ENERGY MARKET INVESTIGATION

Summary of hearing with RWE on 5 August 2015

Opening statement

1. RWE supported a number of the Competition and Markets Authority's (CMA's) provisional findings. It agreed with the CMA's views on vertical integration and that the wholesale market functioned well. It also agreed with the adverse effect on competition (AEC) finding with regard to locational pricing and endorsed the proposed remedy.

2. RWE agreed that the current regulatory regime harmed competition, particularly the impact of SLC25A and the four-tariff rule, and supported a clear delineation of roles for regulators, particularly for Ofgem.

3. RWE had actively promoted the creation of an 'office of energy', which would provide impartial information concerning the competing objectives of the energy trilemma of energy security, affordability and low carbon. RWE hoped that the CMA would consider this proposal further and believed that rebuilding trust was integral to a well-functioning, competitive market that served consumers well.

4. RWE supported the streamlining of code governance and the development of an independent code adjudicator.

5. RWE also identified what it believed were significant flaws in the provisional findings. The AEC in the domestic and small and medium-sized enterprise (SME) market based on weak customer response had no foundation. The CMA had produced no evidence to show that the energy market functioned less well than other markets and had focused on the concept of a perfect market.

6. RWE did not agree that electricity and gas supply were homogenous goods or services: customers considered a number of factors other than price when choosing their energy products.

7. RWE fundamentally disagreed that customers were disengaged and the CMA's survey showed that 89% of customers knew they could switch. RWE questioned the evidence on engagement and believed it was incorrect to

identify all standard variable tariff (SVT) customers as disengaged and questioned the lack of a comparative assessment with other markets.

8. RWE did not believe that price discrimination impacted negatively on customers and as previously relayed to the CMA, price discrimination did not lead to a lack of competition in markets and or demonstrate unilateral market power. The type of pricing in the energy market was common to many competitive markets and delivered customer benefits.

9. RWE asked the CMA to carefully consider its observations on the AECs in the domestic market and believed that the features identified resulted from poorly implemented and managed regulation, which had distorted competition.

10. Regarding the SME sector, RWE believed the CMA's analysis did not fully appreciate the differences between domestic and microbusinesses. While some similarities existed, the CMA's assumptions overlooked important evidence of competition, such as:

   - negotiated prices were an important aspect of the SME market;
   - third party intermediaries (TPIs) were important providers of choice and engagement, though RWE acknowledged that evidence existed of bad practices on the part of TPIs; and
   - the greater risks associated with supplying microbusinesses.

11. RWE's disagreement with some of the AEC findings led it to believe that only some of the proposed remedies were appropriate and would lead to greater customer engagement.

12. RWE supported the removal of the Retail Market Review (RMR) measures, and the provision of clear and helpful information would assist customers in their understanding of products and the energy market. The roll-out of smart meters across the whole market, without particular focus on any one group, would in due course enable customers to manage their energy consumption and bills.

13. RWE opposed the safeguard tariff as disproportionate, unnecessary and unworkable. Its views were shared by a number of industry participants and academics, who believed that such a measure would diminish competition and consumer engagement and negatively impact the wholesale market.

14. The removal of RMR restrictions was intended to address concerns of over-regulation, but the safeguard tariff, which would affect 70% of the market, appeared to contradict this aim. It flew in the face of the last 20 years of

market development and would undermine one of the most liberalised energy markets in the world.

15. RWE believed the CMA's analysis was out of date. It had failed to take into account the positive impact of switching, internal transfers, and the growth of small suppliers, which had increased during the CMA's investigation.

16. RWE believed a safeguard tariff would compromise the promotion and enhancement of competition in the energy market. A package of remedies such as the removal of RMR, allowing the removal of SLC25A to take effect, the introduction of further nudge measures to encourage switching and the roll-out of smart meters would lead to greater customer engagement.

Profitability

17. RWE believed the CMA had over-estimated the level of profitability that underpinned its assessment of the AECs. RWE disagreed with the representation of the Six Large Energy Firms as an amorphous group of companies, ignoring their individual costs, structures and market shares.

18. RWE noted the CMA's claims that customers overpaid by £1.2 billion annually, but argued that if suppliers' revenues were £1.2 billion lower, suppliers would be loss-making. RWE's own analysis showed that suppliers made only a modest margin.

19. RWE argued that the finding on the profitability of the Six Large Energy Firms was based on a flawed analysis and RWE identified four significant issues.

20. First, the inclusion of Centrica's data in the analysis materially skewed the results. The return on capital employed (ROCE) analysis and earnings before interest and taxes (EBIT) and costs benchmarks were driven by Centrica's financial performance. Using publicly available information, RWE had rerun the CMA's analysis to exclude Centrica and identified the following:

- Excluding Centrica reduced the average ROCE of the remaining suppliers over the relevant period from [✂] to [✂].

- Furthermore, by taking the proportion of difference of the relevant period ROCE for the extended period to 2007, the average ROCE may be [✂] (compared with the CMA's upper band of 11.5% for its cost of capital analysis).

- Excluding Centrica reduced the average EBIT margins of the remaining suppliers over the relevant period from 3.4% to 2.2%, which was well within the benchmark EBIT margin of 1% to 3%.

- The CMA excluded notional capital due to the significant range in estimates of the Six Large Energy Firms, from £350 million to £4.5 billion – RWE believed the reason the range might be skewed was due to Centrica's estimate of £2.7 to £4.5 billion.

21. RWE assumed that Centrica's high level of profitability was due to a combination of incumbency in gas, the scale of its business, exemptions such as meter inspections and benefits accrued from a strong ancillary services business.

22. RWE did not believe that the profitability of a single firm should underpin remedies that would be applied across the whole market.

23. Secondly, RWE believed there was an inconsistency between the CMA's ROCE and profit margin results. The CMA failed to acknowledge the material inconsistency between its benchmark of 1% to 3% for the reasonable range of EBIT margins and its ROCE analysis. It was not plausible to expect a domestic business, for example, with a turnover of £2.8 billion, to manage a return of 1%, or £28 million, given the risks and operational leverage it faced. The CMA's analysis suggested that RWE's risks were more akin to that of a bond.

24. The average EBIT margin for the Six Large Energy Firms over the period 2007 to 2013 was 3.3%. The 3% upper bound of the CMA's margin benchmark corresponded to a ROCE of 23%, significantly above the weighted average cost of capital of 10%. This suggested the CMA's estimate of capital employed in its ROCE analysis was likely to be understated or that ROCE was a flawed measure for an asset-light business.

25. Under the CMA's ratio approach, firms were excessively profitable, but under the margin approach they were not. RWE believed this inconsistency demonstrated that a capital employed estimate was materially understated.

26. Thirdly, the CMA had not made sufficient adjustments to properly recognise the economic values of tangible and intangible assets required by a supply business. This resulted in a materially understated capital employed and a materially overstated ROCE. In particular, the CMA excluded notional capital from its analysis, despite submissions from five of the Six Large Energy Firms that notional capital was required. RWE believed the CMA should have performed more robust and well-supported analysis to depart from this consensus.

27. RWE said the CMA's analysis contained an inappropriate assumption that instead of holding notional capital, business risk could be managed through operational processes and a trading fee. RWE contended that this only

covered the cost of attaining access to the market and did not manage additional trading risks, including commodity cost disadvantage, 'shape and swing', and all non-trading related business risks, and it discredited notional capital on the basis that the range of estimates was too wide.

28. RWE had particular concerns around the exclusion of pension deficit repair, the understatement of the value of the customer base, particularly given the recent market activity of the mid-tier suppliers, and the exclusion of regulatory collateral.

29. Finally, RWE argued that the CMA's benchmarking fell short of best practice. The CMA considered that 'ex post' outcomes could be used to measure 'ex ante' efficient costs. The efficiency adjustments had a material effect on the profitability of the Six Large Energy Firms. The analysis was too simplistic and high level and the presupposition that the majority of the Six Large Energy Firms were inefficient was not supported by sufficient analysis or robust evidence. External benchmarking was not conducted to ascertain the relative efficiency of operations and econometric analysis was not conducted to control for scale or geographic factors.

30. The CMA's analysis used an inappropriate lower quartile out-turn costs benchmark, especially given that over time, different firms made up the benchmarks. In the long run, this promoted an impossible benchmark for a single firm to achieve. The CMA's judgement of cost efficiency that a reasonably efficient firm could expect to achieve was unrealistic and based on an assessment of limited evidence from the indirect cost ratios of mid-tier firms.

31. The composition of the mid-tiers' businesses was materially different to that of the Six Large Energy Firms and the CMA's analysis appeared to have little regard to the suitability of benchmarking the Six Large Energy Firms against the mid-tiers' cost bases, operating models and business, particularly as the Six Large Energy Firms were in a transitional phase due to technological and consumer behavioural changes. The benchmarks used by the CMA led to the finding that on an ex poste basis, domestic customers had overpaid by 5% and SME customers by 14%.

32. RWE believed that using the lower quartile out-turn cost benchmark of indirect and direct costs provided an impossible benchmark that was not sustainable by any one firm in the long run.

33. RWE's own performance regarding indirect and direct costs was mixed. RWE thought both direct and indirect costs were relevant. For direct costs it believed it had outperformed that average of the Six Large Energy Firms over

the relevant period. It had less influence over its direct costs, but given the numbers involved, minor improvements made a large difference to its EBIT.

34. Regarding indirect costs, RWE's performance, relative to the market average, had improved over time, with costs per account reduced from [✂]. But it did not believe the cost differentials could be accounted for purely by being efficient or inefficient and the consolidating of its locations business systems and reduction in locations were important factors in the figures.

35. RWE believed the cost structures of the mid-tier firms were very different to the Six Large Energy Firms. This was due to their tendency to operate from one location and the utilisation of an 'out-of-the-box' IT system, which was designed for modern, billing requirements. The mid-tiers also focused on customers that had lower costs to serve, such as those who paid by direct debit. Mid-tiers' composition was very different. They typically had a lower percentage of SVT customers, around 10% to 15% and there were exemptions to consider.

36. The loss of market share to smaller suppliers, particularly those customers that had lower costs to serve, had led RWE to take on a more complex customer mix which made it difficult to keep customer costs down. Costs were also affected by the investment in smart meters and a large investment in making its IT systems fit for purpose.

37. RWE said that it was constantly trying to reduce its costs and implement efficiency programmes. For example, four years ago it had made savings of £[✂] and in the last two years it had made savings of £[✂]. RWE was about to start a further programme of cost reduction.

38. RWE did acknowledge that it had scale advantages over the mid-tiers and smaller suppliers, for example, with regard to regulatory issues. But any advantage was offset by the reality that the energy market was in transition, where the cost of technology and innovative platforms made it easier and cheaper for new entrants to emerge.

39. Price was not the only consideration for customers and RWE had witnessed [✂]. Though disappointing for RWE, it believed this was the behaviour expected in an efficient market.

40. A significant change in [✂]. There was a [✂]. The percentage of RWE's customers on its [✂].

41. [✂]

42. [✂]

Notice of possible remedies

Remedy 11 – A transitional 'safeguard regulated tariff' for disengaged domestic and microbusiness customers

43. RWE believed that the safeguard tariff would create a disengaged market and prevent many of the benefits that would flow from the growing presence of small suppliers and innovations such as smart meters and products such as NEST and Hive. RWE said that [✂].

44. RWE agreed there was a lack of trust in the market, particularly if there was a lack of explanation of why when wholesale costs fell consumers did not see this reflected in retail prices. The media and political storm that often followed price rises obscured the fact that there were a number of components affecting customer bills. RWE believed an independent office of energy would address this lack of information and restore consumer trust by, for example, explaining how smart meter and distribution costs impacted on a bill and also setting out the implications for bills of the 'energy trilemma'.

45. RWE believed that an independent office of energy would also address the lack of faith that both consumers and suppliers had in Ofgem and the Department of Energy and Climate Change (DECC).

46. RWE was concerned about the transitional safeguard tariff remedy and the effect this would have on the hedging position of parties on liquidity in the market, and ultimately on other market positions. Parties would not be able to compete on their hedging strategies because the safeguard tariff would be set at, for example, 12 or 18 months and the incentive for all suppliers would be for everything to be hedged against this period.

47. [✂]

48. RWE acknowledged that there were people who, at the end of their current deal, defaulted to the SVT for a certain period. RWE also believed that that there was another group of SVT customers who appeared disengaged, when in fact a suitable tariff did not exist for them, for example, single fuel customers. It was for this reason that RWE was supportive of the relaxation of simpler choices as it would enable suppliers to offer tariffs that targeted those segments of customers that were currently not best served.

49. RWE said that additional protection could be provided to the most vulnerable customers via more information and education about the options available and through the Warm Home Discount. Clear criteria would need to be established to determine which customers qualified for the safeguard tariff.

RWE did not believe it was fair on consumers that only the Six Large Energy Firms had to provide a Warm Home Discount.

50. RWE maintained a correspondence with its customers on the priority services register, but believed the more proactive approach it would like to take was stifled by regulations governing marketing. RWE hoped that the CMA would address this issue as it believed around two-thirds of its customers did not benefit from advice on the most appropriate tariff, which was not always determined by price.

51. In the event that the four-tariff rule was relaxed, RWE would offer more prepayment tariffs and tariffs that had no standing charges. RWE had offered a fixed, prepayment tariff which had proved very popular with both internal and external switchers, but Ofgem identified it as a fifth tariff and it was withdrawn.

52. RWE believed that customers were interested in products that were more than just energy. This was evidenced by the popularity of RWE's NEST product. It believed that suppliers should have the ability to bundle products and provide discounts.

53. RWE believed the market should determine which customers received smart meters first and it did not believe that prepayment customers should be prioritised. Such a move would lead to higher costs and would be hampered by the fact that a technical solution regarding the installation of smart meters in high-rise accommodation was not due until 2017.

54. RWE disagreed with the assertion that prepayment meter customers were not engaged with the market because they did not switch. RWE believed that prepayment customers were very aware of their energy usage on a daily basis and knew what they spent; RWE provided an application that allowed customers to see the cost of their energy usage on a monthly basis. RWE believed that what prevented more effective engagement was a lack of prepayment tariffs to choose from and it believed this could be rectified by the introduction of a range of prepayment tariffs targeted at prepay meter customers.

55. RWE outlined a number of issues in setting the price of a safeguard tariff. It was difficult to identify pure cost pass-through items and items such network costs involved a degree of estimation. The eco obligations also constituted a large figure and there were big variances across suppliers.

56. [✄]

Microbusinesses

57. RWE had ended auto-rollovers in November 2014 and had noted a [✂]. Of the [✂] customers since November who would have been locked into a contract with auto-rollover, [✂] had contacted RWE and [✂] had switched to other suppliers.

58. The consequences for businesses were profound with regard to the safeguard tariff, both in terms of the complexity of the product and the grouping together of customers who were at very different stages of engagement. The microbusiness market was very heterogeneous, with different risks involved in supplying different types of businesses, and it was very difficult to formulate a safeguard tariff that was appropriate for all firms.

59. RWE did not believe that having price comparison websites (PCWs) publish a list of prices would promote the desired level of customer confidence and engagement. It was impractical and unwieldy to have swathes and swathes of prices without taking into account a customer's requirements and the risk taken on by the supplier. RWE preferred the bespoke solutions offered by TPIs, particularly as they conducted the transaction for customers.

Remedy 6 – Ofgem to provide an independent price comparison service for domestic (and microbusiness) customers

60. RWE agreed with an independent PCW, though not necessarily run by Ofgem. Transparency around the number of deals and commissions and costs was vital to any PCW site. With the potential removal of the four-tariff rule, the tariff comparison rate would be an appropriate tool for consumers to compare offers and monetising the value of benefits – such as cashback – would be helpful.

61. It was important that customers could filter their search to a level that focused on the criteria in which they were interested. RWE was concerned that PCWs only ranked on one-year cost, when consumers were interested in longer-term tariffs.

62. RWE had used SMS and email campaigns to engage customers whose tariffs were ending. [✂].

63. In addition to marketing, bills were also an important driver in customer engagement. RWE noticed an increase in customer activity following receipt of a bill. Following further refinements of the CMA's analysis, RWE would be keen to target those customers who were identified as never having

considered switching, who RWE believed were broadly the older or digitally disengaged consumers.

64. RWE believed it was important that a number of channels existed to target these customers as the traditional methods of switching were probably not available to them. RWE did not believe that a return to door-to-door selling was appropriate, but working with housing associations or charities and a relaxation of simpler choices would enable suppliers to target the most vulnerable.

65. RWE was aware that local authorities offered energy services to its residents and actively looked to engage those who were typically unengaged. In rented accommodation RWE believed that landlords should not be able to bundle utility bills with the rent and the end consumer should be able to choose the energy supplier. RWE identified smartphones and collective switching as other nudges that could engage consumers.

66. RWE supported PCWs being given access to the meter point reference database and saw huge benefits for consumers, but given the sensitivity of the data, it expected that PCWs would be regulated via a licence. RWE did not want PCWs to view the database as a marketing tool, with people bombarded with marketing communications.

67. RWE would extend the licensing regulation to TPIs in the SME sector. There were around 1,000 TPIs and RWE believed it would assure customers that they received the best deal and enable small businesses to deal as confidently with TPIs as larger businesses currently did.

Remedy 12a – Requirement to implement Project Nexus in a timely manner

68. RWE supported Project Nexus and was disappointed that it was delayed, given the number of resources RWE had allocated to the project. The delay had led to uncertainty over the phasing of the project and RWE's costs had increased as a result.

Remedy 12b – Introduction of a new licence condition on gas shippers to make monthly submissions of Annual Quantity updates mandatory

69. RWE would like the ability to update its annual quantities (AQs) on a monthly basis. It was currently done after the AQ review at the year end and monthly updates would lead to more adequate industry charges.

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

70. RWE was supportive of half-hourly settlement and believed it should be introduced in a timely manner, recognising the impact of other industry changes such as smart meters. If smart meters were in place before the current estimate of 2020, RWE agreed that there was a case for bringing forward the implementation of half-hourly settlement.

Remedy 7 – Measures to reduce actual and perceived barriers to accessing and assessing information in the SME retail energy markets

Remedy 7b – Introduction of rules governing the information that TPIs are required to provide to microbusiness customers

71. RWE believed that the heterogeneity of the market made it difficult to produce a one-size-fits-all price list. If it was possible to narrow the market down so that a price list was viable, RWE would support this, but its own experience showed that a significant variety of customers existed.

72. TPIs appeared more effective at engaging customers and took a more proactive approach in doing so. The larger PCWs did not actively court business customers, whereas TPIs would contact business customers to discuss their needs.

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

73. RWE supported the proposed remedy and believed a zonal scheme was appropriate, using the seasonal zonal loss factors proposed under the P229 modification, particularly as Ofgem had confirmed that it fully met the Balancing and Settlement Code objectives.

74. The implementation methodology already existed and implementation costs were known. Because of the identified, large customer benefits, the zonal scheme should be implemented relatively rapidly, between 1 April 2017 and 1 April 2018. Time, though, should be allowed to calculate the losses and give tariffs time to change.

75. Regarding customer benefits, RWE had provided analysis that showed the benefit if the analysis was changed today, which was £880 million net present value. RWE believed the benefits were sustainable and it would expect to see consistently rising dispatch and location efficiencies by having a more cost-effective allocation of losses.

76. The status of interconnectors if P229 seasonal zonal losses was implemented would need to be reviewed in the future, but RWE would want a symmetrical approach adopted to losses in relation to interconnectors in different parts of the country.

Remedy 2a – DECC to undertake and consult on a clear and thorough impact assessment before awarding any CfD outside the CfD auction mechanism

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

77. RWE agreed with the CMA that that a competitive allocation process for contracts for difference (CfDs) should be undertaken whenever possible. A non-competitive allocation should only happen in exceptional circumstances and it was important that a clear framework for assessment and consultation existed.

78. RWE believed that primary legislation should be enacted that required DECC to consult when undertaking a non-competitive process. The factors used to assess whether a non-competitive tender should be used should have a clear and robust consumer benefit and be technology neutral. Consideration of the short- and long-term benefits should be done on a consistent basis, via a weighting efficiency, so that the same assessment framework was applied equally to the different technologies.

79. The allocation of money between pots should be subject to a robust consultation. Investors should also have a clear view of allocation rounds to ensure that that they had some certainty about developing a project given the cost involved. RWE also believed that in the event that sufficient competition did not exist when allocating pots, delaying the auction should be considered.

Remedy 14 – Remedy to improve the current regulatory framework for financial reporting

80. The most granular level of reporting RWE's current framework provided was in its consolidated segmental statements (CSS). The CSS provided considerable transparency for the generation and retail businesses and were

based on audited financial information, prepared to an agreed set of principles which RWE's auditors assessed. RWE believed this framework gave an appropriate level of insight into the company and the way that it operated.

81. The CSS was prepared on a market-orientated basis and was reconciled to International Financial Reporting Standards (IFRS) and the UK Generally Accepted Accounting Practice (UK GAAP), reflecting the correct costs in the respective parts of RWE's business.

82. RWE contested the relevance of including an accounting balance sheet for its retail supply business and making more granular or spurious allocations across retail segments.

83. The market base that RWE used within its CSS reflected its individual, independent commercial hedging strategies. Generation had a hedging strategy that was different to retail and reflected how generation was managed. If the hedging strategy for generation was standardised across many companies, this would lead to a loss of transparency of how the business was managed and what the real costs were of how the business was managed as many of RWE's commodity costs were not tradable, standard products, such as illiquid coal and weather hedges.

84. By standardising resale costs, you would remove a very competitive element of the market and end up with highly stylised numbers that did not reflect the true performance of the company. RWE would like to see segmental statements prepared by all companies, large or small, as they delivered consumer-orientated information. This level of insight should apply across all companies and help consumers in their switching decisions.

85. Ofgem had suspended the Supply Market Indicator, which was intended to provide a forward-looking estimates of costs, but RWE was supportive of a relaunch if it provided consumers with an accurate reflection of what was happening with energy costs.

86. RWE was keen that consumers knew the various components of a bill and the future cost implications of government eco and nuclear policies and signing up for long-term CfDs.

Remedy 16 – Revision of Ofgem's statutory objectives and duties in order to increase its ability to promote effective competition

Remedy 17 – Introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making can be addressed transparently

87. RWE believed that Ofgem should focus on competition and that consumers' interests were best protected through Ofgem promoting effective competition. RWE would like Ofgem to be less conflicted in some of its decision-making, with, for example, impact assessments of its work undertaken by independent bodies. Greater transparency would derive from having an independent assessor determine whether an intervention was effective.

88. RWE would like to see an independent body, such as the Office for Budgetary Responsibility, responsible for assessing costs and looking at affordability. It would like such a body to explain the implications of policy decisions, for example affordability and what they meant for security of supply. This would be welcomed by a whole range of groups, including inwards investors.

Remedy 18a – Recommendation to DECC to make code administration and/or implementation of code changes a licensable activity

89. RWE agreed with the proposal to make code changes a licensable activity. In some cases this was done under the current transmission licence and creating an independent licensable activity avoided potential conflicts of interest through being a code administrator and also a beneficiary of a code.

90. Identifying code administration as a separate function allowed a clear definition of the role of a code administrator and an appropriate administrator could be selected. Managing codes was challenging and complex and came with a cost burden, and the possibility to consolidate the administration of various codes would be helpful.

91. RWE said that for many of the contentious code changes, the delay in implementation often lay with Ofgem. A licence would define the code administrator's role and completing changes within set timescales would help the process.

92. As Ofgem's duties were more open to discretion as they were not solely competition focused, RWE proposed an independent adjudicator to ensure that Ofgem's proposed changes to the codes were consistent with its duties.

Remedies the CMA was minded not to pursue

93. RWE did not have any comments regarding those remedies the CMA was minded not to pursue.