it is our view that it does not have sufficient experience of supplier-consumer relationships, consumer behaviour, and IT technicalities, to fully understand the impact of large scale code change on the industry. RWE is also concerned that there would be a potential conflict of interest for Ofgem, should it be given greater powers to initiate and manage change, as Ofgem must approve any material modifications (i.e. Ofgem could be in the situation where it had initiated a modification and would then have to consider whether to approve or reject it).
116. RWE suggests that Ofgem should instead focus on providing greater guidance to industry work groups, to reduce delays and misunderstanding in discussions. We believe that the overall management of industry change should sit with an overarching code administrator, using uniform processes and fixed timetables. This would reduce delays, and ensure change is focussed on promoting competition and economic efficiency.

Appointment of an independent code adjudicator to determine which code changes should be adopted in the case of dispute

117. RWE agrees with the proposal in remedy 18c that the appointment of an independent code adjudicator to make decisions on code changes would be a positive one, and bring further certainty and efficiency.
118. More specifically, RWE proposes that an independent code adjudicator is appointed, supported by a single code administrator, to make decisions on which code changes are adopted. These decisions would be based on a single set of principles that ensure all code decisions lead to greater economic efficiency and promote further competition. Ultimately, this would avoid any conflicts of interest and accelerate code decisions. We expand on the reasons for this in our detailed response.

INDIVIDUAL REMEDIES

A. REMEDY 1

CMA remedy 1 – Introduction of a new standard condition to electricity generators', suppliers', interconnectors', transmission, and distribution licences to require that variable transmission losses are priced on the basis of location in order to achieve technical efficiency

1. Executive Summary

- 1.1 RWE supports the introduction of an appropriate standard licence condition for electricity generators' suppliers', interconnectors', transmission' and distribution licences with respect to ensuring that variable transmission losses⁵ are priced on the basis of location in order to achieve technical efficiency. The licence condition should include a requirement to ensure that Balancing and Settlement Code Modification Proposal P229 (Proposed) 'Introduction of a Seasonal Zonal Losses'⁶ is implemented no earlier than 1st April 2017 and no later than 1st April 2018.
- 1.2 We have considered the nature and type of a potential licence condition that would give effect to the implementation of a locational losses scheme. As part of this consideration we have reviewed examples of changes that were introduced to electricity licences, in order to implement reforms to the electricity market including those associated with the New Electricity Trading Arrangements (NETA)⁷ and the gas offtake arrangements⁸.
- 1.3 The changes to the electricity licences to implement NETA required licensees to "use all reasonable endeavours to do such things as may be requisite and necessary in order to give full and timely effect to the modifications made" to the licence. Based on this approach a licence condition to ensure implementation of a locational losses scheme could be framed along the following lines:

"Condition XXX: Locational Losses implementation

1. *The objective of this licence condition is to require the licensee to take certain steps and do certain things which are within its power and which are or may be necessary or expedient for the purposes of ensuring that transmission losses are priced on the basis of location in order to achieve technical efficiency.*
2. *Without prejudice to paragraph 1, the licensee shall take such steps and do such things as are within its power and as are or may be necessary or expedient in order to give full and timely implementation of Balancing and Settlement Code Modification Proposal P229 (Proposed) "Introduction of a Seasonal Zonal Losses" no earlier than 1st April 2017 and no later than 1st April 2018 (inclusive) and shall take such reasonable steps and do such things as are reasonable and, in each case, as are*

⁵ Transmission network losses result from the transport of power between power producers and Grid Supply Points through transmission infrastructure equipment such as power transformers, overhead lines, cables and switchgear. Losses consist of two key components: Fixed losses (or no-load losses) result where transmission assets are energised and are therefore independent of loading; and Variable losses (or load losses) are proportional to the square of the current loading of the transmission asset being considered. Heating losses (I²R) due to the resistance of the conductor in overhead lines or copper in the HV and LV windings of the transformers are examples of variable losses. The magnetising ('iron') losses in a transformer's core are an example of fixed losses. Source: National Grid Strategy Paper, National Grid's strategy paper to address Transmission Licence Special Condition 2K: Electricity Transmission Losses, November 2013, revised September 2014 at <http://www2.nationalgrid.com/UK/Industry-information/Electricity-system-operator-incentives/transmission-losses/> (the National Grid Losses Strategy).

⁶ This Modification can be found at <https://www.elexon.co.uk/mod-proposal/p229-introduction-of-a-seasonal-zonal-transmission-losses-scheme/>.

⁷ See for example the Electricity Generation Licence standard conditions at, where the NETA provisions are included as Condition 9) at <https://epr.ofgem.gov.uk/Content/Documents/Electricity%20Generation%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf>.

⁸ See for example at NTS gas offtake: Proposals for licence modification drafting, Ofgem, 20th October 2006 at https://www.ofgem.gov.uk/sites/default/files/docs/2006/10/15823-188_06_0.pdf.

within its power and as are or may be necessary or expedient to give full and timely effect to this modification to its licence.

3. *Without prejudice to the other provisions of this condition, the licensee shall cooperate with other electricity licensees and such other persons as the Authority may determine for these purposes and take such steps and do such things as are reasonable and within its power and as are or may be necessary or expedient to enable such electricity licensees to comply with their licence obligations to give full and timely effect of Balancing and Settlement Code Modification Proposal P229 (Proposed) "Introduction of a Seasonal Zonal Losses".*

- 1.4 The timely implementation of Balancing and Settlement Code P229 (Proposed) forms part of the licence condition. This modification allows for a scaled marginal losses scheme based on allocation of variable losses to generation (45%) and demand (55%) using seasonal loss factors in each GSP Group zone. The modification proposal was fully developed under the Balancing and Settlement Code arrangements, and includes the legal text required to modify the Code to give effect to a locational losses scheme⁹. Consequently it would be straightforward to implement this scheme since it essentially requires putting into effect the legal text associated with P229 (Proposed).
- 1.5 The licence condition includes a window to enable the implementation of the losses scheme. This window would run from 1st April 2017 to 1st April 2018 (inclusive). This would allow for an implementation lead time of between 15 months and 27 months, assuming that there is a CMA decision in December 2015. A lead time is appropriate for the following reasons:
 - 1.5.1 P229 (Proposed) requires the development of central and party information systems to deliver the specific requirements of the modification proposal, including for example the mapping of BMUs to relevant zones by Elexon¹⁰;
 - 1.5.2 P229 includes the procurement of central services to facilitate delivery, including an Agent that will perform a load flow analysis and derive the Zonal Loss Factors¹¹ (this procurement process must comply with relevant European procurement rules for utilities); and
 - 1.5.3 P229 envisages a notification period that would enable market participants to take into account the new loss factors when setting tariffs or revising contract terms¹².

2. General Comments

- 2.1 With regard to the assessment criteria set out in the CMA remedies document we have the following comments.

(a) *whether the remedy may give rise to unintended consequences and, if so, what these might be and how they might be prevented or mitigated*

- 2.2 We do not consider that the remedy may give rise to unintended consequences. With regard to the wider implications associated with the implementation of a locational losses scheme, the potential impacts and benefits have been assessed by the CMA and Ofgem under modification proposal P229. The wider customer benefits are well documented and early

⁹ The Final Modification Report for P229 can be found at <https://www.elexon.co.uk/mod-proposal/p229-introduction-of-a-seasonal-zonal-transmission-losses-scheme/>. This report includes the legal text required to give effect to P229 (Original) in Attachment B.

¹⁰ See for example the Final Modification Report for P229, page 7.

¹¹ As noted in the Final Modification Report for P229: "Implementation of P229 would also include procurement of a new agent, the TLFA, and the appointment of a Load Flow Model Reviewer", page 18.

¹² As noted in the Final Modification Report for P229 "Seasonal TLFs must be made available to Parties at least 3 months before being used in Settlement and the results of the P229 Impact Assessment indicate that most Parties require 6-9 months to implement P229. Therefore an implementation lead time of 12 months in total would allow most participants to complete their own implementation activities prior to receiving the first TLFs", page 19.

implementation will ensure that the current cross subsidy is removed as soon as possible subject to:

- 2.2.1 An appropriate lead time associated with implementation to enable development and delivery of appropriate IT systems and the procurement of central services by Elexon on behalf of the Balancing and Settlement Code; and
- 2.2.2 Sufficient time is required for suppliers to adjust tariffs and contracts to reflect locational losses if P229 (Proposed) were to be implemented. A lead time of between 15 months and 27 months (as set out above) would facilitate the introduction of revised tariffs and contract terms and minimise the impact on market participants. It is our preference that an implementation date of either 1st April or 1st October within the implementation window (1st April 2017 to 1st April 2018 inclusive) should be considered, since these key dates relate to customer contract rounds.

(b) *any relevant customer benefits to which we should have regard as being affected by the proposed remedy*

- 2.3 There have been many cost benefit analyses conducted since 2003, which concluded that the implementation of a locational losses scheme would result in enhanced customer welfare¹³. Furthermore, the analyses represent conservative estimates of the customer benefits once the potential for the effects of enhanced locational signals are taken into account. Therefore the case for implementing a locational losses scheme is compelling.

(c) *any other relevant costs and benefits that we should take into account when considering the proportionality of each remedy*

- 2.4 The CMA has acknowledged that a locational losses scheme will address the AEC and deliver customer benefits. The CMA also notes that previous Cost Benefit Analyses have been based on negligible implementation costs¹⁴. These costs have been derived from extensive consultation with impacted parties as part of the consideration of various proposed modification to the Balancing and Settlement Code to implement a locational losses scheme. The potential costs are materially outweighed by the benefits that arise from a locational losses scheme. We have reviewed our internal costs and estimate it would cost less than £100k to change processes and systems.

(d) *whether there are any alternative remedies that would be as effective as the proposed remedy in addressing the AEC and that would be less costly and/or intrusive*

- 2.5 The CMA approach based on a licence condition to “require that variable transmission losses are priced on the basis of location in order to achieve technical efficiency” is, in RWE’s view, the most effective option for addressing the AEC. Any other approaches to address the potential remedy would have significant drawbacks, would not be as effective as a licence

¹³ See for example:

- “The Welfare Effects of Locational Transmission Loss Factors in the British Wholesale Electricity Market”, Prepared for RWE, 11 May 2015 Confidential submission to the CMA;
- “Cost Benefit Analysis of Modification Proposal P229: Changing to Zonal Seasonal Loss Factors”, A report for Elexon by London Economics and Ventyx, October 2009 at https://www.elexon.co.uk/wp-content/uploads/2012/02/p229_proposed_cba_report_v1.01.pdf;
- “P229 Cost Benefit Analysis: Additional scenarios”, A report on a study for Ofgem, October 2010 at https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/lot-report-2_0.pdf;
- “What are the costs and benefits of zonal loss charging?” Report prepared for Elexon by Oxera, June 2006 at https://www.elexon.co.uk/wp-content/uploads/2012/02/p198_cost_benefit_analysis_report_final.pdf; and
- “The impact of average zonal transmission losses applied throughout Great Britain”, Oxera report for Department of Trade and Industry, June 2003, at <http://www.oxera.com/Latest-Thinking/Publications/Reports/2003/The-impact-of-average-zonal-transmission-losses-ap.aspx>.

¹⁴ See for example the London Economics/Ventyx Report which estimated LE/Ventyx CBA total implementation costs estimates in the range £2.8-£4.1m, page 24.

obligation and carry the risk of alternatives being put forward designed to frustrate implementation¹⁵. Furthermore other approaches to address the remedy¹⁶ will place a reliance on the industry governance mechanisms that have singularly failed to deliver these long envisaged reforms over the last quarter of a century. ¹⁷.

2.6 In the context of the AEC of the current treatment of transmission losses the only way to ensure that this is addressed is a requirement for licence conditions to ensure that variable transmission losses are priced on the basis of location in order to achieve technical efficiency.

(e) whether the CMA should seek to implement the remedy itself via an order (eg to make a licence modification), or whether it should make a recommendation that another body, such as Ofgem or DECC, implement the remedy

2.7 We strongly believe that the CMA should implement the remedy itself via an order to introduce a licence condition as proposed as this will achieve as comprehensive a solution to the AEC (and detrimental effects on consumers arising from that AEC) as possible in a reasonable and practical way by putting into effect P229 (Proposed).

2.8 Conversely, if the CMA were to make a recommendation to another body, there is a risk that the body would choose not to implement the actions contained within the recommendation (which is a real possibility given that recommendations are non-binding) or would take time to investigate alternatives (when this would already have been done by the CMA as part of the market investigation). Clearly then, a recommendation cannot be considered as a comprehensive, reasonable or practical solution to the AEC.

(f) the duration of the remedy and whether a 'sunset' clause should be included as part of the remedy design

¹⁵ See for example, P229 Alternative which had the "aim of preserving the benefit of allocating transmission losses more cost reflectively, as under P229 Proposed, while reducing the distributional impact on Parties in comparison with P229 Proposed. The Alternative is the same as P229 Proposed, except for the addition of the calculation of a scaling factor for each Season", Final Modification Report, P229, page 10 and P229 Alternative which had the "aim of preserving the benefit of allocating transmission losses more cost reflectively, as under P229 Proposed, while reducing the distributional impact on Parties in comparison with P229 Proposed. The Alternative is the same as P229 Proposed, except for the addition of the calculation of a scaling factor for each Season", Final Modification Report, P229, page 10.

¹⁶ Possible alternative approaches towards addressing the remedy could include:

- **Directing Ofgem to initiate a significant code review of Locational losses:** Under this approach there is no guarantee that a modification proposal to deliver a locational losses scheme would be the outcome. In addition, it would require at least 18 months for the SCR and a further 18 months to complete a BSC modification process. Therefore, given an implementation lead time of at least 15 months, the introduction of a locational losses scheme would delay implementation for at least 4 years following a recommendation from the CMA to adopt this approach; or
- **Directing Ofgem or National Grid to raise a BSC Modification to introduce locational losses:** Under this approach Ofgem or National Grid would be required to give effect to a remedy by introducing a BSC modification, perhaps along the lines of P229. While this approach might be quicker than an SCR, the modification process itself would take at least 18 months, and with an implementation time of 15 months would delay implementation for at least 3 years following a recommendation from the CMA to adopt this approach; or
- **Relying on a BSC party to raise a modification to the Balancing and Settlement Code:** The CMA could leave a potential solution to market participants without any specific recommendation. However, there is no certainty that a party would raise an appropriate modification proposal. In addition, a BSC modification would take at least 18 months to complete, and with an implementation time of 15 months would delay implementation for at least 3 years following a recommendation from the CMA to adopt this approach. Furthermore, a number of alternatives to various locational losses schemes could be proposed which would have the effect of delaying implementation or reducing the benefits by failing to address the underlying cross subsidy¹⁶. These alternatives, which must be considered by the Authority, could frustrate the intent of the CMA to address the adverse effect on competition associated with the current treatment of losses in the Balancing and Settlement Code.

¹⁷ The Pooling and Settlement Agreement (P&SA) Losses Proposal, Balancing and Settlement Code Modification Proposal P82 and Balancing and Settlement Code Modification Proposal P198 were all subject to Judicial Review. The P&SA JR was overtaken by NETA implementation, Ofgem lost a JR on P82 as a consequence of a procedural error and Ofgem lost a JR on P198 with respect to powers to direct implementation dates.

- 2.9 A sunset clause is not required as part of the remedy design provided that a licence condition as outlined below contains the following:
- 2.9.1 A general duty to establish and maintain a locational losses scheme that ensures that variable transmission losses are priced on the basis of location in order to achieve technical efficiency;
 - 2.9.2 A requirement to implement P229 (Proposed) in a specific implementation window designated in the licence to ensure effective delivery of the scheme; and
 - 2.9.3 A requirement to cooperate between licensees to ensure the implementation of P229 (Proposed).
3. **Specific Questions**
- 3.1 This section sets out the RWE response to the specific questions raised in the context of CMA remedy 1.
- (a) *What would be an appropriate method for ensuring that variable transmission losses are priced on the basis of location?***
- 3.2 An appropriate methodology for ensuring that variable transmission losses are priced on the basis of location is BSC Modification Proposal P229 (Proposed) given that:
- 3.2.1 Implementation is straightforward, utilising the legal text developed as part of the modification process¹⁸;
 - 3.2.2 Cost Benefit Analyses already exists¹⁹; and
 - 3.2.3 Ofgem has already acknowledged that the proposal meets the BSC Objectives²⁰.
- 3.3 P229 (Proposed) would change the arrangements for allocating transmission losses, and associated costs, across generators and demand customers on the GB transmission system. Under P229 TLF Zones would be created based on the 14 GSP Groups. Historical data would be used to calculate annually a TLF for each BSC season for each TLF Zone for the following year. P229 would affect only the allocation of variable losses. Fixed transmission losses would continue to be allocated to Parties on a non-locational basis through the half hourly adjustment factor (TLMO). The 45:55 split in the allocation of total transmission losses across generation and demand would be retained²¹.

¹⁸ Final Modification Report for P229, Attachment 2 at <https://www.elexon.co.uk/mod-proposal/p229-introduction-of-a-seasonal-zonal-transmission-losses-scheme/>.

¹⁹ "Cost Benefit Analysis of Modification Proposal P229: Changing to Zonal Seasonal Loss Factors", A report for Elexon by London Economics and Ventyx, October 2009 at https://www.elexon.co.uk/wp-content/uploads/2012/02/p229_proposed_cba_report_v1.01.pdf.

²⁰ "Balancing and Settlement Code (BSC) P229: Introduction of a seasonal zonal transmission losses scheme, Ofgem decision letter, 28th September 2011, at https://www.ofgem.gov.uk/sites/default/files/docs/2011/09/p229-d_0.pdf (the "Ofgem P229 Decision").

²¹ Final Modification Report for P229, Attachment 2 at <https://www.elexon.co.uk/mod-proposal/p229-introduction-of-a-seasonal-zonal-transmission-losses-scheme/>, pages 6 – 9.

3.4 Following the implementation of P229, it may be appropriate to review the treatment of losses associated with HVDC transmission assets²² (excluding interconnectors²³), the treatment of losses associated with offshore wind farm connections²⁴ and the split in allocation between generation and demand²⁵. Any changes that are recommended should be compatible with the approach to losses as implemented under Modification Proposal P229 (Proposed) and should not be used as an excuse to delay a remedy that effectively addresses the AEC identified by the CMA.

(b) How should the variable transmission losses be allocated between generators and suppliers?

(i) Is the 45-55 split appropriate or could efficiency be improved further by changing this allocation?

3.5 Under the current scheme it is assumed that both generation and demand give rise to transmission losses in equal proportion. The actual scheme allocates 45% of losses to generation and 55% to demand to reflect the actual metering configuration (the G:D split). This is because generators connected to the transmission system have energy metered on the high voltage side of the generator which means the losses in the transformer are allocated to the generator, whereas energy transferred from the transmission system to the distribution system is measured on the low voltage side of a Grid supply transformer, so the losses in the transformer are included in the overall transmission losses²⁶.

3.6 Under a locational losses scheme based on the 45:55 G:D split, both generation and demand receive locational signals. The generator loss allocation impacts both the short term despatch and long term locational siting decisions of generators. The demand loss allocation impacts on short term demand signals (though demand elasticity is only on rare instances a factor in siting decisions) and long term siting decisions, particularly for larger customers. In addition, generators connecting at distribution voltages receive an "embedded benefit" which is derived from the dispatch of embedded generation to avoid the cost of losses. Therefore any review of the G:D split must consider both the effect on generation, the effects on demand and the direct impact of the costs of market participants (since it would reduce or increase impact the costs of generators or suppliers).

3.7 National Grid has a licence obligation to report on transmission losses and publish an annual transmission losses report. As part of this National Grid will publish a strategy that sets out how National Grid will take account of the level of transmission losses on its transmission network, in respect of National Grid's duty under section 9 (2) of the Electricity Act to develop and maintain an efficient, coordinated and economic system of electricity

²² Final Modification Report for P229 which noted "**High Voltage DC networks** At present the Transmission System does not include any High Voltage DC (HVDC) networks. Such technology may be introduced in the future, as generation (e.g. wind farms) are built further from shore, and that the techniques used to model losses on such networks would differ from those used for the AC Transmission System. However, because it will be some years before any such HVDC system enters operation, the Group concluded it would be appropriate to consider this issue when and if required, when more information will be available on how such networks would be operated. Therefore offshore HVDC networks are not included in the P229 solution. A separate Modification would be needed to incorporate HVDC networks, when the date and nature of their introduction and the details of their operation and technical characteristics are known", page 9.

²³ See Balancing and Settlement Code (BSC) P278: Treatment of Transmission Losses for Interconnector Users, Ofgem decision letter, 1st May 2012 at <https://www.elxon.co.uk/mod-proposal/p278-treatment-of-transmission-losses-for-interconnector-users/>.

²⁴ Final Modification Report for P229, which noted "TLF Zones would be based on the geographical areas of GSP Groups. In June 2009 the BSC was amended to include provisions for offshore transmission networks (which fall outside the geographical area of any GSP Group) which will become effective at go-live in June 2010. For these offshore Nodes (including both DC and AC offshore networks and offshore networks connected to distribution systems), which are part of the Transmission System, the onshore GSP Group to which the network is connected would be the basis for allocating Nodes to TLF Zones, subject to Panel determination", page 8.

²⁵ Final Modification Report for P229 which noted "P229 would affect only the allocation of variable losses. **Fixed transmission losses** would continue to be allocated to Parties on a non-locational basis through the TLMO. The 45:55 split in the allocation of total transmission losses across generation and demand would be retained", page 6.

²⁶ Elxon Guidance Note, Transmission Losses, 7th November 2013 at https://www.elxon.co.uk/wp-content/uploads/2013/11/transmission_losses_v4.0_cqi.pdf.

transmission. National Grid published this strategy in November 2013 and revised it in September 2014²⁷ (the National Grid Losses Strategy).

- 3.8 National Grid has identified a number of investments that will reduce overall losses on the transmission system. They have noted, however, that there are a number of factors which influence net transmission losses:

*"These include: variations in zonal generation patterns, the level of Scottish exports to the E&W system, changes in interconnector net exports, the level of part loaded plant, the degree of geographic dispersal of plant and demand growth. In this case, it is the change in the geographical distribution of generation across the transmission network that is anticipated to have the greatest impact on future losses. In particular, with more generation connected on the periphery of the transmission network, power has further to travel to demand centres and existing local circuits will experience heavier loading. Both of these factors will culminate in higher losses (I^2R). The expected continued change in generation distribution is in part driven by, but not limited to, the connection of low carbon technologies"*²⁸

- 3.9 In the context of National Grid's Losses Strategy there may be a case for reviewing the G:D split in a locational losses scheme to identify an appropriate trade off between loss reduction and the relative locational signals between generation and demand. The Losses Strategy would appear to imply that it may be more efficient to provide a stronger signal for generation connected to the transmission system when compared with demand locational signals. However, retaining a demand location signal may also be appropriate to ensure that there is an incentive to locate efficiently generation connected to distribution networks.
- 3.10 Any review of the G:D split should take place after the implementation of a seasonal zonal losses scheme based on P229 (Proposed) which includes the 45:55 G:D allocation of losses. We do not believe that there should be a requirement to include a revision to the G:D split in any order issued by the CMA as a part of remedy 1.

(c) What will be the distributional impacts of this remedy? Should the CMA take these into account in coming to a view on the proportionality of this remedy?

- 3.11 We note that there will be distributional impacts associated with the implementation of remedy 1. As the CMA has noted²⁹ the current system of uniform charging for transmission losses creates a system of cross subsidisation that distorts competition between generators and is likely to have both short run and long run effects on generation and demand.
- 3.12 We do not believe that the CMA should take into account the distributional impacts in coming to a view on the proportionality of this remedy. We note that a zonal losses scheme has been envisaged since the privatisation of the electricity industry and was allowed for in the introduction of the new electricity trading arrangements. The 25 years of non implementation³⁰ has had important distributional effects as a result of the cross subsidisation which should be taken into account and counterbalanced against any future impacts on transmission users. In addition, since it has been well known that a locational transmission losses scheme could be introduced we believe that this regulatory risk should have been taken into account in any decisions associated with investment in generation.

(d) Should the CMA implement this remedy directly, ie via an order, or should it make a recommendation to Ofgem to initiate a BSC modification instead? Are there any

²⁷ National Grid Strategy Paper, National Grid's strategy paper to address Transmission Licence Special Condition 2K: Electricity Transmission Losses, November 2013, revised September 2014 at <http://www2.nationalgrid.com/UK/Industry-information/Electricity-system-operator-incentives/transmission-losses/> (the "National Grid Losses Strategy").

²⁸ National Grid Losses Strategy, page 21.

²⁹ CMA Summary of Provisional Findings, page 12, paragraph 44.

³⁰ "Zonal Transmission Losses in the GB Electricity Market A Review of Statements by Ofgem and Others" 31 July 2006, Skypex Consulting, at <https://www.ofgem.gov.uk/ofgem-publications/62046/17145-060731-review-070305.pdf>.

particular aspects of Ofgem's objectives and duties to which the CMA should have regard if implementing this remedy by a licence change?

- 3.13 The CMA should implement remedy 1 directly via an order. The long history of attempts to reform transmission losses under the Pooling and Settlement Agreement and various BSC modifications indicates the difficulties associated with this particular area. We see the direct intervention of the CMA as a positive development in ensuring that reform is implemented in a timely manner. As noted above, we would envisage the creation of a licence obligation to ensure the delivery of the required change.
- 3.14 Ofgem concluded that Modification Proposal P229 (Proposed) would better meet the BSC Objectives, but was not satisfied that approving the proposal "*would be consistent with best regulatory practice*"³¹. Ofgem cited distributional impacts, changes to the electricity market at the European level and concerns as to whether the predicted benefits would be realised as reasons for rejecting implementation. We do not accept that these are sound reasons for rejection:
- 3.14.1 **Distributional impacts:** As we have highlighted the distributional impacts reflect the current cross subsidy inherent in the current treatment of transmission losses and the AEC;
- 3.14.2 **Changes at the European Level:** Ofgem has addressed losses and interconnection at the European level through implementation Modification Proposal P278³² and in any event a zonal losses scheme would be compatible with any proposals for market splitting; and
- 3.14.3 **Whether the predicted benefits would be realised:** As noted elsewhere in this response, cost benefit analyses have consistently identified benefits for customers, while Ofgem has demonstrated that a locational losses scheme would better meet the BSC objectives³³.
- 3.15 We believe that the need for direct intervention of the CMA is supported by the fact that there is a clear and well defined approach towards transmission losses in the form of BSC Modification P229 (Proposed). This modification, which was fully developed under BSC Modification Proposal P229 (Proposed), is a practical method for the early implementation of a seasonal zonal losses scheme that addresses the AEC identified by the CMA. Therefore we can see no reason to delay its implementation, given the CMA's wide ranging review of this issue, the clear customer welfare benefits and the acknowledged AEC.
- 3.16 When considering the implementation of a locational losses scheme, we believe that the CMA should focus its regard to Ofgem's principal duty to protect the interests of existing and future consumers in relation to electricity conveyed. In this context, a locational losses scheme will contribute to deliver an economically efficient electricity market and result in significant customer benefits.

³¹ Ofgem P229 Decision, pages 6-7.

³² Balancing and Settlement Code (BSC) P278: Treatment of Transmission Losses for Interconnector Users, Ofgem decision letter, 1st May 2012 at <https://www.elxon.co.uk/mod-proposal/p278-treatment-of-transmission-losses-for-interconnector-users/>.

³³ Ofgem P229 Decision, pages 3-5.

B. REMEDY 2a

CMA remedy 2a – DECC to undertake and consult on a clear and thorough impact assessment before awarding any CfD outside the CfD auction mechanism.

1. Executive Summary

- 1.1 RWE welcomes the CMA's recognition that the recent allocation of CfDs on a non-competitive basis has led to the inefficient distribution of market support. RWE shares the CMA's concerns that *"DECC retains the power to award CfDs outside the auction process without sufficient constraints"*.
- 1.2 RWE agrees with the CMA that *"competitive allocation of CfDs is likely to be a more efficient means of providing support in most cases"*. We therefore support the recommendation that DECC carry out a *"clear and thorough assessment of the impact of any proposal to use its powers to allocate CfDs outside a competitive process"*. In addition we would suggest that the requirement should not simply be for DECC to *"carry out, and disclose the outcome of"* any impact assessment but to carry out such exercises in a fully transparent manner, including through public consultation and with an obligation on the Secretary of State to take into account the results of that consultation. To this end, RWE recommends that the effectiveness of the remedy should be bolstered with an obligation on DECC to carry out its analysis in a transparent way which justifies the outcome (i.e. an obligation to consult) and a corresponding obligation on the Secretary of State to take into account the results of these consultations (i.e. an obligation to have regard to the consultations).

2. Specific Questions

(a) **Would the remedy ensure that CfDs that are allocated outside the auction mechanism are awarded only when the benefits of doing so outweigh the costs?**

- 2.1 In order to ensure that any CfD allocated outside the auction mechanism is awarded only when the benefits outweigh the costs, RWE believes that any consultation process would have to robustly and quantitatively establish the merits of such decisions. To effectively establish the case for non-competitive allocation of public support, DECC should:
 - 2.1.1 Assess the impact of non-competitive allocation on short term and long term efficiency³⁴, as well as the extent of rent minimisation³⁵;
 - 2.1.2 Consider efficiency impacts against a counterfactual scenario whereby that project/technology was allocated support on a technology specific competitive basis (e.g. facilitating competition between projects of the same technology, in a stand-alone pot);
 - 2.1.3 Consider efficiency impacts against a counterfactual scenario whereby that project/technology was allocated support on a pan-technology competitive basis (e.g. facilitating competition between projects of different technologies, such as nuclear and offshore wind projects, as if in the same pot); and
 - 2.1.4 Consider whether an appropriate delay of allocation would better enable competition to be established, where there are deemed to be 'insufficient competitors to hold an auction' for a particular project/technology.
- 2.2 If this analysis was evidenced in a robust and transparent manner we believe this remedy would ensure that the CfDs are allocated outside the auction mechanism only when the benefits of doing so outweigh the costs.

³⁴ In this context RWE considers efficiency to constitute the level of public support required to bring forward each unit of low carbon energy production.

³⁵ In this context RWE considers rent minimisation to mean the avoidance of over supporting any given project/technology, whilst ensuring deployment is maintained.

2.3 At the time of writing, RWE is not aware of any robust analysis from DECC which demonstrates the benefits to consumers of allocating public subsidy outside the auction mechanism (e.g. to nuclear, CCS, tidal lagoons).

2.4 RWE considers that this remedy would be strengthened by an obligation (imposed by primary legislation) on DECC to carry out its analysis in a transparent way which justifies the outcome, and an obligation on the Secretary of State to take into account the results of the DECC consultations.

(b)

(i) How much discretion should DECC retain in terms of the weight it places on each factor that it takes into account in coming to decision on which projects to award CfDs outside the CfD auction mechanism?

2.5 Once the DECC consultation has been completed, DECC should not retain any discretion in terms of the weight it places on each factor, for the period covered by the consultation. We would also expect DECC to treat all technologies on a level playing field, without discrimination, during the decision making process, i.e. the structure of any weighting should be constant across different technologies.

(ii) Should DECC be required to consult on and determine these factors and their relative importance in advance to enhance transparency?

2.6 Given the risk to consumer interests (as demonstrated by FIDeR) posed by non-competitive allocation, RWE believes DECC should be required to consult (in advance) on any factors, used to determine any unorthodox (i.e. non price competitive) approach to allocation.

(iii) Should their weighting of each factor be constant across projects?

2.7 Given the demonstrated risk to consumer interests posed by non-competitive allocation, RWE believes the weighting should be constant across all projects (whatever the technology). This would help to avoid discrimination, and guard against inappropriate political intervention which could harm consumer interests.

2.8 RWE recognises it is important that the CMA considers the structure/weighting of any assessment framework for determining the case for non-competitive allocation. However it is also important the CMA considers the related evaluation criteria/methodology upon which each factor is scored/rated. We note that with regard to FIDeR, whilst the assessment framework was technology neutral in some (not all) respects, its evaluation system was unclear and subjective, undermining any degree of consistency and neutrality, regarding decision making. For example, the difference between a low and high score could depend on whether the response was considered by the scorer to be 'comprehensive' or 'cogent', with minimal guidance given to the scorer's application or definitional use of such descriptors. To this end, it is important that any assessment as to whether non-competitive allocation is required minimises the level of subjectivity within the evaluation process. There is little point in ensuring that the weights are kept constant, if they are used to take a weighted average of scores that are themselves highly subjective/ discretionary.

(c) In which exceptional circumstances should DECC be able to allocate CfDs outside the auction process? For example, for reasons of industrial policy, where there are wider market failures, or where there may be insufficient competitors to hold an auction?

2.9 RWE cannot currently see any circumstances which may merit non-competitive allocation. Even where there are exceptional circumstances, for reasons of industrial policy or wider market failures, a robust analysis of the circumstances should still be carried out to assess whether allocating CfDs outside of the auction process can be justified. RWE believes that such exceptional circumstances would only arise where it can be demonstrated that the competitively allocated CfD regime cannot be appropriately adjusted to cater for the project/technology specific requirements, and it can be robustly evidenced that non-competitive allocation is necessary to deliver long term efficiency to the consumer (see 1.3-1.5). RWE considers that long term consumer efficiency benefits would include lower clearing prices as well as wider industrial and economic factors.

- 2.10 Where there are deemed to be “*insufficient competitors to hold an auction*”, DECC should be required to consider whether an appropriate delay of allocation would better enable such competition to be established.

C. REMEDY 2b

CMA remedy 2b – DECC to undertake and consult on a clear and thorough assessment before allocating technologies between pots and the CfD budget to the different pots

1. Executive Summary

- 1.1 Short and long term consumer interest is served by effective competition, an essential constituent component of which is investor confidence, supported by a stable and predictable regulatory framework. On the basis remedy 2b reinforces the predictability and stability of the wider regulatory landscape, RWE supports the CMA's proposals. We do however suggest further thinking is required regarding the implementation of remedy 2b. It will be important to strike the appropriate balance between (a) preserving investor confidence through a stable, predictable framework for the allocation of CfDs, and (b) securing sufficient flexibility/agility within that same framework to keep total costs to consumers as low as possible.
- 1.2 RWE believes the appropriate balance is one where long term costs to consumers are minimised. To this end we recommend that this remedy should be bolstered with an obligation on DECC, imposed by primary legislation, to carry out this analysis in a transparent way which justifies the outcome. This would ensure that the consultations are carried out in a robust and fully transparent manner, including through public consultation. In addition, there should be an obligation on the Secretary of State to take into account the results of these consultations.

2. Specific Questions

(a) Would the remedy (2b) ensure that future decisions by DECC on the allocation of technologies and the CfD budget to the different pots are taken in a robust and transparent manner?

- 2.1 Unless the consultation processes outlined in remedy 2b are underpinned by robust analysis (see paragraph 2.1-2.4 in our response to remedy 2a), and appropriate legislative amendments (see paragraph 1.2) RWE is concerned remedy 2(b) will be insufficient to ensure the decisions will be taken in a robust and transparent manner.
- 2.2 RWE believes the CMA has accurately set out the trade-offs between efficiency (short and long term) and rent minimisation. The CMA implies DECC could go further in providing evidence to support dynamic efficiency arguments in favour of separate pots. RWE notes that, specifically in regard to offshore wind, studies³⁶ such as TCE's 'Offshore wind cost reduction - Pathways study' have been carried out to date which evidence the positive impact that predictable, stable, and sufficiently scaled, policy support can have on a technology cost reduction, as well as on indigenous industrial growth. The findings of this report are supplemented by additional research³⁷.
- 2.3 RWE observes that CMA "analysis indicated that the level of support per MWh under a single pot was very close to the result under the actual CfD auction". This would seem to imply that moving to a single pot would offer limited short term efficiency improvement (in this allocation round), presumably owing to loss of rent optimisation. We note that such a single pot approach would possibly deliver negative impacts to long term efficiency, gained

³⁶ Leading report produced by TCE "Offshore wind cost reduction - Pathways study": <http://www.thecrownestate.co.uk/media/5493/ei-offshore-wind-cost-reduction-pathways-study.pdf>.

³⁷ Other supporting reports could include:

- RUK: <http://www.renewableuk.com/en/publications/index.cfm/Offshore-Wind-Forecasts-of-future-costs-and-benefits>;
- RUK: <http://www.renewableuk.com/en/publications/index.cfm/UK-Offshore-Wind-Building-an-Industry>; and
- Poyry/CCC: https://www.theccc.org.uk/wp-content/uploads/2013/05/325_Technology-supply-curves-v5.pdf.

through progress on cost reduction for less mature technologies, and related supply chain development.

- 2.4 On balance of recent evidence of cost reductions, and available analysis of which technologies can be deployed in large enough volumes to meet 2030 decarbonisation targets, it would appear to RWE that DECC's decision to pursue a dual pot approach was the right one for consumers in the long term.
- 2.5 However we agree with the CMA that the categorisation of technologies into discrete pots should be reviewed periodically against a fixed set of principles, such as sector specific decarbonisation targets and aspirational deployment profiles/pathways (informed by affordability/security of supply/decarbonisation objectives and optimal energy mix analysis), to ensure consumer interests are protected. That said, careful thought is required as to how such a process will be implemented, what lead times investors will be given of any changes, and on what basis such adjustments will be made.
- 2.6 We recommend that to ensure efficient allocation, industry should always have visibility (pot structure, budget availability) of at least one future allocation round at the point of auction participation. To this extent the lead time for any changes would be partially restrained by the frequency of the allocation rounds (See 2.12). Visibility of future auction budget availability will help to mitigate perverse bidding behaviour characterised by price taking and/or speculative bidding. Unless this type of behaviour is sufficiently deterred (e.g. through bid bonds / financial securities), auction clearing prices will suffer price suppression and higher price volatility. Such impacts will damage investment certainty, raise clearing prices in the medium term (through reduced auction liquidity), as well as threaten non delivery for allocated projects, and the timely meeting of decarbonisation objectives.
- 2.7 Regarding budget allocation, RWE notes that some European markets have adopted a mechanistic approach to the allocation of market support (e.g. Poland allocate a % of remaining low carbon target per auction), based on realisation of progress against sector specific decarbonisation targets. RWE would welcome a more mechanistic approach to budget allocation in the UK, on the basis that the mechanism was transparently designed to deliver predictable outcomes. Furthermore, we do not believe it insurmountable to develop a budget allocation system which also adequately addresses technology categorisation (e.g. based on combination of technology cost / pre-stated indicative pathway of deployment ambition).
- 2.8 Whilst DECC may not have carried out "*any significant analysis ... on the rationale for its decision on how to allocate the budget between the pots*" we note that there are various publicly available historical studies (see footnotes 36 and 37) on technology cost reduction, and the annual deployment necessary to secure them, as well as covering technological mix scenarios necessary to efficiently meet 2020/2030 targets. In the past such work has supported/informed DECC statements regarding technological specific allocation methods, as published with the DECC EMR Delivery Plan. More explicit reference to such analysis as the basis for prevailing policy decision would be helpful and would help to ensure future decisions are taken in a robust and transparent manner.

(b) *Is the remedy likely to result in a positive change in how DECC makes decisions regarding the allocation of the CfD budget to different pots?*

- 2.9 Although consultations have been carried out by DECC before from time to time, until a broader, more robust decision making framework is made to determine budget release and technology categorisation, it is likely that investor confidence will be undermined by the potential for inefficient political intervention (e.g. potential exclusion of onshore wind from CfD auctions).
- 2.10 Therefore, whilst RWE believes that CMA has identified the issues at hand, and that the remedy 2b proposals are directionally appropriate, the proposals do not go far enough in prescribing the level of 'thoroughness' necessary to drive an effective solution.
- 2.11 RWE believes positive change in DECC decision making can be further secured by:

- 2.11.1 Amending primary legislation to ensure the effectiveness of the CMA's remedy proposals (see paragraph 1.2), with the Secretary of State being compelled to give due regard to related analysis and consultation.
- 2.11.2 Providing investors with a predictable and stable policy framework via (a) ensuring sufficient lead times of any policy change/update are upheld, (b) giving sufficient visibility of forward policy framework (see paragraph 2.6).
- 2.11.3 Introducing a mechanistic approach to budget release (see paragraphs 2.14 - 2.16).
- 2.11.4 Basing technology categorisation (into relevant allocation pots) on robust, technology neutral, quantitative analysis (see paragraphs 2.1-2.4 in our response to remedy 2a).

(c)

(i) How regularly should DECC review the allocation of technologies between pots?

- 2.12 RWE believes DECC should review the categorisation of technologies (in technology groupings or pots) on a periodic basis, where the frequency can support lead times for preannounced policy decisions (see paragraph 2.6). We believe it sensible to run CfD Allocation Rounds every 1-2 years, with the exact frequency determined on a pot specific basis. Where it can be demonstrated that pot liquidity is sufficiently high to drive effective competition, DECC should look to safeguard investor confidence by administering allocation rounds annually. However we can see an argument where for some technologies (e.g. offshore wind which has longer gestation periods than onshore wind) it may be prudent to reduce the frequency of rounds to 2 years, such that liquidity can be ensured.

(ii) What information should DECC publish when deciding to amend the allocation of technologies between pots?

- 2.13 See paragraphs 2.1-2.4 in our response to remedy 2a.

(iii) Should it also on a regular basis consult and/or publish reasons for not amending the allocation of technologies between pots?

- 2.14 RWE believes DECC should establish a mechanistic approach to budget allocation and technology categorisation, which should be reviewed on a periodic basis against a consistent set of principles (or metrics) which underpin policy implementation. Reviews would be appropriate to assess market progress against such principles/metrics and to reflect this in forward budget allocation decisions. The industry would have visibility of at least 1 future allocation round budgetary availability at all times, in order to address price taking behaviour and related delivery and long term liquidity risk (See paragraphs 2.6 – 2.8).
- 2.15 Such principles would need to consider:
 - 2.15.1 Sector specific decarbonisation targets;
 - 2.15.2 Aspirational deployment profiles/pathways³⁸ (informed by affordability/security of supply/decarbonisation objectives, and optimal energy mix analysis).
- 2.16 Assessment of market progress should include:
 - 2.16.1 Technology specific Efficiency – Rent minimisation analysis (if a technology could no longer demonstrate long term efficiency gains outweighed short term efficiency losses (or if deployment was momentarily ahead of schedule), protective technology categorisation could be (temporarily) downgraded;

³⁸ Such pathways could be reviewed on an annual basis, and changed if robust analysis showed merit in doing so.

- 2.16.2 Short term efficiency potential;
- 2.16.3 Technology costs;
- 2.16.4 Technology pipelines;
- 2.16.5 Technology specific wider economic benefits;
- 2.16.6 Long term efficiency potential;
- 2.16.7 Technology specific cost reduction potential;
- 2.16.8 Technology specific wider economic benefits;
- 2.16.9 Progress toward decarbonisation targets.

(d) *Should DECC be limited in the maximum proportion of the CfD budget that it can allocate to each of the different pots?*

- 2.17 Provided DECC can robustly evidence that any proposed method of budget allocation maximises efficiency for the consumer, no cap on allocation should be applied (see paragraphs 2.14 -2.16).

D. REMEDY 3

CMA remedy 3 – Remove from domestic retail energy suppliers’ licences the ‘simpler choices’ component of the RMR rules

1. Executive Summary

- 1.1 RWE npower agrees with the CMA’s provisional finding that RMR has restricted product innovation by suppliers and has restricted price competition between PCWs. However, as set out in RWE npower’s response to the PFs, it believes the CMA has understated the impact of RMR on price competition between suppliers. In RWE npower’s view, the restriction in the number of tariffs not only limited the options in terms of which tariffs suppliers could launch, but also limited the ability of suppliers to target and trial products at different customer groups, thereby weakening price competition.
- 1.2 RWE npower believes that increasing the number of tariffs allowed will enable suppliers to design innovative tariff structures to meet customer demand, thereby increasing customer choice and stimulating competition between suppliers and PCWs alike. It will also stimulate price competition by allowing cash and non-cash discounts on SVT, and allowing suppliers to compete on price for certain customer groups, for example low/no standing charge tariffs aimed at low consumption customers and low unit rate tariffs aimed at high consumption customers. RWE npower is strongly of the view that relaxing these constraints will intensify both engagement and competition in the retail energy market. RWE npower therefore believes that this remedy would be effective in addressing any concerns the CMA may continue to have that a lack of engagement is giving suppliers a level of unilateral market power over their inactive customers, as well as directly addressing the provisional AEC relating to the distortion of competition brought about by RMR. The reasons for our views are set out below.
- 1.3 We note that if the aspects of the remedy that we support are implemented, this will require a change to the PCW Confidence Code requirement on PCWs to show the whole of the market as a default (which, as the CMA is aware, we had strongly supported as a means of driving customer trust and therefore engagement). We set out below the other provisions we consider are required in order to provide customers with trust and simplicity in using PCWs, and overall we consider that the increased competition and engagement that will result from the changes outweighs any disadvantage from the loss of the requirement to show the whole market. Furthermore, if an independent PCW is established (see our response to remedy 6), this would provide a backstop whole of market view, making it less important for commercial PCWs to do so.

2. Specific Questions

(a) *Would this remedy be effective in increasing competition between domestic retail energy suppliers and/or between PCWs? What additional tariffs would energy suppliers be likely to offer that they currently do not due to the RMR restrictions?*

- 2.1 RWE considers that the removal of the four-tariff rule would create an opportunity for domestic energy suppliers to create differentiated and bespoke tariffs that are positioned to appeal to different customer groups, such as social, green, landlord, charity, electric vehicles, and that incentivise engagement, for example by offering lifestyle bundles, loyalty and reward schemes. It will also increase price competition, both by allowing PCWs to drive competition, and by allowing suppliers to offer cash and non-cash discounts on SVT and, for example, to target different lower price offers at low and high consumption customers. Suppliers could also develop exclusive partnership deals i.e. employee or community offers, which would be aimed at consumers who may not have otherwise been engaged. Having the ability to offer a greater choice of tariffs is essential with the introduction of smart meters, to enable suppliers to develop a wider choice of time of use tariffs. In addition, removal of the ‘simpler choices’ component of the RMR rules would also enable suppliers to trial new concepts, for example time of use tariffs for electric vehicles, thereby building consumer engagement over time and speeding up advancement of technology to market.
- 2.2 RWE npower also believes that relaxing the RMR constraints will result in further benefits to consumers from increased competition between PCWs, provided that it is combined with

the removal of the requirement for PCWs to show a full market view. This would allow the negotiation and promotion of exclusive offers via selected PCWs (contracts not withstanding) which would ultimately benefit consumers in terms of increased price competition and consumer choice, but also, potentially reduce the cost of acquisition, which would ultimately be reflected in lower prices. RWE npower considers that the use of affiliate sites (cashbacks) should also be permitted as they encourage competition and may target different customers to those who use PCWs.

- 2.3 To ensure a clear differentiation between tariffs and offers, RWE believes there should be clear standards of conduct, using principles based regulation, requiring suppliers to act in the best interest of customers. By way of example, the introduction of principles based regulation within financial services created greater transparency for consumers whilst not placing an artificial cap on the number and range of products that providers could offer at any one time. This approach enabled niche propositions to be targeted at particular segments of customers.
 - 2.4 RWE believes that a similar model within the domestic retail energy market would enable suppliers to offer a more innovative tariff range that, in turn, would encourage more customers to be engaged. It is not clear to RWE npower that there is a level at which the cap could be set that would be meaningful and yet which did not run the risk of distorting competition by preventing the development of tariffs valued and demanded by consumers. This is particularly the case as we move towards smart meters and time of use tariffs. As such RWE npower does not advocate a tariff cap. Furthermore the focus on achieving the best outcome for a customer - as enshrined in principles based regulation - would drive suppliers to not simply 'sell' a tariff, but to ensure that a customer's wants and needs were understood.
 - 2.5 RWE npower believes that in removing the 'simpler choices' component of the RMR rules by opening up the number, format and structure of tariffs allowed, this will drive greater customer choice and better engagement. To encourage wider engagement, RWE npower considers the remedy should also be extended to remove, clarify and simplify some of the other more prescriptive requirements around discounts, bundles, incentives and reward points, for example, circumstances where 'cash' is in play, which form part of the RMR restrictions. Cashback websites are able to pass some of the commissions received from suppliers back to customers, however, energy suppliers are unable to offer cash incentives direct to customers. In addition, as set out above, enabling suppliers to offer exclusive discounts to PCWs to accompany their tariff offers would also encourage competition.
- (b) Removing the four-tariff rule is likely to increase the range of tariffs on offer and result in different tariffs being offered on different PCWs. Are there, therefore, any remedies that the CMA should consider alongside this remedy, to encourage domestic customers to use more than one PCW in order to facilitate effective competition between PCWs and domestic energy suppliers?**
- 2.6 Under the Confidence Code, all PCWs are required to show the same tariffs, in the same order with the same prices. If suppliers were able to offer different tariffs or offers on different PCWs, this would result in consumers having to visit more than one PCW in order to find the most appropriate tariff. As PCWs compete to obtain exclusive tariffs and offers from domestic energy suppliers, it will be in PCWs' interests to advertise only these to encourage customers to switch through their website. RWE npower believes that this competition between PCWs, both to obtain the best offers and to attract consumers with exclusive offers, will be effective in encouraging consumers use more than one PCW in order to identify and obtain the best deal for them.
 - 2.7 That being said, to improve engagement with customers and thereby facilitate effective competition between PCWs and domestic energy suppliers, RWE npower believes that PCWs should provide customers with a clear and consistent way to search on the basis of different tariff features such as contract length or energy efficiency measures. This is explained below in more detail in RWE's response to question (d).
- (c) We note that if this remedy were to be imposed, Ofgem's Confidence Code requirement for PCWs to provide coverage of the whole market appears likely to become impractical as the number of tariffs offered increases and PCWs agree**

different tariff levels and commissions with energy suppliers. Should this element of the Confidence Code be removed, therefore, as part of this remedy? If so, are alternative measures to increase confidence in PCWs required? For example, in order to maintain transparency and trust, should PCWs be required to provide information to customers on the suppliers with which they have agreements and those with which they do not?

2.8 If PCWs are able to promote exclusive offers and tariffs, RWE npower agrees that the requirement to show the whole of market view should be removed from the Confidence Code. PCWs should then make it clear to consumers that they are only displaying tariffs for which they receive a commission payment and that other offers could be available. As discussed in RWE npower's response to remedy 6, the Ofgem website should present a whole of market view for domestic customers, providing consumers with information on all available tariffs and offers in the market.

2.9 PCWs focus heavily on ranking tariffs by price. As set out in RWE npower's response to PFs, RWE believes that customers care about more than just price when making choices between tariffs. If customers were able to filter the choices by different tariff attributes during the quotation process (as described in paragraph 2.11 below) then this could help identify the most appropriate offer for them and, RWE believes, would encourage engagement.

(d) Rather than removing all limits on tariff numbers and structures, would it be more effective and/or proportionate to increase the number of permitted tariffs/structures? If so, how many should be permitted and which tariff structures should be allowed?

(i) For example, would requiring domestic energy suppliers to structure all tariffs as a single unit rate in pence per kWh, rather than as a combination of a standing charge and a unit rate, reduce complexity for customers, while avoiding restricting competition between PCWs? Alternatively, would such a restriction on tariff structures have a detrimental impact on innovation in the domestic retail energy markets?

2.10 RWE npower would not support a cap or restriction on the number of tariffs available, as this would have a detrimental impact on innovation in the domestic retail energy market and an adverse impact on customers in the form of a limited number of products that might not meet their needs. That said, RWE npower considers an unlimited number of tariffs presented 'unfiltered' could be potentially confusing for the consumer. It is therefore important that there is clear differentiation of tariff features on PCWs and the customer is able to search accordingly. RWE npower would suggest that the Confidence Code is the mechanism used to ensure PCWs use a common set of search criteria to enable consumers to compare offers, for example by tariff type, payment type, with or without an exit fee and clear guidelines on how the value of any bundle or incentive is displayed.

2.11 RWE npower also considers a cap on the number of tariffs and a restriction in the tariff structure across all market tariffs could materially hamper suppliers' ability to target niche groups. This is particularly the case in the context of the move towards half-hourly settlement and smart meters, where in order to maximize benefits to consumers, retail energy suppliers need to be able to develop multiple targeted products. Customers have different patterns of usage and therefore there should be scope for suppliers to accommodate this in their tariff design.

2.12 RWE npower recognises that a single unit rate could, in principle, help customers identify the cheapest tariff on offer, if all tariffs were structured in this way. However, RWE npower considers that:

2.12.1 Similar to the RMR four-tariff rule that the CMA has provisionally found restricts innovation, a unit rate rule would constrain suppliers' ability to develop tariffs that are tailored to consumers with different consumption levels. This would result in worse outcomes for some consumer groups; and

- 2.12.2 Within this tariff structure every unit rate will incorporate fixed cost recovery and margin and higher users or very low users would be worse off with a single unit tariff, compared with the current tariff structure.
- 2.13 Ofgem has already considered banning standing charges and setting regulated standing charges and has recognised the customer benefit of standing charges (as noted in paragraph 199 of the response to PFs). The setting of regulated standing charges proved to be an insurmountable challenge, even for the simplest case of receipt of bill standard variable tariffs and single rate meters.
- 2.14 RWE npower believes if the limit on tariff structures is removed, suppliers will be able to offer more tariffs which offer better deals at different consumption levels, for example, a high standing charge and low unit rate would be more beneficial for high consumption customers, whilst a low standing charge and high unit rate would benefit low consumption customers. Accordingly, RWE npower would not advocate the introduction of a fixed tariff structure based on a regulated standing charge as an alternative to the removal of the 'simpler choices' component of the RMR rules. To do so would, in RWE npower's view, have a detrimental impact on innovation and, consequentially, on customers.

E. REMEDY 4a

CMA remedy 4a – Measures to address barriers to switching by domestic customers

1. Specific Questions (paragraph 59 of the RN)

(a) Will the roll-out of smart meters address the feature of uncertified electricity meters? If not, what additional remedies should we consider to address this feature?

1.1 In principle the roll-out of smart meters should address the feature of uncertified electricity meters as all traditional electricity meters (domestic and micro-business) are planned for replacement as part of the Smart Programme. This deployment activity should therefore also result in the removal of any meters that have not been certified.

1.2 It must be noted however, that:

1.2.1 The complete removal of uncertified meters is dependent upon consumers agreeing to a smart installation and granting access to their property for the meter replacement activity to be undertaken; and

1.2.2 While the roll-out of smart meters should address the feature of uncertified electricity meters, this is not the primary driver of the smart meter programme and consideration must also be given to rolling out smart meters in a way which promotes cost efficiencies to the benefit of all customers³⁹.

1.3 RWE npower believes that the current roll-out plans will address any issue the CMA has identified with respect to uncertified meters, in an appropriate timeframe. Therefore we do not consider it necessary for the CMA to consider further measures relating to uncertified meters.

(b) Will the roll-out of smart meters address the barriers to switching faced by customers with Dynamic Teleswitched (DTS) meters? If not, what additional remedies should we consider to address this feature?

1.4 In RWE npower's view the replacement of DTS meters with new smart metering technology should remove the barriers to switching that customers with these metering arrangements currently face. The installation of new smart metering technology (SMETS2 meters) should enable suppliers to establish the necessary dynamic switching patterns that will enable them to continue to support these tariff arrangements. The 'smart platform' is designed for interoperability to provide customers with a greater choice should they wish to change supplier.

1.5 However, the development of a fully tested smart meter that can replicate dynamic switching patterns is only part of what is required to tackle the barriers to switching for customer with DTS meters. In order that customers who are currently DTS metered are able to take full advantage of products that take account of new smart capabilities, suppliers need to be able to develop and offer a more extensive range of tariffs than are currently allowed under the RMR four-tariff rule. Our views on the removal of the 'simpler choices' component of the RMR rules from the licences of domestic retail energy suppliers are set out in our response to remedy 3. There is also a need to ensure that the whole market is ready, by implementing proportionate tariff regulation that permits a greater degree of innovation so that suppliers are able to provide a range of differentiated products that appeal to different customer groups.

³⁹ It must also be understood that industry discussions and developments have resulted in a change to the recertification regime. These changes focus on a risk-based approach whereby suppliers are obligated to ensure meters are recertified dependent on the individual risk of meter inaccuracy. This "in service testing" approach will look at samples of meter types to establish an overall risk of inaccuracy of a certain meter population rather than assume that from a certain date all meters in that category will need to be recertified.

1.6 Market readiness will also be necessary to ensure inter-operability and inter-changeability, thereby enabling customers with these smart metering configurations to switch. This will require all suppliers in the market to have developed the technical systems and processes that will be necessary to provide and support any new smart tariffs that are developed to replicate or replace the current DTS offerings. Suppliers should be considering these developments now as part of their smart roll-out strategies, to ensure that they will be in a position to support the whole of their domestic (and smaller non-domestic) customer portfolio as they transition to the new smart platform.

1.7 RWE npower therefore considers that a combination of the roll-out of smart meters and the proposed remedy 3, as well as the development of technical systems and processes that the industry is currently undertaking to ensure inter-operability, will be sufficient to deal with any concerns the CMA may identify with respect to DTS meters.

(c) *Should PCWs be given access to the ECOES database (meter point reference numbers) in order to allow them to facilitate the switching process for customers?*

1.8 RWE npower believes that PCWs should be given access to the ECOES database as this would help improve the quality of data suppliers receive and should in turn provide a better switching experience for the customer. RWE npower believes that Ofgem should regulate PCWs if they are granted access to ECOES to prevent bad practices, protect customer data and to ensure the PCW rather than the supplier is held responsible if incorrect data is submitted by the PCW.

(i) *To what extent would this reduce the rate of failed switches and/or erroneous transfers?*

1.9 RWE npower does not report on how many erroneous transfers (ETs) and delays to new gains are caused by the provision of poor data from the PCWs so cannot comment quantitatively. However, providing the PCWs with access to ECOES would help prevent ETs and should also speed up the switching process if the meter and address details are checked earlier in the process. For example it would avoid the erroneous sales of a single rate tariff to a customer with a complex multi-MPAN or register meter to support their heating.

(ii) *Are there any data protection issues we should consider in this respect?*

1.10 The PCW would need to obtain customer permission in order to access their data via ECOES. The data protection issues depend on whether PCWs are given access in their own right to ECOES or whether they do so under licence from a supplier.

1.11 Where the supplier provides the licence, then the supplier is liable if the PCW does not protect the personal data that they gain access to under the licence we put in place.

1.12 [CONFIDENTIAL]

1.13 RWE npower considers, therefore, that PCWs should be given access to ECOES in their own right. The PCW would need to apply for access to ECOES by signing up to the Master Registration Agreement (MRA) which is the industry agreement that covers the use of ECOES and ultimately the change of supplier process. PCWs would, in effect, be the data controllers in their own right in relation to the information to which they have access and PCWs would therefore be required to have proper safeguards in place to protect customers' data. For example, they would be required to have the appropriate policies and procedures and will have their access restricted so that they can only use the data for certain purposes with the same form of industry audit that suppliers are subject to in order to prevent misuse and/or inappropriate access to an individual's data.

1.14 ECOES access for Third Party Intermediaries (TPIs) has been raised at an MRA forum, however the group has decided to postpone investigating giving TPIs direct access to ECOES as Ofgem is currently holding workshops to agree a TPI Code of Practice. This Code of Practice would include controls on how the data should be used i.e. for change of supply purposes only. RWE npower considers that any controls which are considered necessary for TPIs to access ECOES should also apply to PCWs. As mentioned in paragraph 1.8 RWE

npower believes that Ofgem should regulate PCWs if they are given access to ECOES in order to protect customers' data as well as preventing bad practices, thereby building trust and encouraging engagement in the market.

(iii) Will access to this database still be relevant once smart meters have been introduced?

- 1.15 Yes, access to ECOES will still be required as the Data Communications Company (DCC) will still use a registrations feed directly from ECOES. There are plans in the industry to move registrations into the DCC during 2019.

(d) Should there be penalties for firms that fail to switch customers within the mandated period (currently 17 days, next day from 2019)? How should these penalties be administered? At what level should the penalties be set? Should customers who suffer a delayed or erroneous switch receive the penalty as compensation?

- 1.16 RWE npower would like to clarify that the mandated switching period is 21 days as stipulated in LC14A, not 17 days as mentioned in the remedy. 17 days switching is voluntary and although RWE npower was instrumental in the design and implementation of the change, not all suppliers have adopted it. It should also be noted that 17 days is actually 14 calendar days (to allow for the statutory cooling off period to conclude) plus 3 working days (known as the 2+3 model), so in many cases the switch will naturally be closer to 20 days, when taking into account weekends and any bank holidays. Any penalties associated with timescales should be based on the prevailing licence condition obligation, which is currently 21 days.

- 1.17 There is currently a voluntary agreement where a supplier will compensate the customer £20 where there is a delay in sending the 20 day letter confirming the acceptance or rejection of the erroneous switch. The industry is, in addition, already working with Ofgem, DECC and consumer groups to implement a Switching Guarantee for Domestic customers and compensation for delayed switching is being discussed as part of that Guarantee. RWE npower considers, therefore, that a remedy of this nature is not necessary at this time.

- 1.18 RWE npower would prefer the focus of any remedy to be on ensuring the switching process works well and that customers are engaged, rather than focusing on compensation. If there is a move towards penalties or compensation, then the level of penalties or compensation should be reasonable, not punitive, and should only be imposed where the relevant supplier (gaining or losing) was at fault for a genuine delay or erroneous transfer. For example if a penalty is to be imposed on the gaining supplier, it should only apply when the gaining supplier is at fault and not where the delay is due to the losing supplier's poor performance, delays in industry data flows from other parties or delayed or incorrect information from the customer. Where the gaining supplier is at fault for the delay, it would be difficult for it to know the customer's tariff with the previous supplier and calculate the amount by which the customer would have been worse off during the delay. A potential solution could be an agreed figure of '£x' per day which the gaining supplier deducts from the first bill (or a suitable alternative for prepayment customers) for each day above 21 days where they are responsible for the delay.

- 1.19 RWE npower believes that it is important that any remedy implemented does not add excessive complexity and cost since this may have an adverse impact on the customer. Customer engagement should not only be measured in terms of switching between suppliers; any focus on driving engagement via switching therefore should also consider transfer between the tariffs of their existing supplier. A Switching Guarantee therefore could potentially include certain protections, i.e. guaranteed transfer time frame for those customers who remain with the same supplier, but have transferred to a different tariff and set of terms.

(e) When next-day switching is introduced, will a 'cooling-off' period still be required? Could it be avoided by requiring that no exit fees are charged within two weeks of switching?

- 1.20 The 14 calendar days cooling off period is a statutory requirement from EU Law and will still remain after the introduction of next day switching. Postponing the charging of an exit fee does not remove the statutory requirement to have a cooling off period.
- 1.21 RWE npower acknowledges the desire from Government, DECC, the Treasury and Ofgem to move to next day switching. It is important that the implementation of next day switching delivers meaningful benefits and protections for all customers. This includes allowing the customer to choose their transfer date i.e. at the end of current tariff term and not being forced to switch the next day. It is also important that if a customer does invoke their right to cancel, the associated energy costs incurred whilst they are temporarily supplied by the new supplier are billed appropriately to ensure other customers are not adversely impacted.
- 1.22 RWE npower is currently working with industry partners and stakeholders, through the auspices of Energy UK, to understand how the complexities associated with next day switching can be resolved.
- (f) Are specific measures required to facilitate switching for customers living in rented accommodation (either social or private)?**
- 1.23 Circumstances vary between tenants, landlords and energy suppliers in social and private rented accommodation alike. There are various ways a tenant can interact with their energy supplier and these require different approaches from policy makers to ensure equitable treatment across the rented sector:
- 1.23.1 Contracts for energy may be between the landlord and energy supplier. The landlord may seek to recover the cost of energy used by the tenant separately from any charge for accommodation or, alternatively, the charges for energy may form part of the rent (and which may or may not be shown separately from any charge for accommodation). The energy supplier has no legal relationship with the tenant.
- 1.23.2 Metering arrangements may vary, depending on the type of accommodation and configuration. Bedsits, houses converted into flats or domestic premises above a business may result in there being one primary meter with landlord-owned sub-meters for each tenant's accommodation. Alternatively, there may be one primary meter that supplies the tenant(s), with charges for energy being included in the rent; in either scenario the landlord will be the customer.
- 1.23.3 The contract may be non-domestic. Where the supply contract is with the landlord and the actuality (or the expectation is) that he will recover charges for energy through a collateral arrangement with the tenant, whether or not the energy is used for domestic purposes, the premises will be classified, under Standard Licence Condition 6, as non-domestic premises and, therefore, should be supplied under a non-domestic contract. The tenant cannot change supply as the landlord has responsibility for the energy supply.
- 1.24 RWE npower does not at this time have a clear idea of what would be the most practicable and effective remedies to increase engagement for customers living in rented accommodation. However, if the CMA were to conclude such a remedy were necessary we suggest the CMA may wish to consider the extent to which any of the following ideas may be workable in practice.
- 1.24.1 The energy contract may be between the tenant and energy supplier, however the tenant may have only signed a short term tenancy agreement. According to the latest English Housing Survey 2013-14, nearly 35% of private renters have a tenancy of less than a year compared with just over 9% of social renters. This may mitigate the effectiveness of any annual comparative consumption information that could be provided by the supplier to allow an accurate (or in any way meaningful) cost comparison necessary for a switch. The tenant may think there is little benefit to be gained by changing supplier if they are going to be moving within a year.

- 1.24.2 A significant change that would ensure tenants are always in control of their energy bill would be to prohibit landlords from including energy charges in rental costs and from restricting tenants from changing supply. All tenancy agreements could be amended to ensure the tenant (rather than landlord) is responsible for arranging the energy provider.
- 1.24.3 An alternative measure would be to require landlords and letting agents to provide a checklist or 'energy pack' alongside their tenancy agreement that would summarise at a high level: all the utilities that are currently in place, their responsibility regarding energy supply, their rights (e.g. Ofgem Tenancy Rights Fact Sheet) and how to switch supplier (if relevant), alongside the gas safety certificate. This would make it clear from the outset whether tenants are responsible for these services and where they are, that they have an ability to change them, if required, at their own discretion.
- 1.24.4 Smart metering and the introduction of a wider range of tariffs, as well as the removal of the 'simpler choices' component of the RMR rules, should result in tariff innovation and greater choice and tariffs that are better suited to tenants e.g. shorter term length or lower consumption tariffs. RWE npower is currently investigating new ways of engaging specific tenant groups such as the 'younger, professional early technical adopters' through offers and bundles such as gadget insurance and offering easier and more relevant ways to pay such as PayPal.
- 1.24.5 If there are multiple tenants jointly renting properties, it makes changing supplier harder since multiple signatories are needed but 'split-bills' i.e. billing customers individually could be a potential solution. Taking this one step further, the different tenants could be allowed different tariffs by splitting the consumption in a pre-designated way. This would need further investigation as it may require the development of new industry wide processes or further development of smart capability.
- 1.24.6 Split bills may also be an appropriate solution for landlords and tenants as both parties could pay a certain proportion of the bill. Again this could be developed to allow them to potentially select the most appropriate tariff for their needs.
- 1.24.7 Many social properties are on prepayment meters because of the high frequency of people moving in and out of these properties. Prepayment meters prevent debt being built up and make the moving process more controllable for the domestic customer and the landlord. The introduction of smart meters will provide a greater choice of tariffs and payment options for all customers, including for landlords and tenants.
- 1.24.8 RWE npower considers that letting agents, social housing providers, and others could provide tenants with more information on their rights and switching options and this could increase awareness and switching and (where this was allowed). As mentioned above in 1.23.7 Ofgem could ensure that all landlords provide their tenants with their Tenancy Rights Fact Sheet. Partnerships with trusted organisations, community groups and the National Landlord Association may also increase customer awareness and engagement as well as a targeted national campaign similar to DECC's 'Power to Switch'.

2. **Specific Questions (paragraph 60 of the RN)**

- (a) ***Does the 'Midata' programme, as currently envisaged, provide sufficient access to customer data by PCWs to facilitate ongoing engagement in the market? Should PCWs – with customer permission – be able to access consumer data at a later date to provide an updated view on the potential savings available?***

- 2.1 The current MiData programme includes a downloadable comma separated variable (csv) file with the customer's usage information and a QR code on the bill with the same information. With the products currently available in the market the current MiData solutions should provide PCWs with sufficient access to customer data.

- 2.2 In the future, when the market moves to more complex tariffs, specifically time of use tariffs, then in order to provide a quote that is accurate for each individual customer, it may be necessary to understand usage down to the half hourly interval. There is provision within the roll-out of smart meters to allow customers access to 24 months of daily read data. If the time of use tariffs are daily, then this would provide PCWs with sufficient access and we do not consider that any changes to the MiData projects would be required.
- 2.3 If, however, the time of use tariffs have intra-day rates, then a new route to obtaining and supplying this data would be required. The industry processes that will be put in place as part of the smart roll-out should enable PCWs to access half hourly data. The Data Communications Company (DCC), which will manage the communications from the meters to suppliers, will provide the capability to pull back full consumption data.
- 2.4 The PCWs will be required to sign up to The Smart Energy Code (which is still being drafted) and it is expected that they will then follow a security process to retrieve information direct from the customer's meter via the DCC.
- 2.5 We agree that PCWs should be able to access customer data at a later date to provide an updated view on the potential savings available, but only if a customer has specifically provided ongoing permission. This will facilitate ongoing engagement in the market.
- (b) Do customers need more or better information or guidance on how their smart meters will work?**
- 2.6 RWE npower believes that more information and targeted support will be needed but that suppliers and Smart Energy Great Britain (SEGB) are already taking the necessary steps for achieving this. It is fundamental to the success of the Smart Metering Implementation Programme (SMIP) that customers understand how their smart meters will work and how they can be used, once installed, in order that customers are able to benefit from the enhanced functionality that smart meters offer. However, careful consideration must be given as to the quantity, content, timing and optimum communication method for the provision of information or guidance. In short, there is not a 'one-size-fits-all' approach and engagement with a customer is required both before and after an installation visit in order to provide the correct and properly focussed information and guidance. To this end we have established a dedicated smart customer engagement work-stream that is actively involved in a number of smart consumer engagement activities in order to better understand our customers' requirements. There is a lot of information and guidance for suppliers to prepare in conjunction with SEGB; however RWE npower believes this is being effectively developed, with the needs of individual customers in mind, and therefore it is not necessary for the CMA to consider a further remedy in this area. Set out below is an overview of the steps that RWE npower is undertaking in this regard.
- 2.7 Externally RWE npower continues to support, inform and align itself with national messages via SEGB, external bodies and customer advocate groups. Internally we continue to develop our own 'customer journey' approach, informed by our own consumer research and 'on-site' installation activities that follow the industry approved code of practice (SMICoP), designed to give all customers a consistent, high quality installation experience. In line with this Code of Practice our installation site visit concludes with a full demonstration of the smart meter and display and the provision of some further supporting information. In addition, the SMICoP Code Governance Board are putting in place Customer Survey measures to actively seek feedback from customers regarding their smart meter installation, in order that further improvements can be made going forwards, based on learning.
- 2.8 The consumer awareness and confidence built from the SEGB national campaign will be further supported by complementary, focussed dedicated npower campaigns at a more local level with external bodies and consumer advocate groups. These are being designed to build on the core messages and relationships to take account of more specific consumer and local issues and requirements that may arise.
- 2.9 RWE npower has already implemented learnings from customer research. The research we have undertaken so far has resulted in improvements in the quality of information the customer receives prior to and during their installation visit, in addition to a shortening of

the engagement journey. For example, based on customer feedback, we combined two of our early communication letters in order to better suit customer preferences. Our communication approach has been refined and continues to be improved following comprehensive customer communications research undertaken this year into how best to engage and educate our customers about smart metering in the run up to installation. This programme of research has run for a period of around 8 months and included focus groups, interviews and online diaries to provide detailed responses.

- 2.10 RWE npower's own Customer Journey approach has been designed to provide a number of Customer Information and Guidance documents via a variety of channels to cover initial interest in smart metering, moving home and changing product. The customer can access the information that we have currently developed via dedicated pages online or by requesting the information over the phone.
- 2.11 RWE npower is currently looking to trial a number of small-scale, customer engagement approaches to determine their overall effectiveness. From March 2015 we have been collecting customer feedback on the entire installation journey based on a series of questions covering SMICoP, in order to determine overall CSAT and NPS scores. This feedback has been collected over the telephone and is also be available for customers to complete on the npower.com smart metering micro-site.
- 2.12 In addition to customer communications research, RWE npower is also commissioning research to determine our approach in a number of areas to ensure we deliver the best customer experience possible, and maximise customer engagement.
- 2.13 All of the above forms part of the ongoing development of our broader customer engagement strategy, which is continuing to evolve based upon our own research findings, learnings gained from the deployment of smart metering technology during the Foundation period (during which the technology was trialled and piloted) and our ongoing work with SEGB. Continual assessment and learning will be required throughout the SMIP to ensure that key information and guidance is always relevant and up-to-date.
- 2.14 Future areas of study will include:
 - 2.14.1 Understanding the reasons behind smart refusals so that RWE npower can adjust communication messaging to mitigate them;
 - 2.14.2 Research into how RWE npower should approach installing smart meters for customer groups with specific needs, so that we can ensure their needs are met; and
 - 2.14.3 Understanding what information is most important to the customer post their installation and the timeliness of this information.

F. REMEDY 4b

CMA remedy 4b – Removal of exemption for Centrica on two-year inspection of gas meters

1. Executive Summary

- 1.1 RWE npower considers that the current derogation arrangements distort competition and that, in the short-term, this remedy would be effective at removing that distortion. That said, RWE npower believes that it is necessary to await the outcome of Ofgem's current consultation into future state model options for a revised Metering Inspection Regime, before determining whether this remedy is warranted and proportionate.

2. Specific Questions

(a) *Would this remedy be effective in removing the distortion to competition that currently exists as a result of Centrica's derogation on the inspection of gas meters?*

- 2.1 The future state model under consultation is a risk based approach where the obligation is placed on the supplier to ensure that meters are inspected dependent on the individual customer risk (e.g. based on likelihood of tampering and safety). This approach would be subject to outcomes of the Ofgem consultation exercise, although RWE npower's view is that this approach must be underpinned by the principles of equivalence amongst all suppliers to ensure no distortion of competition ensues.

- 2.2 The reasons for the views in paragraph 1.1 are set out below and RWE npower's response is based on the assumption that any change to British Gas LC12 derogation will affect both gas and electricity metering inspection requirements. In this context, RWE notes:

2.2.1 A GL Industrial Services UK report no 8933 published on 23 July 2009, titled 'Risk assessment to support British Gas review of Supply Licence Condition 12 relating to Meter Inspections'; and

2.2.2 Ofgem consultation reference 167/12 published on 14 December 2012 titled 'British Gas's request for changes to its meter inspection licence obligations'.

- 2.3 Both the above mentioned documents have as their primary subject a change to the Standard Licence Condition 12 Meter Inspections and refer to both gas and electricity meters. It is known that British Gas⁴⁰ was granted derogation to SLC12 Meter Inspections for both gas and electricity metering.

- 2.4 Within DECC's impact assessment and benefits case for UK smart metering, a £2.8 billion benefit was identified in the context of the UK industry revising the current safety inspection regime and moving to an alternative model for both gas and electricity meters measured against a number of key features:

2.4.1 No material deterioration in safety outcomes for consumers (consumer protection) and the industry;

2.4.2 Ensuring accurate billing;

2.4.3 Promoting consumer engagement;

2.4.4 Greater insight and consumption data for suppliers to spot theft outcomes and tampering enabled by smart metering being realised; and

2.4.5 No distortion or adverse effect on the competitive market.

- 2.5 A working group hosted by DECC, attended by Ofgem and a wide range of industry stakeholders e.g. HSE, Gas Safe, Suppliers, DNOs, Meter Operators, has met on a number

⁴⁰ In this part of the response, references to British Gas and Centrica are interchangeable.

of occasions since November 2014. The Terms of Reference for this group were to examine, determine and define future state model options for a revised Metering Inspection Regime. RWE npower has actively participated in this group.

- 2.6 The group was clear that any 'future state' models that may be developed would need to align Gas and Electricity Metering requirements, supporting the traditional and smart enduring metering environments and the transitional period across both throughout smart metering roll-out.
- 2.7 The group's work was completed in June of this year with DECC providing an update to the programme management group responsible for implementation, the Smart Metering Steering Group (SMSG) during the same month. The next steps as we currently understand it are as follows: Ofgem will issue a consultation during July 2015 on the options developed by the DECC group, seeking industry feedback on these, whilst promoting other options and considerations from industry stakeholders, participants and interested parties. The timetable going forward is expected to be the following:
 - 2.7.1 Consultation closes 18 September 2015;
 - 2.7.2 Ofgem to issue a 'minded to' position in December 2015 for industry final response;
 - 2.7.3 Ofgem to present its conclusions in January 2016;
 - 2.7.4 Changes to Licence Conditions/Statutory Instrument to be enacted in April 2016.
- 2.8 Centrica's current derogation arrangements informed the group in the operation, outcomes, safeguards and impact (positive/and negative) on consumers and other parties. Under the current arrangements, Centrica is required to report to Ofgem against a number of metrics quarterly (not available to the group due to commercial/operational sensitivity), which will further help inform Ofgem on potential future models as part of the imminent consultation exercise.
- 2.9 RWE npower believes that the current derogation arrangements distort the market, insofar as suppliers represented at the DECC working group indicated a higher propensity to acquire customers from Centrica when the inspection status had lapsed beyond the two year period (albeit within the five year Centrica derogation). By placing such customers immediately into a non-compliant status within the new supplier's portfolio, this creates additional costs to the new supplier as a meter inspection has to be carried out to ensure compliance. This also has a detrimental impact on the customer experience, due to the requirement for an immediate inspection visit.
- 2.10 RWE npower believes the current DECC consultation and imminent Ofgem consultation should be followed through to completion. RWE's view is that the outcome should be one where all suppliers are operating in parity, without any competitive distortion or advantage. However, if the consultation were not to bring about such an outcome, then we believe that the removal of Centrica's exemption would be necessary to prevent ongoing distortion of competition.
- 2.11 RWE npower believes this could be achieved by (i) amending the current Licence Condition arrangement, with all parties moving to a similar and equivalent derogated position to that of Centrica or (ii) Ofgem repealing the Licence Condition in its entirety allowing Suppliers to operate an entirely risk based approach, with other non-associated Licence Conditions operating to ensure consumer safeguards are implemented and suppliers comply with their legal obligations. Our views on these options are set out in paragraphs 2.12 and 2.13 and, as noted above, this proposal is of course subject to the outcome of the consultation exercise, which we do not wish to pre-empt.

(b) *Would it be preferable to remove Centrica's derogation, or extend the derogation to other suppliers?*

- 2.12 RWE npower believes that, in order to address the distortion to competition described in paragraph 2.10, in the short term it would be preferable to extend the derogation to all suppliers.
- 2.13 Longer term, RWE npower believes that the industry should move to a risk based approach, whereby suppliers are obligated to ensure meters are inspected dependent on the level of individual customer risk (e.g. based on likelihood of tampering and safety). This approach would be subject to the outcomes of the Ofgem consultation exercise, although our view is that this approach must be underpinned by the principles of equivalence amongst all suppliers to ensure that no distortion of competition ensues.
- (c) *If Centrica's derogation were removed, should it be phased out over a period of time? If so, how long should Centrica be given in this respect?***
- 2.14 In this scenario, we consider that Centrica should be given a 3-6 month time frame, subject to sufficient supplier protection and safeguards such that Centrica ensures that every customer lost has a valid 2 year inspection in place prior to the new supplier taking over ownership as described in our answer to part (b) above.
- 2.15 With regard to the risk based approach under consultation, in this scenario RWE npower believes it would be appropriate to follow any implementation plan as set out by Ofgem.

G. REMEDY 5

CMA remedy 5 – Requirement that energy firms prioritise the roll-out of smart meters to domestic customers who currently have a prepayment meter

1. Specific Questions

(a) Would this remedy be effective in allowing prepayment customers to engage fully in the market and benefit from a wider range of tariffs? Would it be effective in reducing the costs of supply to prepayment customers?

1.1 Smart meters are an important enabler in helping customers to engage with their energy usage and they offer suppliers the opportunity to deliver innovative services to customers. RWE npower considers, however, that prioritising and successfully rolling-out smart meters to domestic customers who currently have a prepayment meter would not be practicable. This is due to current technical limitations in the communications infrastructure that have an impact on the functionality of smart meter technology and, where those limitations affect prepayment customers, those customers would face practical barriers to accessing the benefits of smart meter technology.

1.2 The communications infrastructure that is currently in place to support smart meter technology is the following:

1.2.1 Common to all smart meter types is the current Smart Metering Equipment Specifications (SMETS2) which mandates the use of Zigbee 2.4GHz protocol for the Home Area Network (HAN) and it is supplier's obligation to establish and maintain a secure HAN. However, there is a known gap in that the Zigbee 2.4GHz solution will only work in around 70% of properties. An alternative protocol using Zigbee 868MHz is required to serve the remaining properties;

1.2.2 The industry also requires a HAN solution for properties where the signal does not propagate e.g. blocks of flats as neither the 2.4GHz nor 868MHz solutions are guaranteed to work in these situations for a variety of technical and environmental reasons. DECC has recently consulted on the proposed regulatory arrangements to deliver a HAN solution and the decision is expected in 2015. Given that it will take time to establish the mechanisms in industry to support an alternative HAN infrastructure, a solution on this is also not expected until 2017. Early indications show that these additional solutions could be used for around 5% of our portfolio; and

1.2.3 The Data Communications Company (DCC), which will manage the communications from the meter to suppliers, will not have full communications coverage at the start of mass roll-out and, for some areas of the country may never achieve full coverage. The most appropriate way to keep the customer on supply in these circumstances would be via traditional meter, whether credit or prepayment.

1.3 Technical constraints in the current communications infrastructure arise because the current WAN and HAN communications solution does not work for approximately 30% of properties. Customers in these properties that have a smart meter installed will, as a result, be unable to access full smart functionality. Whilst a solution to address these technical infrastructure issues is currently under development, guidance from DECC suggests that this will not be available until Q3 2017 at the earliest.

1.4 Whilst this is an issue that impacts all customers living in affected properties, the impact on customers on a prepayment product or tariff is acute as they would face the following difficulties:

1.4.1 In order to top up, these customers would have to use a manual workaround, which would involve keying in a 20-digit Unique Transaction Reference Number (UTRN). This is designed as a backstop functionality to maintain supply in an

emergency only and was not intended to be used by the customer for the purposes of the day-to-day management of credit on the meter;

- 1.4.2 Any change in metering information, for example supplier, change of tenancy or change in tariff, would require a site visit from their supplier. This would have cost implications for suppliers; and
- 1.4.3 The loss of smart functionality would prevent any meter reading information being passed to suppliers, resulting in inaccurate statements.
- 1.5 Prepayment customers who are affected by these technical communication issues will, therefore, face significant practical difficulties with using their smart meters and, as a consequence, are likely to have a very poor customer experience. Rather than facilitating engagement, the accelerated roll-out of smart technology before these technical issues are overcome would, in RWE npower's view, create barriers to engagement for prepayment customers. RWE npower considers, therefore, that an accelerated roll-out to domestic customers having a prepayment meter will not be an effective and comprehensive means of facilitating engagement amongst this customer group.
- 1.6 RWE npower is taking a measured and cost effective approach to delivering its smart meter obligations. RWE npower has evaluated possible delivery strategies to find the most efficient roll-out plan at the lowest cost and believes that, for our customer portfolio, the most cost effective approach to the smart roll-out, that will benefit all customers, is a density led approach, whereby a supplier can roll-out smart meters to all willing customers in that area. This approach effectively ensures that smart meters are installed regardless of customer grouping or meter type in a manner that is designed to minimise the cost to suppliers and customers. It should be noted that all meters being replaced are traditional meters – either credit or prepayment. This is the RWE npower approach and will include prepayment customers from the start of mass roll-out, subject to the technical constraints that are discussed above.
- 1.7 Our view is that targeting particular customer groups for early roll-out drives inefficiency into the process and therefore additional cost into the overall deployment, which will ultimately impact all customers, including prepayment customers.
- 1.8 RWE npower believes, therefore, that prioritising roll-out to prepayment customers is not the most effective or least onerous way of addressing the potential concerns identified by the CMA. We would propose that measures, such as a wider choice of payment options (for example the ability to top up online), as well as the ability to offer a wider range of tariffs as a result of the CMA's proposed remedy 3, will be more effective at increasing choice and driving engagement of prepayment customers at a lower cost to suppliers. The limit on tariff numbers and restrictions on cash back and non-cash offers is arguably the key barrier to PPM customer choice and relaxing the RMR 'simpler choices' rule would enable suppliers to offer different products to prepayment customers, stimulating engagement. We agree that smart meters will further enhance the choice, but the ability to offer more tariffs is clearly the preliminary step and we believe will be sufficient in itself to stimulate greater competition in the prepayment meter segment.

(b) Which version of this remedy would be more effective and/or proportionate?

- 1.9 RWE does not consider either of these options would be effective or proportionate. The prioritisation of prepayment customers over other customer groups will increase deployment costs and increase inefficiency in the roll-out of smart meters, as set out above. The roll-out period has already been significantly reduced from 8 years in the original Prospectus to less than 5 years as a consequence of Government and DCC delays. Suppliers must be left to manage the roll-out in the most cost effective way, to the benefit of all customers regardless of meter type.
- 1.10 It should also be noted that the only aspect of the Smart Metering Implementation Programme that suppliers control is the cost effectiveness of their own deployment plans.
- 1.11 In addition, as this is a new technology and it is being installed on a new infrastructure, the early deployment of such a technology in its infancy into premises where some customers

will be vulnerable may give rise to some unique challenges in terms of customer understanding and engagement.

(c) *Would any additional or alternative measures be required to ensure that this remedy comprehensively addressed the overarching feature of weak customer response arising in particular from those with prepayment meters?*

1.12 RWE npower does not consider that additional or alternative measures are required.

1.13 We acknowledge that the installation of a smart meter gives customers the means to engage more actively in the market. However, suppliers will also need time to develop a better understanding of how the prepayment group will engage with smart meters and this can only be gained through practical experience. This is another benefit to the demand led roll-out plan, namely problems can be identified early among small groups of differentiated customers and resolutions and best practice developed in time for the roll-out to other similar customers. For example, Smart Energy GB is working with suppliers to develop the necessary communications for customers, including those tailored for smart prepayment customers.

1.14 If suppliers are required to accelerate the installation of smart prepayment meters (although, as stated above, we do not consider that this remedy would be the most effective or least onerous way of encouraging engagement on the part of prepayment customer) consideration will need to be given to the pace of the roll-out to ensure that any unforeseen issues are able to be managed appropriately for the customer.

(d) *What issues may arise as a result of prioritising the installation of smart meters in the homes of customers who currently have prepayment meters?*

1.15 Under our demand led roll-out plan, if we are aware of technical difficulties as a result of the WAN and HAN coverage issues, then customers affected by these will not be considered to have smart meters installed until a solution is available (currently expected in Q3 2017).

1.16 The issues that would result as a consequence of installing smart meters in the homes of customers with prepayment meters which are affected by the key technical issues concerning the provision of WAN and HAN coverage, before a solution is available, are described in paragraph 1.4 above.

(e) *Would it be more effective and/or proportionate to require energy suppliers to accelerate the roll-out of smart meters across the retail markets as a whole, in order to facilitate engagement more broadly, rather than focusing on customers on prepayment meters?*

1.17 RWE npower does not believe it would be effective or proportionate to accelerate the roll-out of smart meters across retail markets as a whole. The roll-out of smart meters is a major national programme: one of the largest and most complex investment programmes undertaken by the energy industry. The programme aims to roll-out 53 million smart electricity and gas meters to all domestic properties and smart or advanced meters to smaller non-domestic sites in Great Britain by the end of 2020, impacting approximately 30 million premises. The roll-out is expected to cost the industry £11.1 billion over the next 5 years.

1.18 As things currently stand, the industry is faced with the challenging task of installing 53 million smart meters in approximately 30 million premises within a 4 to 4.5 year timeframe. This is a significantly shorter implementation timescale than originally planned when the programme was first initiated. This requirement means that at its peak 13 million meters will need to be installed a year, equating to around 60,000 meter installations nationally per day. This will require the services of over 7,000 meter installers, all of whom must be appropriately trained and accredited.

1.19 Bearing the above in mind, and taking safety and the customer experience into consideration, we do not believe that there is any capacity to accelerate the roll-out of smart meters across the retail market as a whole. Indeed, the industry has been in

discussion with DECC and Ofgem for some time regarding the need to extend the current deadline date from 2020, in recognition of the fact that the DCC Live date has been pushed back by a number of years.

- 1.20 Overall consideration must be given to the fact that the original roll-out period was due to start in Q3 of 2013, covering eight years. However, due to Government delays this roll-out time available to suppliers has now halved. RWE npower does not therefore believe that it is either desirable or practical to try to accelerate this Programme any further. Speeding up the process runs the risk (as set out above) that suppliers do not have time to properly explore, understand and address any teething issues with roll-out as they arise, resulting in poor outcomes for consumers in the short-term until these can be resolved.
- 1.21 We do not therefore believe that this would be the most efficient or cost-effective way to address any concerns about engagement that the CMA may have. As noted above, RWE npower believes that removing the four-tariff rule component of RMR, thereby enabling suppliers to offer a range of differentiated products, including those which will meet the needs of customers with prepayment meters, would be an effective and proportionate means of addressing any such concerns.

H. REMEDY 6

CMA remedy 6 – Ofgem to provide an independent price comparison service for domestic (and microbusiness) customers

DOMESTIC RESPONSE

1. Executive Summary

- 1.1 RWE npower believes that price comparison websites (PCWs) play an important role in helping domestic customers to make informed decisions about switching energy supplier. As discussed in RWE npower's response to the Price Comparison Websites Working Paper, if trust is to be rebuilt in the functioning of the energy market as a whole, PCWs need to play their part, and to ensure that they are transparent in all their dealings with consumers.
- 1.2 RWE believes that well-functioning PCWs, alongside the removal of the RMR four-tariff rule, will stimulate competition both in terms of price and product innovation within the domestic retail energy market. RWE believes that the CMA has so far underestimated the extent to which a package of remedies which builds trust in PCWs and encourages innovation amongst suppliers will fully address the weak customer response AEC the CMA has provisionally found.
- 1.3 RWE npower considers that PCWs already play a positive role in the energy market, lowering barriers to search and switching and promoting price competition between suppliers. However, RWE npower recognises that there may be scope for them to have an even greater impact.
- 1.4 RWE supports a proposal for Ofgem, or another independent body able to facilitate an increase in consumer trust in PCWs (such as the Citizen's Advice Bureau), to provide an information service in the form of an independent PCW that displays all tariffs on the market. This is provided that: the independent PCW acts only as an information site and customers are not able to transact through the site; and that commercial PCWs are able to offer exclusive tariffs (see further RWE's response to remedy 3). An independent PCW operating in these circumstances will provide a backstop to consumers helping to build trust in the market, without dampening incentives for commercial PCWs to compete to develop better offers to consumers.
- 1.5 RWE npower believes that an independent PCW could provide a 'whole of market' view, particularly since remedy 3 proposes to remove the restriction on PCWs to show the 'whole of market' view. Customers should be able to search and obtain information on features in addition to price such as term length, payment method, early exit fee versus no early exit fee, or energy efficiency, to enable them to make informed decisions and increase their understanding of energy costs in order to reduce their consumption. The independent PCW service should not be transactional as the potential loss of sales and commission payments would undermine commercial PCWs' incentives to compete for exclusive deals from domestic energy suppliers in the first instance, meaning consumers may miss out on cheaper prices.

2. Specific Questions

(a) Would this remedy be effective in increasing customers' trust in PCWs and thereby encourage engagement in the markets and switching?

- 2.1 RWE npower agrees that a domestic price comparison service operated independently from PCWs by Ofgem (or another independent body, as discussed above) could potentially have higher levels of consumer trust than those services operated by existing PCWs. This is supported by the CMA's survey where seven in ten (70%) are confident about "using the internet to search for information about suppliers of different products or services in

general” but considerably fewer (55%) are confident that they could “get the right deal for your energy supply using a price comparison website”.⁴¹

- 2.2 If properly supported and advertised a site which provides customers with an independent and comprehensive view of the market should give customers the confidence to engage with both PCWs and suppliers.

(b) *Should this service be online-only, or should it also operate over the telephone for those customers without access to the internet?*

- 2.3 RWE npower understands (from anecdotal evidence through RWE’s broker channel) that approximately 40% of consumers who switch their energy supply through a PCW do so via their telesales channels. RWE npower believes that consumers who choose to use this service, as opposed to switching online, are more likely to be confused with the switching process, or may have limited access to the internet. PCWs and TPIs provide online and telesales services giving customers a choice of channel and any independent PCW service should replicate this. RWE npower does however recognise that it would be difficult for a telephone service to provide details on every tariff and offer available in the market i.e. the ‘whole of market’ view and therefore envisages any independent PCW telephone service would be an advice line, taking a similar role to the Money Advice Service within the Finance market.

(c) *Is there a risk that such an independent service could undermine the development of other PCWs in the energy sector? How could this risk be mitigated?*

- 2.4 An independent PCW service that allows consumers to switch could potentially undermine the development of existing PCWs as the PCWs would transact less commission as a result of losing sales as consumers use the independent PCW to switch. This would decrease the incentive for PCWs to compete to negotiate better/exclusive deals from suppliers in the first place leading to reduced price competition. Allowing the independent PCW to implement a switch could therefore distort competition both by putting the independent PCW at a competitive advantage and by reducing commercial PCWs’ incentives to compete in this way.

- 2.5 If the independent PCW were to enable switching, RWE npower is unclear what would happen to the commission in this instance. It also feels that, if Ofgem provided the independent PCW, it could be a conflict of interest to allow Ofgem to continue to manage the Confidence Code, whilst also operating as a participant within this market. It is important that a level playing field is maintained between all market participants, and therefore the Ofgem site would need to identify to consumers where they could obtain a better deal from using another PCW or supplier.

- 2.6 If the independent PCW service provided a ‘whole of market’ view it could encourage the existing PCWs to display more than prices by providing information on other tariff features, RWE believes this would lead to increased and wider customer engagement. As set out in RWE npower’s response to the CMA’s PFs, RWE npower is strongly of the view that consumers care about more than just price and it considers that the ability to search easily across multiple tariff dimensions will encourage some customers to engage, as well as making it easier for customers to find the right tariff for them (improving effective search).

(d) *Should the Ofgem website quote the energy suppliers’ list prices only? Or should it seek to provide full details of all quotes available on the market (including on other PCWs), ie function as a meta-PCW?*

- 2.7 As discussed above, RWE npower believes the Ofgem website (or other independent PCW) should provide an information only service which presents a ‘whole of market’ view, providing quotes on all available tariffs and offers in the market. If the independent PCW did not present a particular tariff or offer that was only available through another PCW,

⁴¹ GfK Survey – page 3 paragraph 17.

then this would seriously undermine the consumer trust in the site and the usefulness of the service to consumers.

(e) How could we ensure that an Ofgem price comparison service was robust in terms of offering all tariffs available on the market? Should there be an obligation on retail energy suppliers and/or PCWs to provide information to Ofgem on their tariffs?

2.8 For the Ofgem (or other independent PCW) service to display a 'whole of market' view RWE npower believes there should be an industry-wide obligation for all suppliers and PCWs to inform Ofgem/the independent PCW of tariffs and offers available on the market.

(f) Should any price comparison service operated by Ofgem be transactional, ie be able to carry out switches for consumers, or should it provide information only?

2.9 As discussed in paragraphs 1.4 and 2.4 RWE npower believes the Ofgem (or other independent PCW) service should be an information only service providing a 'whole of market' view not transactional.

2.10 From a consumer perspective, RWE npower can understand the benefit of the Ofgem/independent PCW service being transactional, however an unintended consequence of this could be a reduction in switching volumes via existing PCWs, which undermines competition between PCWs to negotiate better offers for customers.

(g) What would be the likely costs to Ofgem of offering this type of price comparison service? Would Ofgem need additional funding and/or statutory powers in order to provide this type of service? If so, where should this funding come from?

2.11 RWE npower considers that it is difficult from a supplier perspective to comment on PCW costs, but considers the costs can be split into two categories. First, there are costs of developing, operating and maintaining a tariff calculator. However, this could be provided via association with one of the capability vendors already working with the PCWs. Secondly, there are costs involved with the promotion and advertising of the service. In relation to the latter, RWE npower considers this to be a highly competitive marketplace, with high levels of spend from PCWs in relation to marketing and would see that an independent PCW may need a similar level of spending in order to promote its service. However, some of these costs could be offset by all suppliers being obligated to promote the independent service in their customer communications.

2.12 Ofgem (or other body providing the independent PCW service) would require additional funding to operate a price comparison service. RWE npower has reservations around whether suppliers should incur these costs (and the implications of this), and how this would be managed.

2.13 The issue of funding represents a significant risk to the proposed remedy, as the service would require investment in order to have a prominent role in the market.

(h) How should customers be made aware of the existence of this service? Should information be provided by energy suppliers on bills/during telephone calls? Should PCWs be required to provide links to the Ofgem website during the search process to allow customers to cross-check prices?

2.14 As referred to above, the independent PCW service would need a level of external promotion and advertising to inform consumers of the service.

2.15 However, there are opportunities to promote this service within communications provided by all domestic energy suppliers to customers. On the understanding that the independent PCW provides information and advice only and does not allow consumers to transact, RWE believes suppliers could provide a link to the site from their own website and/or include details in the bill messages they send to consumers.

(i) *Is there any additional information that Ofgem should provide on its website relating to energy suppliers and/or tariffs to facilitate the customer search and switching process?*

2.16 Ofgem needs to provide simple, clear messaging that encourages and facilitates the switching process by directing consumers to supplier and PCW sites. As discussed in paragraph 1.5 RWE npower believes that the independent price comparison service should provide a 'whole of the market' view, enabling customers to search and obtain information on features other than price such as term length, payment method, early exit fee versus no early exit fee, or energy efficiency to enable them to make informed decisions and increase understanding of energy costs in order to reduce their consumption. As discussed in RWE npower's response to remedy 3 the independent PCW service should focus on more than purely price and provide comparisons of a full range of features.

CMA remedy 6 – Ofgem to provide an independent price comparison service for domestic (and microbusiness) customers

SME RESPONSE

3. General Comments

- 3.1 RWE supports the CMA's aim of improving the way in which microbusiness customers⁴² engage with the market, specifically, RWE supports the aim of making the engagement process easier and more transparent.
- 3.2 We acknowledge that some microbusiness customers would welcome the introduction of PCWs into business energy markets. Our view is that the complexity and diversity of factors that will affect price or appropriateness of products to microbusiness customers is a reality that any solution must address.
- 3.3 We consider, in particular, that the diverse nature of business energy markets means that:
- 3.3.1 A PCW that covers all products and all microbusiness customers (and potentially doesn't allow for further negotiation) is, in our view, fundamentally unworkable because of the complexity of customer requirements and meter types and would be undesirable, because it would require a level of product simplification which will result in a loss of significant consumer benefits from the negotiated model (and goes against the CMA's stated aims of promoting product innovation and SMART); and
- 3.3.2 A 'benchmark' PCW comprising a small number of simple tariffs, open to all customers, would in principle be workable, but would not necessarily offer good value for certain customers, for example, for low risk customers. Furthermore, a potentially large proportion of customers who would qualify as a microbusiness under the current Ofgem definition would not be able to buy a product at this price, because adjustments would need to be made to meet their requirements. Even then, if it is to provide prices that most customers with simple requirements can rely on, those prices will inevitably be higher than the prices that might otherwise be available through negotiation, since suppliers will need to make conservative assumptions about customers' requirements, credit risk etc. However at this point these customers may be directed to TPIs or direct to suppliers and therefore the site would still provide them with a useful benchmark to start negotiations.
- 3.4 In short, even if a 'benchmark' PCW were to be introduced, there would still be a need for other products and other channels to market.
- 3.5 This is partly because PCWs, by their very nature, are 'pull channels'; that is, they provide information to those customers who are already researching the market to help them make informed decisions. In contrast, telesales, brokers & TPIs are 'push channels' and reach out to customers who are not active but are open to competitive offers. For example, expert broker/consultants are well placed to advise customers taking full account of their circumstances, the full range of products available and the implications of differences in product features and benefits, terms & conditions⁴³.
- 3.6 The CMA has rightly recognised that the current business energy market is characterised by negotiated deals and we believe that negotiation is a necessary and beneficial feature of the market for many business customers, enabling them to find and agree supply contracts and services that are tailored to their specific needs at lower prices. RWE's

⁴² RWE notes that some of its I&C customers currently fall within the CMA's broad definition of "microbusiness".

⁴³ For those using TPIs, the level of advice and guidance provided will vary. We consider, therefore, that greater governance and transparency of TPIs would be of benefit to those customers wishing to use a TPI for contract negotiation (see our response to remedy 7b below).

experience is that many customers can and do negotiate contracts that are below cost for suppliers at acquisition and renewal.

- 3.7 Anecdotal feedback from a number of brokers who have piloted PCWs for business customers is that they experienced customers researching prices online, but that sales transacted using a PCW were less common, as customers preferred to use the information to support their negotiations with energy suppliers. In this regard, we note the CMA's comments in Appendix 9.1 to the PFs that where PCWs for business customers exist, visitor to sale conversion rates tend to be low because business customers must provide a range of information in order to obtain an accurate quote and, for this reason, more customers successfully engage in switching when speaking to a sales agent.
- 3.8 We consider that it is important, therefore, that customers have the choice of using PCWs and/or agreeing deals directly with energy suppliers, or indirectly through other third parties if they so wish.
- 3.9 To support our views on the practicability and efficacy of the proposed remedy, we have listed below examples of the factors that a price comparison site (covering the whole of the market) would need to capture to reflect the complexity of the current and future microbusiness and broader business market, which is characterised by a heterogeneous customer base with varied circumstances and diverse requirements.
- 3.10 The current range of customer factors that would need to be accommodated by a PCW looking to cover all products and all microbusiness customers includes:
 - 3.10.1 The different status between sole trader, partnership and limited company, which is a critical element of assessing the business risk;
 - 3.10.2 When the customer wishes the contract to start. Customers' preferences regarding when they wish to start to shop around prior to their contract end dates can vary widely. It is now common for some customers to agree new deals up to six months before contract end, whilst others seek an immediate start. That means the prices displayed must be able to handle a variety of contract start dates into the future;
 - 3.10.3 Business customer firmographic e.g. business type, consumption, address/GSP/number of sites;
 - 3.10.4 Customer need and preference with respect to channel, product features and benefits sought e.g. fixed price, variable price, tracker product, level of standing charge, additional services sought e.g. bill frequency, energy management advice;
 - 3.10.5 Complexity of metering arrangements currently used by the customer or sought by them e.g. commercial AMR/Advanced metering that they may already have that may not be inter-operable, traditional metering or SMETS compliant true SMART meter. In some instances separate MOP metering arrangements;
 - 3.10.6 The credit rating of the customer's business.
- 3.11 In addition, the PCW would have to factor in a range of price/product factors, including:
 - 3.11.1 Credit features/terms if required for higher risk customers e.g. price premium, security deposit, compulsory direct debit;
 - 3.11.2 Wholesale, transmission and distribution costs changing over time and hedge/risk costs varying with contract term and start date so prices would vary frequently (currently daily);
 - 3.11.3 The range of suppliers' products, features, benefits, added services plus any discounts for dual fuel, payment method or other services;

- 3.11.4 Differences in terms and conditions between suppliers and products e.g. notice arrangements including whether the customer would be rolled onto a fixed term contract or moved onto a flexible product;
- 3.11.5 Whether the comparison is on the basis of fully inclusive 'fixed is fixed' or whether some cost changes are passed through e.g. FiT, EMR or other charges;
- 3.11.6 Whether the price displayed is a 'firm' offer and capable of being accepted/sold, or subject to further conditions/exclusion;
- 3.11.7 Whether the price can be negotiated further.
- 3.12 In the future, customers will also need to provide additional information such as access to their HH interval data on consumption, which are things we would talk through with a customer on a negotiated price product. PCWs would need to set up access permissions to obtain HH interval data.
- 3.13 In summary, while we support the aim of improving how microbusiness engage with the market, we consider that PCWs in general, including an Ofgem run or sponsored independent comparison service, are only likely to be practicable for a subset of business customers having straightforward requirements, for example single sites with simple metering, those that have consumption that is similar to that of domestic customers and those who are willing to accept the limitations in features and benefits inherent in a comparison of simple products. In addition, we note that products of this nature may need to be created by suppliers specifically for this purpose, for example, a fixed rate product of one, two or three years duration with a start date in the next week. Even for this product, suppliers may need to vary the price materially more often than is currently the case in the domestic market (possibly daily or weekly).
- 3.14 RWE is, therefore, strongly of the view that the only model that would be practicable and that would enable customers to make a meaningful comparison between products would be a 'benchmark' PCW model as outlined above, which would exist in parallel with the negotiated pricing model. Preserving the ability of customers to access the negotiated pricing model, and the ability of suppliers to provide products that customers demand, would maintain the existing benefits customers derived from the opportunity for customers (in particular those with lower risk profiles) to obtain better deals by negotiating directly with suppliers or through TPIS.
- 3.15 Additionally, we believe that if the CMA were to continue to find that competition is not working well for microbusinesses, which we strongly argue is not the case, then we do not believe that a whole market PCW would necessarily be the most effective or least onerous way of addressing these concerns. In addition, as we consider that the implementation of a whole of market independent price comparison service would result in the unintended consequence of a loss of the customer benefits arising from the negotiated pricing model.
- 3.16 We now provide our comments on the specific questions posed by the CMA.

4. **Specific Questions**

(a) *Would this remedy be effective in increasing customers' trust in PCWs and thereby encourage engagement in the markets and switching?*

- 4.1 We consider that the provision of a 'benchmark' independent price comparison service for the subset of microbusiness customers that have straightforward requirements akin to those in the domestic market, as outlined above, could, in principle, assist with building trust in PCWs, given that PCWs in financial services and domestic energy have been challenged recently with regard to the clarity and fairness of their comparisons.
- 4.2 We believe that such a remedy would be more likely to be effective in increasing customers' trust, thereby encouraging engagement and switching, if suppliers were to use a standard template when providing information for these purposes to Ofgem. This would ensure that

Ofgem would process 'equivalent' information when providing the service, which should allow easier comparison of products and prices.

(b) *Should this service be online-only, or should it also operate over the telephone for those customers without access to the internet?*

4.3 RWE considers that a benchmark independent price comparison service could, in principle, be provided online and by telephone.

4.4 If it is provided by telephone, we consider that the service might evolve to be able to adapt to differences in the customers' attributes that we listed earlier, such as why a customer's metering arrangements mean some products are not open to them, or how best to get a deal given their credit rating, but this would risk the service being characterised as 'advice' and would in effect be offering the same service currently provided by TPIs. We do not believe that provision of 'advice' in the FCA sense, is the role of Ofgem and do not think Ofgem should be recommending one supplier or product over another.

(c) *Is there a risk that such an independent service could undermine the development of other PCWs in the energy sector? How could this risk be mitigated?*

4.5 We consider that a benchmark independent price comparison service, in the form described above, should complement other channels to market, such as commercial PCWs that may be developed, direct negotiation with suppliers and TPIs.

4.6 It is however unclear to RWE whether PCWs would enter the market for microbusiness customers, regardless of this proposed remedy, given the complexities discussed above and the low conversion rates. In addition, if this remedy were to be implemented, the existence of a publically funded site which they may not be able to beat, would limit incentives for commercial PCWs further. As noted in our response to (f), our view is that a benchmark service of this nature should not be transactional, as this would seriously undermining the development of any other PCWs in the energy sector.

(d) *Should the Ofgem website quote the energy suppliers' list prices only? Or should it seek to provide full details of all quotes available on the market (including on other PCWs), i.e. function as a meta-PCW?*

4.7 As described above, we consider that only a subset of products for microbusiness customers could conceivably be offered or compared through a 'benchmark' PCW. For this limited set of products, RWE considers that a product feature 'wizard' tool, or tabular comparison of product features and benefits, would help customers understand their options. Even a subset of simple products could vary from supplier to supplier and between products, so it may be necessary for a 'benchmark' PCW to require products to comply with a set of standard features to enable uploading, display and comparison.

(e) *How could we ensure that an Ofgem price comparison service was robust in terms of offering all tariffs available on the market? Should there be an obligation on retail energy suppliers and/or PCWs to provide information to Ofgem on their tariffs?*

4.8 As set out above, RWE considers it to be fundamentally unworkable for an Ofgem run or sponsored PCW to provide a whole market view. For a 'benchmark' PCW to operate, RWE considers that it would be necessary to impose an obligation on retail energy suppliers to provide Ofgem with information on the subset of products that would, in principle, be capable of comparison on an independent service of this nature.

4.9 As noted above, RWE considers that it is important that customers continue to have the choice of using other channels to market (e.g. other PCWs or TPIs) or negotiating direct with a retail energy supplier. Information on products that are subject to negotiation, and thereby take account of specific customer circumstances, could not by its very nature be provided to Ofgem for inclusion on an independent price comparison service.

(f) Should any price comparison service operated by Ofgem be transactional, i.e. be able to carry out switches for consumers, or should it provide information only?

4.10 As set out in more detail in the response to remedy 6 for the domestic market, we do not believe that any price comparison service operated by Ofgem should be transactional, as a service of this nature would challenge the role of commercial PCWs and risks undermining customer engagement that those PCWs may bring about.

(g) What would be the likely costs to Ofgem of offering this type of price comparison service? Would Ofgem need additional funding and/or statutory powers in order to provide this type of service? If so, where should this funding come from?

4.11 We do not have information about the likely costs that Ofgem may incur by offering this type of price comparison service. However, it seems clear to us that any such costs would ultimately be passed back to customers.

4.12 We do not know whether Ofgem would require additional statutory powers in order to provide this type of service.

(h) How should customers be made aware of the existence of this service? Should information be provided by energy suppliers on bills or during telephone calls? Should PCWs be required to provide links to the Ofgem website during the search process to allow customers to crosscheck prices?

4.13 If such a service were to exist, then energy suppliers and intermediaries, such as TPIs and PCWs, could be required to promote it, for example in renewal letters and other communications (e.g. telephone calls) or on their website. Our view is that bills already contain a lot of information and the benchmark service would be less relevant mid contract if a customer is not free to re-contract. Accordingly, we do not consider that this would be the most effective means of making customers aware of this service.

(i) Is there any additional information that Ofgem should provide on its website relating to energy suppliers and/or tariffs to facilitate the customer search and switching process?

4.14 We consider that Ofgem could provide a guide to energy buying, which could list accredited TPIs, if TPIs were to be subject to regulation and such a list were to be created (see our response to remedy 7). That way, customers would be supported in the practical steps that they should take to find a deal that suits them. This arrangement would work in the current market and would allow customers to research the market and choose a deal with confidence, either directly or through an accredited intermediary acting on their behalf.

4.15 We believe there is a close parallel to the market in financial services in that some customers are happy to shop directly with suppliers and some prefer to be advised and supported when choosing products. RWE considers that the FCA approach of licensing providers and individuals who provide 'advice' would be of great benefit to customers in the microbusiness energy market.

I. REMEDY 7a

CMA remedy 7a – Introduction of a new requirement in the licences of retail energy suppliers to provide price lists for microbusinesses on their own websites and to make this information available to PCWs

1. Executive Summary

- 1.1 RWE understands why, in principle, the CMA considers that a remedy of this nature would have positive effects by increasing price transparency.
- 1.2 We are, however, concerned that there are a number of difficult hurdles that would, in practice, need to be overcome and which, in our view, are too great to make this remedy workable or proportionate, unless it is limited to a subset of simple products, in the same way as we have outlined in respect to remedy 6. In a negotiated market, prices vary from customer to customer, from day to day, are dependent on start date and all of the factors that are listed in our response to remedy 6 (which we do not repeat here). In particular the following points need to be considered:
 - 1.2.1 Should all price lists or only price lists for a subset of simple products be provided? Our view is that only the latter would be practicable;
 - 1.2.2 Would negotiation be possible on these prices? If suppliers are required to set prices that anyone can take, they will be concerned to set those prices at levels which protect, insofar as is possible, against the risks that those prices prove to be too low (for example, because of the possibility of default/non-payment etc) which suppliers would be better placed to manage in the context of the negotiated model. Our view, therefore, is that it would be important to retain the negotiated model;
 - 1.2.3 Would all the prices listed be available to all customers? Our view is that only customers with straightforward requirements (e.g. single sites, consumption similar to domestic, etc) would be able to transact on these prices, so listed prices would not be available to everyone; and
 - 1.2.4 Are they immediately transactable? That is, can the customer buy at that price or are those prices subject to further checks and possible adjustment (or even withdrawal)? Our view is that in most cases they would not be transactable for the reasons set out in paragraph 1.2.3 above.
- 1.3 Even if such difficulties can be overcome, the differences in products and approach to terms and conditions and pricing between suppliers will still require many customers to have a good general knowledge of energy buying to be able to properly compare offerings between suppliers and fully understand the potential consequences of differences in pass through, roll-over, and tariff structure (and possible penalty arrangements for shaped demand side products).
- 1.4 In summary, we believe that to be practicable, this remedy should permit us to offer any product that customers demand and should not limit us to those products in respect of which a price list is made available. Absent this freedom, we consider that there would be material adverse implications for product differentiation and innovation, to the detriment of those consumers who currently negotiate, as well as a negative impact on the CMA's aim of strengthening momentum towards HH settlement and demand side products, which do not easily lend themselves to static price lists or traditional comparison sites.

2. General Questions

- (a) ***Would this remedy be effective in increasing price transparency for microbusiness gas and electricity tariffs?***
Would it serve to make comparisons between different suppliers easier, either directly or by encouraging the development of PCW services for microbusinesses?

If not, are there other measures that would encourage this development either as an alternative to this remedy or in conjunction with it?

- 2.1 We consider that this remedy is most likely to be effective in increasing price transparency if it were to apply to a specific set of simple products (as discussed in more detail in the context of remedy 6) which could be readily compared by consumers.
- 2.2 However, as many customers in our view are likely to be better served by products more closely adapted to their needs and negotiated directly with a retail energy supplier or through a TPI, we consider that a more effective remedy would be to require retail energy suppliers to provide clear product descriptions of all available products, with information on features and benefits, terms and conditions and even who the product may benefit on their websites. This could be accompanied by information on how to obtain a tailored quote, which could be fulfilled in a number of ways:
 - 2.2.1 By calling the supplier;
 - 2.2.2 Via a TPI where appropriate;
 - 2.2.3 Possibly on-line for some simple products.
- 2.3 As TPIs currently play an important role in increasing transparency and engagement in the market through push channels (as described in our response to remedy 6), we would also consider that the direct regulation of TPIs would be more effective and proportionate way of increasing customer engagement in the energy market, as described in our response to remedy 7b below.

(b) Do microbusinesses have sufficient access to the information they need (for example on their meter types) in order to engage effectively in the search and switching process?

- 2.4 Microbusinesses will have access to basic information such as contract end date, meter number and other relevant data on their bills, statements and renewal letters, which will be sufficient to begin the process of seeking a quote from a TPI or direct from an energy supplier. However, customer specific information will also be pertinent for the quotation process that we would not be able to provide for obvious reasons (e.g. their credit rating, number of sites, address(es), sic code, product requirements, etc). The sales person should have the knowledge and skill to understand the customer's business, preferences and circumstances and offer appropriate products as required.
- 2.5 Some microbusinesses or SMEs may not have access to consumption information e.g. new starters or movers, or if they do not have recent bills available, although in some instances this could be provided by suppliers in a range of formats such as annual consumption, or consumption profile data where that exists.
- 2.6 Following the introduction of modification P322 (which superseded P272) customers who have PC5-8 meters will be settled half-hourly from 5 November 2015 and will start to build interval data that will be needed as they re-contract in future.

(c) How long should energy suppliers be given to provide the required information?

- 2.7 RWE has interpreted the reference to 'required information' to mean the price lists for microbusinesses that, pursuant to this remedy, suppliers would be required to publish on their websites and provide to PCWs. On the assumption that retail energy suppliers would be required to provide price lists on their websites for a subset of simple products for microbusiness customers (as described in the response to remedy 6), RWE estimates that at least a year would be required in order to confirm the features, benefits, terms and conditions of these products. This was the time required to design and implement the changes needed for the end of roll-over contracts and RWE feels is a reasonable guide to the time it will take to create an appropriate set of simple products, test these on the market and incorporate feedback before providing the required information on websites, and potentially to PCWs. Once the products are established, the time to update prices or change

product attributes for future releases would be similar to that currently found in the domestic market, although as noted above we would expect prices to change much more frequently than they do in the domestic market.

- 2.8 As noted above, we believe that a remedy which applies to a retail energy supplier's full range of products for microbusiness customers would not be workable. In particular, most products currently sold are subject to a commercial negotiation and therefore the publication of price lists is not practicable. A remedy which would extend to a full range of products would require a significant change to our business model which would take a considerable amount of time and cost to implement and would remove the many benefits to customers of the current negotiated pricing model. For example, this would entail replacing all our current products, implementing a new wholesale hedge approach, as well as most likely requiring new CRM and billing systems.

(d) *Should energy suppliers be permitted to fulfil this requirement by providing an automated quoting service on their websites (where microbusinesses can put in their details in order to obtain quotes) rather than a list of prices?*

- 2.9 RWE agrees that energy suppliers should be permitted, in principle, to fulfil this requirement by providing an automated quoting service on their websites, as this may reduce perceived search barriers for some customers. That said, we believe that an automated quoting service is again only likely to be practicable for a limited subset of simple products and prices only. We consider it necessary, therefore, that to the extent that this remedy is considered further, this remedy will also allow for suppliers to continue to offer any product that a customer demands, either via a direct negotiation or indirectly (e.g. via a PCW or a TPI).

J. REMEDY 7b

CMA remedy 7b – Introduction of rules governing the information that TPIs are required to provide to microbusiness customers

1. Executive Summary

- 1.1 We consider that TPIs play an important role in the business energy market. TPIs advise customers on a range of offers, taking into account the customer's attributes and product features (described in more detail in the response to remedy 6), so that the customer is able to find a deal that suits their needs. Around [CONFIDENTIAL] of our [CONFIDENTIAL] SME / microbusiness customer acquisitions come through TPIs.⁴⁴
- 1.2 There is a close parallel for the service that TPI brokers/consultants offer to that provided as 'advice' by financial advisers and financial services companies, in that the customer trusts the TPI to be independent and to recommend a supply deal that meets their needs. Our experience is that the majority of TPIs are reputable and offer a fair range of products and prices. However, we recognise that some TPIs may be influenced by the commission that they can earn per sale, which can vary between suppliers and can also include incentives based on margin or total number of sales achieved. In general, the extent of searches undertaken and the commission that TPIs earn is not visible to the customer and may mean that whilst the customer gets a competitive deal that is tailored to their requirements, it may not reflect the best price possible as the TPI is balancing finding a saleable price with optimising their own commission earnings.
- 1.3 There are, in addition, some documented examples of poor practice in the TPI market, and customers have no means of assuring themselves as to the reputability of a broker that they may be dealing with, other than personal recommendation from peers or through affinities some TPIs may have with a trade association whom they may trust.
- 1.4 Voluntary codes such as that proposed by Eon in 2012 are well intentioned but their effectiveness is, in practice, limited. For example, there have been examples of TPI/broker companies who have been found to be mis-selling, who are dropped by the affected retail energy supplier, only for the TPI /broker to redirect sales to another supplier: [CONFIDENTIAL].
- 1.5 For these reasons, we consider that the proper regulation of the services offered by TPIs is warranted, would benefit customers, by building trust and therefore engagement and would as a result be a proportionate and effective way of addressing the AEC identified by the CMA. Our proposals in this regard are set out below in response to question (f). Direct regulation would clearly address the issues the CMA has identified with respect to a lack of transparency over TPIs' incentives to recommend the best possible deal to customers and, in turn, would enable microbusiness customers to obtain accurate information about the business energy market. Direct regulation of TPIs, including a requirement that TPIs and individual sales representatives must be accredited in order to operate on the market, will strengthen trust and small business' confidence in the services that TPIs provide, thereby promoting greater engagement in the market. Direct regulation would also provide microbusiness customers with the confidence and assurance that they have been recommended a deal which is appropriate for their needs, in light of products available in the market. To the extent that a customer were to have a concern that a TPI had not acted properly when making a recommendation, we consider that only an independent regulator would have the ability to conduct an impartial and thorough review.
- 1.6 This remedy is, in addition, fully aligned to the desire of CMA to encourage greater product differentiation (as proposed in the domestic market) and also the aim of strengthening momentum towards HH settlement and demand side products which do not easily lend themselves to static price lists or traditional comparison sites, but would be well suited to TPI services.

⁴⁴ RWE's response to the CMA's customer acquisition data request, 26 November 2014.

1.7 We believe that the licensing model operated by the FCA is a readymade and proven model for how a governance/compliance mechanism could work in energy markets; TPIs, in effect, offer 'advice' but without the clarity that exists in the financial services sector around services, terms and fees. Direct regulation would address this.

1.8 Finally, in addition to our proposal for direct regulation of TPIs, we consider that an Ofgem guide to buying energy (as described in our response to remedy 6, question (i)), would also assist with promoting customer trust and confidence, thereby facilitating greater engagement in the market.

2. Specific Questions

(a) *Would this remedy be effective in improving transparency over incentives and trust in TPIs in the energy sector? How could the CMA ensure that this remedy was enforced, i.e. that TPIs were providing the specified information?*

2.1 RWE considers that the introduction of rules governing the information about incentives that TPIs are required to provide to microbusiness customers would be effective in improving transparency and could significantly improve customer trust in TPIs.

2.2 As noted above, we would suggest that these rules are enforced using an FCA style licensing system which would require TPIs / brokers to provide (amongst other information) details of the rationale for their recommendations.

(b) *What information should be provided by TPIs to microbusinesses in order to enable them to make informed choices?*

2.3 We consider that TPIs should provide microbusinesses with details of which suppliers' products they represent, the extent of searches that have been undertaken, the results of search, the specific services that they are providing and any fees that they will be receiving for providing the service.

(c) *Could the provision of certain types of information have unintended consequences (e.g. customers choosing tariffs based on commission rates rather than total price)? If so, are there any steps that could be taken to mitigate this effect?*

2.4 We consider that unintended consequences, such as those posed by the question, would be best mitigated by a requirement on the TPI to provide to the customer with full and accurate information about the recommendation that is being made, including the costs of the energy deal and associated services from the energy supplier; any significant inclusions or exclusions; features and benefits of the product; and information about the TPI's fee arrangements.

2.5 The provision of this information will enable the customer to evaluate their total cost of supply of each offer researched, along with the TPI's rationale for its recommendations, as the cheapest product (or the product with the lowest commission) may not necessarily be the product that best meets the customer's requirements and preferences.

(d) *Should the specified information be provided to customers in writing or orally (or both)? At what stage in the sales process should this information be provided?*

2.6 We believe that the information about TPIs' incentives could be provided to customers orally, provided the call is recorded and written confirmation follows as part of the confirmation of sale. This is because:

2.6.1 The customer may want to assure themselves that their needs and requirements have been properly taken into account. Information about the extent to which TPIs, for example, cover the market and fees payable will be important in this context and in making their initial decision;

2.6.2 The customer may choose to use more than one TPI and/or also to approach suppliers directly, in which case a written summary from the/each TPI will better

enable the customer to make an assessment of the products/deals being offered to them; and

- 2.6.3 Ultimately, written confirmation will be important evidence in any claim a customer may have that the TPI acted improperly, although we would only expect to see improper TPI behaviour in exceptional cases provided that our recommendation for direct FCA style regulation is implemented.

(e) *Should this remedy be introduced in addition to Ofgem's proposed code of conduct? Or should only this remedy (or only Ofgem's code of conduct) be introduced?*

- 2.7 We consider that this remedy should be introduced **in addition to** a revised version of Ofgem's proposed code of conduct.

- 2.8 This is because Ofgem's proposed code of conduct will not in our view be effective in either increasing customers' access to information, or improving customer confidence in TPIs. The proposed code of conduct provides for full disclosure of commissions and products searched but unlike the licensing model in the financial services sector that **requires** the disclosure of specified information, the code of conduct would be voluntary in nature. It would therefore face the same challenges as existing voluntary codes. In particular:

- 2.8.1 From the perspective of retail energy suppliers:

2.8.1.1 There is a commercial risk that some TPIs may only deal with retail energy suppliers who do not subscribe to the proposed code of conduct; and

2.8.1.2 There is a risk that TPIs pay 'lip service' to the proposed code of conduct, but that their actual conduct falls short of it. This cannot be monitored by retail energy suppliers, as we have no right of access to call recordings prior to an agreed sale as these may contain commercially confidential price and product information of competitor offers.

- 2.8.2 From the perspective of microbusiness customers, there will be no assurance that a TPI is adhering to the code of conduct. The proposed code of conduct is therefore likely to be of limited effectiveness in increasing transparency of TPIs' incentives, or improving trust and engagement in the market.

(f) *Are there any additional measures that should be implemented alongside this remedy to enhance its effectiveness?*

- 2.9 We consider that the following measures should be implemented alongside this remedy to enhance its effectiveness:

2.9.1 The principles embodied in the code of conduct should be incorporated in direct regulation applicable to all TPIs that wish to serve the microbusiness market;

2.9.2 The rules governing the information that TPIs are required to provide to microbusiness customers should include confirmation of the responsibilities of suppliers, TPIs and customers in any transaction;

2.9.3 The rules should clearly define how TPIs must operate. In particular, we would suggest that TPIs (including individual sales representatives) must gain accreditation in order to offer services in the market and that a list of approved TPIs is established and maintained;

2.9.4 The rules should confirm the organisation that will oversee and enforce them. We suggest that Ofgem would be best placed to perform this role;

2.9.5 Appropriate powers will need to be granted to Ofgem to enforce the rules;

- 2.9.6 A licence amendment would be required, permitting retail energy suppliers to sell only through certified/licensed/approved TPIs; and
- 2.9.7 The rules should incorporate a mechanism to prohibit 'rogue' TPIs from selling in the energy market.

K. REMEDY 8

CMA remedy 8 – Introduction of a new requirement into the licences of retail energy suppliers that prohibits the inclusion of terms that permit the auto-rollover of microbusiness customers on to new contracts with a narrow window for switching supplier and/or tariff

1. Executive Summary

- 1.1 The Six Large Energy Suppliers have voluntarily adopted the practice of moving customers, who are inactive at contract end, onto a flexible product which can be exited on a short notice period – typically 28 or 30 days. Some customers may assume, however, that all suppliers have adopted this practice and if their new supplier still applies auto roll-over clauses, the consequence only becomes apparent after renewal.
- 1.2 RWE npower's view is that it is not the narrowness of the window that is important; companies should not be allowed to roll customers onto a fixed duration contract without customers' explicit consent at the point of recontracting. Our view is that where the customer has not specifically re-contracted, then they should be able to leave on giving 30 days' notice.
- 1.3 We therefore support this remedy and we consider it essential for protecting customers' interests at contract renewal and ensuring effective competition on a level playing field.

2. Specific Questions

(a) Would this remedy be effective in allowing microbusiness customers greater opportunity to engage (by removing the narrow window in which they can choose not to roll-over automatically)?

- 2.1 We believe this remedy would be effective in allowing microbusiness customers greater opportunity to engage.
- 2.2 Since ending auto rollover in November 2014, over 25,000 of RWE npower's customers have had the option of negotiating a new contract with us or switching to another supplier. Our experience is that our customers have taken the opportunity both to discuss different and better terms with us and to leave us to join other suppliers when previously they would not have been able to; since November 2014, around 10% of these customers have moved onto a negotiated Fixed contract each month, and around 6% have switched to another supplier and these figures continue to rise.
- 2.3 RWE npower's experience is that many customers knowingly 'roll' on to a new contract as they are happy to accept the renewal offer of their supplier, this measure will protect those who do not seek to agree a new deal at contract end but who subsequently decide to review their supply needs.

(b) Are there any means by which energy suppliers could circumvent this remedy to continue to lock customers into energy tariffs that they have not chosen for extended periods of time?

- 2.4 The only means we are aware of would be to apply non-interoperable metering arrangements that would make transfer to a different supplier more complex.

(c) What is the minimum or maximum notice period that customers should be required/allowed to give in order to exit a contract that they have been rolled on to?

- 2.5 We consider that the minimum notice period would be one week and the maximum notice period would be one month.

- 2.6 We consider that 30 days is a reasonable notice period, and would allow a supplier to be able to facilitate the arrangements and generate an invoice. This timeframe also reflects the notice period incumbent on the supplier to provide the consumer with the statement of renewal terms in accordance with SLC7A. However suppliers could allow customers to leave on shorter notice, in which case we would suggest the absolute minimum notice period for straightforward contract termination/transfer would be one week.
- (d) *Should energy suppliers be required to inform customers that they are nearing the end of their contract and prompt them to switch?***
- 2.7 Yes. RWE currently does this through its existing renewal process, bills and statements.

L. REMEDY 9

CMA remedy 9 – Measures to provide either domestic and/or microbusiness customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information

DOMESTIC RESPONSE

1. Executive Summary

- 1.1 RWE npower considers the prescriptive regulation imposed by RMR with regard to certain customer communications has restricted the ability of suppliers to engage customers by sending the right information at the right time. RWE has previously highlighted to Ofgem⁴⁵ that whilst RMR has provided a consistent framework for the provision of information about alternative tariffs, promoting switching and encouraging customers to transfer to their supplier's cheapest tariff, RWE's customer research and feedback indicates that whilst customers found some of the new information useful, some found it interrupted the flow of the bill (i.e. where the customer has to look for information on the bill) and impacted on engagement from a digital perspective due to the volume of information.
- 1.2 RWE npower is continually seeking to improve and develop the information it provides to customers and in 2014 RWE npower starting working with the Behavioural Insights Team (BIT) and Ofgem to trial new approaches to supplier communications with a view to promoting tariff switches and consumer engagement (working alongside the Retail Market Review).
- 1.3 RWE npower has a contact strategy with a message hierarchy to ensure that customers do not receive multiple, similar messages which may cause customers to disengage. Regulatory communications such as the bill and Product End Notice (PEN) letter have priority over marketing messages.
- 1.4 RWE npower considers all suppliers should keep their communications under continual review to ensure consumers have the appropriate information, through their communication channel of choice, at the most appropriate time.
- 1.5 RWE npower therefore believes that the CMA should consider relaxing some of the constraints around how information is provided to consumers, to enable suppliers to respond to customer feedback and provide the required information in the most effective way for their customers.
- 1.6 RWE believes that getting communication right is the best way to get customers to engage in the market and, as discussed further below, has been taking steps to trial information provision in order to ensure the messages we give to our customers are provided in the most effective manner. We believe that allowing suppliers to modify their communications to respond to customer feedback will result in significant improvements in engagement levels.

2. Specific Questions

(a) Does the current format and content of energy bills facilitate engagement by customers? Is there additional information that should be included on bills? Should the quantity of information on bills be reduced to enhance clarity?

- 2.1 RWE npower's consumer research conducted prior to RMR found that whilst its customers would value cheapest tariff information, this should not interrupt the flow of the bill and account related information. A year after the RMR compliant bill was introduced, RWE npower's research confirmed that whilst customers are not averse to the inclusion of the

⁴⁵ In RWE npower's response to Ofgem's voluntary call for evidence: Impact of measures introduced as part of the Retail Market Review (Domestic).

RMR requirements, many felt an up-front bill summary would increase clarity and understanding.

2.2 [CONFIDENTIAL]

2.3 RWE npower would like to implement a new bill design in response to this customer feedback but is restricted from doing so by the RMR rules.

2.4 Due to the RMR requirements to include cheapest tariff messaging (CTM) information and the addition of the 'Could you pay less?' section, the 'How your energy adds up' section now features on the bottom of page 2. However, RWE npower's research indicates this is the information which customers want to view first.

2.5 Whilst RWE npower recognises the CTM information can be very valuable in helping customers reduce their energy costs, RWE npower considers it is important to present customers with the information they require at the point they require it.

2.6 Further, customers find the heading 'Could you pay less' confusing, where the open-ended question is thought to relate back to the bill amount. It can prompt some to think they could pay less than the actual bill amount, rather than to prompt a tariff comparison. RWE npower considers the use of 'Helping you save money' may be more appropriate and may be more likely to encourage tariff switching.

2.7 RWE npower's customer research and feedback indicates that whilst customers are receptive to some of the required RMR information (such as cheapest tariff), they are being overloaded with information that is confusing and which may disengage them. RWE npower believes the proposed online bill design summary is clear and easy to understand, whilst offering concise information to customers on their usage/payments – it effectively tells the customers what they need to know, without the need for them to go searching for the information.

(b) *When customers seek to switch tariffs, are they given enough/too much information on the terms and conditions of their new contract?*

2.8 Existing RWE npower customers may seek to switch tariffs via a number of different sales channels. These include internal voice channels (telesales or customer services), npower's website, or via PCWs. All channels provide a slightly different customer journey but give a common level of detail on each tariff option to enable the customer to make an informed choice.

2.9 RWE npower's new and existing customers are provided with a 12 month estimate and comparison versus their current tariff and are made aware of the key attributes and principal contract terms of the tariff via sales scripting or online copy. Customers should be able to make a decision based on this level of information or can opt, certainly via online channels, to review more detailed information in relation to the tariff (including caveats and the specific terms and conditions).

2.10 Once a new or existing customer opts to switch tariffs they receive written confirmation of their selected tariff's key attributes (via the Tariff Information Label or the Tariff Guide which is document RWE npower provides to customers in order to help them review their tariff choice). Customers benefit from a 14 day cooling off period and can, upon reviewing their tariff information, opt to cancel their switch or re-select another, more appropriate tariff.

2.11 RWE npower believes that whilst the customer is currently provided with a sufficient level of detail around their selected tariff in order to make an informed choice, sometimes this information can be presented in a way that appears overly complex depending on the channel they have selected. Anecdotal feedback received from call listening and from telephone agents suggests that reading this information out adds little or nothing to the customer's understanding, and can be both confusing and distracting. Accordingly, it might be appropriate to reduce the amount of information covered on the telephone. For example, it is, in RWE's view, unnecessary to provide customers with Tariff Comparison Rate (TCR)

information over the telephone when the customer is being given a personalised savings comparison based on their consumption (which can vary widely from the TCR which is based on Ofgem's medium consumption level). The TCR would therefore seem more appropriate in written communications or online.

- 2.12 RWE npower therefore proposes that the CMA considers ways to simplify the way in which information is provided to customers seeking to switch tariff, with particular regard to the differences in channel of communication.

(c) *Should customers be prompted to read their meters (quarterly or annually), either by information on their bill or by a phone call from their energy supplier? Would this increase engagement by improving the accuracy of billing?*

- 2.13 RWE npower considers 'Customer Own' meter reads to be relevant to customer engagement with energy consumption in the context of traditional meters, i.e. before smart. To maintain accuracy of the bill in relation to actual consumption and therefore avoid the inadvertent build up of debt, it is essential that there is a read of electricity meters at least once per year. For gas, the seasonality and variability of consumption means there is an engagement benefit in a monthly view of consumption, which is supported by a monthly accurate read through a smart meter.

- 2.14 Monthly meter reads are not essential for either gas or electricity from the perspective of the customer's cash flow element of the bill since i) prepayment meters essentially read themselves at each vend, ii) resetting the direct debit value monthly is not helpful to customers, iii) receipt of bill is no more than quarterly. However, more regular meter readings will result in customers receiving more accurate bills and they can use the information contained in their bills to obtain more accurate quotes before switching tariffs. That said, RWE npower is not aware that customer propensity to switch tariffs increases by having more accurate meter readings or bills.

- 2.15 Accordingly RWE npower does not consider that customer engagement will increase by "*improving the accuracy of billing*" by prompting customers to read their meters (quarterly or annually) either by information on their bill or by a phone call from their energy supplier. However, it may improve the effectiveness of their engagement.

(d) *Once customers reach the end of a contract period, should subsequent bills highlight that they have now been moved onto the standard variable tariff and/or other default tariff and encourage them to check whether they are on the most appropriate tariff for them?*

- 2.16 In line with the RMR requirements all customer bills include the following information on page one:

- 2.16.1 The standardised title "*Could you pay less?*";
- 2.16.2 A personal projection for the next 12 months on the consumer's current tariff;
- 2.16.3 Cheapest tariff messaging, which may or may not be the tariff they are currently on;
- 2.16.4 Details of where the customer can find further information on the tariff options available; and
- 2.16.5 A standardised switching reminder "*Remember – it might be worth thinking about switching your tariff or supplier*".

- 2.17 As discussed in RWE npower's response to (a) above, RWE npower would like to implement a new bill design in response to feedback from its customers.

- 2.18 RWE npower believes that whilst adding an additional message to the bill to highlight to customers that they have moved onto the default tariff following their fixed term contract end may help to encourage some customers to switch tariff, it may be more appropriate to

send a separate communication depending on the customer's billing cycle and the time elapsed between the tariff end and the customer's bill, rather than risk this information getting lost within the customer bill information already provided.

- 2.19 As discussed in RWE npower's response to remedy 10, RWE began working with the Behavioural Insights Team (BIT) and Ofgem in 2014 to trial new approaches to supplier communications with the view of promoting tariff switches and consumer engagement. [CONFIDENTIAL]
- 2.20 The results of this campaign are due in August but initial feedback indicates that response rates were highest for the first prompt sent after customers had received the PEN letter.
- 2.21 RWE npower therefore considers that no action is currently required by the CMA in this respect of customers reaching the end of their fixed term contract as new approaches to supplier communications are already being trialled and it would be premature to take action pending the results of that campaign.

CMA remedy 9 – Measures to provide either domestic and/or microbusiness customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information

SME RESPONSE

3. Executive Summary

- 3.1 We are supportive of providing customers with clear and consistent information. We believe customer engagement and ease of accessing and comparing offers would be improved through the adoption of a common framework that would assist customers with evaluating the key elements of energy contracts.
- 3.2 In relation to any quotation given to a new or existing customer this might include:
- 3.2.1 Clarity on any costs that may be passed through and the circumstances in which this could happen. As a specific example SSE is understood to pass through FiT and EMR charges and to provide estimates of these costs for the first year of a contract only. Npower contracts are fully inclusive of those charges with no pass-through.
 - 3.2.2 Arrangements at contract end e.g. renewal process, roll/non-roll, and notice periods and the product type that customers exit onto.
 - 3.2.3 Confirmation of any consumption information used to quote, to check it is comparable.
 - 3.2.4 Product features and benefits that are included or excluded e.g. Metering, billing, account management, web service.
 - 3.2.5 Discounts or premiums applied e.g. dual fuel, direct debit and other arrangements.
- 3.3 We would envisage this taking the form of a standard method of calculating the annual cost of supply based on a reasonable estimate of the consumption likely to be used by the customer, with clear flagging of any terms that are relevant to that estimate e.g. inclusive or exclusive of other costs and pass-through (we believe that it is in the interests of customers that all costs should be inclusive, where reasonable). This could also operate as a checklist, prepared by Ofgem, and retail energy suppliers would be obliged (via a licence modification) to cover each item on the checklist as part of the sale documentation.
- 3.4 The adoption of this checklist would also assist sales agents and TPis when researching the best deal for a customer.

4. Specific Questions

(a) Does the current format and content of energy bills facilitate engagement by customers? Is there additional information that should be included on bills? Should the quantity of information on bills be reduced to enhance clarity?

- 4.1 RWE believes that this varies by supplier – some energy bills are very clear and others less so. The energy bill is a key communication between energy supplier and customer and we believe energy suppliers should make energy bills as clear and simple as possible. We would suggest that the bill format used by npower since the beginning of 2014, which has received good customer feedback, is a model that the CMA might consider. For example:
- 4.1.1 All the most important information is summarised on the first page;
 - 4.1.2 Information is grouped in a meaningful way;
 - 4.1.3 Ensuring we use simple language; and
 - 4.1.4 We use colour and icons to draw attention to key pieces of information.

- 4.2 Energy bills will not necessarily contain sufficient information on customers' typical consumption patterns in order for them to fully engage in the market; whilst a supplier could estimate total consumption for a retention customer, an acquisition customer may need a number of bills to estimate total consumption. Interval data from AMR/Smart meters would also be needed if the customer sought a time of use product. This additional information may be provided by the customer's current supplier on request (e.g. by email, where a customer has provided a current email address, or by post), although we consider that it would be unwieldy and confusing for a customer if suppliers were to include this additional information in a normal bill.
- (b) *When customers seek to switch tariffs, are they given enough/too much information on the terms and conditions of their new contract?***
- 4.3 Suppliers to microbusiness customers are required to comply with the information requirements contained within Standard Licence Condition 7A.
- 4.4 There is a difficult balance to strike between covering all of the terms of the contract and providing clear and simple information which is readily understandable. We consider that it is more important to provide clear and simple information on the key features that matter to customers. Whilst we believe that our customers are given sufficient information on the terms and conditions of their new contract, the need to ensure that the contract is properly covered means this could feel like a lot of information to them.
- 4.5 RWE's sales agents talk through the principal terms and conditions of the new contract with the customer, providing a clear indication of the duration of the contract, the cost and what the customer needs to do to give notice at the expiry of the fixed term. As customers currently agree their contract verbally, this means that they have to listen to the terms and conditions over the phone which takes several minutes. They then receive a hard copy of their principal terms.
- (c) *Should customers be prompted to read their meters (quarterly or annually), either by information on their bill or by a phone call from their energy supplier? Would this increase engagement by improving the accuracy of billing?***
- 4.6 RWE considers it is in suppliers' interests to seek meter readings, either through a meter reader visit or a customer own read. Estimated bills are one of the main causes of customer dissatisfaction and bills based on actual consumption are more likely to be paid.
- 4.7 Npower already prompts customers to provide meter reads. We believe this to be common practice across the industry and so a remedy of this nature is not necessary.
- 4.8 Energy bills act as a prompt to read a meter and many customers ring in with meter reads on receipt of an estimated bill. We do not believe that calling a customer and prompting them to read their bills would be practicable; it would be unreasonable to expect customers to stop what they are doing in order to locate their meter and provide an immediate reading over the telephone. We also consider that it would not be commercially sustainable from a supplier's perspective.
- 4.9 That being said, we consider that digital prompts (email, text, online account) could, in principle, be an additional useful and cost effective means of prompting customers, although the practicability of this as a solution will depend on having a robust and up-to-date database of customer contact information. For example, whilst RWE npower continues to make progress in this regard, we hold very little email contact information for our microbusiness customers (we have an email address for approximately 20% of customers only) and the information we do hold is highly unlikely to be completely up to date due to changes in customer circumstances. A primary reason for this is that the majority of customers choose not to share such information with suppliers.
- (d) *Once customers reach the end of a contract period, should subsequent bills highlight that they have now been moved onto the standard variable tariff and/or other default tariff and encourage them to check whether they are on the most appropriate tariff for them?***

- 4.10 We note that customers who have reached the end of a contract period may be in very different states of engagement, for example, some customers may have indicated that they are moving supplier, whilst others come off contract, remain with us and contact us frequently.
- 4.11 That being said, we agree that once a customer has reached the end of a contract period, subsequent bills should highlight that they have been moved onto a different product and should encourage them to check whether they are on the most appropriate tariff for them.
- 4.12 RWE npower is therefore supportive of this remedy, although we note that we already do this. 60 days before the end of their contract, npower customers will receive a renewal offer including their renewal price, with a prompt to call us to negotiate a new Fixed or Variable contract at any time. 30 days before the end of their contract, assuming the customer has not contacted us to negotiate a new contract, they will receive confirmation that they will move onto the Flexible rates that were offered 30 days beforehand, with a prompt to call us to negotiate a new Fixed or Variable contract at any time.
- 4.13 At the end of a contract period, customers receive between two and four reminders a year that they are not on the most favourable deal and can call us any time to negotiate a new contract. Customers will also be contacted by competitors and TPIs wanting to acquire them. Customers will also receive quarterly letters from their supplier telling them their latest rates. We believe that suppliers do a lot to highlight to customers that they are no longer in contract, and npower bills and letters already do this in these circumstances.

M. REMEDY 10

CMA remedy 10 – Measures to prompt customers on default tariffs to engage in the market

DOMESTIC RESPONSE

1. Executive Summary

- 1.1 As outlined in more detail in RWE's response to the CMA's PFs, RWE believes that the CMA is wrong to categorise all consumers on standard variable tariff ("SVT") (or those on SVT and paying by standard credit) as disengaged (as the CMA seems to, at times, treat SVT customers and disengaged customer as synonymous). RWE npower believes the SVT customer base is not a homogenous group of customers. The cohort of customers on this tariff type is continually changing as customers switch supplier or tariff and new consumers move onto an SVT, often for only a short period of time. Within its own customer base [CONFIDENTIAL] of RWE's customers who were on SVT at the start of 2014 were not on SVT by the end of 2014.
- 1.2 However, RWE does recognise that there is spectrum of engagement across the consumers on SVT and that some of those consumers may benefit from additional prompts to engage. In principle, RWE npower would support measures to improve engagement through customer prompts, provided these are done in an efficient and effective manner recognising customer preferences for certain communication channels and for not being overburdened with information (and for those who have opted out of (or, as appropriate, not opted into) marketing communications to feel like their preferences are not being respected).
- 1.3 Prompting consumers on so-called default tariffs to consider switching to an alternative tariff could be a useful tool, but needs to be implemented in a way that is simple for consumers and where consumers can opt-out, so as to preserve consumer choice. From a customer perspective the difference between a 'marketing' message and a 'service' message is sometimes unclear and there is the potential for some customers to feel overloaded with information.
- 1.4 As discussed in RWE npower's response to the Updated Issues Statement, RWE npower is committed to engaging with customers on its SVT and to increasing their awareness of alternative npower tariffs. To that end, RWE has undertaken numerous initiatives to stimulate engagement and is continually working to improve the effectiveness of these prompts, for example:
 - 1.4.1 Since 2011 RWE npower has provided Tariff Guides to all new customers, home movers, customers who changed tariffs and to customers coming to their end of their fixed term non-standard tariff contracts, to explain the types of products that are available.
 - 1.4.2 In 2013, RWE npower communicated to all customers (through their bills) prompting them to check if they were on the most suitable tariff and payment method⁴⁶.
 - 1.4.3 In January 2015, RWE npower wrote to 871,000 customers who had been with npower on the standard tariff for more than five years, advising them that alternative tariffs may be more suitable for them.⁴⁷

⁴⁶ The message stated: "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".

⁴⁷ The letters stated: "*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 enclosed calendar, which stated (January):

- 1.4.4 When RWE npower wrote to its standard customers, over and above its regulatory obligations, about its 16 February 2015 price reduction, RWE reminded customers that they could go online to check that they were on the most suitable tariff.⁴⁸
- 1.4.5 RWE npower's web pages also contain a number of statements encouraging customers to look for alternative tariffs⁴⁹.
- 1.4.6 In addition, RWE npower has sent letters to customers in receipt of the Warm Home Discount who could potentially make a saving by switching to another npower tariff.
- 1.5 RWE npower is continually seeking to improve and develop the information it provides to customers, see for example RWE's work with the Behavioural Insights Team (BIT) and Ofgem as referred to in RWE's response to remedy 9.
- 1.6 RWE npower views digital channels and services as increasingly important for driving engagement, providing customers with the information and tools to take control of their energy usage and costs. RWE npower believes it is vitally important that the regulatory framework supports digital innovation. Some of the RMR rules, such as the Product End Notice, constrain RWE's ability to innovate and engage in a digitised manner to satisfy the expectations of RWE npower's customers. RWE npower believes that there is scope to innovate by tailoring a customer journey that better presents the customer with the necessary information and options, whilst satisfying the RMR principles.
- 1.7 RWE npower believes that consumer engagement and switching will also increase if the number of tariffs and offers available in the market increases, as consumers will be able to find, and be targeted with, tariffs that better suit their needs, increasing the benefits of engagement. As discussed in RWE npower's response to proposed remedy 3 RWE believes that relaxing the RMR constraint will give suppliers the opportunity to target different tariffs to different customer groups.
- 1.8 RWE npower believes it has made a number of successful changes in the way in which it uses communications and prompts to encourage customers to engage, and as set out above it continues to work towards improving the effectiveness of its customer communications. In principle RWE is supportive of additional effective measures to improve engagement through prompts. RWE believes that effective communications will continue to stimulate engagement and, combined with other remedies proposed by the CMA, in particular proposed remedies 3, 6 and 9, will be effective at addressing any residual concerns the CMA may have with regard to customer response.

2. Specific Questions

(a) **What information should be included in the prompts to customers on default tariffs in order to maximise the chances that they are acted upon?**

- 2.1 RWE npower believes that the type of information included within the prompt will vary depending on the customer type, their situation (e.g. home-move or someone whose fixed term tariff ended a couple of months ago), their communication channel preference and whether or not they give marketing consent. For example, for a customer who has recently moved into a new home but has not given consent to marketing messages the prompt should direct them to where they can find information on alternative tariffs and potential savings. If the customer had previously been on a fixed term tariff and has given consent to marketing, the message could give more tariff information and promote specific tariffs.
- 2.2 RWE npower considers that, due to the four-tariff rule, suppliers are limited in their ability to encourage some customers on SVT, for whom price savings messages alone may not be

"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".

⁴⁸ *"And remember, you can always go to npower.com/products to check you're on the tariff that suits you best".*

⁴⁹ *"Is your tariff ending? Find a new one to suit your needs".*

sufficient, to engage. Tariffs with other features which might prompt engagement (such as a free carbon monoxide detector, which might appeal to young families, or tariffs which offer a £50 donation to charity) are not currently permitted under RMR.

2.3 As discussed in RWE's response to remedy 9, RWE npower is working with the Behavioural Insights Team (BIT) and Ofgem to trial new approaches to supplier communications with the view of promoting tariff switches and consumer engagement. [CONFIDENTIAL]

2.4 The results of this campaign are due in August but [CONFIDENTIAL]

2.5 RWE npower does not yet have a definitive view on what information should be included in the prompts to customers on default tariffs and awaits the outcome of the BIT/Ofgem trial to provide an evidence based view. However, RWE npower anticipates additional trials will be required to provide more precise insight into the exact information to be included in such prompts.

(i) Should customers who have failed to engage be informed that they are 'no longer under contract for energy', that they have been 'rolled onto a safeguard tariff', or an alternative message, for example, emphasising how many customers in their area have switched in the last year?

2.6 Domestic customers are rolled onto a 'deemed' statutory contract where a customer moves into a new property and has not agreed terms with a supplier who is supplying energy to a property or where a fixed term contract expires and there are no explicit provisions for terms and conditions for the period immediately after expiry. This provides suppliers with means of enforcing payment for the energy used. Accordingly, customers whose fixed term tariff contract has ended are still under contract for their energy with RWE npower, albeit a 'deemed' one. RWE npower feels it would be inappropriate to inform customers on the SVT that they are 'no longer under contract for energy', as this is likely to confuse customers as it is merely their fixed term tariff contract that has ended. RWE would consider an alternative message such as 'you are no longer on a fixed term tariff and are now on our standard variable tariff, please contact us if you wish to discuss alternative tariffs options' would be more appropriate.

2.7 RWE npower notes that for some customers the SVT may actually be the most appropriate tariff for them. When RWE npower's April Price Fix 2015 ended around [CONFIDENTIAL] of single fuel electricity customers had standard as their cheapest 'wide option' tariff. Customers may choose to actively stay on the SVT rather than move to a tariff with early exit fees or other restrictions, particularly for example if they know they are moving home in a few months.

2.8 Whilst RWE npower considers that an alternative message, such as emphasising how many customers in their area have switched in the last year, could increase engagement, it considers that improving the cheapest tariff messaging and constant improvements to the online switching process would be more beneficial as arguably a large proportion of these customers are already engaged.

2.9 Overall, RWE does not consider that it is necessary for customers that have failed to take immediate action upon the expiry of a fixed term product to be informed that they are 'no longer under contract for energy', that they have been 'rolled onto a safeguard tariff', or an alternative message, as they effectively already receive this message in existing communication.

(b) How should prompts be communicated to customers? For example, there is some evidence from the financial sector that text prompts are particularly effective at raising awareness in terms of overdrafts etc.

2.10 RWE npower believes that, where possible, prompts should be communicated to customers through those customers' preferred channels (i.e. whether that be by SMS, email, paper etc).

- 2.11 RWE npower's domestic terms and conditions contain a fair processing notice which enables RWE to send service messages via SMS (unless the customer objects). However, as discussed in paragraph 1.2 from a customer perspective the difference between a 'marketing' message and a 'service' message is sometimes unclear. [CONFIDENTIAL]
- 2.12 RWE npower is communicating to online customers through their preferred channel of choice by providing email prompts when their fixed term tariff ends. From 2015 RWE npower also started to include a prompt on a customer's online account reminding them that their tariff is coming to an end.
- 2.13 RWE npower considers that prompts should be appropriate to the customer's situation and suppliers should be mindful of the timing and frequency of such prompts.

(c) *What should be the timing and frequency of prompts in order to balance effectiveness in terms of encouraging engagement with the cost and potential irritation that might arise from repeated prompts?*

- 2.14 RWE npower considers that the timing of customer prompts should vary depending on the customer type and situation (i.e. the timing might be different for homemove or fixed term tariff end). RWE is continually trialling different approaches to encourage engagement but broadly considers that any prompts should be sent close to the customer receiving their bill, annual statement or another communication such as the Product End Notice (PEN) letter. However, customers should also be able to opt-out of such prompts.
- 2.15 As discussed in paragraph 2.2 the trial with BIT indicates that [CONFIDENTIAL]
- 2.16 RWE npower is also considering trialling an annual 'energy saving review' through either voice / paper or ideally digital channels which would incorporate both a discussion on taking the right steps to save energy, along with a discussion on ensuring the customer is on the right tariff for their needs. RWE considers that an annual prompt strikes the balance between effectively encouraging engagement against the cost and potential irritation that might arise from repeated prompts.

(d) *Who should provide the prompts: customers' energy suppliers, Ofgem or another party?*

- 2.17 As discussed earlier, RWE npower considers that if improvements were made to existing customer communications this may remove the need for additional prompts to customers on so-called default tariffs, as the number of customers on these tariffs would be reduced. However, if such prompts were required in the short term, RWE npower believes that customers' energy suppliers should provide these where appropriate to customers on default tariffs, rather than Ofgem or another party. If a third party were to provide the information, there is a risk that customers would feel overburdened with information from multiple sources and it could cause confusion. A benefit of having customers' energy suppliers contact the customers is that the suppliers would be able to easily facilitate the customer switching to another tariff, whereas Ofgem or another third party may not be able to do this.
- 2.18 There are other issues arising from involving third parties in this process as those third parties would require access to sensitive personal data about the customers in order to provide relevant prompts. As a consequence, if Ofgem or another party were to provide such prompts this would require customer consent. Energy suppliers would need to ensure that a customer was aware of the fact that another party may contact them (i.e. the energy supplier would need to gain the customer's consent to use their data for these purposes). Additionally, if energy suppliers were required to pass on their customers' information to a third party then there would need to be some form of data sharing agreement in place between the energy supplier and that party setting out what the information can be used for. The energy supplier would also need to satisfy itself that the third party could keep the data secure and that only those people who are permitted access to it would have access to it.

(e) *Are there particular groups of customers who should receive prompts at specific points? For example, should house-buyers be prompted to engage with the market on completion of their purchase?*

- 2.19 RWE npower agrees with the CMA that there may be some groups of customers who would benefit from receiving prompts at specific points to encourage them to engage in the market, for example when customers move home or when their fixed term contract is ending, although RWE notes that it already contacts those whose fixed term contracts are coming to an end.
- 2.20 For home-buyers often the simplest option is to use the incumbent supplier on moving in to a property. RWE loses approximately [CONFIDENTIAL] customers each year when they move to a property supplied by a different supplier. As only a small proportion of customers inform RWE npower that they are moving home, RWE feels it would be difficult to prompt customers to engage with the market when they move to a different property.
- 2.21 In any event, RWE npower considers that it would more helpful to engage with a customer a few months after they have moved into a property when they have gained an understanding of their consumption and needs, rather than immediately after or before a property move, when they may not have this understanding. Accordingly, RWE npower considers that home movers would benefit from a prompt a few months after they have moved although RWE is not clear as to how this would work in practice given that very few customers inform RWE that they are moving home. RWE notes that, in an attempt to improve the number of customers that inform RWE when they are moving home, and as discussed in RWE's response to remedy 4, RWE is improving the online homemove journey to make it quicker and simpler for the customer to provide RWE with the relevant information.
- 2.22 As discussed in paragraph 2.2, RWE is currently trialling prompts to customers whose fixed term tariff is coming to an end to engage customers and encourage switching.
- 2.23 With the removal of simpler choices under proposed remedy 3, suppliers would have the ability to target appropriate tariffs to different groups of customers, for example where they are able to identify changes in consumption that could indicate a lifestyle event such as having a baby, suppliers may be able to contact the customer with an appropriate offer or to discuss available tariff options.

(f) *Is there benefit in others in the markets, such as rival energy providers or TPIs, being made aware of which customers remain on default tariffs (or have been rolled on to the safeguard tariff)? In this respect, data protection issues would need to be carefully considered. The ability of other market participants to identify inactive customers, however, has the benefit of potentially encouraging the customer to switch tariffs once out of contract.*

- 2.24 RWE npower is unclear how the data protection issues this proposal raises can be addressed. It considers that any message rival suppliers or TPIs send to customers who have moved to, or remain on, the SVT would be considered as marketing and therefore would require customer consent.
- 2.25 Only [CONFIDENTIAL] of RWE npower's existing customer base has given consent to be contacted across all four communication methods (e-mail, SMS, letter or phone) which, if typical of other suppliers, would limit the effectiveness of the proposal since a large proportion of customers would not be able to receive specific marketing messages on savings and would only receive generic service messages.
- 2.26 RWE would also question whether inactive customers would want to receive increased contact from, potentially multiple, third parties. This proposal potentially means consumers could receive multiple prompts from different parties which has the propensity to frustrate consumers and further reduce engagement with the market.
- 2.27 An alternative option could be for consumers to sign up to a regular alerts service through an independent price comparison service such as the one proposed in proposed remedy 6.

CMA remedy 10 – Measures to prompt customers on default tariffs to engage in the market

SME RESPONSE

3. Executive Summary

3.1 We are very keen to make contact with our customers on what the CMA terms 'default' products and we agree that retail energy suppliers should take reasonable steps to prompt customers who are on these tariffs to engage in the market. Our view is that these prompts should take place through a customer's preferred means of contact (including SMS and email, as well as hard copy letters and bills), as this is more likely to prompt action by the customer, although the use of digital means will necessitate the collection of email addresses and mobile phone numbers, as well as keeping those contact details up to date.

3.2 Against this background, we set out our views on the specific questions posed by the CMA.

4. Specific Questions

(a) What information should be included in the prompts to customers on default tariffs in order to maximise the chances that they are acted upon?

(i) Should customers who have failed to engage be informed that they are 'no longer under contract for energy', that they have been 'rolled onto a safeguard tariff', or an alternative message, for example, emphasising how many customers in their area have switched in the last year?

4.1 We agree with the suggestion that customers should be informed that they are out of contract rates and could save money by phoning their supplier to agree a new deal. We already do this as described in our response to 9d.

4.2 We believe that the emphasis should be on how quick and easy it would be for a customer to agree a new deal – after a 20 minute conversation with their supplier, a customer could move to the new rate on 30 days' notice. This is the experience such a customer would get today if they were to call RWE npower's sales teams. Our aim and our normal performance is to answer 95% of calls to our sales lines within 30 seconds, so customers get through quickly too.

(b) How should prompts be communicated to customers? For example, there is some evidence from the financial sector that text prompts are particularly effective at raising awareness in terms of overdrafts etc.

4.3 Prompts are already communicated by letter and acquisition telesales. We agree that text and email prompts in addition would be likely to engage additional customers who are willing to provide their contact details.

(c) What should be the timing and frequency of prompts in order to balance effectiveness in terms of encouraging engagement with the cost and potential irritation that might arise from repeated prompts?

4.4 We currently give prompts on a quarterly basis and we consider that this is an appropriate interval, particularly as it coincides with us providing information about customer's account (bill and any price changes) and so is more likely to be perceived by customers as a service message rather than a marketing message.

(d) Who should provide the prompts: customers' energy suppliers, Ofgem or another party?

4.5 We consider that prompts should be provided by customers' energy suppliers. They have been entrusted with the customers' contact details. They do not have permission from the

customer to share these details with other parties (unless appropriate, direct marketing consents have been provided).

(e) *Are there particular groups of customers who should receive prompts at specific points? For example, should house-buyers be prompted to engage with the market on completion of their purchase?*

4.6 There is an active data market on prospects for business movers. A number of data suppliers (e.g. Market Location) collect information on businesses moving premises and sell it to energy suppliers and brokers, who use it for the purposes of contacting potential customers as quickly as possible in order to secure them as a customer.

4.7 As we described in our response to question (d) in relation to remedy 9, we currently prompt our Deemed, Default, Tariff and Flexible customers on a regular basis, informing them that they can call in to negotiate a better rate at any time, and also include these prompts on these customers' bills.

(f) *Is there benefit in others in the markets, such as rival energy providers or TPIs, being made aware of which customers remain on default tariffs (or have been rolled on to the safeguard tariff)?*

In this respect, data protection issues would need to be carefully considered. The ability of other market participants to identify inactive customers, however, has the benefit of potentially encouraging the customer to switch tariffs once out of contract.

4.8 RWE recognises that there could be, in principle, some benefit in others in the market being made aware of which customers remain on 'default' tariffs, or have been rolled onto the safeguard tariff. However RWE considers, in practice, that the benefits would be limited for the following reasons:

4.8.1 This remedy could only be implemented for those customers who have provided direct marketing consent (to which our customers would have to 'opt-in'), and the majority do not. Even for those customers providing direct marketing consent, it is typically only consent to receive offers from their supplier or its partners, meaning the remedy will be limited in its effectiveness;

4.8.2 Some of our customers already report that they are contacted more frequently than they would like by their energy supplier and or/third parties and customers may not welcome a large volume of calls and communications from market participants; and

4.8.3 This remedy could not be implemented for those customers who are signed up for the telephone preference service ("TPS") and therefore un-contactable in this respect (approximately 20% of our base is currently signed up to the TPS).

N. REMEDY 11

CMA remedy 11 - A transitional 'safeguard regulated tariff' for disengaged domestic and microbusiness customers

DOMESTIC RESPONSE

1. Introduction

- 1.1 Wherever possible, the CMA should seek to address the causes of any underlying AEC it identifies, rather than mitigating the identified AEC's effects. The underlying cause of the AEC identified by the CMA is "weak customer response" evidenced by a lack of engagement on the part of consumers. RWE has argued strongly in its response to PFs that the CMA has over-estimated the scale of any lack of engagement, and RWE does not repeat those arguments here. However, by considering imposing a safeguard tariff, the CMA risks exacerbating the very problem that it purports to have identified. Its proposed remedy will if anything be likely to decrease customer engagement. Such a remedy would in RWE's view therefore be entirely inappropriate.
- 1.2 RWE believes strongly that the introduction of a safeguard tariff would in any event fail to meet the requirement for proportionality. It would produce disadvantages which are disproportionate to its aim, and when considered in the context of a prospective package of other remedies which are intended to remove previous distortions of competition and to boost engagement through the provision of information and prompts to engage, would be more onerous than is required to achieve its legitimate aim.
- 1.3 For the reasons developed below RWE believes that, once the likely effects and costs of introducing a safeguard tariff are taken into account, the CMA will be unable to conclude that its introduction would be proportionate.
- 1.4 We note (and agree with) the rejection of a safeguard tariff by Professor Stephen Littlechild and other former regulators⁵⁰ who have firmly rejected this, as has Professor Dieter Helm.⁵¹ The adoption of the remedy proposed by the CMA would firmly put the Government or regulator in the seat of setting prices for a large part of the market, and so would fundamentally undermine Great Britain's longstanding approach in aiming to have one of the most liberalised energy markets in the world. To reverse the 1996/1998 liberalisation reforms in gas and electricity supply would be a significant precedent for all regulatory reform. The consequences of imposing such a measure on the GB energy markets would be to introduce a great deal of regulatory uncertainty and risk.
- 1.5 RWE agrees with the concerns identified in para 136 of the notice of provisional remedies in respect of price-controls where the CMA acknowledges (emphasis added) that:

*"... price controls can create significant distortions in markets if the level of the controls are set inappropriately. If the regulated price is set too high, it will be less effective in constraining the regulated firm(s)' market power than it should be. In contrast, if the regulated price is set too low, the regulated firm will not have an incentive to invest in maintaining levels of quality. **For these reasons, price controls are usually only implemented where there is no reasonable prospect of competition, and it is exceptional for them to be put in place where the supply structures enable choice.**"*

⁵⁰ Submission on Summary of Provisional Findings Report and Notice of Possible Remedies, 16 July 2015, by Stephen Littlechild, Sir Callum McCarthy, Eileen Marshall CBE, Stephen Smith, and Clare Spottiswoode CBE, pages 2, 5-6, and 10-11, paragraphs viii, 11, 30-33, 41 and 46. See https://assets.digital.cabinet-office.gov.uk/media/55a908c3e5274a6fea000013/Stephen_Littlechild_-_Submission_to_PFs_and_notice_of_possible_remedies.pdf.

⁵¹ Penalty tariffs, open-ended regulation and embedding overcharging – a critique of the CMA Provisional Findings and remedies, 20 July 2015, Dieter Helm, pages 13-14 and 17, paragraphs 46-50 and 62. See <http://www.dieterhelm.co.uk/sites/default/files/Penalty%20tariffs.%20open-ended%20regulation%20and%20embedding%20overcharging%2007.15.pdf>.

- 1.6 In addition to the points noted by the CMA, RWE believes that if a regulated price is set too low, it poses the additional risk of stifling existing competition and also harming the positive effects of the CMA's other proposed 'enabling' remedies.
- 1.7 However, RWE does not agree with the CMA when it draws an artificially sharp distinction between the disadvantages of a price control on all domestic prices and the way in which a 'safeguard tariff' would operate in terms of a given segment of customers.
- 1.8 In this part of RWE's response to the RN we develop responses under the following Sections:
- 1.8.1 Section A: The CMA's framework for analysis of remedies in this case
 - 1.8.2 Section B: The CMA's evidence on the scale of the detriment
 - 1.8.3 Section C: A safeguard tariff is not an effective remedy
 - 1.8.4 Section D: A safeguard tariff is not the least onerous effective measure
 - 1.8.5 Section E: A safeguard tariff would have very significant adverse effects which are disproportionate to the CMA's aims
 - 1.8.6 Section F: Responses to the CMA's questions in the RN for remedy 11.
2. **Section A: The CMA's framework for analysis of remedies in this case**
- 2.1 RWE understands that in considering the 'reasonableness' of different remedy options, the CMA will have regard to their proportionality and that in making an assessment of proportionality, the CMA is guided⁵² by the following principles. A proportionate remedy is one that:
- 2.1.1 is effective in achieving its legitimate aim
 - 2.1.2 is no more onerous than is required to achieve its aim
 - 2.1.3 is the least onerous if there is a choice of equally effective measures; and
 - 2.1.4 does not produce disadvantages (adverse effects) which are disproportionate to the aim.
- 2.2 The CMA guidelines further note⁵³ that applying these principles to the circumstances of particular cases usually involves consideration of remedy options relative to other effective measures, as well as relative to taking no action and that the CMA will⁵⁴ "*apply these principles to the evaluation of individual measures within a package of remedies as well as to the package taken as a whole.*"
- 2.3 In deciding whether actions are 'reasonable and practicable' in this case, the CMA is required to 'have regard' to the relevant statutory functions of Ofgem, as the sectoral regulator.⁵⁵ In this respect, RWE would ask the CMA to consider the impact of the changes made in the Energy Act 2010 to Ofgem's statutory duties. RWE agrees with the CMA that these changes are likely to have led Ofgem to carry out inefficient trade-offs between competing objectives, which in turn could well have led to decisions that adversely impacted competition. To the extent that these duties are revised / re-focused as a result of the CMA's investigation so as to place Ofgem in a stronger position to promote competition, the anticipated effects of such a remedy ought also to be reflected in the CMA's assessment of the need for a safeguard tariff as part of its package of remedies. Put more simply, if Ofgem

⁵² Guidelines for market investigations: Their role, procedures, assessment and remedies, CC3 (revised), April 2013 ("CC3"), page 73, paragraph 344.

⁵³ CC3, page 73, paragraph 345.

⁵⁴ CC3, page 73, paragraph 346.

⁵⁵ Section 168, Enterprise Act 2002.

is positioned to be more effective in promoting competition then there should be a corresponding reduction in the need for any safeguard tariff to close any remaining "gap" in the remedies required to resolve the CMA's identified AEC in relation to weak customer response.

2.4 The CMA guidelines also describe that the CMA "*will have particular regard to the impact of remedies on customers*" and also "*to the impact of remedies on those businesses subject to them*" as well as others. We address the likely impacts of a safeguard tariff on customers and suppliers in Section E below.

2.5 Of course, a crucial element of any proportionality assessment is a consideration of the scale of the detriment that results from the AEC and it is the CMA's evidence on that topic that we consider first.

3. **Section B: The CMA's evidence on the scale of the detriment and the issue of proportionality**

3.1 RWE does not repeat here in any detail its submissions, in response to the CMA's PFs of an AEC of weak customer engagement, that the CMA has significantly overstated the degree of customer disengagement that exists in the market, and that the CMA is wrong to assert that any such disengagement confers market power on suppliers.

3.2 However, RWE does wish to note that its submissions in respect of the CMA's evidence on the existence and scale of the detriment that results from the provisional AEC are relevant to the CMA's consideration of proportionality.

3.3 Furthermore, as described in much greater depth in its response to PFs, RWE does wish to make clear that RWE considers that there are a number of respects in which the CMA seems to use as its benchmark an 'idealized, perfectly competitive market' rather than the correct standard of a 'well-functioning market'. This is not an appropriate benchmark for a proportionality assessment of any remedy, especially one so intrusive as a price control remedy. RWE notes in particular what it regards as important misconceptions that seem to influence various aspects of the CMA's analysis:

3.3.1 Firstly, the mischaracterisation of energy supply as a 'homogeneous' good, which is key to the CMA's provisional finding of weak customer response and supplier UMP. The PFs *presume* suppliers' products are homogeneous (*despite clear evidence from its own survey to the contrary*) and then proceed to find that there are price differences across products which the CMA labels from the outset as 'gains from switching'. Of course, representing that observed price differences indicate 'gains from switching' is simply introducing a misnomer unless products *are* homogeneous. The PFs' presumption is only confirmed because the CMA gives effectively no weight to the very clear evidence that consumers' choices are driven by product attributes in addition to price. Once the CMA's evidence on the drivers of consumer choice is given proper weight, it becomes clear that suppliers' products are *not* homogeneous, and thus observed price differences cannot legitimately be taken to indicate true 'gains from switching'.

3.3.2 In addition, the PFs fail to appreciate either the importance of hedging of wholesale energy costs or the diverse hedging strategies used to hedge different retail products. This mischaracterisation of the role of hedging impacts on various aspects of the CMA's analysis of supplier UMP.

3.3.3 Secondly, consider the CMA's analysis of barriers to engagement. RWE considers that the CMA has significantly overstated the barriers to engagement by using its mischaracterisation of energy supply products as 'homogeneous' (as already described) and also by exaggerating the true extent of barriers to search or switching. For reasons that RWE does not understand, the CMA has so far largely disregarded evidence it has seen of customer engagement in practice, including significant evidence from its own customer survey. For example, while the CMA provisionally concludes that "*Customers have limited awareness of and interest in their ability to switch energy supplier...*" this conclusion is starkly

contradicted by the CMA's own survey which finds that 89% of consumers are aware it is possible to switch supplier⁵⁶. The CMA's provisional finding of weak customer response – that a “*material proportion*” of customers are “*fundamentally disengaged*” – is not well founded. In reality, the actual barriers to engagement are very low.

- 3.3.4 Thirdly, RWE notes that the CMA has not properly made out its arguments that suppliers have unilateral market power over their customer bases. The market is characterised by a see-saw pricing model, whereby suppliers offer discounts to attract customers with a view to retaining some of those customers on non-discounted prices which is a feature of many other markets where the concept of introductory discounts is well understood by consumers. The CMA has incorrectly assumed that the price variation it observes between discounted and non-discounted tariffs/products, which results from the see-saw pricing model, is evidence of supplier unilateral market power. In fact this kind of pricing is common to many competitive markets and can deliver customer benefits. The CMA supports its findings with a profitability analysis and a competitive price benchmarking analysis, both of which (as is explained in detail in RWE's response to PFs) are fundamentally flawed and which, if carried out properly, would not support a finding of supplier UMP.
- 3.3.5 Fourthly, RWE notes that the CMA's consideration of price discrimination is inconsistent. On the one hand, the CMA considers that SLC 25A distorted competition by imposing regulatory constraints on suppliers' ability to charge prices to different customer groups that could not be justified on grounds of cost reflectivity. On the other hand, the CMA considers that evidence of price variation across customer groups is itself evidence of problematic UMP.
- 3.4 RWE submits that in considering proportionality it is crucial that the CMA properly considers a realistic benchmark for the detrimental effects that the package of remedies needs to address. RWE submits in particular that returns in the market (according to the measure which is most relevant to consumers, which is percentage net margin) are not, in reality, at an unreasonable level.
- 3.5 To the extent that the CMA has provisionally found returns to be unreasonable, those PFs appear in large measure to be due to the impact of the financial results of a single large energy firm, Centrica. That is not a context on which the CMA ought to rely for the introduction of a market wide remedy of the nature envisaged.
- 3.6 It will also be important for the CMA to consider carefully the consequences that may flow from the introduction of a safeguard tariff, for RWE, and for the industry generally.
- 3.7 RWE understands that it is not yet clear whether the CMA will intervene in the manner described under remedy 11 and, from the limited information provided in the RN, it is not clear to RWE how significant an intervention the CMA envisages.
- 3.8 Notwithstanding the current considerable uncertainties, [CONFIDENTIAL]
- 3.9 RWE is not yet in a position to conclude on how it will react to the CMA's remedy package, since its parameters are not yet defined. RWE believes that the safeguard tariff has the potential to be intrusive and has the potential to have a detrimental impact on its business. [CONFIDENTIAL]
- 3.10 In terms of wider industry implications, the suppression of revenues resulting from the imposition of safeguard tariffs can be expected to reduce the ability and incentive for suppliers to discount in order to acquire new customers. RWE's ability (and that of others) to offer such discounts relies on a proportion of those customers moving on to SVT for a period of time, and there is a critical relationship between non-standard and SVT prices. If

⁵⁶ Only 4% say incorrectly that they don't believe it is possible and 6% responded that they did not know. See Figure 35, 'Energy Market Investigation: A Report for the Competition and Markets Authority by GfK NOP.'

revenues from SVT prices are cut as a result of the imposition of a safeguard tariff, suppliers' ability to discount will be impaired. Reduced discounting for customer acquisition would in turn be likely:

- 3.10.1 to reduce competitive pressure for non-standard tariffs; and
 - 3.10.2 to lead to less search and switching (including by customers on the safeguard tariff) as a result of reduced incentives for both customers to engage and for the supplier to promote potentially attractive tariffs in the hope of retaining a customer on SVT for a period of time.
- 3.11 These effects would leave remaining non-exempt suppliers having to fund the delivery of large environmental and social obligations from a reduced customer base, which in turn would increase their relative cost disadvantage compared to the remaining exempt suppliers, and so result in a further distortion of competition.
- 3.12 In respect of each of these issues, RWE encourages the CMA to consider extremely carefully the possible consequences that imposition of a safeguard tariff might have and, in particular whether (or not) those consequences are consistent with the CMA's objectives in designing its remedies package.

4. **Section C: a safeguard tariff is not effective in achieving the CMA's aims**

- 4.1 RWE considers that a safeguard tariff would not be effective in achieving the CMA's aims because it does not address the cause of any AEC.
- 4.2 RWE notes that⁵⁷ the CMA has a "*clear preference ... to deal comprehensively with the cause or causes of AECs wherever possible*" and that while the CMA's guidance suggests⁵⁸ that it will "*consider measures which mitigate the harm to customers created by competition problems*", RWE considers that if the CMA does believe that there are features of the market which are adversely affecting competition that the CMA should seek an effective, proportionate, package of remedies to the problems identified. RWE believes that such a package of remedies should not involve imposing ineffective and distortionary price controls.

A safeguard tariff introduces risk

- 4.3 In considering effectiveness, the CMA's guidelines⁵⁹ describe that the CMA "*will consider the risks associated with different remedy options and will tend to favour remedies that have a higher likelihood of achieving their intended effect*".
- 4.4 In this respect, RWE considers that a safeguard tariff would be difficult to set correctly: If it is set too high it will allow the market to earn excessive profits and not protect those whom it was designed to protect and if it is set too low it will produce significant AECs. RWE considers that it is impossible to set and maintain a price control at a perfect level so that such measures must be regarded as inherently risky.
- 4.5 By way of illustration, the additional costs, complexities and risks involved in implementing a safeguard tariff include:
- 4.5.1 **Risks in forecasting future costs** – The CMA fails to consider that this market is predominantly based on forward looking costs, particularly wholesale price levels. In assessing future costs, the regulator would need to acknowledge that the attrition rate of customers (and therefore a component of commodity risk faced by suppliers) will be linked to the price setting action of the regulator. Additionally, whilst wholesale costs are the highest and most volatile, other cost related risks remain substantial. Network risks are high, particularly at the advent of the new price control period, but also within periods, as networks

⁵⁷ CC3, page 70, paragraph 330.

⁵⁸ CC3, page 70, paragraph 333.

⁵⁹ CC3, page 71, paragraph 335.

devolve their risks back to suppliers through the recovery process. There are in addition further network charging risks to suppliers, such as charging methodology changes, and events that are charged back to suppliers (such as retrospective re-visitation of electrical loss rates).

- 4.5.2 **The risk of errors in assessing impact on costs in other areas that the CMA should consider such as complex commodity positions, swing risks etc** - In gas in particular, suppliers face significant risk from coincident and related changes in gas consumption and wholesale gas prices. In a warm winter with low demand and consequential low gas prices, suppliers have to resell hedged gas to the market at a loss, thereby causing the stranded hedge cost to be loaded onto a lower consumption base. In a very cold winter, with high demand and consequential high gas prices, suppliers must buy more gas, including, at times, at costs exceeding the retail prices, thereby incurring losses. In the absence of a recovery mechanism, the regulator would need to assess this risk on an ex ante basis and apply the cost uplift to the safeguard tariff. However, all suppliers have different demographics in terms of their customers, particularly when considering the number of customers who are dual fuel and who are with the gas incumbent. A single swing cost applied to all suppliers cannot therefore be correct for all suppliers. An additional effect is that different tariff structures have different swing risks. For example rising block tariffs (disallowed under RMR) decrease swing risk in cold weather and standing charges decrease swing risk in warm weather.
- 4.5.3 **The need to assess correctly the length of the forward looking time horizon to calculate costs and impact on the hedge positioning of suppliers** – The level of the safeguard tariff could have a significant effect on the expected residence time on the tariff and consequently on the commodity costs faced by suppliers. An additional complexity is that the hedge could extend beyond the date on which the safeguard tariff would be reviewed / reset. A default tariff set at current SVT may have a similar residence time to current residence on SVT. We emphasise the 'may', as the rhetoric around a default tariff may deter switching from it and may therefore lengthen the residence. A higher tariff would tend to decrease the residence time and a lower tariff would tend to increase it. At this point it is not clear what the reset frequency of the safeguard tariff would be. The uncertainty is in relation to the time horizon over which forward costs would be projected which may manifest itself in the form of additional hedge risk for suppliers (the ex ante cost for which should properly be added to the tariff) and swing risk.
- 4.5.4 **The need to assess and conclude an appropriate degree of headroom to include** – see comments at paragraphs 3.8 to 3.11 above.
- 4.5.5 **The need to decide upon a suitable frequency of price review** – The CMA will need to judge very carefully what the appropriate frequency is for reset of any safeguard tariff.
- 4.5.5.1 If resets are undertaken too frequently:
- (a) Suppliers will incur multiple regular menu costs, and other operating costs associated with price changes (for example updates to literature (electronic/paper), system and website updates, increases in customer handling, service calls and queries, staff briefings, direct debit payment reviews, etc.) Typically, the costs associated with each price change for SVT customers (including systems costs and costs of notifying customers of price increases) currently amount to around [CONFIDENTIAL]. Costs of this magnitude can be expected to be incurred each time there is a change to prices triggered by a change in safeguard tariff where either pre-notification of the change to customers is required pursuant to SLC 23 or where it is otherwise considered important by the business to write to customers in connection with a pricing change.

- (b) Similarly, consumers will potentially suffer from increased volatility in price movements as compared to the relative stability of SVT prices. Whilst volatile prices are beneficial to some customers as this presents opportunities for demand side response, disadvantaged customers may have less ability to realise these benefits and as a result may be exposed to tariffs that are both higher and more volatile. This may create significant affordability problems for them, and suppliers may be exposed to increased levels of bad debt.
- 4.5.5.2 Equally, if resets are *not* undertaken with sufficient frequency this will mean that in falling wholesale markets there is a potentially unsatisfactory lag in the 'correction' of the safeguard tariffs.
- 4.5.5.3 This will be a difficult balance to strike.
- 4.5.5.4 Whilst in theory it would be possible to index the tariff, the complexities of the underlying costs on which any safeguard tariff would be based are such that indexation seems unrealistic. Moreover, in practice we would expect material changes to the methodology to be necessary and hence any index would need to be overridden.
- 4.5.5.5 Irrespective of frequency, the reset of safeguard tariffs may cause a number of other knock on problems including for example:
 - (a) impacts on liquidity caused by immediate and simultaneous hedging activity by all suppliers in the wake of a reset; and
 - (b) other bottlenecks in the market which do not exist in the context of phased and independent price changes by suppliers (for example capacity issues among mailing houses).
- 4.5.6 **The need to decide upon a suitable structure of the tariff** – Different tariff structures have different distributional consequences. There are a range of different Standing Charge levels in the market at present. Wherever the Standing Charge for the Safeguard tariff is set there will be adverse impacts on some customers, e.g. an increase in Standing Charge will cause gas prices (when considered in terms of £/kWh) to be higher for low users, which will impact the less well off. See further at paragraphs 6.14 to 6.23 below.

A price control faces challenges of effective implementation, monitoring and enforcement

- 4.6 The CMA's guidelines make clear that a remedy should be capable of "*effective implementation, monitoring and enforcement*". In this regard, CC3 goes on to note that "*Remedies regulating behaviour generally have the disadvantage of requiring ongoing monitoring of compliance and may also constrain beneficial aspects of competitive rivalry.*"

A price control would need to take into account existing laws and regulations

- 4.7 As the CMA notes⁶⁰, "*remedies may need to take account of existing laws or regulations either currently applicable or expected to come into force in the near future.*"
- 4.8 Whilst SLC 25A on undue discrimination expired nominally on the sunset date and then unequivocally (from the perspective of the regulator) on Ofgem's subsequent notification, SLC 27.2A prescribing cost reflectivity by payment type is still in place, and this originates in EU law. Since cost reflectivity is the natural orientation of markets, SLC 27.2A is not in general a restrictive licence condition. A complication in Great Britain is that the political and social pressure to achieve or resolve distributional outcomes within the energy sector

⁶⁰ CC3, page 72, paragraph 340.

means that prepayment meter customers are cross-subsidised. A default safeguard tariff, in particular given the likely political pressure to set the standing charge below cost reflective levels, would almost certainly cause ex post and possibly ex ante violation of SLC 27.2A. Suppliers would need an explicit statement by the regulator (as Ofgem provided for prepayment cross-subsidy), that they would not be pursued for violation of SLC 27.2A in complying with any aspects of the safeguard tariff requirements that may be in conflict with licence conditions.

- 4.9 The energy liberalisation directive (2003/54/EC) (the "Directive") imposes an obligation on Member States not to discriminate between electricity undertakings as regards either their rights or obligations (Article 3(1)). It seems that it could be contrary to the provisions of the Directive for the CMA to impose a price cap applicable only to the Six Large Energy Firms.
- 4.10 The CMA may also wish to note one further provision of the Directive, Recital 60, which states that: "*Securing common rules for a true internal market and a broad supply of electricity accessible to all should also be one of the main goals of this Directive. To that end, undistorted market prices would provide an incentive for cross-border interconnections and for investments in new power generation while leading, in the long term, to price convergence.*" As described, price regulation of the kind envisaged by the CMA may be expected to distort market prices.

5. **Section D: a safeguard tariff is not the least onerous effective measure**

A package of measures without a safeguard tariff would be effective in addressing the CMA's AEC

- 5.1 RWE accepts some aspects of the CMA's findings in the domestic arena – in particular its findings in relation to the regulatory framework having distorted competition.
- 5.2 With those regulatory distortions removed, RWE believes that an effective package of remedies can be developed from the CMA's suggested 'enabling' remedies which would reduce both consumers' real and perceived barriers to switching, and restore suppliers' incentives and ability to innovate. Once time is allowed for the effects of these changes to be felt, RWE believes competition will flourish further.
- 5.3 RWE considers that the CMA currently understates the impact of the removal of regulatory distortions on competition. It is important that the CMA considers the full impact of these changes when deciding what additional remedies may be required.

A safeguard tariff applied to all SVT customers would be disproportionate

- 5.4 The CMA's remedy seeks to address concerns that suppliers have inactive customers over whom they have unilateral market power. RWE believes that the CMA has failed to provide a clear definition of precisely those customers whom it believes are 'inactive'. RWE further believes that it is important not to equate SVT customers and inactive customers since many SVT customers are not properly considered inactive or disengaged. While there is some ambiguity in PFs about exactly the scope of the CMA's PFs on UMP, RWE believes it is certainly not appropriate to suggest that suppliers have UMP over all cohorts of the SVT portfolio. The CMA acknowledges that there is a spectrum of engagement.⁶¹
- 5.5 An important consequence of the CMA's failure properly to identify customers who can validly be regarded as disengaged is that if a safeguard tariff were applied to all SVT customers it would not be the least onerous effective measure to deal with the AEC the CMA has identified. It would ignore the diversity in activity and engagement that characterises customers on SVT tariffs. As the CMA notes in its PFs, approximately 25% of SVT customers have been on SVT for less than a year.⁶² Some of these customers have

⁶¹ CMA's Provisional Findings Report, page 379, paragraph 9.35.

⁶² CMA's Provisional Findings Report, page 251, paragraph 7.72.

previously benefited from discounts which are simply not sustainable without some customers transferring to SVT at the end of their introductory discount periods.

- 5.6 To the extent to which some customers i) never switch product or tariff; and ii) are vulnerable according to some identifiable measure, there is merit in considering them, albeit not within the context of a safeguard tariff as envisaged by the CMA. There is the Warm Homes Discount for instance, which provides customers in receipt of certain benefits, with a specified discount. This ensures they have full access to the competitive market and are not locked in to a social tariff which may be more expensive than the cheapest tariff available in the market. This seems to be the best route facilitated by energy suppliers to help vulnerable customers. RWE believes it would be a retrograde step: i) to punish engagement by rewarding those who do not engage; and ii) to support non-engagement in switching (which then leads to non-engagement in energy management).
- 5.7 If the CMA does consider, notwithstanding RWE's submissions, that it needs to address outcomes for some consumers, one approach with potentially fewer adverse effects may be to: i) identify the primary identifiable indicator of vulnerability; and ii) ensure that each and every eligible customer receives a discount. Such an approach is achievable through reframing the Warm Homes Discount by: i) removing the ineligibility of customers who are with exempt suppliers; ii) using the data that the Department of Work and Pensions has, and has used in the past with suppliers; and iii) funding from general taxation or raising VAT on energy supply.
6. **Section E: A safeguard tariff would have very significant adverse effects which are disproportionate to the CMAs aims**

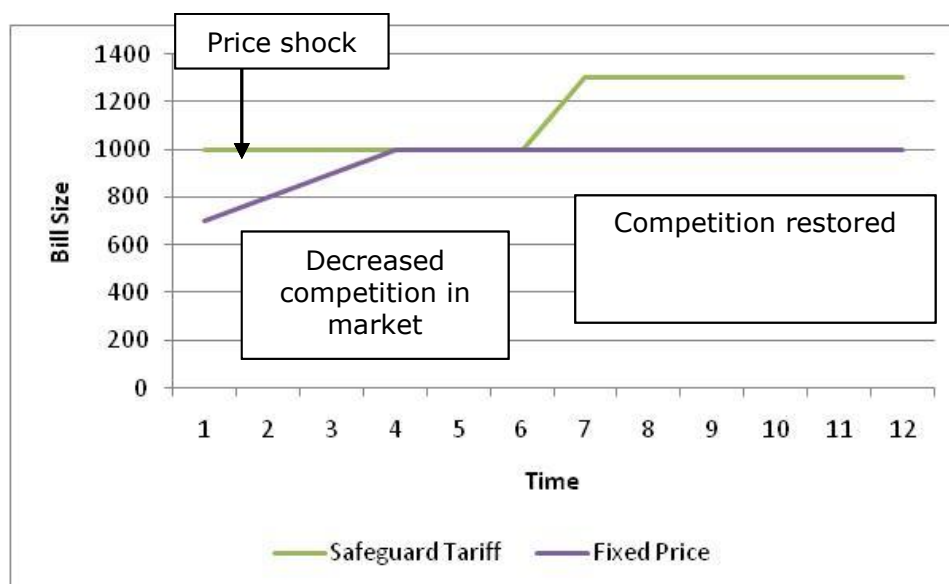
- 6.1 RWE believes that even a temporary price control would have significant adverse effects which are disproportionate to the CMA's aims.

A safeguard tariff would harm competition

- 6.2 RWE believes that currently there is significant competition for SVT customers which would be at risk by the introduction of a safeguard tariff. For example, a reduction in churn / engagement is likely to be driven by a consumer perception that consumers no longer need to look around for competitive prices and products, given the protection implicit in the concept of a fair, regulated, safeguard tariff.
- 6.3 In respect of the existing position, RWE notes that currently:
- 6.3.1 The proportion of npower's meter base that is supplied on an SVT now stands at [CONFIDENTIAL] (Jun-15). This suggests a consistent erosion of RWE's SVT portfolio of c. [CONFIDENTIAL] pts per annum since 2013.
- 6.3.2 In 2015 (to Jun-15), [CONFIDENTIAL] of all losses suffered by RWE were from its SVT portfolio.
- 6.4 These active and engaged SVT consumers are at risk of disengagement via the introduction of a safeguard tariff.
- 6.4.1 During 2014 when npower supplied c. [CONFIDENTIAL] meters with power or gas, [CONFIDENTIAL] meters were either gained from / lost to a competitor (or supply was transferred to another npower tariff) (this excludes customers who default to SVT at the end of a fixed term tariff).
- 6.4.2 The data for 2015 suggests that activity levels are increasing. With [CONFIDENTIAL] accounts on supply with RWE, [CONFIDENTIAL] meters were either gained / lost from / to a competitor (or supply was transferred to another npower tariff) during the [CONFIDENTIAL] (data to June 15)
- 6.4.3 There are now 29 suppliers in the market, and across the market 1.6 million accounts switched suppliers during Q1 this year with 25% of these switches

going to smaller suppliers. Mid-tier and smaller suppliers now account for 10% of all meter points.

- 6.5 If the CMA accepts that the potential gains from switching affect the incentive to engage, as would be consistent with survey respondents' stated reasons for engaging with the market, then it follows logically that a safeguard tariff would lead to a reduction in the pressure that mid-tier and smaller suppliers are able to exert on the rest of the market because the savings available to customers who switch away from the safeguard tariff would be reduced.
- 6.6 In the same way, the introduction of a safeguard tariff may narrow the investment horizons for new entrants. Although they would still benefit from the cost advantages conferred by ECO exemptions, the fact that the differential between safeguard tariff and non-standard tariff will be smaller than the differential has previously been between SVT and non-standard tariff means that the competitive space in which they can operate will be reduced.
- 6.7 RWE therefore believes that a safeguard tariff would lead to reduced, not increased, consumer engagement and competition.
- 6.8 The CMA recognises that search and switching behaviour benefits not only the customers who switch once they have found a better deal themselves, but that it also benefits other customers since the CMA believes that competitive pressure is applied on suppliers when consumers do engage. Any reduction in engagement caused by the introduction of a safeguard tariff will therefore be doubly damaging to competition in the market.
- 6.9 Another AEC may arise as a result of the potential lag between movements in costs and movements in prices. If there is an unexpected rapid increase in costs, acquisition (non-standard) tariffs may immediately be expected to begin to reflect increases in underlying costs as typically energy is bought forward at the launch of the non-standard product allowing costs to be reflected with certainty in product pricing, whilst the safeguard tariff will not be reset until the next price review. As a result non-standard tariffs will potentially be less attractive to consumers, and competition will be distorted over the ensuing period.



A safeguard tariff would adversely affect innovation

- 6.10 The CMA rightly notes in its guidelines⁶³ that measures to control outcomes "are unlikely to generate the dynamic benefits, such as innovation, that are normally associated with

⁶³ CC3, page 71, paragraph 333.

competitive markets. These measures are therefore likely to represent a less comprehensive remedy to the AEC and any detrimental effects."

A safeguard tariff would remove / reduce innovation / efficiency in hedging

- 6.11 It should be noted that the goal of a hedge strategy is to reduce the risk faced by both the supplier and consumer. In a situation where a strategy were prescribed through a price control mechanism a deviation from the prescribed strategy would hold significant risks for suppliers. It would also limit the appetite of suppliers to invest in the development of the science and expertise behind commodity risk management thereby leading to increased wholesale cost volatility with the result of harming consumers.

A safeguard tariff could risk introducing distortions of service

- 6.12 A safeguard tariff may result in a deterioration of service towards levels that are of a minimum acceptable standard to regulators / consumers, as suppliers seek to protect squeezed margins.

A safeguard tariff could risk introducing distortions of competition on non-price attributes

- 6.13 A safeguard tariff could restrict suppliers' ability to differentiate through other non-price attributes to the detriment of consumers.

A safeguard tariff for SVT customers would be complicated to implement

- 6.14 The CMA needs to recognise that SVT customers are not a homogeneous group and that if a safeguard tariff is to be implemented for SVT customers this will require the CMA to take into account a number of important factors in designing the tariff setting mechanism.
- 6.15 RWE considers that setting a safeguard tariff would not be a simple task. In particular, as the CMA has noted, energy tariffs vary according to region, payment type and also with the volume of energy consumption. In respect of the volume of energy consumption, RWE notes that tariff structures usually involve at least a unit rate and a standing charge so that designing a safeguard tariff would be a more complex task than setting a single unit rate. The regulator will therefore have to make careful choices in setting the tariff structure, as these choices raise significant distributional and economic efficiency questions;
- 6.16 The regulator will also have to consider adjustments necessary to accommodate a raft of different subsets of SVT customers.

Tariff structure

- 6.17 The choice of tariff structure would introduce considerable complexity for those tasked with tariff design because the relative size of bills faced by different groups of customers will be affected by the choices made around structure. To illustrate, the CMA writes at paragraph 8.244(c) of its PFs that "RMR curtailed the ability of the Six Large Energy Firms to offer attractive tariffs for low volume users (tariffs with no or low standing charge)". In the context of these remarks, the important point to take from this observation is that tariff design has significant distributional implications as well as having implications for economic efficiency.
- 6.18 Although the RMR consultation in 2013 considered just one question which would need to be answered in setting a safeguard tariff (whether standing charges should be set to zero), it does perhaps usefully highlight some of the inherent difficulties that would be involved in setting a safeguard tariff. In particular, while some stakeholders proposed that standing charges should be set to zero, Ofgem found⁶⁴ to the contrary that it should not specify that the standing charge should be set to zero. In providing its reasoning on this point, Ofgem noted that suppliers have fixed costs which they may seek to recover through a standing

⁶⁴ See paragraph 2.13 https://www.ofgem.gov.uk/sites/default/files/docs/decisions/the_retail_market_review_-_implementation_of_simpler_tariff_choices_and_clearer_information.pdf.

charge and also that there are benefits if consumers have a degree of choice over the standing charges to which they are exposed.

- 6.19 The implications of such considerations are that: (i) a safeguard tariff design would be complex since it would involve setting not a single price, but instead at least: a standing charge and one or more unit rates on a regional basis and for a variety of payment types; and (ii) such decisions could not easily all be made purely on economic efficiency grounds, since they will have significant distributional consequences.
- 6.20 RWE submits that the difficulties that Ofgem encountered in deciding whether the standing charge should (or should not) be set to zero would be magnified many times over if either Ofgem (or the CMA) had to resolve the far harder questions of what a suitable tariff structure should actually be set to.
- 6.21 An additional further complexity is that suppliers will have to comply with the applicable licence conditions which, for example in the case of SLC 27.2, require that price variation across customer groups must be cost reflective. In that respect, RWE notes that - on the one hand - an approach to setting a safeguard tariff in a manner which was other than cost-reflective may be difficult to make consistent with an energy supplier's licence obligations. On the other hand, a purely cost reflective approach would have distributional implications which may, or may not, prove attractive to policy makers.

SVT customer subsets

- 6.22 As well as tariff structure the CMA will need to ensure that safeguard tariffs accommodate the different subsets of SVT customers with special metering or tariff arrangements. For example:
 - 6.22.1 Multi-register - registers record energy usage in pre-determined times of the day/week or season. The most common multi-register tariff is Economy 7 which provides lower-priced electricity for 7 hours at night. Approximately 15% of UK electricity customers are supplied on E7. A register is a time of day, week or month. Each register would need a regulated unit rate. There are more complex tariffs currently, such as economy 8 and economy 10.
 - 6.22.2 Complex meters - these commonly involve complex physical/electrical arrangements in the home. There are very many permutations. Each and every complex tariff would need regulating. This is more complex than multi-register. These meter types are expensive to serve for suppliers, and not targeted for gains. An additional complication is that cost reflective price control for these meter types may well result in increased tariffs. They are commonly associated with in home electrical configurations such that the tariff that they are on is likely to be cheaper for them than a standard tariff that does not recognise their specific configuration.
 - 6.22.3 Dynamic tele-switch.
 - 6.22.4 Independent networks - many customers are served by independent gas and electricity networks. Gas customers in particular are cross subsidised. This cross subsidy would need to be revisited in the construction of safeguard tariffs.
- 6.23 There are extreme difficulties in accurately setting the edifice of safeguard tariffs in absolute terms (region, standing charge vs unit rate ratios, payment method, all consumption volumes, etc.). Then there is the further difficulty in correctly setting and maintaining through time the *relative* levels of different variants of the safeguard tariff for single and multi-registers, so that customers do not receive inappropriate / inconsistent cost signals to change tariffs, e.g. from Economy 7 to single rate. At present suppliers set the rates for their portfolio of tariffs on a cost-reflective basis; any distortion introduced by a safeguard tariff setting mechanism risks corrupting the finely-balanced price relativities and could lead to mixed signals, confusion and, as a result, added costs for customers.

A safeguard tariff would be costly to implement

- 6.24 As currently framed the CMA's safeguard tariff remedy would apply across SVT customers who represent a large majority of the market. As the CMA describes in respect of a market wide price control:

"We observed that the costs of administering a regulated price on an ongoing basis are generally significant as the regulator needs to employ a team of experts and collect a large quantity of data from the regulated firm(s) in order to set prices. In addition, there must be systems in place to allow regulated firms to address the greater regulatory demands etc. Regulators, however competent, are invariably subject to an information asymmetry with the regulated firms, and there is inevitably a degree of judgement involved in the regulator's decisions." (paragraph 135 of RN)

- 6.25 It is not clear that set up costs for the proposed safeguard tariff would be materially lower than those that would be incurred in relation to the regulation of process generally. Given the complexities of implementation already highlighted, RWE considers that the costs of administering the safeguard tariff would also be high.
- 6.26 Moreover, a safeguard tariff will necessitate systems to be in place to allow firms to address greater regulatory demands and the process for tariff setting should satisfy the normal regulatory requirements of fairness and transparency. This will require a process for discussion, consultation, and ultimately challenge and arbitration.
- 6.27 RWE would also suggest that the risks to the industry posed by information asymmetry and the degree of judgment that will be required on the part of the regulator to set multiple tariff variants are greater than those that could be envisaged in the context of simple rate of return regulation. If the regulator sets the safeguard tariffs at such a level that they act to disengage large volumes of customers, competition will be destroyed and barriers will be increased for new entrants to the detriment of consumers.

A safeguard tariff set relative to other energy products would risk increasing the volatility of the price of the safeguard tariff

- 6.28 Setting the safeguard tariff relative to other energy products in the market may increase the volatility of the price of the safeguard tariff to the detriment of risk averse consumers. This methodology risks linking the price of a default variable priced product with energy products that currently have very different characteristics (e.g. fixed term, fixed price). Rules governing how the calculation of the benchmark retail price is performed would require frequent review and strong governance to keep pace with evolving product structures and regulatory risks. The CMA would need to exercise great care when considering which products would be appropriate to include in any benchmarking exercise. Depending on whether the tariff is set high or low it could be unusually sensitive to wholesale prices. Even if set low (leading to longer residence time and lower volatility), if set relative to prevailing tariffs, the volatility could be driven up. Indeed, a possible outcome is that fixed term contracts, which might have short availability windows, could have exceptional volatility for the cheapest tariffs. Behavioural change by suppliers on the advent of a safeguard tariff would be very difficult to anticipate.

A safeguard tariff could distort the wholesale market

- 6.29 RWE believes that a safeguard tariff that defines a hedging approach for suppliers will distort the wholesale market by concentrating suppliers' purchasing activities at particular times to align with the price setting mechanism of that tariff. This would lead to increased market volatility and reduced liquidity at times other than during the defined hedging approach, therefore resulting in higher costs for consumers. In addition, the reduction of liquidity in the wholesale market beyond the one year tenor would reduce the ability of power generators to hedge forward and hence attract finance to support investment.

A safeguard tariff could lead to additional distortions from the Small Supplier Cost Exemptions and compromise of the delivery of Government social policy

- 6.30 The CMA should be mindful of the effect of a safeguard tariff which if set too low could have an impact on the cost/kWh and delivery of social and environmental obligations.

Concluding remarks in relation to this section

- 6.31 For all of the above reasons, RWE believes that a safeguard tariff would have adverse effects which are disproportionate to any conceivable short term mitigating effects that a safeguard tariff remedy would have, bearing in mind that this remedy will only need to address residual aspects of the AEC which are not already addressed by other elements of the CMA's proposed remedies package, as well as changes such as faster switching and smart meters which are already foreseeable.

7. Section F: Responses to the CMA's specific questions

(a) *Should the safeguard tariffs be set on a cost-plus basis, or should they be related to other retail prices?*

- 7.1 For the reasons described above there seems no satisfactory basis for setting a safeguard tariff. Setting tariffs on a cost plus basis, whilst satisfying some regulatory principles (e.g. cost reflectivity), will be extraordinarily complicated. It will be necessary to identify costs by specific customer type on a basis which for some suppliers including RWE has never been done, and which runs the risk of inaccurate or even arbitrary allocation between those customers who are destined for a safeguard tariff and those who are not. Moreover, there will be a series of different costs which should properly be smeared across all customer types and where further potentially inaccurate allocation could occur. Whilst the way in which suppliers use knowledge and trends can perhaps be viewed as akin to an economist's hedonic pricing model (in which relative demand for product plays a role in cost allocation) there is no clear exact science that could be replicated by the regulator more formally, even for one supplier. The challenges of cost determination (and therefore cost plus) for wholesale costs is noted above. For other costs such as supplier opex and capex, there are clearly substantial differences in phasing (e.g. smart roll-out, billing system replacement) and amount across suppliers. We have also noted above the risks of setting a safeguard tariff by reference to the price of other energy products.
- 7.2 That said, in concept, a cost plus basis would be preferable to a 'relative to other prices' basis, given the potential for distortions that the alternative involves. A cost-plus basis would in principle enable the CMA to regulate prices whilst providing consumers and other stakeholders with total cost transparency. Through the cost-plus model, the CMA can in principle also influence the level of price volatility that consumers face by prescribing the frequency that prices will be reviewed and the future time horizon considered for calculating future costs.
- 7.3 There have been considerable past difficulties in accurately forecasting future costs that have been imposed upon the industry. The CMA should consider carefully the appropriate mechanism to adopt in a cost plus model to reflect forecasting errors. For example in 2013 DECC estimated the cost of rolling out smart meters at £12.1bn. In 2014 the estimated costs had reduced by c.10% to £10.9bn. Since this revised estimate other significant cost items have materialised such as additional security requirements (CESG); Smart Energy UK (SEGB) marketing campaign costs; and further technical solutions 2.4/868/alternative HAN/Dual Comms Hub. The CERT scheme (1/4/08 to 31/12/12) cost £0.8bn vs the impact assessment of £1.1bn; CESP (1/10/09 to 31/12/12) cost £205m vs the impact assessment of £102m and ECO (1/1/13 to 31/3/15) was initially assessed to cost £1.3bn and this has since been revised down to £0.9-£1.0bn in the Post Autumn Statement impact assessment.
- 7.4 There are a number of further costs that a supply business manages that must also be considered in a cost-plus approach to setting a safeguard tariff. When assessing its cost base RWE considers a number of costs around complex commodity positions (such as half hourly shape in power), swing risks, environmental obligation risks and network risks to be particularly important and which a regulator would need to take into account in the calculation of any cost-plus approach. It is important to note that these commodity positions and other risks have non-zero expected costs.
- 7.5 While such risks are universal to all supply businesses for 'standard' domestic customers, approaches to managing these may differ by company. One option would be for the CMA to provide the capability for supply businesses to manage these costs in what they consider to be the most effective way. To achieve such an outcome, it would be appropriate for the CMA to include an element of expected cost and risk management cost in the headroom of any safeguard tariff. RWE recognises that it will present a very significant challenge for the CMA to fix on the 'right' level for this element of the headroom so as to allow properly for these aggregate risks.
- 7.6 A second, perhaps no less complex option, is for the CMA itself to assess the risk capital and anticipated costs of managing these positions and add this to the other costs considered when calculating the safeguard tariff. An appropriate risk capital cost would need to consider the cost of capital for an appropriate benchmark supply business. It should be

noted that both the presence and the level setting of the safeguard tariff could have a significant effect on cost of capital, particularly if, in combination with the prevailing obligation exemptions, there is a risk of supplier exit (see further paragraph 6.30 above).

- 7.7 Regulating energy prices by benchmarking tariffs against an external retail price index such as CPI increases the risk that the retail price of energy rapidly diverges from the fundamental costs of supplying energy to a consumer.
- 7.8 As described above, setting the safeguard tariff relative to other energy products in the market may also increase the volatility of the price of the safeguard tariff. This methodology risks linking the price of a default variable priced product with energy products that currently have very different characteristics (e.g. fixed term, fixed price). Rules governing how the calculation of the benchmark retail price is performed would require frequent review and strong governance to keep pace with evolving product structures and regulatory risks. The CMA would need to exercise great care when considering which products would be appropriate to include in any benchmarking exercise.
- (b) *If the safeguard tariffs were set on a cost-plus basis, which approach(es) we should consider to determining the wholesale energy cost element of the tariffs? What are the relative merits of the proposed approach(es) in the context of the purpose of the safeguard price cap?***
- 7.9 The wholesale energy cost element of the tariff should reflect the future energy costs of suppliers over a balanced forward looking time horizon. The CMA should carefully consider the length of the appropriate time horizon, bearing in mind the impacts upon both consumers and competition. A balanced time horizon should protect consumers from price volatility and rapid price increases; ensure adequate liquidity exists within the wholesale market; limit the credit constraints that small suppliers may face; prevent the safeguard tariff from becoming the cheapest tariff if wholesale prices climb rapidly; and limit the price divergence of the safeguard tariff and acquisition tariffs.
- 7.10 As noted in response to question (a), RWE considers a number of risks around complex commodity positions (such as half hourly shape in power) and swing risks to be important in the calculation of any cost-plus approach.
- (c) *Could the imposition of a transitional safeguard price cap result in energy suppliers reducing the quality of service offered to customers on this tariff? Is this risk reduced by customers' ability to choose alternative, unregulated tariffs?***
- 7.11 See the discussion above, in particular paragraph 6.12.
- (d) *Should all domestic and microbusiness customers on default tariffs be rolled onto the safeguard tariff, or should this remedy only apply to a subset of these customers? If this remedy should not apply to all customers, why? And how should energy suppliers identify those customers who should be covered?***
- 7.12 As noted above we see no safeguard tariff mechanism that clearly protects, in all reasonable market outcomes, those consumers for whom it is designed. The potential deterrent to engagement extends beyond tariffs and into demand management. A safeguard tariff applied to all SVT customers ignores the diversity that characterises the SVT portfolio. Treating all SVT customers uniformly is a disproportionate response to the AEC that the CMA has identified.
- 7.13 Where there are consumers who can properly be regarded as disengaged and whose position is unlikely to be changed by other remedies envisaged by the CMA, there are approaches that could be adopted to confer any necessary protection without the need to resort to such an intrusive remedy as a safeguard tariff (see paragraphs 7.15 to 7.18).
- 7.14 More targeted approaches provide scope for greater financial protection than a universal safeguard tariff approach; they remove the significant risk of setting the safeguard tariff such that competition is harmed; they do not incentivise those SVT consumers that are

engaged to become disengaged; they limit the countering effect that a safeguard tariff may have upon the CMA's proposed remedies designed to stimulate churn.

7.15 RWE would propose that the cohort of consumers that most require protection are those that currently receive the Warm Home Discount.

7.16 The CMA has found in its survey that consumers who may be considered to be socially disadvantaged are less likely to consider their cost / tariff when considering their choice of supplier:

"Cost or tariff were less likely than average (73%) to be mentioned first as the most important aspect of choosing a supplier by the following:

On the priority service register (69%); in social rented accommodation (67%); carers (67%); a vulnerable indicator (65%); living with someone with a disability (64%); aged 65 or more (63%); with no qualifications (62%); receiving a warm home discount (62%)"

7.17 Identifying / targeting each of these specific customer groups may require data sharing with Government departments to ensure that those eligible for protection receive it.

7.18 A simple method to protect eligible WHD customers would be to enhance the level of discount that these customers receive, removing the requirement for complexities that a regulated tariff would necessarily involve.

(e) *How should the headroom be calculated to provide the right level of customer protection while not unnecessarily reducing healthy competition?*

7.19 For the reasons described above the instability of the headroom is such that there can be no satisfactory level. Indeed a single tariff could find itself both too high and too low at different times and for different consumers. The CMA has provisionally found that price is the most important factor that consumers consider when switching energy products (although see in this regard RWE's response to the PFs). The headroom should be calculated to ensure that the level of savings available in the market are material enough to maintain consumer engagement.

7.20 Moreover, as described at paragraphs 7.5 to 7.6 above, RWE does not consider that there is any easy way to calculate the headroom reliably.

(f) *What regulatory information would be required to set the safeguard tariffs?*

7.21 A regulator setting the safeguard tariff would require the following information in order to make an informed determination. This is in effect the same set of information that is needed by a supplier when setting its SVT tariff: wholesale price vectors and volatility; demand forecasts and weather dependence; weather forecast and weather variation forecast; wholesale and network costs on all register combinations; fixed and variable costs in all regions and all payment types; demographic variations within each supplier; independent network charges and removals of cross subsidies; payment type cost differentials (i.e. working capital, debt, metering, service, churn etc.); dynamic tele-switch and numerous other metering configurations.

7.22 The regulator would not only have to have regard to the information set just described, but also to the associated timing of any variations in these tariff components, and the relative timings of changes versus the timing of resetting the safeguard tariff itself. The frequency of resetting the safeguard tariff and how variations in the information inputs and relative timing of changes in them are dealt with will clearly impact the process for providing transparent notification to customers of the impact of any change in the safeguard tariff, and further change may be required in relation to obligations under SLC 23 as a result.

(g) *How long should the safeguard price caps be kept in place? Is it appropriate to include a specific sunset provision, or should there be a commitment to review the need for and level of the safeguard price caps after a certain period of time?*

- 7.23 A safeguard tariff is likely to exacerbate the issues of engagement which have prompted the CMA to consider its introduction. The longer it remains in place the greater the problem of residual customer disengagement is likely to be. Consequently, RWE considers that it is essential for any remedy of this nature to be clearly defined in terms of its duration, with no potential for the remedy to become open-ended. Duration would be key to proportionality, and so the period should be as short as possible.
- (h) *How frequently – if at all – would the level of the cap need to be reassessed? If the cap is set on the basis of directly passing through wholesale and network costs, then it may not be necessary to revisit the safeguard price level.***
- 7.24 See discussions at paragraphs 4.5.1, 4.5.3 and 4.5.5.
- 7.25 If the safeguard tariff is set on the basis of directly passing through wholesale and network costs it should nevertheless be reassessed periodically so that changes to underlying costs can be reflected within the safeguard tariff. The CMA would require to have a specified measure of what those costs are and a means of translating these movements into the tariff effectively to avoid having to revisit the safeguard price level.
- 7.26 The level of headroom should be reviewed regularly to consider whether any unintended consequences have materialised.
- 7.27 RWE suggests that suppliers should have a 're-opener' clause that prompts the level of the cap to be reassessed in the event of unforeseen consequences / insufficient headroom.
- (i) *Which energy suppliers should be subject to the safeguard cap, and why? Should it be restricted to the Six Large Energy Firms, or should all retail energy suppliers be covered?***
- 7.28 If the CMA is able to identify a category of customers who can properly be regarded as disengaged, and whose disengagement will remain unchanged following the adoption of any of the other remedies proposed by the CMA, then in RWE's view it would be appropriate to confer protection on all customers falling into this category, irrespective of which supplier they buy their energy from. Not to do this would be clearly distortionary.
- (j) *How should the transition from the current arrangements be managed? We note that an immediate requirement to change the prices for all customers on standard variable tariffs, rollover, evergreen, deemed and out-of-contract tariffs might put pressures on certain suppliers more than others. Should there be, therefore, a period over which the safeguard price cap is phased in? If so, how long should this period be and how should the transition work?***
- 7.29 In principle any safeguard tariff should be phased in over a period of time to smooth out operational constraints that suppliers may face if a 'big bang' approach was adopted. The exact timeframe required and the details around how the transition would work would depend upon the volume of customers subject to the regulated tariff and the details around the expectations placed upon suppliers to notify consumers of price increases and/or decreases.
- 7.30 For the reasons already given, RWE considers that the introduction of a safeguard tariff with such wide application as is indicated would be manifestly disproportionate. It will therefore be appropriate for the CMA to re-consider this question if it is able to identify a category of customers who can properly be regarded as disengaged and whose disengagement will remain unchanged following the adoption of any package of remedies proposed by the CMA. RWE considers that the only effective way in which there could be a phasing in of such a remedy is if there were objective criteria by reference to which such customers could be distinguished (e.g. never switched product, never switched tariff, switched and on eligible benefits, etc.).
- 7.31 Given the CMA's own concern that setting a regulated tariff at the right level is very difficult, the CMA might also usefully give consideration to a staged approach to establishing the appropriate headroom within any safeguard tariff, so that the headroom might be set at a

cautious (higher) level at the outset, and then reducing subsequently. This could help diffuse the potentially harmful impact to customers of stifling competition – although clearly as the situation can change quickly such an approach remains far from providing a simple solution.

(k) *Would energy suppliers have the ability to circumvent the remedy, for example, by encouraging disengaged customers to switch on to less favourable, unregulated tariffs, and how such risks could be mitigated?*

7.32 The CMA should explain clearly what it means by a less favourable tariff. It is not clear whether a premium priced long term fix is a more or less favourable product compared to a safeguard tariff which is subject to regular price reviews and market volatility.

7.33 It is difficult to envisage a scenario where a supplier could encourage customers (that the CMA has concluded are disengaged) to switch to a 'less favourable tariff' as these same customers have so far rejected repeated attempts by suppliers to entice them to subscribe to more favourable (price) tariffs.

7.34 In any event, however, RWE considers that the scope for circumvention would be limited. Existing marketing rules (SLC 25 and the associated principles) and Standards of Conduct, as well as Trading Standards, Advertising Standards etc., preclude misleading practices. Indeed it is usually not in the interests of suppliers to encourage customers to switch onto unsuitable products.

7.35 By ensuring that any safeguard tariff is visible across all price comparison services, consumers will be able to make an informed choice as to whether they wish to switch to a different tariff.

(l) *Should the CMA set the level of the safeguard price caps itself, or should make a recommendation to Ofgem to do so?*

7.36 RWE would favour Ofgem as setter of the safeguard tariff. In any event however, the mechanism for setting the safeguard tariff must be clear, detailed, and fully transparent, and any decisions in relation to the setting of the safeguard tariff levels should be subject to normal rights of appeal.

(m) *Are there any potential unintended consequences of setting safeguard price caps, for example, in terms of their potential impact on the level of other, unregulated tariffs?*

7.37 All tariffs in the market affect all other tariffs. RWE believes there are very significant risks of adverse effects associated with the introduction of a safeguard price control as described above in paragraphs 4.3 to 4.5.

CMA remedy 11 - A transitional 'safeguard regulated tariff' for disengaged domestic and microbusiness customers

SME RESPONSE

1. Introduction

1.1 RWE does not agree that a safeguard tariff, even a transitional one, could be a part of an effective and proportionate package of remedies to the AEC that the CMA identifies.⁶⁵

1.2 In particular, RWE considers that a safeguard tariff would not directly address the AEC arising from an overarching feature of weak customer response and would not be an effective remedy, since it would be costly and inherently risky to implement. Specifically, RWE considers the complexity inherent in the wide mix of customers and meter types would impose very significant practical barriers to the implementation of a safeguard tariff. The business market is characterised by a heterogeneous customer group who are provided with largely bespoke negotiated contracts. The reasons for these bespoke negotiated contracts include the large degree of underlying variation across customers in at least the following dimensions: (i) meter types; (ii) supply and service offerings; (iii) consumption levels; (iv) legal status (e.g. sole trader, partnership, limited company); and (v) credit ratings.

1.3 More generally, RWE does not believe that a safeguard tariff could form part of a package of proportionate remedies since:

1.3.1 RWE believes that the CMA's PFs are currently significantly overstating the scale of any detriment for at least the following reasons: There are methodological problems in the CMA's profitability analysis, including the CMA's dismissal of evidence in terms of the greater risks associated with supplying energy to SME/microbusinesses customers; a failure to take into account that margins have declined over the period review and adoption of competitive benchmarks that are unrealistic. In addition, RWE considers that the CMA's PFs have overstated the levels of disengagement in the market; many of those SME/microbusiness customers that the CMA regards as disengaged by virtue of being on so-called 'default' tariffs have in fact engaged in the recent past, so it would be wrong to regard them automatically as disengaged. Additionally, it is very important that the CMA takes proper account of the recent voluntary ending of auto-rollover by the largest SME/microbusiness retail energy suppliers, which we would expect to increase engagement.

1.3.2 To the extent that there is a detriment, RWE believes that a package of remedies including remedy 7b, remedy 8, remedy 9 and remedy 10 will address the detriment that the CMA identifies in an effective, timely, manner.

1.3.3 RWE submits that the adverse effects of a safeguard tariff would, in any event, be manifestly disproportionate to any residual benefits from attempting to mitigate short term residual detrimental effects on consumers from the AEC.

1.4 The rest of this response develops each of these important points in further detail.

2. A Safeguard Tariff for the microbusiness market would not be effective

2.1 We agree with the concerns the CMA has identified in respect of price controls at paragraph 136 of the RN but RWE does not agree with the sharp distinction that the CMA draws between the disadvantages of a market-wide price control and the possible safeguard tariff.⁶⁶

⁶⁵ This response should be read in conjunction with RWE's response to Remedy 11 for the domestic market since we have sought not to duplicate the material in the submissions except to the extent appropriate.

⁶⁶ See paragraphs 1.5 to 1.7 of RWE's submission in respect of Remedy 11 for the domestic market.

- 2.2 With regard to the CMA's concerns about the risk of the tariff being set either too high or too low, which are considered in more detail in the Domestic Response, RWE notes that the complexity of the meters and customer types in the microbusiness market in particular exacerbates these risks significantly.

A safeguard tariff would be costly

- 2.3 RWE would expect the cost to set-up and maintain the Safeguard Tariff would be significant.

A safeguarding tariff is not effective in achieving the CMA's aims and introduces additional risk, thereby increasing the likelihood of adverse effects

- 2.4 When considering effectiveness, the CMA's guidelines state⁶⁷ that the CMA "*will consider the risks associated with different remedy options and will tend to favour remedies that have a higher likelihood of achieving their intended effect.*" RWE believes that a safeguard tariff would be an inherently risky and therefore an ineffective remedy. As the CMA describes in respect of price controls in general:⁶⁸ "If the regulated price is set too high, it will be less effective in constraining the regulated firm(s)' market power that it should be. In contrast, if the regulated price is set too low, the regulated firm will not have an incentive to invest in maintaining levels of quality."

- 2.5 RWE believes that there are a variety of specific risks that would result if the CMA were to implement a safeguard tariff in the microbusiness market. These include:

- 2.5.1 **Risks from incorrectly setting the required degree of headroom:** The CMA refers to the need for headroom at paragraph 93 of the RN, where the CMA writes: "*a transitional safeguard price cap would need to include some 'headroom' in addition to an assessment of cost to allow for active and effective competition while still providing sufficient protection for customers. The level at which a safeguard cap is set has important implications. If it is set tightly, it will have a damaging impact on competition, undermining incentives for customers to engage in the markets. On the other hand, if set at too high a level, then at best it will provide no protection to customers, and at worst potentially provide a higher focal point for default prices to settle.*" RWE submits that the CMA needs to consider carefully the very significant risks of incorrectly setting the headroom and more generally the difficulties in doing so, particularly given the wide variation in microbusiness customers.

- 2.5.2 **Forecasting risks:** Many elements of cost must be forecast and there is an inherent risk that this may be done incorrectly. For example:

- 2.5.2.1 In National Grid's Transmission Charging Methodology Forum meeting on May 15th 2015, information was presented on the accuracy of year ahead price forecasts for balancing system costs. This showed that National Grid's actual costs in 2014/2015 out-turned 28% higher (£0.43/MWh) than had been forecast

- 2.5.2.2 RWE does not publish or finalise its feed-in tariff rates until around September following the chargeable period (April to March), meaning that forecast costs are always used in price setting. If a firm's own forecasts out-perform those available in the market then that firm's view of costs could be very different to the regulator's.

- 2.5.2.3 It is frequently the case that a firm's own-cost forecasts prove in retrospect to have been materially inaccurate. RWE submits that there is every reason to believe that a regulator would be less well placed to forecast the required costs than firms in the industry

⁶⁷ CC3, page 71, paragraph 335.

⁶⁸ RN, paragraph 136.

currently are when setting price-levels. As a result there may be an increased risk that tariffs that do not reflect actual economic costs. It is also unclear who (the suppliers or the regulator) would be responsible for errors in forecasting costs and, if there were to be a windfall profit arising from a miscalculation, how this would be treated.

- 2.5.3 **Distortions in competition from incorrect forecasting.** Incorrect forecasting increases the risk that the distortions of competition set out in 2.5.1 materialise. That is, if the safeguard tariff were too low relative to other prices offered by suppliers, customers who would ordinarily have chosen competitive tariffs, may find that it is more attractive to remain on the incorrectly priced safeguard tariff.
- 2.5.4 **Reduced innovation in cost management:** Under competition, suppliers have strong incentives to invest in cost management, including the development of innovative methods for accurate forecasting. RWE notes that many costs need to be forecast, and expertise within individual firms can be a key differentiator that materially impacts suppliers' performance. This in turn provides rewards from having innovated and invested in, say, forecasting capability. To illustrate, RWE has described to the CMA its investment in developing an innovative approach to managing its wholesale energy costs through hedging⁶⁹. Under a safeguard tariff, while there will remain incentives to manage costs (as costs help margins), there will no longer be the same incentive to outperform other suppliers to be able to charge a lower price in respect of those customers who remain on the safeguard tariff.
- 2.5.5 **Distortions of competition in relation to hedging:** A tariff with a hedge profile defined by the CMA (or other) would not be optimal and responsive to market pressures; it would not respond dynamically to changes in the market. A supplier is always trying to manage its risk, not use a hedge strategy to speculate on the direction of the wholesale market, therefore the supplier would follow the defined path to reduce its risk of getting it wrong. This would be sub-optimal for the market as there would be no competitive pressure to change hedge strategy.
- 2.5.6 **Specification risk:** RWE submits that the design of a safeguard tariff in relation to other retail prices would be subject to risks described in the CMA Market Investigation Guidelines as 'specification risk'.⁷⁰ In particular, RWE considers that the CMA may find it challenging to provide a suitable definition of the reference retail price – which it submits would be critical.
- 2.5.7 **Monitoring and enforcement risks:** RWE submits that the design of a safeguard tariff in relation to other retail prices would be subject to risks relating to the ability of the regulator to either calculate the reference prices itself or to monitor/audit the calculation of those prices by suppliers.
- 2.5.8 **Increased prices to engaged customers:** As noted above, microbusinesses encompass a diverse range of customers, ranging from sole traders with consumption that is akin to a domestic customer, potentially with strong credit histories, to small customers with much higher consumption with different credit standings. As stated in paragraphs 412 to 421 of the response to PFs, RWE does not consider that it makes excess profits from its SME business and therefore if the cap is set too low, i.e. the headroom is insufficient to cover the additional costs and risks which are inherent in this varied group of customers, then prices offered to engaged customers may have to rise to compensate. This would result in a loss of some of the customer benefit associated with the bespoke negotiation model.

⁶⁹ See, for example, RWE's responses to Questions S18 and S19 of the Retail Supply Financial & Market Questionnaire, 23 September 2014.

⁷⁰ CC3, Annex B, page 99, paragraph 40(a).

- 2.5.9 **Loss of customer benefits from different products:** If a safeguard tariff was applied equally to all so-called 'default' microbusiness customers, customers in different states/circumstances would be treated the same, with the consequence that some may be charged less than they would be based on their risks and costs, and others more. This is because, within the current CMA definition of 'default', RWE has customers who have notified us they are leaving (Default), customers who have moved properties and not yet set up a contract (Deemed), customers who are still on the same product that they were on prior to liberalisation of the markets (Tariff), and customers who have negotiated a contract in the past 1-3 years but have not yet notified us of their future intentions. These customers have very different risk profiles and this is described in more detail in paragraph 2.7).
- 2.5.10 **Distortion to competition through reduced engagement:** RWE submits that a safeguarding tariff would be likely to reduce engagement and churn because at least some customers are likely to have the perception that they do not need to look around for competitive prices and products, given the protection implicit in the concept of a fair, regulated safeguard tariff.
- 2.5.11 **Distortion to competition through reduced innovation and new market entry:** As the CMA notes with regards to price control regulation (which it is not minded to recommend⁷¹), the maximum price level for default tariffs becomes the effective price cap in the market for all products, thus becoming a potential barrier to innovation and new market entry.
- 2.5.12 **Distortion to competition through reduced incentives for TPIs to be active:** A safeguard tariff may reduce the incentive/ability for TPIs to be active in the market. The TPI model is driven by the savings that TPIs can offer its customers as compared to their current products. If the safeguard tariff reduces the differential between the prices and therefore reduces the savings customer could make by going through a TPI, this would be expected to put pressure on TPI margins as they strive to engage customers. The reduced TPI margins may reduce their incentive to engage in the microbusiness segment.

RWE believes a safeguarding tariff would not be part of a proportionate remedy package

The CMA has overstated the scale of detriment

- 2.6 RWE believes that the CMA has considerably overstated the extent of any detrimental effects that need to be remedied. In particular, RWE submits that it does not make excess profits from its SME business. In fact, RWE believes that the CMAs analysis in relation to consumer detriment (see 362 to 403.2 of response to PFs) is fundamentally flawed.
- 2.7 RWE further believes that the CMA has significantly overstated the extent to which microbusiness consumers are, in truth, disengaged. In respect of this point, RWE notes that the microbusiness market is very diverse comprising several very different products that are available for various customers with different circumstances. RWE notes that the CMA envisages this remedy applying to 'default tariffs', stating that "[c]ustomers who, in spite of the prompts provided, did not actively choose a new tariff at the end of their existing contract, would be rolled on to ... a microbusiness default tariff"⁷². RWE therefore interprets the CMA's definition of 'default' to include any customer who has not actively chosen the product they are on, regardless of tenure. In RWE's experience, 'default tariffs' would include the following four groups of customers, who have varied characteristics and have demonstrably very different levels of engagement. In RWE's view, customers on these products are not a homogenous group and nor are they necessarily disengaged:
- 2.7.1 **Deemed** - If a business consumer moves into a premises that are on a networked gas and/or power supply, then until such time they enter into a bilateral contract with a supplier, they are deemed to have a contract with the

⁷¹ Paragraphs 132 – 182 of the RN.

⁷² Paragraph 92 of the RN.

supplier that is registered to the meter point. This is a transitional product until we can convert the customer onto a fixed term contract, an alternative product or the customer leaves npower. These are currently subject to regulatory oversight from Ofgem, and the pricing methodology is required to be cost reflective.

- 2.7.2 **Default** - The customer has terminated their contract, and has remained on supply after their contract end date but has not yet been registered with a new supplier. This is another transition product until the customer either leaves npower or negotiates another contract.
- 2.7.3 **Tariff** - This is a protected product for customers who have not moved since privatisation. [CONFIDENTIAL]. Around [CONFIDENTIAL] of RWE's Tariff customers [CONFIDENTIAL].
- 2.7.4 **Flexible** - This is a renewal product that a customer goes onto if they do not negotiate another contract. It is a fixed price for 12 months and the customer can leave giving 30 days' notice or can negotiate another contract at any time. It gives customers the combination of price certainty and freedom to leave. This has been available to all RWE customers since November 2014, and since this time [CONFIDENTIAL] customers have moved onto the Flexible product who would otherwise have been on the Auto-renewal product, with approximately [CONFIDENTIAL] of customers moving on [CONFIDENTIAL] each month, and around [CONFIDENTIAL] of customers choosing to leave RWE who would otherwise have been locked in for another year. Moreover, these figures are steadily [CONFIDENTIAL] over time as customers' awareness of their ability to either negotiate or change supplier increases.
- 2.8 RWE submits that it is unarguably inappropriate to treat customers on all of these tariffs as analogous for the purposes of considering the appropriateness and proportionality of a safeguard tariff for microbusiness customers. In particular, RWE submits that Deemed and Default customers are fundamentally in a transitory state. However, RWE accepts that, in contrast, this may not be the case for those who are on a legacy tariff, and for some customers who have remained with us since the end of a fixed term contract, although in this regard we note that some Flexible customers appear to be using it as a transitory product whilst they shop around for an alternative product, as evidenced by the data referred to in paragraph 2.7.4 above.
- 2.9 RWE's Default and Deemed customers are, as noted above, in a transitional state and there are unique risks associated with managing these customers (they may leave at short notice, leaving RWE with energy that has been purchased on the wholesale market, for which RWE will not be compensated, and a higher proportion of debt).
- 2.10 With respect to customers on our Default tariff, it is important for the CMA to properly take account of the fact that these customers are clearly engaged as they have actively terminated their contract and have indicated to RWE that they wish to leave. RWE considers, therefore, that these customers cannot properly be regarded as disengaged and a safeguard tariff for these customers would not be necessary or appropriate.
- 2.11 The Deemed product is applied as a result of a customer moving into new premises and any business should expect to have to make arrangements with all its suppliers relating to a new location. The Deemed product is an industry provision to give security of supply whilst contractual arrangements are put into place and the average tenure on the Deemed product is short ([CONFIDENTIAL]). Furthermore, the methodology underpinning this product is already regulated by Ofgem to reflect cost reflectivity and if there are concerns over the methodology that is employed, then we would suggest that it would be more effective and less onerous to review the current regulation in place than to apply this remedy. As we have explained previously to the CMA, there is a higher degree of risk associated with this product, particularly with regard to debt recovery, and in order for this remedy to be practicable if it were to be imposed (even though we do not think that this would be effective or proportionate), it would be necessary to set a safeguard tariff specifically for this product which would add to the complexities of implementing this remedy.

A safeguard tariff is not the least onerous effective measure, and is not proportionate in relation to the CMA's proposed AEC in the microbusiness market

The CMA's other remedies, in combination with changes already in train, will effectively address the CMA's concerns

- 2.12 RWE notes that in assessing proportionality, it is important that the CMA takes proper account of the changes that are already occurring in the microbusiness market and also of the impact of other elements in the CMA's proposed package of remedies.
- 2.13 In this respect, RWE believes the end of auto-roll-over has increased competition. The absence of any tie-in with respect to contract length on Default tariffs means that suppliers are now highly incentivised to engage with those customers in order to secure their supply onto a fixed term contract. The other large suppliers have also made this change, with varying implementation dates. This fundamental change has had only a few months to impact on the market and already RWE is seeing that churn rates are [CONFIDENTIAL], as customers take advantage of not being locked into a contract term. Since November 2014, out of [CONFIDENTIAL] customers who moved onto the Flexible product:
- 2.13.1 [CONFIDENTIAL] customers have chosen to negotiate a fixed term contract with us;
- 2.13.2 [CONFIDENTIAL] customers have left us, or are in the process of doing so.
- 2.14 These customers are taking advantage of the new terms and conditions of RWE's Flexible product, and most of these re-negotiations and losses would not have taken place under the old auto-renewal terms and conditions. RWE expects these figures to rise over time with more customers being aware of and opting to exert their right to either negotiate a new contract or change supplier at any point by giving 30 days' notice.
- 2.15 RWE believes that in making its assessment the CMA should take into account its proposed remedy 8 which will ensure a level-playing field, making the market more competitive with even greater 'protection' for customers who choose not to engage or switch, and thereby reducing the extent of the CMA's concerns. RWE believes that the market-wide end of auto-roll-overs would result in a smaller degree of 'see-saw' pricing because it would result in a reduction in the degree to which the smaller suppliers currently use very low acquisition prices to acquire customers in the anticipation of automatically rolling them over. The change envisioned by the end of auto-rollover will mean RWE's acquisition price could return to more normal levels and our Flexible prices would also reduce as a result.
- 2.16 RWE believes that the abolition of auto-renewals alone, especially when widened to all suppliers (as proposed in remedy 8), will have a significant positive impact on customer engagement in the business market. It will be in a supplier's interests to contact customers on their Flexible product (or equivalent) as customers will have an increased ability and incentive to shop around for a new product once their contract has ended.
- 2.17 RWE also believes the CMA must take into account the increase in competition that has followed from the introduction of greater transparency over contract price and energy usage information on customer bills. More specifically, there have also been some recent changes to how suppliers communicate with microbusiness customers, for example contract end dates and consumption on bills, additional price information on renewal letters and improvements to customer letters, that we believe will all increase engagement in the SME market. RWE has had substantial contact with its most long standing customers over the last three years and RWE has already provided evidence to the CMA that these customers may have negotiated a different contract rate with us during that time.
- 2.18 We refer, in addition, to our proposal in the context of remedy 9 concerning the adoption of a common framework to allow customers to evaluate key elements of energy contracts which, in our view, would improve customer engagement and ease of accessing and comparing offers in the SME market.

Conclusion

- 2.19 In summary, RWE believes that the introduction of safeguarding tariff would be disproportionate and would fundamentally change the microbusiness market without truly addressing the AEC in question and, for the reasons set out above, would in turn give the majority of customers (who qualify as microbusinesses under the current Ofgem definition):
- 2.19.1 Less choice;
 - 2.19.2 Less value for money;
 - 2.19.3 Less incentive to engage with their suppliers;
 - 2.19.4 Less incentive for suppliers to engage with them;
 - 2.19.5 Less chance of contacting/being contacted by a TPI to be offered competitive deals; and
 - 2.19.6 Less protection from short term commodity price changes.

3. Specific Questions

(a) ***Should the safeguard tariffs be set on a cost-plus basis, or should they be related to other retail prices?***

Cost-plus basis

- 3.1 For the reasons set out above, there does not seem to be a satisfactory basis for setting a safeguard tariff for microbusiness customers. The challenges of cost determination (and therefore costs-plus) for wholesale costs and the challenges brought about by the very different risk and consumption profiles of microbusiness customers are discussed above in paragraphs 2.5.2 and 2.7;
- 3.2 RWE further submits that it has a specific concern that arises because it is unclear how a safeguard tariff would deal with meter-specific costs, such as meter asset charges (MAC) on gas meters. As an example, we have a deemed gas meter that was formerly an oil refinery site but is only now used for offices. The MAC is approximately [CONFIDENTIAL] per year and, if a safeguard tariff were to be set, it would be impossible to recover costs for this particular meter unless the safeguard tariff allowed for some pass-through of specific cost items. In this case, if the safeguard tariff failed to pass through the meter-specific costs, then the customer would be actively discouraged from entering into a different product or to engage with any supplier.

Retail Price basis

- 3.3 RWE considers that there are considerable risks that would result from using retail prices to set the safeguard tariff. We explained in paragraphs 2.5.7 – 2.5.8 the potential significance of specification, monitoring and enforcement risk that may arise using this approach. In addition, the problems associated with deriving the appropriate extent of any headroom to be added would also remain (see paragraph 2.5.1).
- 3.4 Under either scenario the level of detail at which the safeguard tariff is set would also influence the efficacy of the calculation method, and RWE gives a detailed response on this aspect under question (f) below.
- (b) ***If the safeguard tariffs were set on a cost-plus basis, which approach(es) we should consider to determining the wholesale energy cost element of the tariffs? What are the relative merits of the proposed approach(es) in the context of the purpose of the safeguard price cap?***
- 3.5 RWE believes that there are considerable risks that would make a safeguard tariff set using a cost-plus methodology ineffective and also subject to a number of potential adverse effects (see paragraphs 2.5.1 to 2.5.12). RWE also believes that the views expressed at paragraph 7.9 to 7.10 of the response to remedy 11 for the domestic market are applicable to the microbusiness segment.
- 3.6 RWE also submits that if the CMA were to proceed with this approach, then it is vital that there is at least full transparency of the cost bases used.
- (c) ***Could the imposition of a transitional safeguard price cap result in energy suppliers reducing the quality of service offered to customers on this tariff? Is this risk reduced by customers' ability to choose alternative, unregulated tariffs?***
- 3.7 Due to the costs of managing a varied and volatile customer portfolio, the costs of gaining and losing customers, and the desire to achieve economies of scale on operating costs, suppliers are currently incentivised to retain customers whenever possible, and preferably on a fixed tenure basis due to the increased certainty that this brings. Customer satisfaction is therefore a critical success factor for us.
- 3.8 However, as discussed above, if the safeguard tariff is not set to reflect the different cost profiles of customer groups or if costs are incorrectly forecast, such that the safeguard tariff does not allow suppliers to recover the costs of their highest risk / highest cost customers,

the result may be an increase in prices to customers the CMA considers to be engaged and/or a deterioration of services, as suppliers seek to protect squeezed margins. Although suppliers will continue to meet standard of conduct obligations, there is a risk that there will be an adverse impact on customers as suppliers attempt to meet their obligations at a lower cost and with lower innovation budgets, with the consequence that there will in the future be fewer communications with and offers to customers, leading to a negative impact on customer satisfaction.

- 3.9 RWE notes, in addition, that the incentive to retain customers on a fixed contract may also change, if margins on the safeguard tariff are greater than on acquisition and retention products. In these circumstances, suppliers may have less incentive to engage customers and more of an incentive for them to remain on the safeguard tariff.

(d) *Should all domestic and microbusiness customers on default tariffs be rolled onto the safeguard tariff, or should this remedy only apply to a subset of these customers? If this remedy should not apply to all customers, why? And how should energy suppliers identify those customers who should be covered?*

- 3.10 RWE sets out in paragraph 2.7 above the four tariffs that would, according to the CMA, be characterised as a 'default tariff' (Flexible, Deemed, Default and Tariff). As described in paragraph 2.7 above, there is a fundamental difference between customers who are engaged but in a transitory state (Deemed & Default) and those who have been with us since the end of a fixed-term contract (Flexible) or who are on a legacy product. RWE considers that customers on these four products demonstrate very different characteristics and should not be considered as a single, homogenous group. RWE considers, therefore, that all microbusiness customers on 'default tariffs' should not be rolled onto the safeguard tariff.

- 3.11 As well as considering product types, there are customer or meter characteristics that should be excluded from any safeguard tariff. Mandatory changes to half-hourly (HH) settlement are underway for meters in Profile Classes 5 to 8 and some of these customers will be classified as microbusiness. The application of a safeguard tariff that did not take into account the specific HH consumption data for an individual meter would effectively negate the positive reasons for moving to HH settlements. Customers who consume volume at expensive times of supply could actually be incentivised to stay on the safeguard tariff, unless the headroom is set sufficiently high to cover the most costly consumption profiles – but that would disadvantage other customers with less peaky consumption.

- 3.12 RWE does not agree that a safeguard tariff, even a transitional one, could be a part of an effective and proportionate package of remedies to the AEC that the CMA identifies. Provided a microbusiness customer receives the relevant information that it requires in order to engage effectively in the search and switching process (see our responses to remedies 9 and 10), has the freedom to renegotiate after their contract ends (as we have seen with the voluntary ending of auto-roll-over and see our response to remedy 8), and the TPI market is regulated (see our response to remedy 7), we do not believe the CMA can have any material concerns with respect to the engagement of microbusiness customers and, therefore, the imposition of a safeguard tariff is not necessary.

- 3.13 However, to the extent that the CMA still considers such a remedy is required, RWE considers that a safeguard tariff should, as a matter of principle, only apply to those customers who can properly be regarded as disengaged and whose position is unlikely to be changed by other remedies envisaged by the CMA.

(e) *How should the headroom be calculated to provide the right level of customer protection while not unnecessarily reducing healthy competition?*

- 3.14 For the reasons set out above at paragraphs 2.5.1 to 2.5.12, RWE does not believe it will be possible in practice to strike the right balance.

(f) *What regulatory information would be required to set the safeguard tariffs?*

- 3.15 RWE has interpreted this question to mean what information would a regulator require to set the safeguard tariff.

- 3.16 As set out under question (a) above, information would be required on input costs. In addition forecasts of customer numbers, profile of debt risk, costs to serve would be required. The prices should be reviewed (at least) every quarter to take account of changes in wholesale, network and Government levy costs.
- 3.17 In addition, the CMA will need to be clear on the structure of the proposed tariff and which customers it applies to. As noted above, if the CMA were to impose this remedy, RWE considers that multiple safeguard tariffs would be required (for example, for existing Deemed customers, and subsets of customers on any other products), given the underlying variation in customer characteristics, risks and costs. This would add to the complexity of implementing the safeguard tariff and may run the risk of increasing disengagement by so doing. RWE believes the information that would be required would depend on the definition and structure of the tariffs and to fully take account of the diversity of microbusiness costs, risks and consumption levels, would require the CMA to consider, at least some of, the following aspects.

Definition & Structure of Tariffs

- 3.18 The information required will depend on the level of detail at which the tariff would be set, e.g. single rate, day/night, by area, by payment method, by volume band etc. Similar to our responses to remedies 6 and 7a above, we consider that prices for different customers depend on a variety of factors relating to the nature, requirements and risks of the individual business. The current range of customer factors that need to be considered when setting prices, and which a regulator would need to consider to set the safeguard tariff, include:
- 3.18.1 Legal status e.g. sole trader, partnership, limited company;
 - 3.18.2 Business customer firmographic e.g. business type, consumption, address/GSP/number of sites;
 - 3.18.3 Bill frequency and payment methods;
 - 3.18.4 Complexity of metering arrangements currently used by the customer or sought by them e.g. commercial AMR/Advanced metering that they may already have that may not be inter-operable, traditional metering or SMETS compliant true smart meter (in some instances separate MOP metering arrangements);
 - 3.18.5 Time of day tariff structures; and
 - 3.18.6 The credit rating of the customer's business.
- 3.19 If the tariff is does not take into account these factors, then there are risks to competition due to effectively introducing cross-subsidisation between these differing customer types. The tariff will not reflect real differences in the costs of supplying and serving different types of customer. For example, suppliers incur some fixed costs to serve each meter and therefore the consumption level of a meter will determine the impact of these costs on rate charged when expressed as a unit rate. If the safeguard tariff does not differentiate for consumption levels then low consuming customers are highly likely to benefit (or high consumers to be penalised), potentially to the extent that it will not be commercially viable to offer an alternative product to low consumers. This particular example could also be addressed through the level of standing charge applied, but see question below on the application of the tariff.
- 3.20 Suppliers are currently able to set up different time of use patterns, and this will become even more the case as we move into a smarter world. Centrally defined tariffs would not be able to reflect that variation and individuality, thus limiting innovation and the very STOD developments that the CMA wishes to encourage.
- 3.21 It is not clear whether we would be obliged to charge the exact tariff in a set structure (unit rate, standing charge etc.) or whether it would be applied as a Total Spend cap for a customer, leaving suppliers free to make their own decisions with regards standing charge

and time of day rates. Applying the tariff as a total spend cap would leave it dependent on the view of customer volume and time of day splits, and as such could be open to manipulation. However, matching the exact rate structure will limit innovation around STODs, and has implications for our implementation and system requirements.

(g) *How long should the safeguard price caps be kept in place? Is it appropriate to include a specific sunset provision, or should there be a commitment to review the need for and level of the safeguard price caps after a certain period of time?*

- 3.22 A safeguard tariff is likely to exacerbate the issues of engagement which have prompted the CMA to consider its introduction. The longer it remains in place, the greater the problem of residual customer disengagement is likely to be. Consequently, RWE considers that it is essential for any remedy of this nature to be clearly defined in terms of its duration, with no potential for the remedy to become open ended. Duration is a key consideration when assessing proportionality and in this case we consider, given the limited extent of any potential concerns once the other proposed remedies take effect, the period should be as short as possible.
- 3.23 In addition, due to the risks associated with this remedy, we suggest there should be ongoing monitoring of key engagement indicators throughout the period that any safeguard tariffs were in place.
- 3.24 Customer engagement would need to be clearly defined to provide a benchmark against which to assess market changes, including how suppliers respond to any package of remedies that the CMA decides to impose.
- 3.25 Overall, RWE considers that the potential detriment the CMA is seeking to address is small and that a combination of ongoing industry changes and remedies 7b, 8, 9 and 10 will more effectively address the underlying causes of any disengagement across some narrow customer groups. In addition, as outlined above, there are numerous difficulties inherent in setting a safeguard tariff, which result in a high risk of distorting competition across the microbusiness segment. RWE's view is that a safeguard tariff would be ineffective and disproportionate, but to the extent that the CMA did decide it was necessary, RWE is strongly of the view that it should be in place for as short a period as is feasible.

(h) *How frequently – if at all – would the level of the cap need to be reassessed? If the cap is set on the basis of directly passing through wholesale and network costs, then it may not be necessary to revisit the safeguard price level.*

- 3.26 In light of the risks we describe above associated with setting the cap, we consider it essential that the cap is reassessed regularly if implemented, although a conclusion of the reassessment may be that no change is necessary. It is our view that it would be difficult to expect this to be done any less frequently than our current quarterly price reviews.
- 3.27 In the proposed remedy it is currently unclear how the safeguard tariff would apply over time to customers who fall onto this tariff. Under our Flexible product we provide a fixed price for 12 months, but leave the customer with the option to leave at any point with 30 days' notice. This provides customers with price certainty over a 12 month period which RWE believes is beneficial to customers. The prevailing safeguard tariff would be applied at the point a customer moved onto the Flexible product. If the safeguard tariff were updated during that 12 month period and we were obliged to change the price, then we would need to change this product's terms and conditions. In addition, if the level of the cap were to change on a regular basis, suppliers would be compelled (under their existing obligations) to notify customers of price changes. This would add to the cost and practical difficulties of implementing this remedy, as well as having the potential to impact negatively on customer satisfaction.
- 3.28 Whatever timetable is set for reassessment there should be provision to reassess if any input costs experience a material change, for example due to a change in government policy.
- 3.29 We would expect the domestic and microbusiness timetables to be different, due to variations between those two markets.

(i) Which energy suppliers should be subject to the safeguard cap, and why? Should it be restricted to the Six Large Energy Firms, or should all retail energy suppliers be covered?

3.30 If the CMA is able to identify a category of customers who can properly be regarded as disengaged, and whose disengagement will remain unchanged following the adoption of any of the remedies proposed by the CMA, then in RWE's view it would be appropriate to confer protection on all customers falling into this category, irrespective of which supplier they buy their energy from. Not to do this would be clearly distortionary.

3.31 Moreover, RWE submits that in the SME sector (and indeed in I&C) there are many firms operating and the concept of the 'Six Large Energy Firms' is not appropriate. In the event that remedy 8 was not implemented, then this remedy becomes particularly relevant to suppliers who are not the Six Large Energy Firms, as many of them still have auto-renewal clauses. In RWE's view, if the CMA's findings are such that a safeguard tariff is necessary, then the same level of protection should be provided to similar customer types irrespective of their supplier.

(j) How should the transition from the current arrangements be managed? We note that an immediate requirement to change the prices for all customers on standard variable tariffs, rollover, evergreen, deemed and out-of-contract tariffs might put pressures on certain suppliers more than others. Should there be, therefore, a period over which the safeguard price cap is phased in? If so, how long should this period be and how should the transition work?

3.32 For the reasons already given, RWE considers that the introduction of a safeguard tariff with such wide application as is indicated would be manifestly disproportionate. It will therefore be appropriate for the CMA to re-consider this question if it is able to identify a category of customers who can properly be regarded as disengaged and whose disengagement will remain unchanged following the adoption of any package of remedies proposed by the CMA. RWE considers that the only effective way in which there could be a phasing in of such a remedy is if there were objective criteria by reference to which such customers could be distinguished.

3.33 In principle any safeguard tariff should be phased in over a period of time to smooth out operational constraints that suppliers may face if a 'big bang' approach was adopted. The exact timeframe required and the details around how the transition would work depend would depend upon the volumes of customers subject to the safeguard tariff and the details around the expectations placed upon suppliers to notify consumers of price increases and/or decreases.

3.34 If the safeguard tariff were to replace Deemed, Default and Flexible products, this would require the rewriting of pricing and CRM routines, billing and fulfilment materials and revising all our customer journeys and this would be disruptive and costly. It is difficult to estimate how long this transition should be at this stage, but we think that it should take no less than one year.

3.35 Given the CMA's own concern that setting a safeguard tariff at the right level is very difficult, the CMA might usefully give consideration to a staged approach to establishing the appropriate headroom, so that the headroom might be set at a cautious (higher) level at the outset and then reducing subsequently. Clearly as the situation can change quickly, such an approach remains far from providing a simple solution.

(k) Would energy suppliers have the ability to circumvent the remedy, for example, by encouraging disengaged customers to switch on to less favourable, unregulated tariffs, and how such risks could be mitigated?

3.36 It is difficult to envisage a scenario where a supplier could encourage customers (that the CMA has concluded are disengaged) to switch to a 'less favourable tariff' as these same customers have so far rejected repeated attempts by suppliers to entice them to subscribe to more favourable (price) tariffs.

3.37 [CONFIDENTIAL].

(l) Should the CMA set the level of the safeguard price caps itself, or should it make a recommendation to Ofgem to do so?

3.38 Subject to the application of the remedies to Ofgem on the transparency of its policy making decisions, and consistent with the views expressed in RWE's response to remedy 11 for the domestic market, we consider that Ofgem should perform this role.

(m) Are there any potential unintended consequences of setting safeguard price caps, for example, in terms of their potential impact on the level of other, unregulated tariffs?

3.39 All tariffs in the market affect other tariffs. As stated above, RWE npower believes that there is a very significant risk that the safeguard tariff would become a de facto price cap for all suppliers' products and the safeguard tariff would have to allow suppliers to recover their costs and continue as a viable business (one of Ofgem's duties set out in the Electricity and Gas Acts is to ensure that companies can continue to fund their activities).

3.40 RWE believes, in addition, that there are very significant risks of adverse effects associated with the introduction of a safeguard price control, as described above in paragraphs 2.5.3 to 2.5.12.

O. REMEDY 12a

CMA remedy 12a – Requirement to implement Project Nexus in a timely manner

1. Executive Summary

- 1.1 The CMA considers that some of the ways in which gas settlement arrangements currently function create an AEC in the SME and domestic gas markets.
- 1.2 The CMA considers that this remedy would require Xoserve (the central body that manages meter point registration, meter reads and supplier settlement charging) and the gas suppliers to ensure that Project Nexus is implemented within a given time frame in order to address most of the current inefficiencies in the gas settlement system without undue delay.
- 1.3 One of the main reasons Project Nexus has been delayed and has taken some time to develop is the sheer scale of the project and changes required. It is a significant market reform that impacts all participants. Managing the risk that this poses to both the industry and customers has also been recognised as a considerable challenge.
- 1.4 RWE is supportive of Project Nexus, and is investing considerably in the delivery of internal systems to support it. We are disappointed by the delay and have taken steps including raising industry modifications to attempt to ensure that it is delivered to the revised date of the 1 October 2016 and that there is no further slippage. Despite our disappointment in the delay we believe this is necessary in order to deliver a fully functioning solution.
- 1.5 We note that the CMA remedy focuses on Xoserve and gas suppliers. However, Xoserve is not a licensed entity and operates as the gas transporters' agent that discharges the gas transporters' licence obligations on their behalf. We therefore believe that any requirement should be placed on the gas transporters, rather than on Xoserve itself.

2. Specific Questions

(a) How long should the parties be given to implement Project Nexus?

- 2.1 It is clear that the Project Nexus implementation date of 1 October 2015 is not now going to be met. PwC has been appointed to assure delivery of the project and based on PwC's findings and assessment of the readiness of all parties, the industry's Project Nexus Steering Group has recently recommended that delivery be deferred to 1 October 2016. A new UNC (Uniform Network Code) modification has been raised to amend the Nexus go-live date accordingly.
- 2.2 RWE npower has its own Project Nexus delivery programme and has been on track to deliver on 1 October 2015, despite the numerous delays to the central programme. In addition we are fully involved in the industry programme of meetings and technical workgroups including provision of an alternate representative for the Project Nexus Steering Group. Furthermore we have done all we can to support Xoserve to deliver by 1 October 2015 both bilaterally, for example through the provision of project management advice, and by contributing to wider industry meetings. Therefore we are very disappointed by the delay. However, we do not believe that a remedy by the CMA requiring an earlier delivery date than 1 October 2016 could bring the go-live date forward, as RWE understands that the central programme cannot deliver Nexus any earlier (and this is the reason for the deferral). However, we would support the introduction of a remedy requiring go-live with core functionality on 1 October 2016, as this would help to ensure there is no further slippage in delivery.

(b) Should the CMA implement this remedy directly (eg via an order and/or a licence modification) or should it make a recommendation to Ofgem to implement the remedy?

- 2.3 In our view the CMA should make a recommendation to Ofgem to take this forward, given that Ofgem already has visibility of all the relevant issues and information. We suggest that

a licence condition is placed on Gas Transporters to deliver Nexus by 1 October 2016, in the same way that one is being placed on them to deliver the new Xoserve Funding, governance and ownership arrangements by April 2016. Delivery should inter alia include central functionality considerations and the duties of the Gas Transporter in consultation with the industry. The penalty for non-compliance with that measure should also be made clear and should take into account the impact of the central programme's delays on the programmes of other parties such as gas shippers and their customers.

P. REMEDY 12b

CMA remedy 12b – Introduction of a new licence condition on gas shippers to make monthly submissions of Annual Quantity updates mandatory

1. Executive Summary

- 1.1 The CMA considers that some of the ways in which the gas settlement arrangements currently function create an AEC in the domestic retail market. Specifically, it considers that the inaccuracy, relative to the actual consumption over the last year, of Annual Quantity Updates (AQs) and the lack of ex post reconciliation of settlement charges to the best estimate of actual consumption (as happens in electricity) do not provide the correct incentives for suppliers and that, in particular, they disadvantage certain types of supplier – notably those that have been particularly effective in helping their customers reduce their gas consumption – and lead to gaming opportunities (whereby a shipper may delay adjusting an AQ value if it would be to its disadvantage).
- 1.2 The CMA considers that this may be resolved by introducing a new licence condition making it mandatory for energy shippers to update all AQs on a monthly basis in order to remove the scope for gaming.
- 1.3 RWE believes that the current AQ process for Small Supply Point (SSP) meters is outdated in that, aside from a small number of exceptions (200 SSP appeals per month per shipper), it only allows for AQs to be updated annually. However, as the CMA notes, Project Nexus (which is due to be implemented on 1 October 2016) will enable and incentivise more frequent meter read submissions and provide the opportunity for AQs to be updated on a rolling monthly basis. Additionally a new Gas Performance Assurance Framework (PAF), due to be implemented alongside Project Nexus, will strengthen the governance around meter reads and AQs, including through the potential for financial penalties to be imposed against shippers that fail to perform in this area. More details of this can be found in our answer to question (a) in relation to remedy 12(a).
- 1.4 In the meantime there is currently a reasonably robust governance structure surrounding the review of a gas shipper's AQs in that:
 - 1.4.1 Submitted meter reads go through a validation process by the central data service provider, Xoserve, to ensure they are suitable to inform the AQ value; and
 - 1.4.2 Following the introduction of UNC Modification 81 in 2006, Xoserve produces annual reports designed to identify variances in shipper behaviours (including the overall impact of AQ recalculation and any bias towards increasing or decreasing AQs). These reports provide some protection from the potential manipulation (either upwards or downwards) of AQs by increasing the level of scrutiny on gas shippers directly by Ofgem and also through an anonymised version which is available to all industry parties. Ofgem monitors this report and is able to take action if it has concerns that gaming has taken place; for example Ofgem published an open letter to gas shippers and suppliers informing them of its intention to monitor the progress of the 2013 Annual Quantity (AQ) review both to gain a better understanding of the underlying issues and to provide a health check on the 2013 AQ review as a whole. This was subsequently followed up with a request for further information in May 2014.

2. Specific Questions

- (a) ***Is it proportionate to require the mandatory monthly updating of AQs? Would it be more proportionate to require less frequent updating of AQs? Would less frequent updating still be effective in terms of removing the scope for gaming of the system?***

- 2.1 The introduction of a new licence condition on gas shippers to make monthly submissions of AQ updates mandatory is a disproportionate response to an issue that is already being addressed through Project Nexus and the Gas PAF.
- 2.2 Any move to require mandatory monthly updating of AQ values would impose significant costs, be operationally challenging and would put considerable stress on an industry sector that is already in the midst of several major change programmes including the smart roll-out, Project Nexus, the Gas PAF and changes to the funding, governance and ownership model of its central service provider.
- 2.3 Until Project Nexus is implemented and rolling AQs are automatically updated, the ability of Xoserve to manage the monthly updating of AQs is constrained by system capability and resource capacity. Shippers would be similarly constrained by resource as the current AQ Review process is largely manual and is therefore resource intensive. Furthermore AQs should be based on actual meter reads, as the current process incentivises. Without monthly meter reads only those sites for which a read has been obtained within that month can be updated to ensure the reads used are current. Some IT changes are likely for suppliers and shippers to identify these. Until the mass roll-out of smart meters, monthly reads are generally not available for most suppliers and shippers therefore, if the requirement was to update all AQs on a monthly basis before then, the cost of acquiring monthly 'on foot' reads would be significant.
- 2.4 The frequency of AQ updates is not directly relevant to the opportunity to game. We believe that the key to removing any opportunity to game is to strengthen industry governance to remove both the opportunity to game and provide the correct incentives to behave responsibly and appropriately. The industry is already investing significantly to implement settlement reform via Nexus, which will incentivise (rather than mandate) shippers to procure and submit more frequent meter readings (although in reality this is unlikely to happen en masse until the roll-out of smart metering). This in turn will be quality-assured via industry-specific, consumption tolerance-based validation rules. Further to this, the industry will underpin this reform by incentivising (UNC) shipper performance using the Gas PAF, in order to drive appropriate, and penalise inappropriate, shipper behaviour. PAF will incentivise shippers to submit meter readings on a proportion of their portfolios each month (with the frequency based on the meter point AQ) and will monitor AQ change-related activity.
- 2.5 With this in mind, we believe that it would not be proportionate to mandate monthly, or less frequent, updating of AQs when the industry is already focused on delivering the three key enablers for gas settlement reform: smart meter roll-out to provide shippers with more frequent meter reads; Project Nexus to enable those reads to be submitted more frequently in order to adjust AQs on a rolling basis; and the Gas PAF to strengthen governance around the meter read and AQ processes in order to incentivise a fair and equitable settlement regime and disincentivise some shippers benefitting from inappropriate behaviour in the form of gaming.
- 2.6 RWE would, however, be supportive of suppliers having the ability to submit monthly meter readings and for this information to be used in the settlement of industry charges.

Q. REMEDY 13

CMA remedy 13 - Requirement that domestic and SME electricity suppliers and relevant network firms agree a binding plan for the introduction of a cost-effective option to use half-hourly consumption data in the settlement of domestic electricity meters

1. Executive Summary

- 1.1 RWE agrees that this remedy is necessary and believes it is essential, that greater clarity of regulatory goals and that change is coordinated on an industry wide basis across all aspects of codes and licence regulation if we are to avoid significant sunk costs and poor customer experience
- 1.2 RWE believes that the plan and associated milestones timetable must pragmatic and deliverable across the market, taking account of the scale of direct change and enabling change that may be needed, and the capacity of customers to accept such change and of the market to deliver it. An example of direct change would be the installation of smart meters or changes to billing and systems to use such meters. An example of enabling change would be changes to industry 'Change of Measurement Class' processes so they are capable of processing the likely volume of transactions we will see, or changes to customer permission requirements to allow HH polling of consumption information without need for explicit consent.
- 1.3 Overall, the move to universal half-hourly settlement is going to be a large, very complicated and expensive industry program with the need to plan accordingly and with recognition that the costs are going to be borne by customers.
- 1.4 There is a significant risk that regulatory uncertainty will result from insufficient coordination and alignment of the multiple initiatives that may impact metering, settlements and billing. The initiatives will require substantial investment by companies and will lead to disruption to customers. There is a risk that investment today will be a stranded cost tomorrow if further changes are required. The service impact and cost burden of this will ultimately be borne by customers and if the various regulatory interventions are not coordinated there is a serious risk that policy goals will be undermined.
- 1.5 Simple practical examples of considerations that must be included in a plan are:
 - 1.5.1 For customers to participate in the smarter new markets they will need to have a smart meter;
 - 1.5.2 Unless and until we have reached a point where the majority of customers have a smart meter there is a risk that customers are going to have to pay for an industry change program to facilitate behavioural changes that they may also want to be able to get involved in but cannot until they also have a smart meter (so this is not fair for all customers);
 - 1.5.3 Although this remedy may create demand from some customer groups for a move to smart meters, there is unlikely to be the additional capacity to roll-out smart meters even more aggressively than the existing timetable (so the industry cannot address this issue);
 - 1.5.4 So you must roll-out the meters substantially in advance of the settlement costs being borne and policy makers will still be able to reap the benefits of customers being more engaged with smart meters and reducing their consumption by demand reduction ahead of the additional demand side response that HH settlement may facilitate.
- 1.6 The remedy seeks to address three objectives:

- 1.6.1 More accurate and timely settlements;
 - 1.6.2 More customer engagement;
 - 1.6.3 Demand side response.
- 1.7 The remedy appears to group domestic and microbusiness customers; they are not the same and microbusinesses are themselves a diverse group. The remedy should be applied appropriately and proportionately to these groups; a one size fits all approach would not work. This is because industrial and commercial customers have little discretion as to their energy requirements but they have significant capability to implement controls to manage their requirements. Domestic customers have a fine level of discretion as to how much energy they use, but currently few controls (e.g. in terms of tariff) over that usage. Small and medium-sized enterprises do not have a lot of discretion over their energy requirements, nor do they have the capital investment capability of industrial and commercial customers to control their requirements.

More accurate and timely settlements

- 1.8 The first objective, a move to universal HH settlement for AMR and smart meters would be a significant IT and business transformation programme for suppliers, industry agents and network operators. A project of this type would require a clear strategic vision and a well-resourced overarching industry project management office with a design authority.
- 1.9 Given that the mass roll-out of smart meters is a crucial enabler for universal HH settlement, suppliers must firstly be given time to focus on delivering the roll-out successfully. In particular engaging successfully with customers to ensure that they are engaged with their new meter, open to the possibilities of using it to manage their demand beneficially and equipped with the knowledge of how to do so.
- 1.10 The shared experience of other suppliers and our own AMR programme has demonstrated that the roll-out itself will not be without its problems. For example, electricity metering data (metering technical information and in some cases meter readings) is notoriously poor and we envisage large volumes of data errors being unearthed across the industry as suppliers progress further with their meter exchange programmes. Suppliers must be given adequate time to correct these errors in both settlements and, where appropriate, customer's bills to ensure data is sufficiently robust before migrating to HH.
- 1.11 Allowing sufficient time at this stage to address these issues should avoid cost and further delay (to the detriment of the consumer) on or after migration to HH. We expect these errors to continue to be found throughout mass roll-out so would not advocate migration to HH settlement until the roll-out has completed and the majority of errors have been addressed (i.e. post 2020).
- 1.12 Ofgem has already started its settlement reform work through its Smarter Markets Programme and several issues have been identified that need to be addressed before HH settlement can take place, including revising the change of measurement class process that is currently unfit for purpose for the existing small numbers of meters that migrate from NHH to HH. Secondly, the SMETS 2 meter specification⁷³ does not meet the existing HH settlement requirements so more work is needed to understand whether it is possible to change the current HH settlement requirements. More fundamental is the issue of data privacy which must be addressed, that is to say that suppliers cannot access customers' within day data without the customer's written opt in consent. Obviously without such data it will not be possible to undertake settlement on a HH basis. This has been raised in the Smarter Markets Settlement Reform Workstream and Ofgem has agreed that it needs to be addressed.

More customer engagement

⁷³ SMETS 2 is the only domestic meter.

- 1.13 This could be met through the introduction of a range of different products associated with suppliers (and third parties) having access to HH data, providing customers with access to more information, for example on their consumption levels and patterns, quicker switching, payment and a variety of products including time of use ones. However, not all customers will want these, and the development of them should be left to suppliers (and others) responding to customer demand.

Demand Side Response

- 1.14 This may deliver a number of Ofgem and DECC policy objectives such as those related to promoting sustainability, but we do not believe that this remedy will encourage electricity suppliers to offer innovative tariffs. Again, some customers may want such products if they can make the necessary behavioural changes, and suppliers will respond to that demand by offering innovative products; some may rely on HH settlement, others may not.

Other considerations

- 1.15 In the Government's 2012 Response to the Consultation on the Consumer Engagement Strategy, two of its strategy aims were to 'build consumer support for the roll-out, by increasing confidence in the benefits of smart meters and by providing reassurance on areas of consumer concern' and to 'facilitate the realisation of consumer benefits, by building acceptance of the installation of smart meters and by helping consumers to use smart metering to manage their energy consumption.'
- 1.16 We believe that these strategy aims (along with the third strategy aim related to vulnerable, low income and prepayment meter customers) should be the primary focus of customer engagement in smart metering during the roll-out and that forcing customers into providing access to their half-hourly data and, to some extent, on to time of use ("TOU") tariffs through HH settlement too early will have the opposite effect on those strategic aims and will alienate customers.
- 1.17 Technological developments are also changing the market in ways that policy makers may not have foreseen and may overtake some policy aims. For example, there is now 8 GW of installed solar photovoltaic panels in Great Britain which is starting to alter traditional demand patterns. Large scale energy storage devices are being tested and they too could be used in a way that affects the demand and generation patterns.
- 1.18 If one of the policy makers' aims is to shift demand peaks and to reduce overall demand, these measures may do that without the need for HH settlement. If this were the case it would reduce but not eliminate the need for HH settlement. So whilst it is desirable, we believe that it should be done in a manner that takes account of the wider changes to the market; some may use HH settlement to deliver results, but other elements will not. As such, the argument for Demand Side Response as a reason for the development of HH settlement is not strong.
- 1.19 We consider that this element of the remedy will not be effective in addressing the AEC that the CMA has identified and suggest that allowing parties to innovate to provide the solutions consumers want will lead to a demand side response without always using HH settlement.

2. Specific Questions

(a) *Would this remedy be effective in stimulating tariff innovation, in particular in terms of time-of-use tariffs?*

- 2.1 To be effective TOU products should have HH settlement, but there should be a demand for them by customers too. Some domestic and some Microbusiness customers will want them although many may not. So the transition to HH settlement will create the opportunities to develop TOU products and tariff innovation. However, suppliers and third parties will innovate in different ways to meet the needs of customers. The mass deployment of these products should be allowed to develop in a way that differentiates between offerings. The move to HH settlement should proceed in a way that achieves the objective of widespread HH settlement without requiring suppliers to offer TOU tariffs if they do not see a need for them from their target market.

- 2.2 The market arrangements should allow for the development and deployment of products, but in a manner which is proportionate to customers' demand. In our view some microbusinesses would not respond to TOU pricing. Moving to a settlement arrangement to facilitate products some customers do not want is not a way to stimulate competition. There is no compelling need to move to HH settlement quickly (see paragraph 1.2 above).
- 2.3 With changing patterns of demand and generation, there will be a range of ways that some customers may adopt DSR products; for example, National Grid notes that there is now 8GW of photovoltaic solar panels installed in Great Britain which is beginning to affect traditional demand patterns. The development of low cost storage capacity and an increase in the sale of electric vehicles could also result in customers' demand profiles altering without recourse to smart meters and the need for HH settlement. Given this uncertainty about the future of the energy market, a framework of HH settlement with a long term objective of deployment of DSR products should be sufficient to allow suppliers, network operators and third parties to innovate in response to customer demand rather than to meet policy objectives. Ofgem's Smart Grids Forum (Workstream 6), and the Ofgem Settlement Reform workshops of 2014, have both looked at options to create a framework for delivering TOU and the workstreams are expected to join together under the Flexibility Project to create an end to end solution in the near future.

(b) *How long should the parties be given to agree this plan?*

- 2.4 The transition to universal HH settlement needs to have a clear vision of what is to be achieved. Through its Smarter Markets Programme, Ofgem is reviewing several arrangements that are important elements of the settlement processes and demand management, for example HH settlements, changing the roles of agents, the reduction of settlement timescales and Demand Side Response. Under the same programme, Ofgem is also consulting on quicker switching, registration and the use of objections. The nature of all of these arrangements needs to be clear before industry parties can develop a plan for universal HH settlement.
- 2.5 When a considered and robust plan has been agreed, the stability of no further regulatory major changes would give the industry the time and confidence to embark on major IT and business transformation. This would be an opportunity to simplify arrangements but needs a clear and concise strategic vision of the development for the industry from Ofgem that has hitherto been lacking. Co-ordination from Ofgem and DECC is also integral to ensure that objectives from both parties are supportive and complimentary. Both Elexon and Ofgem have consulted on changes to settlement arrangements from as long ago as 2005. Even at this time, many respondents cited the risk and size of the task as being one that is fundamental to running of the UK electricity supply market, RWE for example stressed the need for a long term delivery plan to deliver HH settlements in Elexon's 2005 Evolution Steering Group.⁷⁴
- 2.6 In order to consider options for reforming settlements, we would need to agree a design/approach, test and implement. Where this has been achieved (almost) in gas, we have struggled with continued delays and setbacks both due to regulatory and technical issues that are, in part, due to the setting of unrealistic delivery timescales and lessons should be learned from this. The Half-Hourly settlement calendar must balance across 17,520 half-hourly periods in a year. Whilst the deployment of smart meters continues and switching timescales and processes are updated, it is difficult to see how this could be achieved in tandem.
- 2.7 Already, the deployment of domestic smart meters has been subject to delays as the timescales for delivering DCC have been moved. The original intention of the Smarter Markets Programme to move to HH settlement from 2018 onwards would now fall into the peak of the smart roll-out. As previously mentioned this would present significant risk to the market at a time when gaining customer trust and engagement is vital for the success of smart metering, and for creating a stable platform on which to create new product offerings.

⁷⁴ https://www.ofgem.gov.uk/sites/default/files/docs/2013/03/20130326_way-forward-on-longer-term-electricity-settlement-reform_0.pdf.

- 2.8 As with Project Nexus, if we can learn lessons from the implementation of P272 (Migration of profile Classes 5-8 to HH settlements), the market needs sufficient time and unwavering milestones, on which to plan and manage the interim period of transition.
- 2.9 For these reasons, and based on experience gained from other large scale projects, we consider that a minimum of 5 years would be required before migration to HH settlements begins and this would be on the assumption that there are no further delays to smart metering. The migration plan would need to take into account industry-wide progress on the smart roll-out; delivery of the necessary changes identified by the Smarter Markets Workstreams; the extent of changes required to suppliers' systems and processes to enable HH settlements as well as customer engagement plans that may include contractual changes. With all of this in mind we believe that again a timeframe of a minimum of 5 years is required to agree to a final robust plan which satisfies the milestones as previously mentioned.
- (c) *What are the principal barriers to the introduction of a cost-effective option to use half-hourly consumption data in electricity settlement for profile classes 1 to 4? How could these be reduced?***
- 2.10 Data collection and storage issues are key barriers and would necessitate the construction of substantially increased IT storage facilities. The cost of these facilities increases with any increased requirement in the pace of implementation. Suppliers would have HH data for sites that previously only had three or four meter readings a year (going from 3 to 17,250 a year). The experiences of P272 and P322 (Supplier Migration Plan to Support P272) show that we should put customers' interests first in such changes. Some will want better information about their consumption (which does not need HH settlement), some may want DSR, but many will be indifferent to the changes. We should not drive through changes that will be disruptive for customers merely to meet policy objectives without clear evidence that customers want the products that the changes could facilitate.
- 2.11 Secondly, successful delivery of HH settlement will also require parties to transform their business processes, in addition to changing metering and settlement arrangements. As previously mentioned in our response to question (b), this will need extensive and detailed planning and co-ordination for an orderly and timely transition that minimises both disruption to customers and the costs of migration. Although the assumption is that smart meter equals HH settlement, this is not an automatic switch from a profile and tariff, to HH settlement and billing. As a supplier we must be able to ensure that the charging, forecasting, and billing are aligned, either to tariff and profile, or product and HH data. To give some idea of potential cost and time implications of such a change, we can look to P272 and P322. As the CMA has stated in Appendix 11.2, the second cost assessment exercise estimated costs in the order of £46 million to £199 million to deliver P272 and a migration timeframe has now been agreed of 17 months for around 167,000 customers in profile classes 5-8. Another, less recent example is that of the New Electricity Trading Arrangements (NETA) introduced in England and Wales in March 2001. The NETA Summary Report on May 2003 (by the Comptroller and Auditor General) stated that the new market-based arrangements were implemented "at a cost of £39 million. Ofgem estimated that, in total, businesses in the industry could incur costs of up to £580 million (in the event the costs of closing the Pool were £40 million less than expected) including in adapting their operating procedures and IT systems to the new arrangements, and that participants could additionally incur operating costs of £30 million a year". Thirdly, having the granularity of HH data to bill and settle is the optimal position as this gives both the customer and the supplier an opportunity to supply energy in a transparent and cost effective way. Equally, the NHH billing must align with NHH settlement arrangements for the costs of profiling to tariff to be reflective. If the billing and settlement are not aligned across either/or (HH and NHH) this can cause considerable losses for the supplier.
- 2.12 Finally, a large barrier for suppliers is the uncertainty created by the lack of a strategic vision and the instability of the present regulatory arrangements. A change of the nature that is envisaged by the CMA would be a major capital investment that would take place over several years. To give an indication of the scale, gas settlement reform through Project Nexus is a multi-million pound programme for many industry parties and, as previously flagged by the CMA, has taken many years to deliver. Having agreed a plan, parties would also need assurances from DECC and Ofgem that the agreed targets and objectives would

not change unduly during the project. To ensure this, it is essential that the plan is not rushed into too early and takes into account the factors cited in our response to question (b).

(d) *Should the use of half-hourly consumption data in settlement for these profile classes (or certain of them) be optional for energy suppliers, or should it be mandatory? What are the advantages/disadvantages of each approach?*

2.13 RWE npower considers that the use of half-hourly consumption data in settlement for the profile classes in question should be optional.

2.14 Mandatory deployment has the advantage of enabling all parties to carry out changes at the same time, but the target date would be to a large extent arbitrary and could create difficulties for some parties. In RWE npower's view, the optional use of this data is preferable for the following reasons:

2.14.1 Although the transition to HH settlement may encourage suppliers to use half-hourly consumption data, we consider it likely that there will always be some sites that will be settled on a NHH basis; customers may not want AMR or smart meters and some sites may not have the necessary communications equipment for data collection;

2.14.2 an optional approach would allow parties to make changes in accordance with their own IT and product programmes, their commercial objectives and more importantly, in response to their customers' demands for the products that smart meters could facilitate; and

2.14.3 The nature of HH settlement for low demand sites is still unclear so an optional approach, underpinned by a clear strategic vision and plan, would allow suppliers to differentiate, innovate and reduce risk to the consumer. The disruption costs which would result from sudden movement from profiled models to granular HH data must not be underestimated. Previous discussions through the Smarter Markets Programme have highlighted that transitional arrangements need to be in place to allow suppliers to move from profiling to HH settlement.

(e) *Are there any distributional considerations that we should take into account in relation to time-of-use tariffs? For example, might vulnerable customers end up paying more if they fail to change their consumption patterns? Or will the decline in the required generation capacity outweigh any increase in peak prices?*

2.15 Although there can be savings for the domestic customer by switching to a TOU tariff, in the future world of smart metering, the onus will be on the supplier to signal to the customer when demand can be shifted. If the market structure is not developed enough to transmit a real time signal for shifting demand then tariffs offered will be experimental and not truly cost reflective.

2.16 All customers, (not just vulnerable) would have the ability to save on their energy when they respond to a signal and all customers, including those that are vulnerable, will be likely to benefit from a variety of payment options that a smart meter will offer. The ability to switch between payment methods will be more flexible and prepayment meter outages, due to lack of credit, will be easier for the supplier to detect, and potentially reduce the risk of self-disconnection. However, there would be no reason to offer a tariff that penalises the consumer, should they not engage. We can only incentivise consumers to encourage a change in behaviour.

2.17 Some businesses may be able to change their pattern of energy use to take advantage of DSR products but many may not. The range of demand for products will stimulate innovation by suppliers and third parties. Also, the changing nature of work, energy production, technology (PV, LED lighting, EV) and energy use will alter the demand profiles. The impact is uncertain, but putting all business customers on TOU will mean those that cannot respond to price signals will pay more than those that can, simply because they cannot shift their consumption to take advantage of the cheaper time bands.

- (f) *When should the (optional/mandatory) use of half-hourly consumption data replace settlement based on assumed customer profiles? Is it necessary to wait until 2020 when all domestic customers have smart meters installed? Alternatively, could the use of half-hourly consumption data be phased in for those customers with smart meters prior to 2020?***
- 2.18 The risks of changing settlement timescales and moving to HH settlement for domestic consumers during the period of peak roll-out will present significant risk to the market. Suppliers have a unique opportunity to engage with customers and present the technology which has the power to transform the way customers interact with their supplier. Moving to HH settlement is secondary to this as the benefits to the consumer will only be realised through trust. The customer needs to trust the supplier with data which the supplier would not otherwise have.
- 2.19 As stated previously, suppliers must be given time to deliver a successful smart roll-out bringing customers along with them before HH settlement can be implemented. Therefore a long term strategic plan is required to deliver a successful move to half-hourly settlement that takes this and the other previously mentioned issues into account. RWE npower considers that any move to mandatory HH settlement before the end of mass roll-out, (for the avoidance of doubt, including for those customers whose smart meters are installed prior to 2020) would be premature and should be avoided. Suppliers need to have the flexibility to move to half-hourly settlement at a time when it will limit risk, improve the consumers' experience and promote engagement.

R. REMEDY 14

CMA remedy 14 – Remedy to improve the current regulatory framework for financial reporting

1. Executive Summary

- 1.1 RWE agrees with the CMA that financial reporting within the industry should be transparent, robust and should aim to build rather than detract from consumer confidence. This is an area where RWE will support and assist with the discussions in enhancing the information currently available.
- 1.2 However, given the CMA's provisional finding that there are no fundamental issues with the operation and presence of vertical integration across value chains in the industry (which we support), there is no compelling need for significant changes to the current reporting framework and careful thought will be required in relation to the presentation of financial information on a segmental basis that is deeper than currently necessary under the CSS.
- 1.3 RWE believes that current reporting in the CSS provides considerable transparency in relation to the generation business, and highlights the main drivers of the supply business. The CSS is audited and prepared on the arm's length basis.
- 1.4 RWE's reporting:
 - 1.4.1 Aligns with the scope of the market (generation, supply for domestic and supply for non-domestic);
 - 1.4.2 Is market orientated, including wholesale costs at point of delivery and RWEST contracts made at market prices;
 - 1.4.3 Aligns to the licence structure; and
 - 1.4.4 Is not just limited to the CSS (RWE also reports on an IFRS and UK GAAP basis).
- 1.5 RWE supports reporting based on P&L as an indicator of profitability. However, RWE does not support further allocation of balance sheets between segments, which would result in too arbitrary an allocation. Further allocation would also require a number of material adjustments to be made to calculate economic capital employed.
- 1.6 As a company operating in a liberalised market, RWE would not expect to have to submit regulated accounts. In addition, RWE believes that firms' management should be able to make decisions on the granularity of internal reporting required to run a business. Further granularity in reporting would take the business beyond what is considered strategic/competition sensitive confidential information.
- 1.7 RWE considers that CSS reporting should be the standard requirement for all suppliers regardless of size. With respect to information for individual policy making, RWE believes government should be able to request any supplementary information, for disclosure in consultation processes or as and when required. Furthermore, RWE considers that ex-post policy costs could be shown on the face of bills.
- 1.8 RWE has answered the questions below on the basis of information already available to the external market relating to RWE, sourcing RWE AG Group accounts, UK statutory accounting and also OFGEM's own CSS report. Costs of preparing the information envisaged by the CMA will vary depending on how much additional information is required, and how it diverges from systems and processes already employed by the business in question.
- 1.9 In responding to questions (a) to (h), RWE is using the following definitions in responding to this proposed remedy:

- 1.9.1 *Information provided on a 'Market Orientated' basis:* Reporting information provided by a retail (supply) business on a stand-alone basis (as opposed to on an intra-company divisional basis)
- 1.9.2 *'Standard products' traded on the open wholesale:* Products traded by and available to stand-alone retail (supply) businesses, and not products traded by generation firms or on a proprietary basis

2. **Specific Questions**

(a) *Should the scope of the individual areas reported on align with the scope of the markets as set out for generation and retail supply in our provisional findings? For example, should a requirement to report wholesale energy costs on the basis of standard products traded on the open wholesale markets be imposed?*

- 2.1 RWE supports transparency of profitability by business area, e.g. by clearly segmenting retail and Generation performance.
- 2.2 RWE believes that all costs and revenues relating to generation and retail supply activities should be reported regardless of whether they relate to standard or non-standard products, illiquid fuels etc. as these reflect the true costs incurred to operate the relevant business segment. In addition, there is a risk that basing costs on 'market standard products' could (a) make energy costs across the sector look more similar rather than reflecting the way that companies actually buy energy and (b) reduce cost efficiency for the customer through the use of innovative products to manage risk.
- 2.3 RWE's supply business purchases electricity and gas at market prices (with these costs reflected in the npower financials at the contracted rate for the point of delivery). Transactions are carried out by RWEST on npower's behalf at market prices. To this extent RWE believes the CSS as it stands reflects a 'market-orientated' view, recognising the fact that npower employs hedging strategies. These financials are also directly reconcilable to the IFRS numbers reported in the RWE Accounts.
- 2.4 The structure of RWE's generation and trading businesses in the UK means that all profits related to generation assets are reported in the generation P&L. In this respect, financial reporting is aligned to the market in the sense of business activities. It is not practical to provide profitability by fuel generation type without significant approximations including allocation of balance sheet and overheads, making that level of information unreliable.

(b) *What regulatory reporting principles would be particularly relevant to the preparation of regulatory financial information in this sector?*

- 2.5 The CMA should look to ensure that the right balance is struck between transparency and commercial confidentiality when making any changes in this respect, to ensure competition in the market is not restricted.
- 2.6 RWE believes that any segmental mapping should align to the respective licensing structure. As the CMA notes, the CSS will not always map naturally to company structure, but the structure should be transparent to the extent to which commercial information is not compromised. RWE would also expect to see 'adjacent' market activity transparency (e.g. boiler market activity carried out by energy market participants).
- 2.7 In addition, RWE would expect to see any transfer pricing audited at the forward curve vector at the point of hedging, and not the ex-ante spot price at the point of delivery, as this reflects the way that commodity risks are managed and hence the true makeup of the commodity costs used in the Supply business.
- 2.8 We already report IFRS accounts as part of RWE Group Reporting, local company accounts (under UK GAPP) in accordance with the UK Companies Act, and finally pseudo regulatory accounts filed as the 'Consolidated Segmental Statements' (CSS) with Ofgem.

2.9 We would not advocate the creation of a fourth set of more heavily specified 'regulatory accounts'. Should further specific disclosure be required we would suggest this is taken up within the already existent CSS framework.

(c) *Would summary profit and loss account and balance sheet information for each area be sufficient to enable the effective regulation of the sector and the development of appropriate policies? Or should the large domestic and SME energy suppliers be required to collect and submit additional, more granular financial information?*

2.10 RWE believes that the existing information provided in the CSS in relation to the npower supply business is sufficiently granular to provide transparency of business performance in the form of regular routine financial reporting. We strongly support dialogue between the industry and regulator as a key component of the decision making process, in order that any changes needed from time to time to the information to be provided can be agreed.

2.11 Current reporting of the supply business splits the domestic business and non-domestic businesses, and the CSS has required increased levels of granularity and comparability in recent years. These reports are now also audited.

2.12 RWE does not see value in delivering a split balance sheet for the domestic and non-domestic businesses. In particular, this would not assist in comparing profitability across segments. This is because it is not appropriate to calculate ROCE without converting accounting values of capital employed into economic values, which as RWE has explained, is very difficult to do robustly. The CMA has appeared to acknowledge that a ROCE calculated based on an unadjusted balance sheet values of capital employed is a meaningless measure of profitability.⁷⁵ RWE also does not agree that regulators should input into how a business segments itself i.e. beneath the main classifications of domestic and non domestic for retail supply.

2.13 Furthermore for the supply business we do not agree that Return on Capital Employed is an appropriate measure, especially when produced and reported on a historic ('accounting') convention. Whilst the analysis may become more meaningful as a measure when produced and reported on an 'economic' basis, considerable care and attention needs to be undertaken in arriving at an appropriate conversion (e.g. with respect to MEAV for intangible assets, customer bases, notional and regulatory capital).

2.14 In terms of more effective clarity on the impact of government policies on consumer prices we would suggest that the degree of impact could be made much more visible (and communicated) at the time of policy consultation, and furthermore could subsequently be broken down on the face of customer billing (e.g. ECO costs, smart metering investment) as and when policies are delivered.

(d) *Should Ofgem require that the summary profit and loss and balance sheet information be audited in accordance with the regulatory reporting framework?*

2.15 It should be noted that our auditors PWC already audit our accounts on both an IFRS (RWE Group consolidation) basis and UK GAAP (local company accounts) basis.

2.16 Furthermore PWC already audits our CSS submission (from 2014) both against the reported IRFS numbers and also in respect of the reasonableness of any segmental allocations and judgements.

2.17 We would not advocate the creation of a fourth set of more heavily specified 'regulatory accounts'. Should further specific disclosure be required we would suggest this is taken up within the already existent CSS framework.

⁷⁵ Provisional Findings, Appendix 10.3, page A10.3-8 paragraph 20.

(e) *Should this remedy apply to the firms that are currently under an obligation to provide Ofgem with Consolidated Segmental Statements? Or should it apply to a larger or narrower set of firms?*

- 2.18 RWE believes that if information is considered important to consumers, then it must be important for all suppliers, especially those suppliers that consumers consider switching to. If on the other hand the information is not important, then no supplier should have to provide it.
- 2.19 RWE also notes that for the supply business, the CSS is already at the point of revealing strategic/competition sensitive information, and that further transparency of granular information may be commercially damaging, and would distort competition, particularly if only some suppliers have to report.

(f) *What would be the costs of imposing such a remedy? We note that some firms' reporting systems are not currently capable of providing information on such a 'market-orientated' basis and that our remedy could require significant additional system requirements.*

- 2.20 RWE believes that the costs of imposing such a remedy would be proportionately greater for larger firms, such is the cost of making significant changes to existing and in some cases 'legacy' financial systems. In order to be more specific in the costing of this we would need to see more detail of the CMA's requirements but clearly the more that is requested by the CMA of existing systems that are not set up to provide the information, the more it will cost. The cost stack would typically comprise system development costs, potentially further employees in the accounting and regulatory departments and increased audit fees.
- 2.21 Any further segmentation within RWE's reporting systems would have to rely on assumptions-based allocations, and consequently becomes less robust as levels of segmentation are increased. Outside of this, RWE would expect significant additional systems requirements, which would be accompanied by increased and possibly disproportionate costs.

(g) *Should the CMA implement this remedy by way of licence modifications or by way of a recommendation to Ofgem?*

- 2.22 RWE believes that this remedy should be implemented by way of a recommendation to Ofgem. It must follow due process and ensure that the CSS remains current and fit for purpose. Ofgem is also best placed to maintain the link between CSS and the new supply market indicators.

(h) *To what extent should this financial information on performance be published?*

- 2.23 RWE fully supports transparency, whilst recognising the need to ensure that commercially sensitive information is protected to ensure effective competition in the market.
- 2.24 We believe that in relation to the conventional generation, renewables and supply businesses, the existing CSS reporting is sufficient. In addition to this the statutory accounts of RWE Generation UK plc and RWE npower are publicly available. Any further information requests would need to be reviewed for confidentiality (in particular, strategic/competition sensitive information, disclosure of which may restrict competition) on a case by case basis.

S. REMEDY 15

CMA remedy 15 - More effective assessment of trade-offs between policy objectives and communication of impact of policies on prices and bills

1. Executive Summary

- 1.1 We share the CMA's views that there needs to be a more effective assessment of the trade-offs between energy policy objectives and communication to a wide audience of the impact assessments relating to policy proposals, and the interactions between policies and policy trade-offs. RWE believes that this would assist in building greater transparency and accountability as well as facilitating more effective formulation of sustainable policies going forward.
- 1.2 We believe in order to achieve this there is a strong case for a role for a new institution (described below) which would provide independent scrutiny of the impact of DECC's programme and in particular evidence on the interactions and trade-offs between policies. We also believe that a balanced scorecard particularly with respect to the energy trilemma, which could be used to track changes in key metrics as they respond to policy, regulatory and market changes, could usefully summarise and provide clarity on the UK's performance across its energy priorities.
- 1.3 We believe the impartiality of the institution entrusted with this role will be central to its success in enhancing trust and clarity in the market. In our view a new independent institution will be required.
- 1.4 As we outline in RWE's response to remedy 17 above, we also believe that there is a need for clearer delineation of the roles and responsibilities of the government and Ofgem. This would involve government (DECC, HMT, DWP and BIS) being responsible for setting out policies and making decisions on trilemma policy trade-offs, with Ofgem's primary focus and objective being to protect the interests of consumers through competition. We have also recommended the introduction of a new institutional role of an independent 'Office of Energy' which would be tasked with providing impartial information about the industry, the market and the impacts of policies.

2. Specific Questions

(a) Are such assessments of the impacts of policies on prices, bills and on the trilemma trade-offs carried out to a sufficient extent currently?

- 2.1 As the CMA notes, impact assessments and evaluations of energy policy are undertaken by a range of different institutions (e.g. DECC, Ofgem, Climate Change Committee, National Audit Office), either as a statutory requirement or in an ad hoc manner. We note that DECC generally publishes impact assessments for new policies and changes to policies. These state the impacts in various terms, including issues such as impacts on bills. Where policies have an impact on security of supply, the costs of remedies are usually also identified. DECC and BIS have also analysed impacts on energy intensive, trade-exposed firms and their supply chains, because these firms are among the most sensitive to changes in the cost of energy.
- 2.2 However, DECC has not maintained a regularly updated assessment of the aggregate current and projected future impacts of its policies on the cost of energy, on bills and on security of supply. Nor has it maintained a regular publication of statistics on fuel poverty, taking into account the effect of its policies, changes in wages and living costs, and changes in social security and personal taxation. There is little transparency currently around projected costs relative to agreed budgets for individual policies within the Levy Control Framework⁷⁶. Performance against the Levy Control Framework is of public interest because it is an indicator of DECC's overall policy budget and the performance of individual policies. Publication of this information would allow investors to make more accurate assessments

⁷⁶ The Levy Control Framework is a part of the Government's public spending framework. It places limits on the aggregate amount levied from consumers by energy suppliers to implement Government policy, covering the Warm Home Discount, Renewables Obligation, Feed in Tariffs, Contracts for Difference, but not the Capacity Mechanism.

of policy risk. Whilst we acknowledge that DECC has periodically assembled this information, what the market needs is a regular periodic publication with a common structure.

2.3 In respect of whether policy assessments are carried out to a sufficient extent, RWE submits that it is not just important to carry out the assessment, it is also important to make sure that the assessment embodies a realistic approach. In this respect we would flag in particular the need for commercial understanding.

2.4 Specifically, when DECC's policies address areas of commercial complexity and market design, policy making processes tend to take longer and concerns arise in particular with regards to DECC's commercial experience and ability to deliver efficient policy design. A recent example is Electricity Market Reform, which moved forward too slowly to its conclusion, creating a period of considerable investor uncertainty. Other examples are the Carbon Capture and Storage pilots and nuclear procurement, where the commercial terms became unattractive to bidders.

(b) *Are there specific areas where such assessments are not currently carried out, or might be undertaken more comprehensively?*

2.5 RWE would flag three areas in particular where assessments might be carried out more comprehensively:

2.5.1 **Value for money:** DECC oversees a large and complex set of policy instruments and it attempts to pick winners (e.g. FiD enabling contracts, CFD allocation). DECC has had to intervene in markets which are exposed to a large number of, often overlapping and potentially conflicting, policies. The complexity of policies also raises the costs of compliance for market participants and increases the costs of management for DECC. The policies appear to vary greatly in their value for money to achieve the ends of decarbonisation, secure and affordable supply. However, DECC's challenge is routinely to ensure value for money comparisons across its range of policies. DECC traditionally attempts to 'pick winners' by technology using the justification that some technologies are more costly than others and so require more support, rather than requiring technologies to compete against each other for policy support. RWE is of the view therefore that DECC sets its criteria in terms of its policy assessment too narrowly as opposed to adopting a more expansive approach which would compare value for money across its entire programme encompassing both the supply and demand sides and including emergent and potentially disruptive technologies which could deliver potentially significant future cost benefits for consumers.

2.5.2 **Treatment of uncertainty in cost projections:** Whilst we recognise that there are challenges in presenting evidence or information on both complex and uncertain issues, the current treatment of uncertainty in so far as cost projections is concerned is weak, despite the fact that uncertainty is so prevalent in energy. For example, DECC currently assesses the likely impact of its policies on bills in 2020 and 2030, but this analysis is not transparent because DECC offsets certain policy impacts with energy efficiency savings in its public communications, while sensitivity analysis is confined to potential future fossil fuel price projections. Furthermore, in recent years there has been noticeably less regular stakeholder review and update of DECC's energy projections than in the past, even though these form the basis against which DECC assesses the impacts of its policy.

2.5.3 **Risk assessment:** While some policies have performed well, DECC has appeared to be taken by surprise by the out turn cost (e.g. the change in position on solar PV FiTs, withdrawal by developers of CCS demonstration projects at Kingsnorth and Tilbury) or poor take up (e.g. Green Deal, with DECC recently withdrawing support for the Green Deal Finance Company) of some of its flagship policies. In some cases it has reacted slowly as events have developed. These examples are, in RWE's view, evidence of inadequate risk assessment and risk management planning. In a recent example, government assessments failed to foresee and therefore did not adequately consider the risks involved in removing

the Levy Exemption Certificate from renewables, announced in the last Budget. Government is not transparent about its performance in these areas.

(c) Are the assessments sufficiently scrutinised?

- 2.6 Generally, DECC makes sensible assumptions about base values and scenarios and takes care to produce robust assessments including an appropriate consultation with stakeholders. However, we consider that policy making is insufficiently scrutinised.
- 2.7 There is a concern that DECC's policy making process does not begin by reviewing the evidence in order to assess the merits of a change in policy. Rather DECC is directed to introduce and deliver a new policy by No. 10 or the Cabinet Office. As a result the impact assessments then become a justification for the policy, rather than a demonstration that among all possible actions and inaction, the chosen policy is optimal and one which is supported by robust evidence. DECC could be more proactive in reviewing its policy performance across its programme and this would make its policy making more evidence-led. As described above, RWE believes that a new institution, the Office of Energy, could usefully serve to subject DECC policies to independent scrutiny.

(d) Are the assessments sufficiently disseminated to interested parties? Which parties need to be informed about these assessments?

- 2.8 It is generally the case that all impact assessments are published and the specialist audience and stakeholders in consumer bodies, trade associations, industry and finance, are able to access to them. Assessments are complex documents and conclusions may not be easily understood by non-specialist audiences, in effect limiting the accessibility of information to expert audiences, although it is hard to see how this can be avoided. Relevant Parties need all the information to be properly synthesised and to include clear summaries of anticipated performance against policy priorities and their trade-offs, so that that they do not each have to do this job themselves.
- 2.9 As noted in Vivid Economics' report (2015)⁷⁷, while stakeholders may be able to access impact assessments, much of the current analysis fails to enter the public debate. Vivid Economics conclude from their stakeholder interviews that this is in part due to the large volume of information that is published, which could be made more relevant and concise; and in part due the fact that institutions spend too few resources on communication.

(e) Is there an additional role for either Ofgem and/or DECC in carrying out assessments of the impacts of policies and trilemma trade-offs or communicating the results of them?

- 2.10 We believe there is a strong case for a new institutional role such as an Office of Energy, which would provide independent scrutiny of the full impact of DECC's programme and in particular an analysis of the interactions and trade-offs between policies. As described in Vivid Economics' report (2015), ⁷⁸ this scrutiny should focus on impact metrics which describe the trilemma, and on public commitments encompassed by the Levy Control Framework. One way in which this might operate is by adopting the Office of Budget Responsibility model, in which DECC and Ofgem present their estimates of impact for the policy and regulatory programme, and the Office of Energy would in turn present its independent view, commenting on the origin and nature of differences. The energy sector is sufficiently complex that it merits a specialist role to perform this type of independent scrutiny function. This scrutiny could be applied at programme level (i.e. a strategic view across all departmental policies) to ensure adequate coverage of policy interactions. If DECC is required to make statements about the value for money of its programme, then the Office of Energy would also be able to scrutinise and make an independent assessment of those claims. Whilst the assessment could go further so that the Office of Energy would give its own view on the value for money of new and existing policies, in our view there is a risk that this could be seen as too interfering by Government ministers who might view

⁷⁷ Vivid Economics (2015), 'The case for an Office of Energy'.

⁷⁸ Vivid Economics (2015), 'The case for an Office of Energy'.

the role as being politically intrusive and it seems unlikely therefore that such an organisation could sustain ongoing political support.

- 2.11 Across Whitehall there has been an encouraging move towards retrospective evaluation of policies. This complements the impact assessments that are already commonplace. There is an additional role therefore to scrutinise these evaluations, so that the programme level assessment of impact can as far as possible be based on observed impacts, whereby the policies delivering poor value for money are identified and will be subject to review. Either an Office of Energy or the National Audit Office could scrutinise evaluations. The National Audit Office offers a mechanism for identifying and disseminating cross-departmental lessons but only has the resources to review a small proportion of policies, so has to be very selective in its review. By using evaluations as an input to its programme level assessment, an Office of Energy would be able to comment on adjustments between initial impact assessments and later evaluations, and in both cases, could identify where it takes a different view on impact from that taken either by DECC or Ofgem, explaining the origin and nature of the differences.

(f) *Should further authoritative analysis be published to assist the public discussion? What form might this take? Which existing bodies are best positioned to undertake this role?*

- 2.12 DECC already routinely publishes energy statistics, including prices. The quality and extent of this reporting has improved over recent years. What is now needed is the same routine, structure and rigour applied to reporting against the energy trilemma, with clarification as to the attribution of changes over time to the causes of those changes. This work should expose the trade-offs between the trilemma that are taking place. It should also communicate in very clear and accessible ways; reporting information in relevant metrics making efforts to bring the results to a wide audience. In addition, it is our view that there would be substantial merit in subjecting all policies across the DECC programme to a value for money review every five years.

- 2.13 As outlined in (f) below, it is our view that an independent body is most likely to achieve this in a manner which gives it sufficient credibility because of its independence from the policies and because of the focus it could devote to effective communication.

(g) *Is there a sufficient case to justify creating a new, independent body tasked with scrutinising the impact assessments of policy-making bodies and/or providing authoritative analysis to inform the public debate?*

- 2.14 The CMA has acknowledged that there is at least a rationale for an independent institution to scrutinise elements of current energy policy and we welcome this. It is our view that the impartiality that would be ascribed to the institution that is tasked with scrutinising the impact assessments of policy-making bodies is central to the success of this role. The Office of Energy for instance would have to have sufficient capability and expertise to deliver robust analysis and competent political handling. Government intervention in electricity markets has increased in recent years and will continue to grow with the aim of delivering an affordable low carbon, secure energy supply. There are many complex issues and competing priorities which government has to address, and in analysing the impact of policy, the analysts would need to have the adequate level of understanding and expertise in order to fulfil such a role. In principle, it would be possible to use or employ analysts with the skills within DECC, Ofgem, or a new, independent body.

- 2.15 It will be essential that any new institution has appropriate governance arrangements, scope of activity, rights of access to information and budget to ensure it can function effectively and efficiently. With these qualities, it can be sufficiently trusted by industry to carry out the work.

- 2.16 Finally we should emphasise that if an independent body was to be appointed for this role it would require sufficient independent financial resources. If it is to succeed it will need its own independent budget and responsibility for it.

T. REMEDY 16

CMA remedy 16 - Revision of Ofgem's statutory objectives and duties in order to increase its ability to promote effective competition

1. Executive Summary

- 1.1 We share the CMA's view that the changes to Ofgem's objectives and duties under the Energy Act 2010 (EA10) constrain Ofgem's ability to promote competition by making the pursuit of competition secondary to the protection of consumer interests. As a consequence, Ofgem and DECC's actions have distorted competition in a manner which is adverse to consumers' interests (e.g., in relation to locational pricing and RMR). This issue is exacerbated further by the lack of clear definition of the objective of consumer protection. This makes it difficult for Ofgem to assess measures which affect some customer groups at the expense of others, or to assess wider trilemma policy trade-offs with security and sustainability objectives (as discussed in the response to remedy 15).
- 1.2 The only way to properly appraise the costs and impacts of interventions is against a benchmark of how effective competition would operate in the absence of such interventions. Giving Ofgem a primary objective to protect the interests of consumers wherever possible by promoting effective competition would therefore usefully focus Ofgem on delivering the best solution for consumers through effective competition. RWE considers that good policy will usually encourage competition and that the alleged tension with other policy objectives is sometimes a false one. For example, whatever the scale of policy interventions for environmental sustainability or security of supply, competition will often still be good for consumers in achieving the lowest cost way of delivering the desired policy outcomes. RWE further considers that it would be desirable for those policy decisions which do modify competitive outcomes (eg, decisions to socialise costs or to cross-subsidise different customer groups) to be made in a transparent and accountable fashion against a competitive benchmark. This would have the further benefit of helping to differentiate Ofgem's consumer protection role in ensuring that individual customers are treated fairly by suppliers from wider attempts to achieve 'fairness' between particular customer groups (e.g., by cross-subsidies which might inhibit competition). Such an approach will help Ofgem avoid needing to make opaque value judgements to trade-off sometimes conflicting objectives.

2. Specific Questions

(a) What specific changes should be made to Ofgem's statutory objectives and duties in order to ensure that it is able to promote effective competition in the energy sector?

(i) For example, would it be possible to revert to the role of competition that existed before the introduction of the Energy Act 2010?

- 2.1 Ofgem's statutory duties and objectives should be revised to give Ofgem a primary objective to protect consumers' interests wherever possible by promoting effective competition in the supply of electricity and gas. Reverting to the role of competition that existed in Ofgem's duties and responsibilities prior to the introduction of the Energy Act 2010 would be one means to further that aim. However, a fresh look at Ofgem's powers and duties to sharpen the focus on promoting competition might be warranted in the light of the CMA's wider observations on the regulatory framework and potential institutional solutions. Specifically, as we highlight in our responses to remedy 15 above and remedy 18 below, we envisage new roles for an 'Office of Energy' to appraise the effectiveness and trade-offs between various DECC policies and an 'Independent Code Adjudicator' to decide on code modification proposals. These parallel initiatives would further help to focus Ofgem's role on the economic regulation of the monopoly networks and the effective operation of the competitive generation, retail and wholesale markets. If the CMA recommends changes along these lines, corresponding changes to Ofgem's duties and responsibilities might be required to ensure clarity and consistency on the allocation of duties and responsibilities between the institutions.

U. REMEDY 17

CMA remedy 17 - Introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making can be addressed transparently

1. Executive Summary

- 1.1 We share the CMA's concerns that 'institutional pressure' from DECC on Ofgem to implement particular policies reduces transparency and accountability and we agree that there should be greater clarity in the exercise of policy measures to ensure that the costs to customers – or particular groups of customers – are transparent and justifiable. In our view, greater clarity and rigour around trilemma policy trade-offs (under remedy 15) and giving Ofgem a primary focus on the promotion of competition (remedy 16) will go a long way to ensuring that policy interventions that deviate from competitive outcomes are properly identified, appraised and justified as such.
- 1.2 Measures which solely seek to 'air disagreements' are unlikely to be sufficient in themselves without first better clarifying Ofgem and DECC's respective responsibilities. Transparency requires that it first needs to be clear who is responsible for ensuring which objective (i.e., Ofgem for competition, DECC for policy) if the nature of a difference of opinion is to become clear. Without this clarity, informal means for resolving disagreements would continue to prevail over formal and public fora for airing differences of views to avoid 'washing dirty laundry in public'. Nor is any such measure likely to avoid the implied or explicit threat to legislate to solve the 'problem' (or to require Ofgem to solve the problem).
- 1.3 It is for these reasons that the primary focus should fall on ensuring genuine independence for Ofgem and the primacy of its duties and powers in promoting competition and the transparent appraisal of measures which lead to deviations from competitive outcomes. Effectively anchoring one side of the debate to the delivery of effective competition is, in itself, the best means to ensure that policies which may alter or blunt competition are clearly identified, properly appraised and transparent to customers.

2. Specific Questions

(a) *In which circumstance should Ofgem have the right or duty to express views on DECC's policies and DECC/Ofgem strategy for their implementation? What format should such views take? Should DECC have a duty to formally respond?*

- 2.1 Ofgem should have the right and duty to comment on all DECC's policies which are likely to affect competition in the supply of electricity and gas. Those views should take place in the context of an impact appraisal of such measures which would inter alia appraise:
 - 2.1.1 the costs and benefits of the measure;
 - 2.1.2 the distributional impacts of the measure between different market participants and/or customer groups; and
 - 2.1.3 the impact of the measure on the development and promotion of effective competition in the generation and supply of electricity and gas.

(b) *In what circumstances should Ofgem have the right to seek a formal direction from DECC to implement a certain policy?*

- 2.2 Ofgem should have the right to seek a formal direction to implement any decision or policy which is likely to deliver outcomes which deviate from those expected to result from the operation of effective competition (e.g., to socialise certain costs or to cross-subsidise a particular group of consumers). Such directions and the reasons for making them should be made public.

(c) *Would DECC's formal direction undermine (or appear to undermine) Ofgem's independence?*

- 2.3 No – if the formal mechanism is implemented properly, such a measure could significantly strengthen Ofgem’s independence and perceived independence. Clearly allocating responsibility and accountability for policy, would both allow Ofgem to take a clear stance on the most competitive approach and allow the costs, benefits and distributional consequences of DECC interventions to be transparently appraised rather than negotiated or pushed through behind the scenes. The net result should be greater confidence and accountability for both Ofgem and DECC.
- 2.4 To achieve this outcome, however, it would still be necessary to ensure that Ofgem’s powers and duties deliver sufficient independence in the first place and to ensure that those powers and duties comply with other applicable laws (e.g. EU requirements on National Regulatory Authorities).
- 2.5 The mechanism would help drive out the uncertainty RWE and others have experienced in recent years arising from dealing with formal processes undertaken by the regulator on the one hand and informal suggestions by the Government that it intends to take action on the other. For example, both of Ofgem’s recent reviews of the energy market took place against the backdrop of very public positions being adopted by the Government, with the promise of Government intervention if it perceived regulatory actions were not delivering in line with expectations.
- 2.6 Prime examples of this informal and public interjection were the statements and actions of Government during Ofgem’s Retail Market Review. For example, on 17 October 2012, the Prime Minister made the following statement during Prime Minister’s Questions:
- "..... I can announce that we will be legislating so that energy companies have to give the lowest tariff to their customers. Something the Labour Party didn't do in thirteen years."⁷⁹*
- 2.7 The statement was delivered only 9 days before Ofgem’s update on the RMR review on 26th October 2012⁸⁰. The statement ran contrary to Ofgem’s (non-legislative) proposals and ran the risk of being interpreted as the lowest tariff in the market - rather than the supplier’s best available tariff as Ofgem would propose. DECC quickly rebalanced the position and the Secretary of State was quoted in the press on the 18th October as already having plans to improve competition, referring to the work Ofgem was undertaking around simplifying and making tariffs clearer. This statement then fed into a DECC consultation document issued on 20th November 2012 on proposals to legislate in the Energy Bill including measures to (1) deliver the PM’s commitment to ensure consumers get the “*cheapest tariff offered by their supplier that meets their preferences*”; (2) simplify and reduce the overall number of tariffs; (3) ensure consumers receive clear information so they can compare tariffs more easily; (4) enhance overall consumer protection; and (5) facilitate collective purchasing and switching.⁸¹
- 2.8 Further confusion about the direction of and responsibility for the setting and implementation of policy was apparent again when DECC’s response to their consultation in May 2013 talked about building on Ofgem’s Retail Market Review proposals, but also reflected their intention to legislate in the Energy Bill to ensure Ofgem was not frustrated or delayed in delivering the relevant reforms.⁸² While the DECC consultation process realigned their position to be closer to Ofgem’s RMR review exercise, it also made clear that there was a prospect of direct intervention and legislation if they believed Ofgem was being frustrated in delivering positive outcomes or if the process was dragging.
- 2.9 It is precisely such examples of the interplay between Ofgem and DECC that such a formal mechanism would help address. This in turn would deliver greater regulatory certainty

⁷⁹ Q3. [122162] Chris Williamson (Derby North) (Lab): At the Prime Minister’s energy summit last year, he promised faithfully that he would take action to help people reduce their energy bills. Will he tell the House and the country: how is it going?

⁸⁰ www.ofgem.gov.uk/sites/default/files/docs/2012/10/the-retail-market-review---updated-domestic-proposals.pdf.

⁸¹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/66515/6996-better-deal-energy-consumers.pdf.

⁸² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/200051/gov_response_ensuring_better_deal_consumers.pdf.

rather than stakeholders being put in a position where they are trying to decipher what the future regulatory landscape would look like, having received statements from two separate sources, whilst trying to manage what changes may or may not be required to processes, systems and business models in order to meet the potential requirements.

- 2.10 The formal mechanism would therefore help ensure Ofgem maintains its independence and ability to interact constructively with the energy industry and arrive at outcomes that protect consumers' interests through effective competition.

(d) *Would other measures be effective in promoting the independence of regulation?*

- 2.11 The most effective means of ensuring regulatory independence is to ensure that Ofgem's primary objective is the protection of consumers' interests by promoting effective competition and that DECC are clearly responsible for policy measures which might seek to modify competitive outcomes. It is the current blurring of these objectives and responsibilities which creates the current room for manoeuvre to deliver opaque and unspecified policy measures. Greater thought might also be given to Ofgem's governance and appointments to the Authority to bolster further its independence. We would also like to see greater transparency around the proceedings of the Gas and Electricity Markets Authority. This would promote openness and trust in the regulatory process.
- 2.12 Ofgem's primary focus on competition could be further supported and clarified by a better delineation of functions and responsibilities between economic regulation of the markets and networks on one hand and consumer protection and enforcement on the other. This would ensure that customers continue to be treated fairly and in an open and transparent manner while reducing the risk of inadvertently harming competition through overly prescriptive retail standards or interventions to promote 'fairness' between consumer groups (as opposed to the fair treatment of individual customers). Here, we fully support Ofgem's proposed move away from licence-based standards of conduct towards principle-based regulation and envisage a move away from prescriptive licence conditions concerning the design of bills and the provision of information to customers to a set of key principles that suppliers would be required to observe in their dealing with customers, e.g., *"retailers should ensure that customers know what product they are on, when it ends and how much it's costing them"*.
- 2.13 Further consideration should also be given to manage the transition of strategy (set by Ofgem, the industry and government) into practice. This could be achieved by assigning a clear role to a 'design authority' to manage and implement major projects (e.g., see RWE's response to remedy 13 regarding the move to universal HH settlement).
- 2.14 Finally, as we have noted in our response to remedy 15, an Office of Energy would provide impartial information about the industry, the market and other countries' energy regimes.

V. REMEDY 18a

CMA remedy 18a - Recommendation to DECC to make code administration and/or implementation of code changes a licensable activity

1. Executive Summary

- 1.1 We agree with the recommendation that code administration should be a licensable activity. The creation of a separate licensable activity would effectively ring-fence code administration from other activities which may be affected by changes to the codes.
- 1.2 For example, National Grid ("NGT") currently administers the CUSC, BSC and the UNC. As stated in RWE's response to the Updated Issues Statement, we think that this situation leads to a potentially significant conflict of interest for National Grid because it is a privatised company acting in many capacities (e.g. transmission owner, system operator, metering, onshore/offshore network build/own/maintain, interconnector owner etc) as well as having administrative roles in relation to codes that govern the commercial terms of agreements of which it is one of the beneficiaries. Creating a separate licensable activity would address these concerns by transferring code administration to an independent body. We believe that transferring the administration of the CUSC and UNC to an independent and separately licensed entity would be beneficial. .
- 1.3 We note however that despite Elexon's responsibilities being set out in NGT's transmission licence and it being owned (although not controlled) by NGT, the administration of the BSC has been successfully ring-fenced and is dealt with independently. The Elexon model could therefore also appear to be a viable alternative to creating the required independence surrounding a separate code administration licence.
- 1.4 The creation of a separate licensable activity would also introduce the possibility of competitive tendering for code administration (and potentially the combined administration of several codes by one administrator) which would bring further potential benefits as described below.

2. Specific Questions

(a) Is this recommendation likely to result in a positive change in the initiation, development and/or implementation of code changes that pursue consumers' interests?

- 2.1 We believe that making code administration a licensable activity would lead to positive change particularly if service provision of the role was subject to competitive tender for a defined period. This would incentivise the administrators to improve their performance and service offering (including through improved compliance with the licence obligations) to prove their worth for the next tender period. It would also provide a mechanism for improving code administration standards, and facilitating the progression of the principles outlined in the Code Administration Code of Practice.
- 2.2 We think that the creation of a single over-arching code administrator, with the adoption of high level uniform governance arrangements across all codes, could bring more benefits than having a number of separately licensed code administration entities. For example, an overarching body could ensure a joined-up approach to developing and implementing industry change across all the codes. This single code administrator could be subject to a code administration licence which would again be for a defined tendered period.

(b) Would this remedy be more effective if certain functions currently carried out by code panels and/or network owners (eg setting up working groups) were transferred to code administrators?

- 2.3 We strongly believe that code administration and implementation should be undertaken by bodies that have the appropriate level of experience required to understand the full impact of large scale industry change such as the way suppliers interact and contract with customers and, in some cases, how customers themselves interact with energy. We believe that this could be achieved through licence obligations placed on individual code

administrators, with an overarching view of change across the industry and the opportunity to deliver that change through a robust integrated plan.

- 2.4 Whilst the sponsorship of working groups often lies with code panels (i.e. the working groups are usually sub groups of the panels) the process of setting up modification working groups is by and large already carried out by code administrators. The code panels' involvement tends to be focused on checking that modifications are in line with the relevant code objectives and confirming the timetable for progression.
 - 2.5 However, we agree that this remedy would be more effective if code administrators could take on more tasks. They could, for example, carry out quality checking and provide 'critical friend' advice to parties seeking to raise new modifications, for example by confirming the validity of a modification and checking that modification templates have been fully and accurately completed. They could also take on the role of chairing working groups and provide more analytical support to panels and workgroups.
 - 2.6 We also believe that improvements could be made in the way that code administrators carry out their secretariat duties in industry meetings and in the 'critical friend' role - some are better at it than others. Good code administrators play an important role in breaking down barriers for smaller and newer parties as well as consumer representatives by providing well managed governance, ensuring meetings are effective and in providing a gateway to understanding the codes. Therefore, we recommend that 'best practice' requirements are embodied in the new code administrator licence conditions as this would improve the quality of service provided.
 - 2.7 Again, we think that the creation of a single overarching code administrator would bring benefits, through facilitation of cross-code change management and improvements in levels of service.
- (c) *Would this remedy be more effective if Ofgem or DECC were to impose stricter requirements relating to the selection (eg competitive tender), financing and/or independence of code administrators (and/or delivery bodies)?***
- 2.8 We agree that requiring code administrators and/or delivery bodies to be subject to competitive tender/be independent parties would be helpful. Whilst such a change of approach would require significant change to the governance arrangements of several of the industry codes, we think this would be worthwhile.
 - 2.9 For example, the UNC is currently administered by the Joint Office of Gas Transporters, which is not a separate legal entity, but rather an organisation created by a collaborative arrangement of the gas transporters. The UNC would therefore need to be amended to introduce the option to procure an independent administrator. We think that having an independent administrator would be beneficial for the reasons explained above. Such arrangements already exist in SPAA/DCUSA/MRA, where special purpose vehicles exist to manage such activities and independent code administrators are appointed.
 - 2.10 As mentioned above, we would support the creation of a single code administrator for all codes along with an adoption of uniform governance procedures across all codes. This would streamline the codes and provide a window to reduce code complexity. Such an administrator could be independent and procured through a competitive tender process.

W. REMEDY 18b

CMA remedy 18b – Granting Ofgem more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes

1. Executive Summary

- 1.1 RWE does not believe that Ofgem should be granted more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes.
- 1.2 While Ofgem has significant industry experience, it is our view that it does not have sufficient experience of supplier-consumer relationships, consumer behaviour, and IT technicalities, to fully understand the impact of large scale code change on the industry. Any increase in Ofgem's powers to control or direct code changes is likely to introduce uncertainty and delay in the code change process. To give one example of where this has happened previously, Ofgem set an unrealistic timetable for delivery of Project Nexus, given that it required such large scale IT changes. The central programme has found delivery of the project milestones extremely challenging, which has resulted in delays to their deliverables that have then caused delays to other parties' deliverables. These issues, in combination with a significant amount of parallel user and industry testing, led PwC, the Nexus programme assurance providers, to conclude that the Project was too high risk to roll-out within Ofgem's timetable. As a result, Project Nexus has now been delayed by one year with the possibility that other parts of the programme (retrospective amendments and unique sites) may be delayed even further.
- 1.3 There would also be a potential conflict of interest for Ofgem, should it be given greater powers to initiate and manage change, as Ofgem must approve any material modifications (i.e. Ofgem could be in the situation where it had initiated a modification and would then have to consider whether to approve or reject it). Ofgem's impartiality in the modification process could be compromised.
- 1.4 We suggest that Ofgem should instead focus on providing greater guidance to industry work groups, to reduce delays and misunderstanding in discussions. We believe that the overall management of industry change should sit with an overarching code administrator, using uniform processes and fixed timetables. This would reduce delays, and ensure change is focussed on promoting competition and economic efficiency.

2. Specific Questions

(a) Is this recommendation likely to result in a positive change in the initiation, development and/or implementation of code changes that pursue consumers' interests?

- 2.1 We do not believe that this recommendation would result in positive change in the initiation, development and/or implementation of code changes that pursue consumers' interests.
- 2.2 RWE does not believe that Ofgem should have the ability to specify timetables and draft code modifications itself. Whilst Ofgem undoubtedly has a significant amount of regulatory and industry expertise, our view is that this process should be undertaken by a body that has the appropriate level of experience required to understand the full impact of large scale industry change such as the way suppliers interact and contract with customers and, in some cases, how customers themselves interact with energy. In addition, in order to assess credible timelines some understanding of the technicalities of IT change programmes is required, which Ofgem does not have.
- 2.3 We think that an overarching code administrator could fulfil such a function, particularly if supported by an independent Industry Change Overview Board providing a cross code Design Authority function with the power to decide on the optimum 'go-live' dates of large scale changes, taking into account the scale and timing of other changes. The over-arching code administrator could initially obtain such expertise through employing staff with experience of the industry codes and it would develop further cross-code experience over time through having a bird's eye view of and interaction across all the industry codes.

2.4 We believe that giving Ofgem a greater role in initiating and managing the progress of modifications could lead to a conflict of interest. This is because Ofgem's approval is required for all material modifications and its neutrality in making these decisions could be compromised where it had initiated or influenced the progress of a modification.

2.5 Nevertheless, it is important that Ofgem acts in an expedient manner in fulfilling its role in the process of change. It needs to ensure that it participates more effectively in the development of industry changes, by attending working groups to provide input when this is required and progressing decisions in a timely way. An example of where that has not always happened is that of the Xoserve Funding Governance and Ownership Programme where there have been delays on Ofgem's part in providing useful information on the future charging methodology. This has caused knock on delays to the design of the future model resulting in concerns from Gas Transporters in particular that the, soon to be mandated, go live date of April 1st 2016 is too early.

2.6 In RWE's view, the overall management of industry changes best sits with a single independent code administrator, with uniform processes including a fixed maximum timetable for processing modification proposals. Increased use of timescales and deadlines at all stages within the modification processes would help to reduce delays in progressing industry change. Decisions on change should be made by an independent code adjudicator applying criteria of promoting competition and economic efficiency, rather than on the basis of Ofgem's complicated set of primary and secondary duties. This independent code adjudicator should take on the role currently carried out by Ofgem in relation to industry code modifications.

(b) *Would this undermine the principle (and effectiveness) of industry-led code changes?*

2.7 Yes, we believe that increasing Ofgem's powers in this way would undermine the principle and effectiveness of industry-led code change and would introduce uncertainty into the change process. We do not believe that Ofgem has the necessary experience to understand the full impact of industry change, and giving such powers to Ofgem would detract from industry's focus on progressing change and could introduce inertia and lead to reduced industry participation in the change processes.

2.8 However, we believe that the industry-led process could be improved through changing the code administration arrangements.

2.9 We think that making code administration a licensable activity, creating an overarching code administrator and improving the change processes by the introduction of tighter timescales would improve the effectiveness of industry-led code changes.

2.10 In addition, Ofgem needs to act expediently when playing its part in industry change, whether this be through providing views and guidance at workgroups, or by making timely decisions and issuing any requests for information quickly.

(c) *Should this power be limited to the completion of certain elements of the development or implementation phase (eg consultation, setting up working groups)?*

2.11 For the reasons outlined above, we do not believe there should be increased powers afforded to Ofgem.

2.12 However, we do believe that Ofgem could play a more proactive role in industry working groups, particularly in offering guidance and views when needed to move change discussions forward. This would be beneficial for the industry and help to reduce delays and misunderstandings. In return it would allow Ofgem to have greater input to the respective industry change.

(d) *Should Ofgem's ability to use this power be limited to defined circumstances (eg modification proposals which are relevant to Ofgem's principal objectives) or should it be left to Ofgem's discretion?*

- 2.13 For the reasons outlined above, we do not believe there should be increased powers afforded to Ofgem.

X. REMEDY 18c

CMA remedy 18c – Appointment of an independent code adjudicator to determine which code changes should be adopted in the case of dispute

1. Executive Summary

- 1.1 We agree that the appointment of an independent code adjudicator to make decisions on code changes would be a positive one, and bring further certainty and efficiency.
- 1.2 Ofgem's current role in this process can lead to inefficiencies and consumer detriment, since it has multiple duties which leads to a risk that it promotes, supports or rejects code modifications for reasons other than the economic efficiency of the proposals. In the past, this has led to code-change decisions which have had an economically inefficient outcome, imposing costs on the industry without providing a corresponding consumer benefit.
- 1.3 We propose that an independent code adjudicator is appointed, supported by a single code administrator, to make decisions on which code changes are adopted. These decisions would be based on a single set of principles that ensure all code decisions lead to greater economic efficiency and promote further competition. Ultimately, this would avoid any conflicts of interest and accelerate code decisions.

2. Specific Questions

(a) *Are there benefits in terms of independence, impartiality and/or industry know-how of an independent code adjudicator that are not available with Ofgem, given its other responsibilities, when undertaking the adjudicator role?*

- 2.1 In RWE's response to the Updated Issues Statement we recommended the creation of an independent code adjudicator on the basis that:
 - 2.1.1 RWE believes that Ofgem's role in code governance can sometimes act against the interests of consumers. 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 consistent with the objectives of promoting competition and economic efficiency, while other policy aims (sustainability, security of supply) are best attained through the use of dedicated instruments.
 - 2.1.2 Requiring Ofgem to weigh up conflicting objectives has at times led to opacity and regulatory uncertainty. RWE believes this problem should be resolved by having decisions on codes made by an independent code adjudicator, independently of Ofgem. This adjudicator would have a focused remit to promote competition and economic efficiency rather than Ofgem's current wider statutory duties.
- 2.2 Under most of the codes, Ofgem is empowered to approve or reject proposed industry code changes. In the past, Ofgem's intervention under objectives, duties and matters to which they must have regard have not at all times knitted together well. We have previously cited the case of BSC Modification P272, which suffered from the complexity of Ofgem's obligations and where the wider statutory duties of the regulator created confusion in the regulatory process. This led to an economically inefficient outcome that imposed costs, for example, through inappropriate Transmission Use of System (TNUoS) demand charges and industry parties' implementation costs without providing a corresponding consumer benefit. Many SME businesses, for example, are unable to alter their consumption patterns to benefit from Time of Use tariffs, one of the key drivers of half hourly settlements. Additionally the timeframe for delivery of P272 did not give suppliers time to migrate customers to half hourly settlements at the end of their contract period, instead many would have had to move mid contract. The industry has had to take further steps to address this (through CUSC Modification CMP241 and BSC Modification P322).
- 2.3 We believe that an independent code adjudicator would be in a better position to take a long term view of industry change, particularly if supplemented by an overarching code

administrator and independent industry Change Overview Board (as suggested in our response to remedy 18b). We believe these recommendations would lead to reduced costs and complexity, avoiding the potential for conflict of interest, and accelerated decision-making, for the benefit of consumers.

(b) *Would there be unintended consequences, arising for instance from an increased lack of coordination between code modification governance, licence modifications and legislation?*

- 2.4 We believe there could be unintended consequences from the implementation of this proposed remedy, but a solution could be found to address these.
- 2.5 For example, the code adjudicator might need to take decisions on issues where there are conflicting regulatory objectives or duties. To overcome this, it would be necessary to create a set of principles setting out what decision making factors should take precedence. In our view, code modifications should primarily be made on the basis of promoting competition and economic efficiency.
- 2.6 In our view the benefits of having such a body outweigh any potential disadvantages. There will clearly be a need to ensure that the powers and functions of the new code adjudicator are clear, transparent and understood. We believe that the introduction of an independent code adjudicator will enable decisions to be taken applying criteria of promoting competition and economic efficiency, rather than on the basis of Ofgem's complicated set of primary and secondary duties, and this will lead to overall improvements in the efficacy and speed of the codes modification process. We believe that whilst remedy 15 looks to ensure that DECC and Ofgem carry out more effective assessment of trade-offs between policy objectives and communication of impact of policies on prices and bills, an independent adjudicator working to these two primary criteria is still necessary for the effective functioning of industry change.

REMEDIES THE CMA IS CURRENTLY NOT MINDED TO CONSIDER FURTHER

1. The CMA sets out in paragraphs 131 to 154 of the RN the remedy options that it has considered but currently does not intend to pursue. For the reasons set out below, RWE agrees with the CMA that those remedies would not be effective and/or proportionate and that therefore they should not be considered further.

Remedy a – Price control regulation of all domestic and microbusiness retail energy tariffs

2. RWE strongly believes that 'remedy a' would not be effective in addressing any AEC related to weak customer response identified by the CMA, and furthermore it would be entirely disproportionate to the extent of any AEC that may exist. We do not repeat here the significant concerns identified by RWE in its response to proposed remedy 11 (the safeguard tariff), but we note that these concerns would also exist, and indeed the level of concern would be even more severe, in relation to remedy a. As the CMA correctly notes in the RN, price controls should only be implemented where there is no reasonable prospect of competition, which is clearly not the case in the energy market in Great Britain.
3. RWE strongly agrees with the CMA that the imposition of price control on the retail energy markets in Great Britain would result in a number of negative effects, leading in particular to reduction in competition between energy suppliers in relation to both price levels and innovation. In addition, price control would deter entry and growth by potential competitors as there would be likely to be insufficient headroom within the regulated price level to allow them to invest in advertising and other costs associated with customer acquisition.
4. RWE also agrees with the CMA that price controls can create significant distortions in markets if the level of the controls are set inappropriately. If the regulated price is set too high, it will be less effective than it should be in constraining any market power the regulated firm is found to have. By contrast, if the regulated price is set too low, the regulated firm will not have an incentive to invest in maintaining levels of quality.
5. The CMA correctly observes in the RN that the costs of administering price regulation are generally significant, not only for suppliers (who are required to implement system changes to deal with the greater regulatory demands), but also for the Regulator which needs to administer the regulated price on an ongoing basis.
6. However, RWE disagrees with the CMA that the clear disadvantages of a price cap on all domestic and microbusiness tariffs (as envisaged by 'remedy a') would not apply to a safeguard tariff for a given segment of customers (i.e. proposed remedy 11). This issue is addressed further in RWE's response to proposed remedy 11.

Remedy b – Requiring energy firms to inform customers about the cheapest tariff on the market (across all suppliers)

7. RWE agrees with the CMA that forcing energy suppliers to share detailed pricing information would not be a proportionate remedy to address any lack of engagement found by the CMA to exist, and considers that this remedy is very likely to weaken competition and lead to price convergence.
8. RWE also agrees with the CMA that requiring suppliers to advertise competitors' tariffs would not provide customers with the correct incentives to engage effectively in the market in the longer term, as they could rely on their supplier to conduct a search on their behalf and provide them with the results. Therefore RWE does not consider that this would be an effective remedy to address any AEC relating to weak customer response identified by the CMA. Furthermore, as the CMA has identified, this would undermine the CMA's proposed remedies designed to facilitate widespread customer engagement (such as those outlined in proposed remedies 3, 6 and 9 which RWE broadly supports).

Remedy c – Opt-out collective switching of disengaged customers.

9. RWE considers this remedy to be disproportionate and strongly agrees with the CMA that this remedy suffers from several important weaknesses, including:

- 9.1 The collective switching of large numbers of accounts at a single point in time could create significant confusion and disruption for customers and (notwithstanding our comments in the PFs response relating to erroneous transfers) could result in a number of delayed and erroneous transfers; and
- 9.2 By specifying the type and quality of service to be offered to customers in advance, this type of scheme may limit innovation as energy suppliers would be unable to test and refine different products with customers.
- 10. RWE also believes that, far from being an effective remedy for addressing disengagement (the scale of which RWE considers the CMA to have significantly overstated in any event), this remedy would in fact decrease customer engagement by:
 - 10.1 Creating a customer perception that they no longer need to shop around or switch, given the protection implicit in the concept of a 'competition for the market' (with the lowest bid winning) for those who have not engaged in the market;
 - 10.2 As a result, reducing customer engagement in energy management.

Remedy d – Introduction of a single price for gas and electricity customers

- 11. In RWE's view, a remedy requiring suppliers to offer a single price to all their gas and electricity customers would significantly reduce price competition in the market and dramatically reduce incentives for suppliers to innovate. Accordingly, RWE strongly agrees that this remedy would not be effective in reducing prices to disengaged customers. Nor would it facilitate the development of competition in the market. Further, RWE agrees with the issues the CMA has identified with this remedy, and in particular that:
 - 11.1 A single price for each energy supplier may result in price convergence as a result of the increased transparency in the markets;
 - 11.2 Energy suppliers would have an incentive to increase their prices towards the level charged to disengaged customers rather than reduce prices towards the level charged to engaged customers;
 - 11.3 It would similarly limit competition between intermediaries, such as PCWs, in the markets (indeed, to a much greater extent even than the four-tariff limit under the RMR simpler choices rules), preventing energy suppliers from agreeing discounts with specific PCWs.

Remedy e – Introduction of price non-discrimination provisions

- 12. RWE believes that this remedy would have similar negative effects to requiring suppliers to offer a single price for gas and electricity customers, in that it would severely hamper price competition in the market and reduce incentives for suppliers to innovate on the structure and level of tariffs in order to design products that appeal to different types of customer.
- 13. RWE shares the CMA's concerns identified in the RN, in particular that this remedy would reduce incentives to switch for engaged customers, which may undermine the level of competitive pressure in the market in the longer run.
- 14. Furthermore, RWE notes that the CMA itself has criticised the non-discrimination provisions introduced by Ofgem in SLC 25A, and considers that many of the restrictive effects resulting from SLC 25A can be expected to result from any broader price non-discrimination provision introduced by the CMA.
- 15. Accordingly, RWE does not consider that 'remedy e' would be effective in reducing prices to disengaged customers. Nor would it facilitate the longer term development of competition in the market.

Remedy f – A transitional safeguard regulated price structure

16. The CMA implies that such remedy might be targeted at customers who move onto SVT at the end of their fixed term non-standard tariff. If so, RWE considers that it would be entirely inappropriate to regard these customers as disengaged or exhibiting weak customer response. Therefore any remedy targeted at such customers is unnecessary and cannot be regarded as proportionate. Even if targeted at customers who are less engaged, RWE would have serious concerns about this remedy.
17. RWE refers the CMA to RWE's response to the proposed remedy 11 on safeguard tariffs (remedy 11) and to RWE's response to 'remedy a' above, much of which applies equally to 'remedy f'. In particular, RWE considers that 'remedy f' would result in a reduction in competition between energy suppliers in relation to both price levels and innovation. Further, there could still be significant costs of administering this remedy, both for the regulator and for suppliers. As the CMA correctly acknowledges in the RN, price controls should only implemented where there is no reasonable prospect of competition, which is clearly not the case in the energy market in Great Britain.
18. Finally, RWE shares the CMA's concerns in relation to this remedy and agrees that if awareness of the default tariff levels remained low and / or customers did not act on this awareness, then this remedy would not provide any protection to customers and therefore would not be proportionate or effective in remedying the AEC identified by the CMA in its PFs.

CMA ENERGY MARKET INVESTIGATION

PROVISIONAL FINDINGS

SCHEDULE 2

RWE RESPONSE TO THE CMA'S PROFITABILITY ANALYSIS INCLUDING RESPONSES TO APPENDICES 10.3, 10.5 AND 10.6

A. Introduction and summary

1. The CMA uses profitability analysis to "*assess the potential level of detriment arising*" from the AECs it has identified.¹ Without prejudice to RWE's position that the CMA is wrong to conclude that features of retail energy supply markets give rise to AECs, RWE considers that there are serious weaknesses in the CMA's profitability analysis which causes it to materially overstate the level of detriment (if any) arising as a result of any AEC which may be found to exist.
2. This response is structured as follows:
 - 2.1 in Section B, we summarise RWE's views on the CMA's profitability analysis;
 - 2.2 in Section C, we explain why the CMA's overall approach to profitability analysis is inappropriate and we restate why the ROCE is not a reliable measure of profitability for retail energy supply businesses;
 - 2.3 in Section D, we comment on the CMA's Appendix 10.3 and explain why the CMA's methodology materially understates the ROCE;
 - 2.4 in Section E, we comment on the CMA's Appendix 10.5 and explain why the CMA's assessment of "reasonably efficient" economic costs should be disregarded; and
 - 2.5 in Section F, we comment on the CMA's Appendix 10.6 and explain that the CMA's assessment of the evidence for the competitive level of EBIT margins is inconsistent with its ROCE analysis, regulatory precedent and selective.

B. Summary of RWE's views on the CMA's profitability analysis

a. Introduction

3. The CMA has based its findings on the profitability of the Six Large Energy Firms on simplistic and unreliable analysis. It falls short of best practice, and below the standard that is needed for the CMA to robustly assess the extent of any AEC identified by the CMA and the proportionality of its various proposed remedies, some of which would represent significant costly interventions in the market. We consider that any finding of excess profitability is unreliable, and therefore should not form a basis from which to assert that large suppliers have – and indeed exert – unilateral market power over aspects of their customer base. We summarise our views on the CMA's profitability analysis in more detail below.

b. ROCE is not a reliable measure of profitability in retail energy supply

4. The CMA refers to, but does not accept, parties' arguments that ROCE is not a reliable measure of profitability for retail energy supply. In particular:
 - 4.1 the CMA wrongly concludes that its ROCE results are robust on the basis of misconceived and simplistic analysis. The CMA considers the sensitivity of its ROCE estimate to individual changes in just two inputs: the trading fee and overall capital employed. It finds that these inputs would need to increase very materially to bring the ROCE down to the cost of capital

¹ CMA PFs, 10.2

for the four firms whose ROCE (in the CMA's calculation) persistently exceeded the cost of capital. We disagree with the CMA's conclusions. The CMA's calculation exaggerates the required increase in capital because:

- 4.1.1 it does not consider the joint sensitivity to changes in multiple inputs. As we explain below, the CMA has understated capital employed in a number of areas. As a result, there is a significant risk of error in its analysis, which means it is particularly important to conduct a proper sensitivity analysis;
- 4.1.2 it does not appreciate that the required uplift falls within the range of values put forward by parties. Hence, the CMA's assertion that an uplift to capital employed of 300% is so high that it could not be plausible, is unreasonable because the firms have in fact provided support for highly material values for their notional capital, which the CMA has disregarded;
- 4.1.3 it presumes that even the most successful firms should not earn a return in excess of the cost of capital because it assesses the required change in inputs for the average ROCE of the four most profitable firms to become equal to the WACC, which is inconsistent with the CMA's own description of outcomes in a competitive market; and
- 4.1.4 it does not take into account that the significant inherent uncertainty in estimates of ROCE, particularly in an asset-light industry, means that any gap between the ROCE and the WACC would need to be significant before it could be reasonably interpreted as evidence of excessive profits;
- 4.2 [CONFIDENTIAL]
- 4.3 the CMA disregards the evidence that its ROCE analysis is inconsistent with its profit margins analysis. The upper bound of the CMA's EBIT margin benchmark of 3% corresponds to a ROCE of 23%, which is significantly above the upper bound of the CMA's WACC of 11.5%. This suggests that the CMA's estimate of capital employed in its ROCE is likely to be understated or that the ROCE is a flawed measure of profitability for asset light businesses; and
- 4.4 the CMA does not address parties' submissions that ROCE in asset-light industries is inherently volatile, which is demonstrated by the sensitivity of the CMA's findings. The CMA proposes that "*economic profits are less sensitive to ... movements in the capital basis*". However, the CMA does not establish why this would be the case. Further, economic profits are calculated as the difference between the ROCE and the WACC, multiplied by the value of capital employed, so it is not clear why it would be less sensitive than ROCE.

c. The CMA's ROCE methodology materially overstates profitability (Appendix 10.3)

- 5. The CMA has made only limited changes to its ROCE analysis since the working paper. We consider that the weaknesses which remain are that:
 - 5.1 the CMA does not accept and account for the full range and quantum of business risks against which suppliers hold notional capital. In particular, the CMA:
 - 5.1.1 disregards the evidence on the existence and use of notional capital by five of the Six Large Energy Firms without sufficient analysis. The CMA implies that the variation in values indicates that the calculations are not valid. A more balanced conclusion would be that the quantification is a complex exercise and variation is to be expected given the different customer bases, business strategies and profiles. Methodologically, the CMA could have proceeded by removing outliers and adjusting for scale when making a comparison between firms. It could alternatively have performed its own bottom up analysis. While notional capital can be difficult to value, this is no reason for it to be disregarded;

- 5.1.2 does not appear to recognise the types and size of non-trading business risks that suppliers face, which results in the CMA making an implausible assumption that non-trading risks can be removed through operational procedures and a trading fee. We contend that this only covers the cost of attaining a route to market – not managing additional trading risks, including commodity cost disadvantage, shape and swing risk, and all non-trading risks;
- 5.1.3 does not address RWE's concerns that the risk management practices of the Independents may result in an inappropriately high probability of default and are therefore an inapplicable model for the Six Large Energy Firms to adopt. The CMA must carefully consider the consequences on the stability of the industry if it is advocating a risk management policy without notional capital. To do this, it should assess the appropriate probability of default for suppliers using a cost benefit analysis of risk management approaches. In the majority of cases, it should be noted that the business models of the Independents have not been stress tested over a medium term business cycle; and
- 5.1.4 does not take into account the views presented by RWE on its definition, calculation and use of notional capital within its business and is selective in its use of evidence. For example:
 - 5.1.4.1 [CONFIDENTIAL]² and
 - 5.1.4.2 [CONFIDENTIAL]
- 5.2 the CMA does not address RWE's submissions that a retail energy supply firm is required to post material amounts of regulatory collateral to operate as a business and this should be reflected in its ROCE;
- 5.3 the CMA does not address RWE's submissions that there is material additional value in its customer base and that the CMA's cost-based estimate understates its value; and
- 5.4 the CMA does not address RWE's submissions that it requires an additional allowance to cover its pension deficit repair costs. The CMA does not acknowledge the existence of this cost or provide any justification for excluding it from its ROCE analysis. Regulators have accepted that such costs must be recovered by firms in the past.

d. The CMA's benchmarking of economic costs is not robust and has conceptual issues (Appendix 10.5)

- 6. The CMA has assessed what it considers to be "reasonably efficient levels of cost" for each of the three main categories (i.e. direct costs, indirect costs and capital costs). The CMA did not issue a working paper covering this analysis. This is therefore the first opportunity that RWE has had to comment on it. RWE considers that there are problems with the benchmarks the CMA has used and with how it combines them. In summary:
 - 6.1 the CMA makes an inappropriate ex post assessment of the level of costs that a "reasonably efficient" operator could have been expected to achieve, by imposing a presumption that is unsupported by evidence in its benchmarks that the Six Large Energy Firms were inefficient in each of the three main cost categories. The CMA does not perform the normal econometric, overhead and functional benchmarking analyses that are commonly applied by regulators when assessing an efficiency gap;
 - 6.2 the CMA's "scenarios" combining multiple cost benchmarks across different cost categories are unrealistic, because they imply that a "reasonably efficient" operator would have achieved better-than-average performance across multiple cost categories;

² For example, at the 2013 year end, RWE group held €4.0 billion of cash and €2.8 billion of liquid securities. (RWE's Response to Approach to Financial and Profitability Analysis, paragraph 5.63, Footnote 65)

- 6.3 the CMA's proposed benchmarks for wholesale costs are unrealistic and do not reflect the level of wholesale costs that a firm could achieve over the long term. In particular, the CMA's approach:
- 6.3.1 does not appear to recognise the complexities of wholesale purchase hedging strategies and does not appropriately account for the impact on outturn wholesale costs of exogenous market movements. Each firm's strategy will be affected differently by exogenous market movements that cannot be predicted ahead of time. No *ex ante* static hedge strategy can consistently result in lower than average outturn wholesale costs;
 - 6.3.2 uses the lower quartile outturn cost, which is likely to change from year to year. This sets an unrealistic benchmark for a single firm to achieve in the long run and therefore tends towards a finding that firms' costs are inefficient;
 - 6.3.3 inappropriately uses the wholesale cost of mid-tier firms to support the choice of a lower quartile benchmark;
 - 6.3.4 [CONFIDENTIAL]
 - 6.3.5 includes an incomplete investigation into the range of possible benchmarking methods. We consider that the CMA could instead use the average of the Six Large Energy Firms' outturn wholesale costs. This would represent a more reasonable return of outturn costs over time; and
 - 6.3.6 includes a flawed analysis based on spot market costs which we do not consider represents a feasible scenario.
- 6.4 the CMA's proposed benchmark for indirect costs is simplistic and implies that the majority of operators have been inefficient without adequate supporting evidence. Its main weaknesses are:
- 6.4.1 it incorrectly assumes that all differences in unit costs between firms can be characterised as inefficiency because it does not control for other drivers of differences in costs, such as customer mix, geography, legacy issues and scale. Under regulatory standard practice, these factors can be controlled for using econometric analysis and other quantitative techniques. Consequently, there is a risk that the CMA's will wrongly ascribe differences in cost arising from these factors to inefficiency;
 - 6.4.2 it performs no external benchmarking to determine whether the Six Large Energy Firms are inefficient by reference to other competitive industries. The CMA makes an unsupported presumption that the Six Large Energy Firms must on average be inefficient. This position has not been tested; and
 - 6.4.3 the CMA supports its benchmark based on limited evidence from the indirect cost ratios of mid-tier firms. It therefore wrongly compares the "greenfield" mid-tier firms, whose total market share is only around 10 per cent, with the "brownfield" business of the Six Large Energy Firms which will have substantially difference cost bases, operating models and business strategies.
- 6.5 the CMA's proposed benchmarks for capital costs:
- 6.5.1 are commercially unrealistic because they do not recognise that firms manage their working capital on a net basis;
 - 6.5.2 depart from the CMA's own standard practice for determining the MEAV of fixed assets; and
 - 6.5.3 are based on assertions that are not supported by evidence.

e. The CMA's assessment of the evidence for the competitive level of EBIT margins is inconsistent and selective (Appendix 10.6)

7. The CMA has reached a preliminary finding that the reasonable range for EBIT margins is between 1% and 3%. The CMA's range is unreasonable because it has given undue weight to inappropriate comparators from within GB retail energy supply (i.e. the mid-tier firms and I&C margins). There are the following principal issues with the CMA's assessment of the evidence:
 - 7.1 the CMA inappropriately places weight on the outturn gross margins of mid-tier firms and their "target" EBIT margins. In doing so, it:
 - 7.1.1 does not control for significant differences between the firms;
 - 7.1.2 overlooks the limitations on comparability of the mid-tier suppliers on the basis of assertions that are not supported by evidence; and
 - 7.1.3 assesses the evidence it has received inconsistently because many parties argued that the mid-tier firms are inappropriate comparators and another mid-tier firm submitted that they are operating unsustainable business models.
 - 7.2 the CMA incorrectly places weight on outturn I&C margins and, in doing so:
 - 7.2.1 suggests that differences in the degree of pass-through of wholesale costs to I&C customers *"would be reflected in costs, but not margins"*. [CONFIDENTIAL]
 - 7.2.2 makes assertions that do not appear to be supported by evidence. For example, it asserts that *"I&C is likely to be more correlated with the economy than is domestic supply, but possibly less so than SME"*;
 - 7.2.3 disregards EBIT margins in other industry sectors and overseas energy retail markets. In doing so, it applies an inconsistent argument; the CMA concludes that it cannot adjust for differences in risk and cost between these comparators and GB retail energy supply. This is inconsistent with regulatory precedent and its own assessment of mid-tier firms and the I&C segment where it identifies differences but proposes that these do not invalidate the comparators; and
 - 7.2.4 concludes that the reasonable margin need not be in excess of regulated margins despite the fact that retail energy supply firms face competition risk and cost uncertainty that regulated monopolies do not. The CMA also overstates firms' ability to pass through costs. The fact that some firms incurred losses and the high degree of variability in profitability over the period is evidence that firms cannot pass through costs.

C. ROCE is not a reliable measure of profitability in retail energy supply

8. The CMA adopts ROCE as its *"principal measure of profitability for energy retail supply"*.³ The CMA notes that *"ROCE is the CMA's standard approach to measuring out-turn profitability"*,⁴ as it takes account of the capital required to operate business. We accept that it may be the CMA's standard approach; however this does not mean that the CMA should be constrained to a "one size fits all" methodology if there is sufficient evidence to show that the methodology is inappropriate for a particular industry. We note that the CMA acknowledged that *"[s]everal of the Six Large Energy Firms argued against the use of ROCE"*.⁵ In fact, all six firms raised concerns with the use of ROCE. This should be sufficient for the CMA to be concerned about the appropriateness of the ROCE in this case.

³ CMA PFs, Appendix 10.1, 23

⁴ CMA PFs, 10.9

⁵ CMA PFs, Appendix 10.3, 19

9. In our view, the CMA has not adequately addressed the serious weaknesses of ROCE as a measure of profitability for retail energy supply businesses that have been identified by RWE and the other parties. We consider the CMA's argument for using ROCE as the principal measure of profitability are weak because it:
 - 9.1 inappropriately concludes that its ROCE results are robust on the basis of misconceived and simplistic analysis;
 - 9.2 does not recognise its findings are materially driven by a single firm's financial performance;
 - 9.3 does not recognise its ROCE analysis is inconsistent with its profit margins analysis; and
 - 9.4 does not address parties' submissions that ROCE in asset-light industries is a flawed measure of profitability, which can be demonstrated simply by the volatility of the CMA's findings
10. We expand on each of these points in turn below.

a. The CMA's ROCE results are not robust

11. The CMA has performed only a limited "sensitivity" analysis of its ROCE estimates:
 - 11.1 it calculates the amount by which the capital employed by the four most profitable firms would need to increase for its estimate of their average ROCE to be equal to its point estimate of the WACC; and
 - 11.2 it calculates the percentage increase in its benchmark "trading fee" that would be required for the average ROCE of four most profitable firms to be equal to its point estimate of the WACC.
12. From this analysis, the CMA concludes that *"the broad results of this analysis are not very sensitive to inaccuracies or differences in assumptions"*.⁶ RWE considers that this analysis is simplistic and does not demonstrate that the CMA's ROCE results are robust. We provide support for this conclusion below.
13. First, the CMA implies (but does not demonstrate or explicitly state) that changes in the capital employed of the required magnitude to eliminate any "excessive" profit are outside the range of plausible values. However, the CMA acknowledges that more than one firm's estimate of the notional capital was *"sufficiently large to bring their returns down close to their cost of capital."*⁷ This suggests that in fact the adjustments are plausible. Given that the CMA appears to misunderstand notional capital (see Section D below), we consider that the CMA's sensitivity analysis is not informative. We therefore consider it is inappropriate to interpret the large increase in capital employed required for ROCE to be equal to the WACC benchmark as evidence of the robustness of its finding of "excessive" profitability.
14. As RWE demonstrates in Section D, the CMA's estimate of its weighted average ROCE over the period 2007 to 2013 changes materially in response to reasonable adjustments to EBIT and/or capital employed.
15. Second, it is not clear why the CMA has truncated its analysis by considering the average ROCE of the four most profitable firms. It results in the CMA overstating the magnitude of the changes required for it to find a normal level of economic profit. This approach also implicitly assumes that no firm should earn a ROCE in excess of the WACC. This assumption contradicts the CMA's own guidelines, which state that *"a competitive market would be expected to generate significant variations in profit levels between firms and over time"*.⁸

⁶ CMA PFs, 10.38

⁷ CMA PFs, 10.27

⁸ CMA, Guidelines for market investigations, paragraph 117

16. Economic theory suggests only that the marginal firm in a competitive industry should not expect to persistently make positive economic returns.⁹ As the CMA's chief economist has previously described: *"The theory predicts that the marginal firm in long-run equilibrium earns zero economic profits, but firms with lower costs will earn positive economic profits."*¹⁰
17. Third, it is inappropriate for the CMA to calculate the change in EBIT or capital employed that would be required for its estimate of ROCE to be equal to the mid-point of its WACC range. RWE has previously stated that profitability analysis is inherently uncertain and that any gap between ROCE and WACC would need to be significant before a finding of excessive profits could be supported.¹¹
18. Fourth, it is inappropriate for the CMA to consider the sensitivities in terms of the required total reduction in EBIT or increase in capital employed separately. As explained in Section D, RWE considers that the CMA has underestimated the value of both capital employed and relevant costs. Therefore, the CMA should consider the impact of changes to multiple inputs simultaneously. For example, the CMA should consider the sensitivity of ROCE to:
 - 18.1 notional capital;
 - 18.2 a higher value for customer relationships, given the CMA appears to have understated this asset;
 - 18.3 regulatory collateral; and
 - 18.4 pension deficit repair costs.
19. The CMA is then likely to find, as we explain further in Section D and in accordance with RWE's previous submissions, that the required changes to several inputs cumulatively have a material impact on the ROCE.¹²
20. Further, it is clear that the CMA's findings are sensitive to both the time period of the analysis and inclusion of outliers. In particular, we note that:
 - 20.1 the average ROCE in 2007 and 2008 was substantially lower than later years. As the CMA notes, including these years reduces the period average ROCE from 28% to 24%;¹³ and
 - 20.2 [CONFIDENTIAL]
21. In conclusion, the CMA's sensitivity analysis is simplistic and it draws inappropriate conclusions from the analysis. We note that the CMA should also consider points made in the Confidential Submissions of RWE's Authorised Advisers regarding its calculations of the ROCE of the Six Large Energy Firms.

b. The CMA does not consider the impact on its findings of Centrica's financial performance, which skews the average

22. [CONFIDENTIAL]¹⁴

⁹ For academic papers where this statement is heavily relied upon see for example the "free entry" literature following Berry, S. (1994) "Estimation of a model of Entry in the Airline Industry" *Econometrica*, Journal of the Econometric Society, p.999-917.

¹⁰ See page 4, Professor R. Lind and Dr. M. Walker "The (mis)use of profitability analysis in competition law cases" Available from http://ecp.crai.com/ecp/assets/CRA_DP9.pdf.

¹¹ RWE Response to the CMA's Approach to Financial and Profitability Analysis, 6.22

¹² The CMA should also consider points made in the Confidential Submissions of RWE's Authorised Advisers regarding the sensitivity of its ROCE calculations.

¹³ CMA PFs, 10.37

¹⁴ CMA PFs, 10.40

23. To the extent that we are able (based on the limited information in the CMA's redacted PFs), we consider the impact of Centrica on the CMA's analysis and make the following observations:
- 23.1 excluding [%] reduces the weighted average ROCE of the remaining five Large Energy Firms between 2009 and 2013 from [%] to approximately [%].¹⁵ This compares to an upper bound for the CMA's cost of capital of 11.5%. This is without even making the numerous adjustments to the CMA's ROCE analysis that we consider to be essential (see paragraph 17 above);
- 23.2 the ROCE for the seven years from 2007 to 2013 is lower, at 24%, and therefore we would expect that the ROCE excluding Centrica for this period would be lower than the 18% observed over the five year period;
- 23.3 excluding Centrica reduces average EBIT margins of the remaining five of the Six Large Energy Firms between 2009 and 2013 from 3.4% to 2.2% (well within the CMA's benchmark range for the competitive EBIT margin of 1% to 3%);¹⁶ and
- 23.4 one reason why the CMA appears to exclude notional capital is that the range of estimates provided by the Six Large Energy Firms is wide.¹⁷ However, this range may be skewed by Centrica's estimate of £2.7bn to £4.5bn.¹⁸
24. Centrica's financial information may also distort the CMA's analysis of the "efficient levels of costs". We discuss this further in Section E.
25. We note that the CMA should also consider points made in the Confidential Submissions of RWE's Authorised Advisers regarding the materiality of Centrica to the CMA's findings.

c. The CMA's ROCE analysis is inconsistent with its profit margins analysis

26. The CMA asserts that "*different sources of evidence on profitability and prices give broadly consistent results*".¹⁹ RWE disagrees with this assertion. The CMA finds that "*margins in the range of 1 to 3% would appear to provide a reasonable guide for what is required to cover efficient levels of capital employed and operating costs*".²⁰ As RWE discusses in Section F, the CMA's analysis is selective by relying on benchmarks which suggest lower margins.²¹
27. By contrast, the CMA notes that the competitive margin implied by its ROCE analysis is 1.3%²² (i.e. towards the lower end of the CMA's proposed reasonable range) and comments in a footnote that "[s]imilarly low margins are implied by our benchmarking analysis".²³ RWE disagrees that 1.3% would represent a reasonable return for a retail energy supplier operating in the highly competitive UK market, given the very substantial market, regulatory and the risks that it faces. RWE discusses the risks to which its retail energy supply business is exposed in more detail in Section D. Such a low return is more akin to the risks associated with a bond rather than a retail energy supplier.

¹⁵ Based on rounded financial data disclosed in the CMA's PFs, Table 10.1 and Table 10.2.

¹⁶ Based on Consolidated Segmental Statements ("CSS") data and published CMA data.

¹⁷ CMA PFs, 10.27

¹⁸ CMA PFs, Appendix 10.3, 91

¹⁹ CMA PFs, 10.138

²⁰ CMA PFs, 10.131

²¹ RWE also provides its comments in relation to the CMA's evidence on gains from switching in paragraphs 29 to 244 of its Response to the PFs, and in paragraphs 261 to 274 in its Response to the PFs provides its views on the CMAs cost pass-through analysis. RWE does not believe that the CMA's results paint a consistent picture once the CMA adopts appropriate methodologies and affords appropriate weight to the full set of evidence available to it.

²² CMA PFs, 10.101

²³ CMA PFs, Footnote 596

28. RWE highlights that the CMA's ROCE analysis would imply that a firm earning an EBIT margin of 3% (which is within even the CMA's proposed reasonable range, which RWE considers too low) would translate into an ROCE of 23%.²⁴ Consequently, there is a clear inconsistency in the CMA's findings, which the CMA does not recognise or explain.
29. This inconsistency should have caused the CMA to question its ROCE analysis. The obvious implication of this is that the CMA has significantly understated capital employed in its ROCE analysis, which supports our view (as set out in previous submissions) that this is the case.
30. For the avoidance of doubt, we note that RWE does not accept the CMA's conclusions on a reasonable range for margins. In Section F, we repeat that there is evidence to support higher margins.

d. The CMA wrongly dismisses the inherent volatility of ROCE in asset-light industries

31. The CMA acknowledges the inherent volatility of ROCE, stating that "*ROCE can fluctuate significantly year on year and across firms*".²⁵ The CMA asserts that "[e]conomic profits are less sensitive to such movements in the capital base and, as a result, may give a more easily comparable measure of profits across firms and over time." The CMA does not demonstrate how or why this would be so. Economic profits are the absolute level of returns above the cost of capital, calculated as the difference between the ROCE and the WACC, multiplied by the value of capital employed.
32. The CMA has not addressed that economic profits are simply an output of the ROCE. Given that the CMA's estimate of ROCE is materially overstated, the same issue applies to economic profits.
33. Given these issues, we are not convinced by the CMA's explanation for why volatility is not a weakness in its ROCE analysis. Despite this, the CMA persists in using ROCE as its principal measure of profitability. We consider that the CMA is unreasonably tied to its "standard" approach, despite the obvious advantages of the EBIT margin approach, which provides for a demonstrably more stable measure of profitability.²⁶

D. The CMA's methodology in Appendix 10.3 materially understates ROCE

34. RWE explained in its response to the CMA's retail energy supply ROCE analysis that the inherent volatility of ROCE estimates for asset-light industries is compounded by the CMA's approach that materially understates the value of capital employed, leading to a materially overstated ROCE and results that are inconsistent with the CMA's own margin conclusions as we highlight in the preceding section.²⁷
35. RWE notes the CMA appears not to accept that its ROCE methodology underestimates the value of capital employed. The CMA states that it "*recognises the need to ensure that all capital employed by firms is identified and included*" in its analysis.²⁸ However, it goes on to note that it has only included assets which meet its criteria for recognition. This suggests that the CMA's criteria for recognising economic assets are not appropriate or the CMA has not appropriately interpreted them.

²⁴ This follows given from the definition of these two measures. $ROCE = (EBIT / CE)$ and $EBIT \text{ margin} = (EBIT / \text{Revenue})$. By substituting and rearranging these relationships, it can be shown that: $(CE / \text{Revenue}) = (EBIT \text{ margin} / ROCE)$. The CMA states that, when the ROCE is 10%, the EBIT margin would be 1.3%, which means that $(CE / \text{Revenue})$ is 0.13. Therefore, if the EBIT margin were 3.0%, the ROCE would be $(3.0\% / 0.13) = 23.1\%$.

²⁵ CMA PFs, Appendix 10.3, 21

²⁶ See RWE's Response to the CMA's retail energy supply ROCE analysis, Figure 7-1.

²⁷ RWE Response to the CMA's retail energy supply ROCE analysis, 2.10 – 2.19

²⁸ CMA PFs, Appendix 10.3, 20

36. RWE does not repeat here all of the comments made in its earlier responses. In this section, RWE highlights the most material issues that the CMA has not addressed. In particular, the CMA appears inappropriately to disregard RWE's submissions:
- 36.1 regarding the full range and quantum of business risks against which RWE holds notional capital (see paragraphs 40 to 57 below);
- 36.2 that a retail energy supply firm needs to post material amounts of regulatory collateral and this should be reflected in its ROCE (see paragraphs 58 to 59 below);
- 36.3 that the value of the customer base is materially higher than the amount it has allowed (see paragraphs 60 to 61 below); and
- 36.4 that it requires an additional return to cover its pension deficit repair costs. The CMA does not acknowledge the existence of this cost or provide any justification for excluding it from its ROCE analysis (see paragraphs 62 to 64 below).
37. RWE emphasises that the CMA's disregarding of notional capital has the most material impact on its ROCE results although the other issues with the CMA's ROCE analysis all result in higher estimates of ROCE than would be likely had a more balanced approach been applied.
38. The CMA should also consider points made in the Confidential Submissions of RWE's Authorised Advisers regarding its calculations of the ROCE of the Six Large Energy Firms.
39. In the remainder of this section we comment further on the issues summarised in paragraph 36 above. We then explain that market-based evidence supports RWE's view that the CMA has materially understated capital employed. Finally, we update the CMA's estimate of RWE's ROCE²⁹ after correcting the CMA's methodology.

a. Adjusting ROCE for business risks faced by a supply business

40. The CMA applies a trading fee to its ROCE calculation to represent the costs to manage trading risks. The CMA does not adjust the capital employed of the Six Large Energy Firms for notional capital.³⁰ RWE considers that the CMA's approach contains issues because the CMA has not performed sufficiently robust analysis and does not substantiate its assertions with the necessary evidence required considering the materiality of notional capital. In particular, we consider the CMA:
- 40.1 has not properly understood the types and size of non-trading business risks that suppliers face, which results in the CMA making an implausible assumption that non-trading risks can be removed through operational procedures;
- 40.2 does not address RWE's concerns that the risk management practices of the Independents result a probability of default that for any of the Six Large Energy Firms would be inappropriately high, and are therefore an inapplicable model for the Six Large Energy Firms to adopt;
- 40.3 does not address RWE's concerns on the CMA's calculation of the trading fee;
- 40.4 disregards the evidence on the use of notional capital by the Six Large Energy Firms without sufficient analysis and places too much emphasis on one firm's submission; and
- 40.5 does not take into account the views presented by RWE on its definition, calculation and use of notional capital within its business.

²⁹ The CMA previously provided its calculation of RWE's ROCE as part of its putback to RWE on its Retail energy supply – ROCE working paper. We update this analysis for the changes to its methodology that the CMA specifies it has made in Appendix 10.3 and the further shortcomings

³⁰ CMA PFs, Appendix 10.3, paragraph 98.

41. We expand on these criticisms in detail below. First, however, we summarise a number of actions that we consider the CMA should take to properly assess notional capital:
 - 41.1 fully understand the types and magnitude of non-trading risks;
 - 41.2 review operational procedures of the Six Large Energy Firms and the Independents to understand operational differences between suppliers and assess what effect this would have on risk reduction;
 - 41.3 assess the appropriate probability of default for suppliers using a cost benefit analysis of risk management approaches;
 - 41.4 address RWE's comments on the trading fee in relation to the counterparty credit risk, capturing other risks in relation to trading, trading arrangement termination and the one sided exposure of a trading intermediary;
 - 41.5 quantify notional capital by either reviewing the approaches of each of the Six Large Energy Firms and conclude which is correct, or applying a high level approach by dismissing outliers and calculating an average per customer based on the other firms' estimates of notional capital (or some similar metric). It should then perform a sensitivity analysis on its calculation;
 - 41.6 [CONFIDENTIAL]; and
 - 41.7 investigate energy suppliers' operational requirement to post regulatory capital and incorporate this into a ROCE calculation.

i. Exclusion of non-trading related business risks

42. The CMA accepts that businesses face a number of risks and explains that the trading fee it applies in the ROCE calculation relates to "*business risks associated with trading on the wholesale market*".³¹ The CMA bases its trading fee on the fee arrangements used between Independents³² and Trading Intermediaries.³³
43. The CMA recognises that "*the fee arrangement* [it assumes for the purposes of its ROCE calculations] *does not lay off all business risks*"³⁴. It suggests that "*sound financial and operational management*"³⁵ can mitigate these remaining risks, and uses the Independents as a reference point.³⁶ These management measures include working capital management, cost control, use of credit facilities, weather derivatives and insurance.³⁷
44. RWE agrees that sound financial management can reduce the effect of business risks but the CMA has misconstrued entirely what this involves. [CONFIDENTIAL]
45. RWE's comments on the operating procedures of the Independents are restricted because the CMA redacts information that explains how the Independents use operating procedures to manage risks in both its published PFs and the version disclosed in the Disclosure Room. RWE considers this restricts our ability to fully comment on the procedures of the

³¹ CMA PFs, Appendix 10.3, paragraph 97.

³² We use the CMA's definition of "Independents" to refer to fully stand-alone UK energy suppliers that are starting to achieve a level of scale. CMA PFs, Appendix 10.3, Annex A, paragraph 2b.

³³ We consider Trading Intermediaries are entities that trade on the wholesale markets on a similar basis to the Six Large Energy Firms and act as a route to market, among others, as a service for a trading fee. CMA PFs Appendix 10.3, paragraph 93.

³⁴ CMA PFs, Appendix 10.3, Annex A, paragraph 31.

³⁵ CMA PFs, Appendix 10.3, Annex A, paragraph 31.

³⁶ CMA PFs, Appendix 10.3, paragraph 90.

³⁷ CMA PFs, Appendix 10.3, paragraph 89.

Independents. However, we assess the CMA's approach at a high level and consider its reasoning to be inappropriate because:

45.1 [CONFIDENTIAL]^{38 39}

45.2 [CONFIDENTIAL]⁴⁰

45.3 the CMA's implicit assumption that the operational procedures of the Independents are better than the Six Large Energy Firms and are consequently able to manage non-trading risk is not based on evidence. We expect the CMA to perform an in-depth review of operational procedures at the Six Large Energy Firms and the Independents to understand operational differences between suppliers, assess what effect this would have on risk reduction and satisfy itself that the risk management of the Independents is in fact adequate to withstand a significant adverse shock.

ii. The use of Independents as a benchmark

46. The CMA calculates the cost of the trading fee using the commercial agreements between Independents and Trading Intermediaries. The CMA states that Independents are the efficient industry benchmark for risk management through their use of the fee approach to managing trading risks and by "*efficiently running their business*".⁴¹

47. RWE has stated in its previous submissions that it does not consider Independents to be an appropriate risk management benchmark because they have only a very small market share. In particular:

47.1 the Independents' risk management approach has not been applied at sufficient scale or for a sufficient length of time to be considered an appropriate benchmark for the Six Large Energy Firms. The approach is based on only 10% of the current energy supply market. Many of the Independents have only been operating since 2009. The CMA does not provide evidence to prove that the Independents' risk management approach is sustainable when exposed to adverse shocks over the long run;

47.2 the risk management approach used by the Six Large Energy Firms serves 90% of the market and, in RWE npower's case, has been in place for well over a decade, and therefore more weight should be placed on the risk management approaches of these firms;

47.3 we consider that Independents hold insufficient notional capital relative to the size of their business risks. This results in a higher probability of default relative to the Six Large Energy Firms;⁴²

47.4 the CMA should be aware of the consequences of its conclusions on notional capital. Its PFs recommend a risk management approach with a higher probability of default relative to an approach that uses notional capital. We consider that if the Six Large Energy Firms had a similarly high probability of default as the Independents, the expected costs to consumers would be considerable; and

47.5 RWE commented that the CMA should investigate what the appropriate probability of default for suppliers should be.⁴³ The CMA has not responded to this in its Provisional Findings, but we consider that a full cost benefit analysis should be performed before making recommendations on risk management approaches.

³⁸ RWE's Response to ROCE Working Paper, Appendix A, paragraph A6.

³⁹ We outlined these remaining risks in RWE's Response to ROCE Working Paper, paragraph 5.11.

⁴⁰ RWE's Response to ROCE Working Paper, paragraph 5.26.4

⁴¹ CMA PFs, Appendix 10.3, paragraph 90.

⁴² RWE's Response to ROCE Working Paper, paragraph 5.33

⁴³ RWE's Response to ROCE Working Paper, paragraph 5.34

iii. The use of a trading fee

48. Notwithstanding our primary concern that the CMA has not accounted for non-trading business risks in its current methodology, the CMA has also not responded to a number of concerns RWE raised in relation to the trading fees, including:
- 48.1 the trading fee only relates to trading activities for standard products and fails to account for additional costs of trading such as the costs of shape and swing risk (i.e. the cost to purchase weather derivatives which the CMA identify can be used to partially hedge swing risk). We consider it understates the full costs of wholesale procurement to meet the needs of customers;⁴⁴
- 48.2 the clauses within the trading fee arrangement that result in the revocation of the contract will increase the probability of default for a supplier. Any covenant breaches would result in the loss of trading credit services. This could result in significantly increased risk under financial distress. Any ability of the trading intermediary to revoke the arrangement would vitiate entirely the effectiveness of the trading fee in covering off the risks against which it is intended to protect;⁴⁵ and
- 48.3 a Trading Intermediary has a choice when operating at scale to either be exposed to one side of the market or, to hedge the exposure which requires large quantities of capital to be posted as trading collateral.⁴⁶ The CMA asserts that a Trading Intermediary's portfolio is "*not significantly exposed to the market*". However, if the trading fee arrangement were to be applied across the industry, the Intermediaries would be required to buy all GB demand volumes, which would significantly increase their exposure to the market compared to the current arrangement.⁴⁷ This exposure can only be removed by taking a large hedge position. The hedge position would require large quantities of collateral, the cost of which would need to be reflected in the trading fee payable by suppliers.

iv. Issues with the CMA's understanding of notional capital and interpretation of evidence

49. The CMA disregards evidence that supports the inclusion of notional capital in a ROCE calculation. We explain below why we consider the CMA's rationale for doing so is selective and inappropriate.
50. First, the CMA is selective in its findings by accepting the views of the Independents on notional capital and appears to disregard the weight of the evidence in support of the requirement for notional capital. Five of the Six Large Energy Firms clearly state that notional capital is required to operate their business. The sixth firm, Scottish Power, explained that a stand-alone supply business of a similar scale to its own supply business would require notional capital "*in the order of hundreds of millions of pounds*".⁴⁸ Four of these firms (Centrica, EDF Energy, SSE and RWE) also provide an estimate of notional capital. These estimates need to be taken into account in a ROCE calculation, to ensure the ROCE is reliable. To disregard this consensus of evidence the CMA has to ensure it has robust evidence to the contrary.
51. In respect of Scottish Power, the CMA focuses on its comments that the Six Large Energy Firms do not need ring fenced risk capital and "*riskiness from supply was reflected in the group WACC*".⁴⁹ We agree that risk capital may not need to be explicitly "ring fenced", but instead RWE npower requires notional capital from within the group structure. We disagree that the WACC reflects the "riskiness from supply". The Capital Asset Pricing Model

⁴⁴ RWE's Response to ROCE Working Paper, paragraph 5.42.2.

⁴⁵ RWE's Response to ROCE Working Paper, paragraph 5.42.5.

⁴⁶ CMA PFs, Appendix 10.3, Annex A, paragraph 102.

⁴⁷ The Trading Intermediaries would have a requirement to purchase large volumes in the wholesale market on behalf of the suppliers because they will not hold upstream generation assets capable of serving the entire GB demand.

⁴⁸ CMA PFs, Appendix 10.3, Annex A, Supplement 2, 13

⁴⁹ CMA PFs, Appendix 10.3, Annex A, paragraph 50.

("CAPM") applied by the CMA will not account for notional capital. Adverse cash flows caused by the outcome of an uncertain event are unlikely to alter a firm's beta because the risk factors are specific in nature (e.g. weather events are likely to be uncorrelated to the wider business cycle), but can result in a material change to a business's financial viability. Further, extreme adverse events are unlikely to be included within the CMA's calculation of WACC because they occur infrequently. Therefore, they are unlikely to have been observed over the time period on which the WACC calculation is based.

52. Second, the CMA discredits the requirement for notional capital because of the wide range in estimates (£350 million to £4,500 million).⁵⁰ RWE agrees that notional capital is difficult to calculate which results in a wide variation in estimates. We do not, however, agree that this is a reason for the CMA to avoid calculating notional capital, and to exclude it from capital employed. In addition, it is not clear if outliers skew this range. If these are removed it might be that the range is narrower.
53. We consider the CMA should investigate the quantification of notional capital by:
 - 53.1 further investigating the approaches of the Six Large Energy Firms to understand their methodologies and reach a view on which may be the most appropriate. The CMA has not investigated the calculation methodology in detail to assess their reasonableness.⁵¹ We think this is a necessary and important step in an evidence based process; or
 - 53.2 applying a high level approach by dismissing outliers and calculating an average per customer based on the other estimates of notional capital (or some similar metric).⁵² It could then perform a sensitivity analysis on this basis.
54. Third, the CMA inappropriately relies on its finding that notional capital does not exist as cash or equity reserves for Independents or the Six Large Energy Firms.⁵³ We disagree with this finding. We stated in our response to the profitability analysis that "*RWE group has significant cash and liquid securities available for short-term liquidity needs of its subsidiaries (for example, at the 2013 year end, RWE group held €4.0 billion of cash and €2.8 billion of liquid securities)*".⁵⁴ Unlike the financial services industry, energy suppliers are not required to have a segregated reserve of notional capital for regulatory purposes. [CONFIDENTIAL]^{55 56}
55. Fourth, the CMA considers notional capital an inappropriate approach because financing of business risks can be replaced with a "*significant credit facility*".⁵⁷ As we explained previously in RWE's response to the CMA's ROCE Working Paper, we do not consider that credit lines are appropriate to finance business risks over the long run because they do not provide a way to fully manage adverse shocks due to short term repayment requirements. In order to ensure solvency for a business, large adverse shocks need to be funded by long term (i.e. notional) capital.⁵⁸
56. Fifth, the CMA observes that Centrica does not include notional capital in its measure of economic profit for commercial performance and remuneration and concludes that this

⁵⁰ CMA PFs, Appendix 10.3, Annex A, paragraph 52.

⁵¹ The CMA has not requested RWE to provide further information to explain its calculation methodology.

⁵² The CMA provides a range for firms which have varying sizes. Centrica has approximately 3 times the number of customers than RWE. The CMA should scale the notional capital estimates by the size of the firm.

⁵³ CMA PFs, Appendix 10.3, Annex A, paragraph 51.

⁵⁴ RWE's Response to Approach to Financial and Profitability Analysis, paragraph 5.63, Footnote 65.

⁵⁵ RWE's Response to ROCE Working Paper, paragraph 5.4.1

⁵⁶ As explained before, RWE considers that notional capital is in the form of equity or long term debt. Given that equity is defined by the excess of assets above liabilities on a balance sheet, this comprises a wide range of assets (including cash) that can be transformed into more liquid assets if required to respond to an adverse shock. RWE's Response to ROCE Working Paper, paragraph 5.27

⁵⁸ RWE's Response to ROCE Working Paper, paragraph 5.26.4

absence suggests that notional capital is not a robust concept.⁵⁹ RWE does not consider this to be appropriate evidence. Remuneration statistics should be easily understood and given the complexity of notional capital, it is no surprise that it is not included. Therefore, this fact does not mean that Centrica does not require notional capital.

57. [CONFIDENTIAL]⁶⁰

b. Regulatory capital

58. The CMA includes regulatory capital within its broad category of business risks⁶¹ and does not acknowledge our comments in response to the CMA's ROCE working paper.⁶² We consider regulatory capital a contingent liability and not a business risk. There is no uncertainty surrounding whether RWE needs to post regulatory capital or not. For a supply business to operate, it must post the required regulatory capital (or collateral) for codes and obligations in order to access the services.

59. We consider the quantity of regulatory collateral to be material. We require [CONFIDENTIAL] regulatory collateral for codes and obligations. This comprises: [CONFIDENTIAL] net cash and issued bank guarantees and the remaining [CONFIDENTIAL] PCGs.⁶³ It is not appropriate to assume that this is included within the adjustment to the cash on the economic balance sheet constructed by the CMA. The average cash adjustment to RWE's capital employed was [CONFIDENTIAL],⁶⁴ which the CMA states is for working capital needs.⁶⁵ This cash for working capital is entirely distinct from regulatory collateral (and even if it could be put towards regulatory collateral requirements, it would be insufficient). The CMA should accept the firms' need for regulatory capital and should incorporate this into its ROCE.⁶⁶

c. The value of RWE's customer base

60. RWE noted in its response to the CMA's working paper on retail energy supply ROCE, that a cost-based estimate of the value of the customer base should include both:

60.1 [CONFIDENTIAL]

60.2 wider marketing expenses, such as sponsorship, that are not specifically targeted at new customers but whose principal purpose is to build and maintain brand value for the purposes of attracting new customers. [CONFIDENTIAL]⁶⁷

61. The CMA does not appear to have included these additional costs within its estimate of the value of RWE's customer base. RWE continues to consider that these additional costs give rise to future economic benefits and therefore an economic intangible asset that should be included in capital employed. Therefore, the CMA overstates its assessment of ROCE, as we go on to show in our updated estimate of RWE's ROCE below.

⁵⁹ CMA PFs, Appendix 10.3, paragraph 22.

⁶⁰ RWE's Response to ROCE Working Paper, Appendix A, paragraph A6.

⁶¹ CMA PFs, Appendix 10.3, Annex A, paragraph 12.

⁶² RWE's Response to ROCE Working Paper, paragraph 5.46 to 5.49.

⁶³ RWE's Response to ROCE Working Paper, paragraph 5.49.

⁶⁴ CMA Putback to Supply ROCE Working Paper. RWE-Supporting data for the analysis of retail supply profitability, RWE-BS analysis.

⁶⁵ CMA PFs, Appendix 10.3, paragraph 79.

⁶⁶ Further, the CMA does not respond to our comments to adjust EBIT to account for the cost to replace PCGs with bank guarantees in a stand-alone entity. RWE's Response to ROCE Working Paper, paragraph 5.49.2.

⁶⁷ RWE's Response to the retail energy supply ROCE Working Paper, 4.12.

d. RWE's pension deficit repair costs

62. As RWE has previously explained, we consider that if new entrants were to replace the Six Large Energy Firms, the costs of legacy pensions would still need to be covered by the industry.⁶⁸ It is not realistic for the CMA to imply in its analysis that these costs would not need to be borne. The CMA does not respond to RWE's previous submission regarding the need to cover its pension deficit and does not appear to allow for it in its estimate of RWE's ROCE.
63. We consider that all of the Six Large Energy Firms which have pension deficits should be allowed to earn a reasonable return after the costs of repairing these deficits. We note that there is precedent from price control determinations in the regulated industries for allowing firms to recover the on-going cost of pension deficit repair.⁶⁹ For example, the energy industry has a policy requiring that "*legacy obligations are funded in network operators' regulated revenues*".⁷⁰ This suggests that RWE npower, and other firms with such deficits, should be allowed to recover these legacy pension costs.
64. The annual costs of pension deficit repair for RWE's supply business averaged [CONFIDENTIAL]

e. Market-based evidence that supports RWE's view that the CMA has materially understated capital employed

65. RWE has explained in previous submissions that it considers that the CMA should also have regard to market-based evidence for the value of intangible assets and it considers that the CMA's cost-based estimates are likely to understate its value.⁷¹
66. Recent market-based evidence further supports RWE's view that the CMA materially understates the capital employed of RWE and, it is likely, the others of the Six Large Energy Firms.
67. First Utility is subject to current market activity with an implied current enterprise value in the order of magnitude of £500m. First Utility has approximately 800,000 customers.⁷²
68. The CMA previously explained that it disregarded evidence of value based on market transactions because it considers that this could include some element of capitalised excess profits. However, the CMA appears to consider that the profitability of the mid-tier firms represents a possible competitive benchmark level.⁷³ Although RWE does not consider that the mid-tier firms provide a relevant competitive benchmark, it does not consider that the valuation of a mid-tier firm would incorporate any element of capitalised excess profits.

f. Updated estimate of RWE's ROCE after correcting the CMA's methodology

69. Drawing together the corrections to the CMA's ROCE analysis that we have outlined in the preceding subsections (notional capital, regulatory collateral, additional value in the customer base and pension deficit repair), the CMA will note that this significantly reduces RWE's calculated ROCE, to well within the bounds of the CMA's WACC.

E. The CMA's benchmarking in Appendix 10.5 of the "reasonably efficient" levels of economic costs is not robust

70. In Appendix 10.5 of the PFs, the CMA presents for the first time its analysis of what it describes as the "*reasonably efficient levels of costs*" which "*had competition functioned*

⁶⁸ RWE's Response to the retail energy supply ROCE Working Paper, 6.5 to 6.8.

⁶⁹ These industries include: water, post and energy (network operators).

⁷⁰ Ofgem. 2014. Resetting pension deficit funding allowances and our reasonableness review.

⁷¹ RWE's Response to the retail energy supply ROCE Working Paper, 4.3 to 4.5

⁷² <http://www.ft.com/cms/s/0/fb7bd6fe-2fc4-11e5-8873-775ba7c2ea3d.html>

⁷³ CMA PFs, Appendix 10.6, 56

*more effectively over the period” it “would expect prices to have been driven down to”.*⁷⁴ RWE considers that to properly perform an analysis of this type would be a substantial exercise involving significant sophisticated analyses.

71. The CMA did not issue a working paper covering this analysis. This is therefore the first opportunity that RWE has had to comment on it. The CMA is unclear to what extent it relies upon the results of this analysis in its assessment of the extent of any AEC. However, it appears that its results may be highly material to the CMA’s findings.
72. The CMA applies the following benchmarks to assess efficiency:
 - 72.1 the lower quartile of the unit wholesale costs of the Six Large Energy Firms in each year and the average of two firms whose purchasing strategy it concludes most closely resembles that of a standalone supplier;
 - 72.2 the lower quartile of the unit indirect costs of the Six Large Energy Firms in each year;
 - 72.3 the lower quartile and the average of the debtor days and the upper quartile and the average of the creditor days of the Six Large Energy Firms in each year; and
 - 72.4 the fixed-assets per customer of Centrica in each year.
73. In RWE’s view, this analysis falls short of best practice and cannot be relied upon to form conclusions on cost efficiency in GB energy retail markets. In particular, RWE considers that:
 - 73.1 the CMA presupposes that the Six Large Energy Firms are inefficient without performing the necessary analysis to identify if this is in fact the case. Typically, a regulator will perform sophisticated econometric, functional and overhead benchmarking analyses to identify whether an efficiency gap exists. The CMA has not performed such analysis;
 - 73.2 the CMA’s “scenarios” in which it combines multiple cost benchmarks for different cost categories are misconceived and simplistic;
 - 73.3 the CMA’s proposed benchmarks for wholesale costs are inappropriate and based on unrealistic assumptions regarding the wholesale costs that can be achieved over the long term;
 - 73.4 the CMA’s proposed benchmark for indirect costs does not account for the range of drivers of costs that are beyond firms’ direct control such as mix of customers, location and other firm-specific factors. It is standard regulatory practice to apply appropriate quantitative techniques to control for these factors. The CMA’s benchmark is therefore simplistic and artificially low; and
 - 73.5 the CMA’s proposed benchmarks for capital costs are inappropriate and based on assertions that are not appropriately evidenced.
74. RWE considers the analysis is inconsistent with best practice and that the CMA should disregard it in forming conclusions on either the existence of an AEC or the quantum of any detriment arising. In the subsections below RWE expands upon its criticisms of the following aspects of the CMA’s approach:
 - 74.1 conceptual weaknesses in its cost benchmark scenarios;
 - 74.2 its proposed competitive benchmarks for wholesale costs;
 - 74.3 its proposed competitive benchmark for indirect costs; and

⁷⁴ CMA PFs, 10.43

74.4 its proposed competitive benchmark for capital costs.

a. Conceptual weaknesses in the CMA's cost benchmark scenarios

75. To establish its benchmark for the overall "competitive level" of economic costs, the CMA:
- 75.1 defines four "scenarios" comprising different combinations of its benchmarks for each of the three categories of economic cost (i.e. direct cost, indirect costs and capital costs);
- 75.2 calculates the counterfactual level of total economic costs for each firm under each scenario, based on its actual volumes had its unit costs been in line with the chosen benchmarks for each category;⁷⁵ and
- 75.3 calculates the average of these four benchmark total cost levels to define an overall competitive benchmark for economic costs, which is used to benchmark revenues.⁷⁶
76. Because the CMA includes an allowance for capital costs, it considers that these economic costs (inclusive of the capital charge) are equal to the revenue that each firm would have earned if it had generated a return exactly equal to the WACC i.e. had earned zero economic profit.
77. RWE considers that the CMA's scenarios are not appropriate benchmarks for costs in three respects. The CMA:
- 77.1 sets an aggressive benchmark for the overall costs of a "reasonably efficient"⁷⁷ operator that could not realistically have been achieved;
- 77.2 does not acknowledge the natural variation in relative cost performance that will arise between firms and over time in competitive markets; and
- 77.3 sets benchmarks at a level which are inconsistent with the CMA's own guidelines for outcomes that can be expected in a competitive market.
78. We expand on each of these points in the subsections below.

i. The CMA's benchmarks

79. RWE considers that all firms operating in competitive markets – which include the retail energy supply market – face an economic incentive to continually seek to become more efficient so as not to be at a cost disadvantage against their competitors. It is well understood in economic regulation that a firm's cost efficiency at a given point in time reflects:
- 79.1 the location of the "efficiency frontier" i.e. the lowest level of costs a firm can feasibly achieve after adjusting for non-controllable drivers of cost; and
- 79.2 the firm's relative distance from that frontier.⁷⁸
80. To define a reasonable "efficient" level of costs over the Relevant Period requires a robust *ex post* assessment of: (i) the minimum level of costs that could feasibly be achieved (i.e. the "efficiency frontier"); and (ii) a judgment of how close to that level a "reasonably

⁷⁵ CMA PFs, Appendix 10.5, 62

⁷⁶ CMA PFs, Appendix 10.5, 63

⁷⁷ CMA PFs, Appendix 10.5, 1

⁷⁸ These concepts are well illustrated in Figure 4 of the following report prepared for Monitor, Methodology for efficiency factor estimation, 23 April 2014, Deloitte (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/317572/Supporting_document_A_-_Deloitte_Efficiency_Factor_for_publication352b.pdf)

efficient” operator could reasonably have been expected to be. The CMA’s approach does not make a robust or reasonable assessment of either of these variables.

81. In each of its scenarios, the CMA selects combinations of benchmarks which imply that a “reasonably efficient” operator would have achieved better-than-average performance in more than one of the three categories of economic costs. This is unrealistic. Firms face real options to invest in different cost reduction projects and cannot simultaneously undertake all possible projects to reduce costs across all categories. As a result, just as the CMA accepts that there may be relationships between indirect costs categories,⁷⁹ so causality is likely to run between firms’ relative performance in different cost categories.

82. [CONFIDENTIAL]⁸⁰

ii. Variation in cost performance

83. Submissions to the CMA from independent experts as well as RWE have previously noted that some variation in the performance of firms is to be expected in a competitive market because some strategies and projects will succeed and some will result in losses or low levels of profitability.⁸¹ The CMA has not acknowledged this point or taken account of it in its analysis.

84. This point is reiterated in a recent submission to the CMA in response to its PFs from a group of former GB energy regulators, including Professor Stephen Littlechild, who note that “[m]ost firms will not have the same level of costs as the lowest cost firm: that is a reflection of reality, not a sign of lack of efficiency or competition.”⁸²

iii. Inconsistency with the CMA’s own guidelines

85. The CMA benchmarks are based on better-than-average performance in more than one of the three main cost categories and appear to be set separately in each year and, in some cases, for each segment and fuel type. Applying the CMA’s benchmarks therefore may imply that no firm in the industry in fact operated with above-average efficiency over the period and therefore should be allowed earn an above-average return. This results in the CMA disregarding its own characterisation of competitive markets. The CMA’s Guidelines for Market Investigations note that “[a]t particular points in time the profitability of some firms may exceed what might be termed the ‘normal’ level. There could be several reasons, including ... some firms earning higher profits as a result of past innovation, or superior efficiency.”⁸³

b. The CMA’s proposed competitive benchmark for wholesale costs

86. The CMA makes adjustments to the wholesale energy costs for the Six Large Energy Firms based on what it considers an appropriate benchmark to cover reasonably efficient levels of costs.⁸⁴ The CMA creates its benchmark by comparing the outturn costs of the Six Large Energy Firms over the Relevant Period and selecting costs at the low end of the range.
87. We have significant concerns about the CMA’s analysis. Suppliers are subject to wholesale cost uncertainty because exogenous market movements affect procurement strategies in different ways. The CMA should not misidentify the realisation of risks outside firms’ control

⁷⁹ CMA PFs, Appendix 10.5, 42(b)

⁸⁰ RWE npower CMA hearing 18 March 2015, pages 100 to 102

⁸¹ Letter from Professor Stephen Littlechild, published by the CMA 24 March 2015: https://assets.digital.cabinet-office.gov.uk/media/5511630bed915d1427000012/Stephen_Littlechild_submission_20_February_2015.pdf and RWE’s Response to the CMA’s retail profit margins working paper, 7.8

⁸² Professor Stephen Littlechild et al., Submission on Summary of PFs and Notice of Possible Remedies, 16 July 2015, 65

⁸³ CMA, Guidelines for market investigations, 117

⁸⁴ CMA PFs, paragraph 10.43.

as being the result of operational choices resulting in efficiency or inefficiency. We consider that the CMA incorrectly applies a flawed wholesale costs benchmark because it:

- 87.1 does not appear to recognise the complexities of wholesale hedging strategies and does not appropriately account for the impact on outturn wholesale costs of exogenous market movements. Each firm's strategy will be affected differently by exogenous market movements that cannot be predicted ahead of time. No *ex ante* static hedge strategy can consistently result in lower than average outturn wholesale costs;
- 87.2 uses the lower quartile outturn cost, which is likely to change from year to year. This sets an unrealistic benchmark for a single firm to achieve in the long run;
- 87.3 inappropriately uses the wholesale cost of mid-tier firms to support the choice of benchmark;
- 87.4 [CONFIDENTIAL] Differences in wholesale costs between firms reflect differences in the timing of contract signing within a year;
- 87.5 includes an incomplete investigation into the range of possible benchmarking methods. We consider that the CMA could instead use the average of the Six Large Energy Firms' outturn wholesale costs. This would represent a more reasonable return of outturn costs over time; and
- 87.6 includes analysis based on spot market costs which we do not consider represents a feasible scenario.
- 88. We expand on these criticisms below.

i. The uncertainty within wholesale cost procurement strategies

- 89. The CMA comments that "*energy retailers have some control over the level of (wholesale) costs because they can choose which products to buy and when, and can choose their purchasing strategy*".⁸⁵ RWE agrees that supply firms have a choice over how they procure their energy. However, exogenous market movements, which are uncontrollable, are the major determinant of outturn wholesale costs.
- 90. Firms hedge to limit price volatility, but wholesale costs vary between firms because each one uses a different hedging strategy. Exogenous market movements will affect each strategy differently and result in different outturn cost. *Ex post* evaluations may suggest that certain procurement strategies result in lower costs. However, this is not true and cannot be predicted from an *ex ante* perspective. Due to the exogenous movements, if a company adopts a particular static hedge profile, it cannot expect to achieve lower outturn costs than the average outturn cost of other static hedging strategies.
- 91. RWE npower recognises that it is not possible for a supplier to consistently have the lowest wholesale energy costs. [CONFIDENTIAL]⁸⁶ This is clear contemporaneous evidence that we did not consider it possible to consistently achieve the minimum cost through operational strategy.
- 92. The CMA needs to consider what is the most appropriate method to benchmark wholesale costs. If the CMA continues to benchmark it should apply a reasonable benchmark for wholesale costs. We consider the most appropriate benchmark would be the average of the Six Large Energy Firms' wholesale costs, calculated in each year of the Relevant Period.⁸⁷
- 93. Further, the CMA should investigate carefully the consequences of advocating a wholesale cost benchmark. We would expect that the publication of establishment of a benchmark

⁸⁵ CMA PFs, Appendix 10.5, 19.

⁸⁶ [CONFIDENTIAL]

⁸⁷ For example, the benchmark in 2009 would be the average of the 2009 wholesale costs of each of the Six Large Energy Firms.

would result in a convergence of hedging strategies because each supplier would seek to minimise cost disadvantage relative to the benchmark itself, and in turn avoid the significant risks associated with deviating from the benchmark. As explained in our response to Remedy 11, the goal of a hedge strategy is to reduce the risk faced by both the supplier and consumer. In a situation where firms converged to the same strategy, it would limit the appetite of suppliers to invest in the development of the science and expertise behind commodity risk management thereby leading to increase wholesale cost volatility with the result of harming consumers. See further our response to Remedy 11, paragraph 6.29, where we explain the consequences for the functioning of the Gas and Electricity wholesale markets of the implementation of a wholesale cost benchmark.

ii. Why the CMA's wholesale cost benchmark is not appropriate

94. The CMA proposes the following two benchmarks which we consider to be flawed:
 - 94.1 lower quartile wholesale cost for the Six Large Energy Firms in each individual year;⁸⁸ and
 - 94.2 average wholesale costs for RWE and EDF (the two firms with the highest proportion of energy procured through standard products).⁸⁹
95. The lower quartile benchmark is inappropriate. The hedging strategy that achieves the outturn lowest quartile wholesale energy costs is likely to change from year to year. To achieve this benchmark in each year, the supplier would need a known forward view to ascertain the appropriate hedging approach, which is impossible given the exogenous market movements. Therefore, the CMA use of a lower quartile benchmark within each individual year is artificially low and unrealistic for a single firm to achieve.
96. Further, based on our review of wholesale energy costs from CSS data,⁹⁰ we do not observe that any one individual firm is consistently the lowest cost firm. This suggests that the CMA should not look at each year separately, because no firm can outperform the market every year and in every segment/fuel. This is because firms are subject to costs outside of their control.
97. Using average wholesale costs for RWE and EDF is also inappropriate. RWE and EDF represent a small proportion of the energy supply market, and basing a benchmark on such a small sample introduces further margin for error. The average of several firms is a better reflection of the wider market conditions for the industry, where exogenous market movements will affect each firm's wholesale costs differently.
98. The CMA should also consider points made in the Confidential Submissions of RWE's Authorised Advisers regarding its benchmarking of wholesale costs.

iii. Why the CMA should not benchmark SME wholesale costs

99. The CMA benchmark wholesale costs for domestic and SME separately, and finds that SME revenues exceeded the competitive benchmark more than Domestic revenues did.⁹¹
100. RWE considers assessing the commodity cost achieved in aggregate for the SME business is wrong because it misunderstands the nature of the SME marketplace. The SME business is characterised by individually negotiated tariffs, where the wholesale cost element is immediately agreed within the contract. [CONFIDENTIAL] We expect other suppliers to

⁸⁸ CMA PFs, Appendix 10.5, Table 1.

⁸⁹ CMA PFs, 10.58

⁹⁰ Consolidated Segmental Statements ("CSS") are annual statements segmenting the financial results of their supply and generation activities.

⁹¹ Over a 5 year relevant period, for the combined firms, the gap was 3% for both domestic gas and electricity, and 15% for both SME gas and electricity. CMA PFs, Appendix 10.5, 71.

operate in a similar way. Therefore, it is inappropriate to consider SME wholesale costs as part of any cost benchmark because [CONFIDENTIAL]⁹²

iv. Inconsistency with the conclusions from the generation profitability and wholesale energy markets

101. Based on the way in which RWE operates in the wholesale markets, the results of the CMA's profitability analysis of the generation businesses of the Six Large Energy Firms does not suggest that the wholesale costs incurred by the retail businesses of these firms exceeded competitive levels. The CMA found that the returns of the generation operations of the Six Large Energy Firms between 2009 and 2013 were generally in line with or below the cost of capital,⁹³ and its provisional view was that wholesale market prices were not above competitive levels. Based on the way in which RWE npower procures its energy in the wholesale market, if the CMA found that wholesale prices were not above competitive levels, this also implies that the wholesale costs incurred by energy retailers were not above competitive levels. This suggests that it is not appropriate to set a benchmark level for wholesale costs that is lower than the out-turn wholesale costs.

v. Inappropriate to use the mid-tier firms to justify the wholesale costs benchmark

102. The CMA justifies using the lower quartile by observing that "the mid-tier suppliers tended to have wholesale costs that were below or at the lower quartile of the larger firms, despite their small scale".⁹⁴ There are two major issues with the comparison of wholesale costs between the mid-tier suppliers and the Six Large Energy Firms.
103. First, many of the mid-tier firms entered the market or grew rapidly around the period 2009 and 2010, and would have been purchasing energy at the prevailing market price during the growth period. The Six Large Energy Firms, however, had hedged into longer term positions, and paid higher legacy prices as a result of the significantly higher prices observed in 2008. This would mean that the mid-tier firms might appear to have lower costs, but only because of their smaller market share during the 2008 and not from operational advantages. This cost difference has nothing to do with efficiency but results from exogenous factors.
104. Second, the CMA has not had regard for the different product mixes between firms and the impact that has on any comparison. [CONFIDENTIAL] The majority of the customers of the mid-tier suppliers are on non-standard tariffs, where suppliers purchase the product's entire wholesale energy requirements at the time of launching the product. Firms manage SVT and non-standard products using fundamentally different hedging strategies. During the period of review, hedging of non-standard products resulted in lower costs than longer profile hedging because of outturn market trends (i.e. wholesale prices have fallen since the peak in 2008/ early 2009). This apparent competitive advantage in commodity costs could have been a significant disadvantage if outturn market trends had resulted in higher rather than lower wholesale costs in the short term. This means it is not appropriate to use the wholesale costs of the mid-tier firms (purchased primarily for non-standard products) as a benchmark for the Six Large Energy Firms.
105. Further, there are likely to be significant differences in the tariff mix within the Six Large Energy Firms. For example, SSE has an estimated 10% of non-standard customers,⁹⁵ whereas our own portfolio of non-standard customers would be approximately 35%. The CMA has not controlled for the different product mix of the Six Large Energy Firms within its wholesale benchmarking.

⁹² In all scenarios, each hedge is appropriate and will represent the lowest possible cost hedge at that time for the customer.

⁹³ CMA Summary of PFs, page 9, paragraph 38

⁹⁴ CMA PFs, 10.50

⁹⁵ Bernstein analyst report, 22.06.15, 'SSE: The Calm Before the Storm Reiterate Underperform', page 5, exhibit 5.

vi. Alternative benchmarks for wholesale costs

106. While we note that the CMA should reconsider the use of benchmarking for wholesale costs in paragraphs 95 to 97 above, if it proceeds to do so, the CMA must perform a wider benchmarking exercise. The CMA has concentrated its benchmarking analysis on close to the lowest the outturn costs in any given year from the Six Large Energy Firms. This is just one of many methods to assess wholesale costs.
107. First, the CMA could use the average of the Six Large Energy Firms' outturn wholesale costs. This would represent a more reasonable return of outturn costs over time.
108. Second, RWE agrees that traded products provide an open and transparent reflection of the competitive market process.⁹⁶ The CMA could construct a benchmark using standard products, but they must ensure that the benchmark is fully reflective of total wholesale costs for energy suppliers.
109. Suppliers will face a number of additional costs which should be included in a standard product benchmarking and all other benchmarking. For example, costs in relation to brokerage, spread, weather derivatives, shape and imbalance are all costs that suppliers incur when managing wholesale price risk. The CMA disregards these additional costs because they "*considered that these were likely to be small in extent, and therefore that these levies were unlikely to be cost-justified*"⁹⁷ but provide no quantitative evidence. These costs need to be included in the benchmark.
110. Further, there may be different allocations of costs between the categories of costs specified by CMA. Given the CMA uses a benchmark for wholesale, but passes through the remaining direct cost items (network and obligations), there is a risk that the CMA is double counting certain costs for some firms, and not including any costs for others.
111. RWE notes that there may be a wide range of reasonable outcomes in costs. This means, if the CMA continues to proceed with wholesale cost benchmarking, it needs to be careful not to establish a single benchmark that could contribute towards the CMA making a false positive finding of excessive profitability. RWE considers that the most reasonable benchmark would be the average of the Six Large Energy Firms' wholesale costs, calculated in each year of the Relevant Period.

vii. Spot price scenario

112. The CMA calculates that, had suppliers purchased energy on the spot markets rather than purchasing forward, competitive benchmark Domestic electricity prices would have been around 12% lower than actual prices and SME electricity prices around 27% lower.⁹⁸ The CMA acknowledges a number of objections in relation to the spot price scenario in Annex B, Supplement A. RWE considers such a scenario to be infeasible, and should be disregarded as a benchmark.
113. First, on an *ex ante* basis, as stated above, the wholesale energy market is uncertain and subject to exogenous market movements. It is impossible to know whether the spot or forward price will be higher at a future delivery point. The CMA performs *ex post* evaluations of wholesale costs over short time horizons when hedged prices were higher than spot prices and implies that this means firms should not hedge. However, it has not had regard to other time periods, for example 2005 to 2008, when outturn spot prices were higher than outturn future prices. Further, our analysis presented in the response to PFs, Figures F.b.2 and F.b.3, shows that in a market of falling prices, spot prices will be lower than hedged prices,⁹⁹ but in a market of rising prices, spot prices will be higher.

⁹⁶ CMA PFs, Appendix 10.5, Annex A, paragraph 4.

⁹⁷ CMA PFs, Appendix 10.5, Annex A, 85

⁹⁸ CMA PFs, 10.75

⁹⁹ When based on a static hedge strategy.

114. Second, if the CMA considers the spot market scenario has validity, RWE questions whether the CMA is recommending that all GB energy suppliers should procure their energy requirements on the spot market. We consider there would be extreme consequences of such a strategy, including significantly increased price volatility resulting in unpredictability for suppliers and customers. The CMA does not recognise the benefit of hedging to the supplier and customer from the reduction in risk. These are explained fully in Section F.b of our response to PFs.
115. Despite the CMA acknowledging these flaws,¹⁰⁰ it still refers to the spot market scenario throughout Chapter 10 and Appendix 10.5 and identifies that *"the competitive benchmark domestic electricity price would have been around 12% lower than actual prices"*. It is not clear to RWE why the CMA refers to this scenario.

c. The CMA's proposed competitive benchmark for indirect costs

116. There are a number of shortcomings in the CMA's benchmark of "efficient" indirect costs. The CMA's analysis is simplistic and its misunderstandings lead it to select an inappropriately low benchmark that implies that most operators have been inefficient. The principal shortcomings are that:
- 116.1 the CMA's analysis is simplistic and mischaracterises differences in unit costs as resulting only from inefficiency;
- 116.2 the CMA does not control for volume differences; and
- 116.3 the CMA's conclusion on what a "reasonably efficient" firm could feasibly be expected to achieve is unrealistic due to a selective assessment and reliance on limited evidence.

i. The CMA's mischaracterisation of all differences in unit costs between firms as reflecting differences in efficiency

117. The CMA's indirect cost analysis ascribes all differences in indirect costs between firms to differences in efficiency. This is very simplistic and suggests that the CMA has not taken into account previous submissions from independent experts¹⁰¹ or RWE¹⁰².
118. Although RWE comments principally on the CMA's quantitative analysis, it wishes to highlight that some of the comments that the CMA makes in its report appear to be inconsistent with its approach to benchmarking indirect costs. The CMA acknowledges:
- 118.1 *"that there may be reasons why indirect costs are higher for some energy retailers, including differences in the costs to serve certain types of customers";*¹⁰³ and
- 118.2 that *"[i]ndirect costs alone cannot prove or disprove efficiency."*¹⁰⁴
119. However, in contrast, the CMA also states that *"[t]hose suppliers with higher than average levels of indirect costs told us that they recognised that they were inefficient and were working to improve cost efficiency. This suggests to us that the differences in indirect costs are primarily the result of differences in efficiency and not merely as a result of differences in business models or cost allocation."*¹⁰⁵
120. RWE disagrees with the inference that *"differences in indirect costs are primarily the result of differences in efficiency"*. This does not reflect a balanced interpretation of parties' views.

¹⁰⁰ CMA PFs, Appendix 10.5, Annex A, Supplement A.

¹⁰¹ Letter from Professor Stephen Littlechild, published by the CMA 24 March 2015: https://assets.digital.cabinet-office.gov.uk/media/5511630bed915d1427000012/Stephen_Littlechild_submission_20_February_2015.pdf

¹⁰² RWE's response to the CMA's retail profit margins working paper, 7.8.

¹⁰³ CMA PFs, Appendix 10.5, 44(d)

¹⁰⁴ CMA PFs, Appendix 10.5, Annex C, 30

¹⁰⁵ CMA PFs, 10.62

RWE has previously explained to the CMA that it considers that there is scope for it to become more efficient.¹⁰⁶ However, as RWE explains above, this does not imply that it considers it has operated inefficiently over the period, given its “brownfield” starting position. Moreover, it is inconsistent with the other comments made by the CMA which we highlight above.

121. The CMA does not control for the various drivers of differences in indirect costs (some of which it has acknowledged to exist) which may vary between firms for reasons outside their control. The CMA has not accounted for the different costs to serve different customers, which reflect differences in creditworthiness, payment method and geographical factors. Further, the CMA has not taken into account the differing corporate and institutional backgrounds of the Six Large Energy Firms. The businesses are at different stages in their lifecycle and had different operating models and associated cost bases at the start of the Relevant Period.¹⁰⁷
122. Hence, because it has not controlled for known differences between businesses, the CMA’s analysis falls short of best practice and the established methodologies that have been used by UK economic regulators to assess efficiency.¹⁰⁸ Typically, regulators deploy a range of approaches including international benchmarking, econometric analysis, Total Factor Productivity, support cost benchmarking and functional benchmarking. The CMA has not performed this analysis of this type.

ii. The CMA does not control for volume

123. The CMA determines its benchmark for indirect costs on the basis of indirect costs per customer account (£ per customer). RWE has previously explained that there are multiple drivers of indirect costs, other than just customer numbers.¹⁰⁹ However, RWE accepts that given the data limitations faced by the CMA, the number of customers is likely to represent a reasonable unit by which to assess costs.
124. It is well established in UK economic regulation that benchmarks of indirect costs must control for volume.¹¹⁰ This is because, at least in the short run, as illustrated in the figure below, not all costs are variable and therefore changes in volume necessarily result in changes in costs per unit which may reflect a movement along the efficiency frontier, rather than a shift in the firm’s underlying relative cost efficiency compared to the efficiency frontier.

¹⁰⁶ See, for example, RWE’s Response to the CMA’s retail profit margin working paper, 7.6 to 7.8

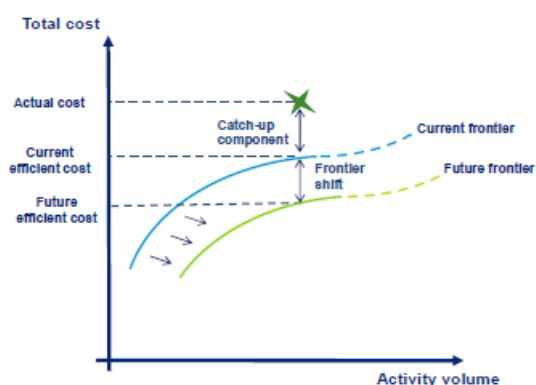
¹⁰⁷ RWE’s Response to the CMA’s retail profit margin working paper, 7.6

¹⁰⁸ RWE’s Response to the CMA’s Profit margin analysis, 7.14.1

¹⁰⁹ RWE’s Response to the CMA’s Approach to Financial and Profitability Analysis, 5.26

¹¹⁰ The following 2012 paper prepared for National Grid summarises the approach taken to control for volumes in three regulated industries in the UK: telecoms, postal services and airports: <https://www.ofgem.gov.uk/ofgem-publications/53695/201a20921nationalgridrio-t1ipresponsesupplementaryinfo-productivity-grow-the-efficiency.pdf>

Figure E-1: Efficient frontier



Source: Methodology for efficiency factor estimation, 23 April 2014, Deloitte

125. The fall in customer numbers over the Relevant Period for the Six Large Energy Firms and the increase for the mid-tier firms, particularly within some fuels/segments, may therefore distort the CMA's results, because it has not controlled for volume.
126. Any robust analysis of indirect cost efficiency must be performed on a volume-adjusted basis, which is consistent with established best-practice.

iii. The CMA's unrealistic assessment of the costs of a "reasonably efficient" operator

127. Within each segment/fuel type, the CMA determines a benchmark at the level of total indirect costs, rather than at the level of individual subcategories within indirect costs. The CMA does this on the basis that: "(a) there may be differences in definitions and allocations across different indirect cost categories across the Six Large Energy Firms; and (b) higher costs in one cost category may yield efficiency benefits in another category".¹¹¹ RWE agrees that possible inconsistencies in cost classification and causal relationships between cost categories mean that any benchmark should be defined at the level of total indirect costs.
128. The CMA judges the lower quartile indirect cost ratio of the Six Large Energy Firms in each year to be an appropriate benchmark for the level of indirect costs of a reasonably efficient operator. This is likely to be different firms in different years. RWE considers this benchmark falls below the level of costs that a "reasonably efficient" operator could have been expected to achieve over the period because it does not reflect that all firms' relative cost performance fluctuates over time, reflecting that no firm can maintain a consistent relative cost advantage and all firms periodically incur one-off costs. The CMA's benchmark therefore makes an inappropriate presumption that the majority of firms have been "inefficient". By selecting an artificially low benchmark, the CMA's analysis is constructed so as to confirm the hypothesis that firms have been inefficient.
129. The CMA has not presented robust evidence to support a benchmark of better-than-average performance. To do so, the CMA would need to address the methodological issues that RWE raises in the preceding subsections, such as undertaking a detailed review of firms' cost bases, adjusting for volume and applying an efficiency benchmarking framework that is consistent with established regulatory practice.
130. The only evidence which the CMA presents to attempt to justify its use of the lower quartile as a benchmark, is its analysis of the indirect cost ratios of "some of" the mid-tier suppliers.¹¹²
131. The CMA therefore disregards submissions from the Six Large Energy Firms explaining that the mid-tier firms are not appropriate comparators. The CMA is wrong to confuse the

¹¹¹ CMA PFs, Appendix 10.5, 42

¹¹² CMA PFs, Appendix 10.5, 47

“greenfield” mid-tier firms with the “brownfield” business of the Six Large Energy Firms. These two groups of firms will have substantially different cost bases, operating models and business strategies for a number of reasons that are beyond the control of the Six Large Energy Firms. We discuss further the significant differences between the Six Large Energy Firms and the mid-tier firms in Section F.

132. The only source of differences in indirect costs which the CMA acknowledges is the fact that the mid-tier firms have targeted customers with lower costs to serve. The CMA reasons that *“whilst we agree that the mid-tier suppliers have a higher proportion of direct debit customers, we would note that the Six Large Energy Firms could encourage more of their customers to move on to direct debit payment methods or improve their online services, to influence their costs to serve in other ways.”*¹¹³
133. RWE has previously explained to the CMA that it has made significant efforts to move more customers to direct debit payment methods. However, RWE’s experience in practice is that a significant minority of customers choose standard credit notwithstanding that there are discounts available for paying by direct debit, which is due to factors beyond its control, such as some customers not having bank accounts and others preferring to pay by standard credit because of the greater control this may give them over the timing of their outgoings. See further our comments in paragraphs 176 to 180 of our response to PFs.
134. We also consider that the CMA has been selective in its analysis of mid-tier firms. The CMA cites three of the four mid-tier firms as comparators: First Utility, Ovo Energy and Co-op Energy.¹¹⁴ The CMA explains that it *“found that First Utility’s indirect cost ratios were significantly higher than any of the other relevant firms, including both the mid-tier suppliers and the Six Large Energy Firms.”*¹¹⁵ However, in reaching conclusions, the CMA disregards the indirect cost ratios of this firm while placing weight on those of two others, without justification. The CMA therefore places weight on evidence from a very small sample while disregarding the views of several of the Six Large Energy Firms.
135. RWE considers that not accounting for all the sources of uncontrollable differences in costs between the mid-tier and the Six Large Energy Firms and the inconsistent use of evidence are examples of selectivity in the CMA’s approach.
136. The CMA should also consider points made in the Confidential Submissions of RWE’s Authorised Advisers regarding its comparison of the indirect cost ratios of the Six Large Energy Firms with mid-tier firms’ indirect costs.

d. The CMA’s proposed benchmark for capital costs

137. The CMA defines benchmarks for the following three elements of capital employed:
 - 137.1 debtor days;
 - 137.2 creditor days; and
 - 137.3 fixed assets.¹¹⁶
138. We comment on each of these in turn below.

i. Debtor and creditor days benchmarks

139. For debtor days, the CMA considers the following two benchmarks:

¹¹³ CMA PFs, Appendix 10.5, 46
¹¹⁴ CMA PFs, Appendix 10.5, 45
¹¹⁵ CMA PFs, Appendix 10.5, Annex C, 27
¹¹⁶ CMA PFs, Appendix 10.5, Table 3

- 139.1 the lower quartile across the Six Large Energy Firms; and
- 139.2 the average across the Six Large Energy Firms.
- 140. For creditor days, the CMA considers the following two benchmarks:
 - 140.1 the upper quartile across the Six Large Energy Firms; and
 - 140.2 the average across the Six Large Energy Firms.
- 141. The CMA does not provide rationale or supporting evidence for its proposed benchmarks for debtors or creditors.
- 142. In particular, the CMA does not discuss why it considers that lower quartile debtor days and upper quartile creditor days may be appropriate benchmarks. RWE considers that this benchmark is commercially unrealistic and reflects a misunderstanding on the part of the CMA. Firms typically manage their working capital on a net basis; thus a firm with a higher debtors balance than another firm may still have a lower net working capital requirement if it also has a higher creditors balance. The CMA does not present evidence to support its presumption that a firm could feasibly have simultaneously achieved net working capital consistent with lower-than-average debtor days and higher-than-average creditor days.
- 143. In setting this benchmark, the CMA therefore makes a presumption that firms with average working capital requirements have managed their working capital inefficiently. The CMA presents no evidence to support such an assumption. It has not undertaken any external analysis of debtor and creditor days in, for example, other retail businesses. As we have explained above, this is not consistent with usual regulatory practice.
- 144. RWE considers that there are a number of drivers of variations in average working capital balances between firms, many of which are outside a firms' control. Variables such as customer mix and payment type mix will have a significant effect on working capital. For example, firms with more direct debit customers and prepayment customers will have lower working capital requirements. The CMA has not controlled for these underlying drivers which are outside of firms' control.
- 145. By calculating the benchmark debtors and creditors days separately for each year, the CMA further artificially depresses its benchmark, because it is based on different firms' debtors and creditors in different years. It therefore does not reflect that, if a single firm is not consistently the best-performing, then there must be drivers of performance other than costs for which the analysis does not adequately control.
- 146. In the absence of more robust and well-evidenced analysis RWE considers that the CMA must disregard these benchmarks and instead use firms' actual outturn debtor and creditor balances.
- 147. The CMA should also consider the points made in the Confidential Submissions of RWE's Authorised Advisers regarding its proposed debtor and creditor benchmarks.

ii. Fixed assets benchmark

- 148. For fixed assets, the CMA adopts Centrica's total fixed assets per customer account as a competitive benchmark. It does so on the basis that: *"Centrica appeared to have invested consistently into their systems over the relevant period, and had encountered less major implementation issues with their new systems than some of the other Six Large Energy Firms."*¹¹⁷ RWE considers that this proposed benchmark is inappropriate.
- 149. First, in its explanation of its approach to its ROCE analysis, the CMA notes that the values of fixed assets in the balance sheet *"are typically based on their original cost less any*

¹¹⁷ CMA PFs, Appendix 10.5, 57

depreciation made against the assets.”¹¹⁸ The CMA goes on to assert that: “[w]here firms have chosen an appropriate depreciation schedule, we would not expect a material difference between the net book value of these assets and their depreciated replacement cost.”¹¹⁹

150. Firms invest in fixed assets at different points in time and many material categories of fixed assets have relatively long useful economic lives. It follows that the net book value (or depreciated replacement cost) per customer of fixed assets will fall over time as assets age and rise as the firms make new investments.
151. When the CMA explained its approach to profitability and financial analysis, it explained that “the CMA considers MEA values to be the economically meaningful measure for the purpose of measuring profitability in most cases” and that “this valuation should be based on the most efficient technology available at the time and assumes that assets are optimally configured ... even if the assets in question actually use legacy technology.”¹²⁰ RWE agrees with this approach. By contrast, the CMA’s benchmark effectively replaces each firm’s (approximate) depreciated replacement cost per customer with the costs per customer of a different firm which has a different investment cycle. This introduces an inappropriate distortion to the CMA’s analysis that runs counter to its stated ROCE approach and, in our view, has no basis in economic logic.
152. Second, we highlight the CMA has drawn precisely the wrong inference from its observation that “Centrica appeared to have invested consistently into their systems over the relevant period”. This observation suggests that Centrica has undertaken substantial addition to and renewal of its fixed assets over the period. The logical implication of this is that, in earlier years of the period, Centrica is likely to have been operating a relatively aged fixed asset portfolio. Its fixed assets would therefore be relatively highly depreciated and therefore the value of its fixed assets per customer would be likely to understate the value of fixed assets that an “efficient” operator would be expected to have.
153. Third, as RWE has previously explained, firms must make material upfront investments, for example in billing systems, in order to increase their cost efficiency. It is logically inconsistent for the CMA to adjust firms’ historical indirect costs to any proposed “efficient” level without also appropriately adjusting the value of their assets to reflect the MEA value of those assets that have would have been required in order to achieve an “efficient” level of costs.
154. In the absence of more robust and well-evidenced analysis, RWE considers that the CMA should disregard its proposed benchmark as it is not appropriate. RWE has undertaken significant new investments in systems over the period from 2007 to 2013 in order to increase its cost efficiency. Therefore, it considers that the value of its fixed assets per customer in 2013 may provide a conservative benchmark for the MEA value of the assets it would require to achieve lower unit indirect costs. RWE is not able to speculate as to what may be an appropriate benchmark for the others of the Six Large Energy Firms.
155. The CMA should also consider points made in the Confidential Submissions of RWE’s Authorised Advisers regarding its benchmark of fixed assets per customer for the Six Large Energy Firms.

F. The CMA’s assessment of the evidence for the competitive level of EBIT margins in Appendix 10.6 is inconsistent and favours comparators which suggest lower margins

156. In previous submissions, RWE has advocated the use of EBIT margins to assess the profitability of retail energy supply, in favour of ROCE.¹²¹ RWE considers that outturn EBIT margins should be compared against a reasonable range of competitive EBIT margins. RWE

¹¹⁸ CMA PFs, Appendix 10.3, 40

¹¹⁹ CMA PFs, Appendix 10.3, 41

¹²⁰ CMA PFs, Appendix 10.1, 51

¹²¹ RWE Response to the CMA’s retail energy supply ROCE analysis, 2.6, 2.9 and 3.15

still considers this to be the most appropriate approach to assessing the profitability of retail energy supply businesses.

157. The CMA finds that *"margins in the range of 1 to 3% would appear to provide a reasonable guide for what is required to cover efficient levels of capital employed and operating costs"*.¹²² The CMA's view is that *"comparators within the GB energy retail supply markets are likely to be more informative than those outside the GB energy retail markets"* because, without controlling for risk characteristics and level of capital employed, comparison of profit margins with those generated in GB energy retail *"would not yield robust conclusions"*.¹²³
158. RWE considers that the CMA has been selective in its assessment of the available evidence on the level of competitive EBIT margins and has placed more weight on benchmarks that suggest lower margins while disregarding those which suggest higher margins. RWE considers that many of the issues that existed in the CMA's working paper on profit margin comparators remain present in its PFs. The CMA has disregarded points made by RWE and other parties in their responses to the working paper on profit margin comparators.
159. RWE does not repeat all of the criticisms that it made of the CMA's assessment of profit margin comparators in its working paper response. Instead RWE highlights the key areas of deficiency in the CMA's assessment of the evidence.
160. In particular, RWE considers that the CMA inappropriately:
 - 160.1 places weight on the outturn gross margins of mid-tier firms and their "target" EBIT margins and, in doing so, disregards parties' submissions, is inconsistent and makes assertions that have limited or no evidential support;
 - 160.2 places weight on outturn I&C margins and is inconsistent and makes assertions that have limited or no evidential support;
 - 160.3 disregards parties' submissions on EBIT margins in other industry sectors and overseas energy retail markets on a basis that is inconsistent with its assessment of other evidence; and
 - 160.4 concludes that reasonable margin need not be excess of regulated margins on the basis of inappropriate reasoning and insufficient evidence.
161. We discuss these points in turn below.
 - a. Margins of mid-tier firms**
162. The CMA finds that *"[t]he evidence from the mid-tiers suggests that 'competitive' gross margins are likely to be around 12%... We consider that the target EBIT margins of 3% mentioned by some suppliers may indicate an aspirational margin for a supplier operating with an efficient level of capital employed and operating costs"*.¹²⁴
163. We consider that this is weak evidence because the CMA:
 - 163.1 has not controlled for significant differences between the firms; and
 - 163.2 is inconsistent in its use of the evidence made available.

¹²² CMA PFs, 10.131

¹²³ CMA PFs, Appendix 10.6, 16

¹²⁴ CMA PFs, Appendix 10.6, 82

i. The CMA does not control for significant differences between the firms

164. The CMA is wrong to confuse the “greenfield” mid-tier firms, whose total market share is only around 10 per cent, with the “brownfield” business of the Six Large Energy Firms. RWE has previously explained that these firms are not appropriate comparators because *inter alia*:
- 164.1 at the gross margin level, margins will be distorted by differences in strategy and operational practice for which the CMA has not controlled, such as the different customer mix that results from the mid-tier’s targeting of dual-fuel, direct-debit customers;
- 164.2 there are significant differences between the mid-tier firms and the Six Large Energy Firms, in terms of life-cycle, risk and cost, which will affect comparisons at both a gross margin and EBIT margin level; and
- 164.3 the CMA has selected only two firms upon which to base its benchmark. This is a very small sample size which could distort the CMA’s analysis and conclusions.¹²⁵
165. The CMA itself identifies the following areas in which mid-tier firms have different characteristics to the Six Large Energy Firms:¹²⁶
- 165.1 rapid growth;
- 165.2 different business models;
- 165.3 differences in customer mix;
- 165.4 absence of a legacy customer base; and
- 165.5 differences in cost.
166. The CMA proposes that some, but not all, of these differences can be overcome or do not invalidate the mid-tier as a benchmark. It proposes that profitability comparisons between the mid-tier firms and the Six Large Energy Firms should:
- 166.1 “take account of differences in customer acquisition costs”, which it considers it does by making comparisons at the gross margin level; and
- 166.2 “be limited to the profitability of their respective domestic supply businesses, and for only certain periods of time”.¹²⁷
167. RWE disagrees that a meaningful comparison can be made at the gross margin level and considers that the limitation of the comparison to the Domestic segment in certain time periods significantly undermines the appropriateness of the mid-tier firms as comparators.
168. RWE notes that one approach that the CMA proposes to overcome this is to compare the margins of the Six Large Energy Firms and the mid-tier excluding costs to acquire (“EBITC2A”). We do not consider, that this would adequately control for the many differences between the Six Large Energy Firms and the mid-tier firms, notwithstanding the weaknesses of its analysis that the CMA itself identifies. For example, differences in customer mix and the absence of a legacy customer base would also be likely to materially affect mid-tier firms’ costs to serve. Mid-tier firms also do not face the same operational, cost and risk impacts that arise from the corporate and institutional backgrounds of the Six Large Energy Firms.

¹²⁵ RWE’s Response to the CMA’s Assessment of profit margin comparators, 2.9

¹²⁶ CMA PFs, Appendix 10.6, 58

¹²⁷ CMA PFs, Appendix 10.6, 59

169. The CMA makes the following assertions, which it appears to use to support a view that the mid-tier firms would be expected to earn lower margins than the Six Large Energy Firms:
- 169.1 that “[t]he absence of a legacy customer base for independent suppliers may suggest lower profitability”; and
- 169.2 that “the Six Large Energy Firms may face cost advantages in terms of wholesale energy procurement or economies of scale benefits”.¹²⁸
170. RWE does not agree with either of the above assertions and highlights that the CMA does not present evidence to support them. RWE considers that these points remain unproven.

ii. The CMA’s inconsistent assessment of evidence

171. The CMA has placed weight on financial and other information from a very small sample of two companies, while disregarding other comparators covering much larger samples, as we explain in later sections.
172. In addition, the CMA inappropriately places weight on the stated “target” EBIT margins of some mid-tier suppliers. RWE does not consider unverifiable assertions from suppliers¹²⁹ with limited experience of operating in the market to be relevant or reliable evidence for the competitive benchmark. The CMA also does not explain why it describes the target margins of 3.0% stated by some mid-tier firms as “aspirational”. RWE would request that the CMA explains this statement and the evidence on which it is based.
173. RWE still considers that an EBIT margin of at least 5% represents a reasonable return over the Relevant Period, and sought to achieve this return. The CMA has not explained why the stated EBIT margin targets of the mid-tier firms are more relevant or reliable than those of the Six Large Energy Firms, which it appears to have disregarded.
174. The CMA also disregards the views of several of the Six Large Energy Firms regarding the comparability of mid-tier firms as well as the view expressed by another mid-tier firm – Utility Warehouse – that “independent suppliers were operating unsustainable or non-profit making businesses”. It rejects this on the basis that it does not “believe that this would apply to the mid-tier suppliers we looked at given the importance of credit worthiness ... when dealing with trading counterparties to access the wholesale markets or posting collateral with network operators”.¹³⁰ The CMA again presents no evidence to support this assertion. However, RWE notes that a firm earning returns below its cost of capital could still very easily be considered highly credit-worthy.

iii. Conclusion

175. RWE considers that the CMA makes selective use of evidence from parties, rather than making a balanced assessment of all the submissions it has received. In particular, RWE highlights that the CMA:
- 175.1 overlooks significant limitations on the comparability of mid-tier firms’ margins on the basis of assertions which it presents no evidence to support; and
- 175.2 treats the submissions of different parties inconsistently.
176. RWE considers that the CMA has not demonstrated that the outturn gross margins or “target” EBIT margins of two mid-tier firms provide a robust or reliable benchmark. The CMA’s overlooking of a number of significant comparability issues is inconsistent with its basis for rejecting other possible comparators.

¹²⁸ CMA PFs, Appendix 10.6, 59

¹²⁹ CMA PFs, Appendix 10.6, 82

¹³⁰ CMA PFs, Appendix 10.6, 68

b. I&C margins

177. The CMA states that its analysis shows that “I&C EBIT margins based on a five-year period total basis were 2%.”¹³¹ The CMA rejects parties’ arguments that I&C is a lower risk business, stating that:
- 177.1 “it was not clear to us that bad debt risk was clearly lower in I&C than for the combined SME and domestic business”;¹³² and
- 177.2 “[i]n relation to shaping risks and wholesale energy cost risks, we accept that ... [t]his may increase suppliers’ domestic and SME wholesale energy costs due to increased hedging, balancing, and demand forecasting costs. However, we do not consider that this justifies higher EBIT margins...”¹³³
178. On the first point, it is not clear to us from the PFs that the CMA has carried out any analysis of relative bad debt levels of the different segments, other than to argue that “I&C is likely to be more correlated with the economy than is domestic supply, but possibly less so than SME.” It is not evident that the CMA has sought to assess whether bad debt is solely influenced by the economy or whether SME customers, by virtue of the risks inherent in operating a small business, might present a greater bad debt risk irrespective of changes to the economy. RWE considers that there is no proper evidential basis for the CMA’s conclusion.
179. [CONFIDENTIAL]
180. On the second point, although the CMA accepts that “a significant proportion of I&C customers are on tariffs which vary with wholesale prices to a greater extent than domestic and SME tariffs”¹³⁴ it argues that these differences in risk would be reflected in costs, but not margins. This is directly contradictory to the reasoning which the CMA uses to suggest that regulatory precedents are not a lower bound for margins. In that instance, the CMA cites its belief that “GB energy retailers appear to have significant ability to pass through costs to customers” to support its view that “it is not automatic that a supplier in a competitive market will be more exposed to revenue and cost fluctuations relating to economic conditions”.¹³⁵
181. In conclusion, RWE considers that the CMA has not been able to adequately overcome the limitations on the comparability of I&C with other retail segments. Further, the CMA’s willingness to overlook these comparability issues is inconsistent with its basis for rejecting other industry sectors and overseas energy retail markets as comparators.

c. EBIT margins in other industry sectors and overseas energy retail markets

i. Other industry sectors

182. In regard to margins in other sectors, the CMA concludes that “sectors outside GB energy retail, would face different risks and have different capital requirements – these differences yield a wide range of profit margins, and we considered that such comparisons were therefore unlikely to yield robust conclusions.”¹³⁶ As we explain in this section, the CMA’s assessment of these benchmarks is inconsistent with its assessment of those on which it does place weight and that it is wrong to have disregarded them. The CMA appears to have been selective in placing weight on benchmarks which suggest lower margins and disregarding those which suggest higher margins.

¹³¹ CMA PFs, Appendix 10.6, 83

¹³² CMA PFs, Appendix 10.6, 90

¹³³ CMA PFs, Appendix 10.6, 90

¹³⁴ CMA PFs, Appendix 10.6, 90

¹³⁵ CMA PFs, Appendix 10.6, 55

¹³⁶ CMA PFs, Appendix 10.6, 35

183. RWE reiterates that, although it accepts that there are differences between the GB energy retail markets and other retail markets, these comparators can still be used in the determination of the competitive benchmark. This is consistent with regulatory precedent from Ofgem's Retail Market Review. Ofgem first calculated a generic retail margin of 5.8% then made a number of adjustments to account for differences in capital intensity and cost pass-through and a number of upward adjustments to account for volume and balancing risk, forward price risk and collateral that are required in GB energy retail.¹³⁷ It arrived at a range of the competitive margin of 3.0% to 8.9%. We observe that the bottom of the range for the reasonable margin established by Ofgem corresponds to the top of the range put forward by the CMA, whereas RWE's proposed competitive margin benchmark of 5% lies towards the lower end of this range. This suggests that the CMA's analysis has placed undue weight on evidence which suggest lower margins.
184. The CMA has not followed established industry regulatory practice, nor has it explained why it has not done so. RWE considers that this causes the CMA to wrongly disregard an informative source of evidence for the competitive margin and is an example of the CMA not making a balanced assessment of all the evidence.

ii. Overseas retail energy supply markets

185. In regard to overseas retail energy supply markets, the CMA concludes that "[a]gain, the issues of comparability and the need to make adjustments, would not suggest that benchmarking international energy retailer margins offers a robust approach."¹³⁸
186. RWE previously highlighted a comparison study by London Economics which covered 163 companies across 44 jurisdictions. Regarding this evidence, the CMA comments that "[i]n relation to the London Economics study, the relevant issue in our consideration was not the sample size, but the sample quality given that the benchmarking study ... considered a wide range of firms operating in different markets and regimes."¹³⁹
187. Although RWE accepts that adjustments would be required to directly compare margins between jurisdictions, it nevertheless considers that a large sample across a large number of jurisdictions provides a valuable sense check for the CMA's assessment of what is a reasonable margin. RWE highlights that the study found that the weighted average EBIT margin of 4.2% for Great Britain was the fourth lowest EBIT margin across the 44 countries and regions measured.¹⁴⁰ RWE disagrees with the CMA's basis for disregarding this evidence. RWE considers that, in defining a range for the competitive EBIT margin that is below the level of achieved EBIT margins across a range of other competitive retail energy supply markets in the EU, this is further evidence that the CMA has not made a balanced assessment of all the evidence.
188. RWE has also previously pointed out that the weighted average EBIT margins over the review period for the FTSE 100 and FTSE 250 were 12.1% and 9.9% respectively. Additionally, an independent statistical analysis of market data over the period 2008–12 suggests that a typical FTSE 100 firm with no (accounting) assets would still be expected to earn a profit margin of at least 5%.¹⁴¹ As sense checks, these benchmarks strongly suggest that the competitive level for EBIT margins is significantly higher than the CMA's proposed range. RWE considers that the CMA is wrong to disregard this evidence.

d. Regulated margins

189. The CMA considers EBIT margins in regulated markets do not necessarily constitute a lower bound because "it is not automatic that a supplier in a competitive market will be more exposed to revenue and cost fluctuations relating to economic conditions than a regulated

¹³⁷ Ofgem, Retail Market Review: Findings and initial proposals, Appendix 9

¹³⁸ CMA PFs, Appendix 10.6, 47

¹³⁹ CMA PFs, Appendix 10.6, 47

¹⁴⁰ London Economics Study, Section 7.4.

¹⁴¹ RWE's Response to the CMA's profit margin comparators working paper, 5.12

firm would be as this could depend on the regulatory arrangements and the extent to which suppliers in both types of market were exposed to risk. We note that GB energy retailers appear to have significant ability to pass through costs to customers...”¹⁴²

190. RWE disagrees with this. The differences in the risks to which regulated firms are exposed and the risks to which firms in competitive markets are exposed are a factual and an empirical matter. As RWE has previously explained, retail energy suppliers operating in the competitive GB market face significantly higher risks than a regulated business including the higher degree of competition driven by consumer choice of supplier and volatility in input prices, as well as their inability to fully pass through costs.¹⁴³
191. RWE disagrees with the CMA’s assertion that GB energy retailers appear to have significant ability to pass through costs to customers.¹⁴⁴ As RWE explained in its response to the CMA’s Cost pass-through working paper, there are a number of respects in which retail energy supply firms cannot pass through costs, irrespective of the level of competition. These include:
 - 191.1 firm-specific (as opposed to industry-wide) costs typically cannot be fully passed through. Differences in firm-specific costs are likely to be significant given that, as the CMA is aware,¹⁴⁵ firms use difference wholesale hedging strategies and market movements occur which favour one strategy over another;
 - 191.2 the existence of menu costs, which the CMA has acknowledged, reduces the ability of firms to pass through costs; and
 - 191.3 notwithstanding their chosen wholesale hedging strategy, no firm is fully hedged and all firms face some residual wholesale price risk, which cannot be fully passed on.¹⁴⁶
192. RWE considers that there is clear evidence that the risk in retail energy supply is higher than in regulated industries from the variation in profitability between firms and over time. This variation, which includes multiple firms periodically earning below the cost of capital, or even making losses, is far greater than such variations in regulated industries.
193. The CMA also considers that the cost structures in precedents cited from other regulated industries and overseas energy retail markets may not be “*sufficiently comparable to that of GB suppliers to enable a like-for-like margin comparison*”. RWE refers to its comments in the preceding subsection that, in fact, the data to adjust for such differences does exist and there is regulatory precedent for making such adjustments.
194. In conclusion, RWE does not consider that there is any theoretical or empirical support for the CMA’s assertion that regulated margins could represent more than the lowest bound for the competitive margin.

¹⁴² CMA PFs, Appendix 10.6, 55

¹⁴³ RWE’s Response to the CMA’s profit margin comparators working paper, 4.10

¹⁴⁴ RWE Response to the CMA’s Working Paper on Cost pass-through, 12 and 21

¹⁴⁵ CMA PFs, 10.44.

¹⁴⁶ RWE response to the CMA’s Cost pass-through working paper.