

CMA ENERGY MARKET INVESTIGATION

PROVISIONAL DECISION ON REMEDIES

RWE RESPONSE

I. INTRODUCTION AND STRUCTURE OF THIS RESPONSE

1. RWE notes the publication by the CMA on 17 March 2016 of its Provisional Decision on Remedies ("PDR") in the Energy Market Investigation (the "Investigation"). This document provides RWE's formal response to the CMA's PDR. It should be read in conjunction with RWE's Authorised Advisers' Confidential Submissions made in respect of the Disclosed Material (together "RWE's Response").
2. RWE's Response should also be read in conjunction with RWE's responses to the CMA's PFs and Addendum to PFs and the CMA's Remedies Notices and two Supplemental Notices of Possible Remedies (together, "RWE's Previous Responses").
3. This document is structured as follows:
 - 3.1 In Section II, we set out our significant concerns about key CMA analyses relating to the Domestic retail supply market which underlie its provisional findings of AECs and the extent of customer detriment (and which, therefore, are crucial to assessing the appropriateness of the CMA's proposed package of Domestic remedies).
 - 3.2 Section III contains our consolidated responses to all proposed remedies relating to the AECs and comments on the CMA's update analysis/provisional findings contained within the PDR and as outlined below.

RWE Response Section	Title
III A	CFD AEC
III B	Locational Pricing AEC
III C	Electricity Settlement AEC
III D	Gas Settlement AEC
III E	Prepayment AEC, RMR AEC and Domestic Weak Customer response AEC
III F	Microbusiness Weak Customer Response AEC
III G	Governance AEC
III H	Codes AEC

- 3.3 Our response to the CMA's updated analysis of retail energy supply profitability in Appendices 3.4 and 3.5 (the CMA's "indirect approach" to assessing the detriment resulting from the AECs provisionally identified by the CMA) (the "Profitability Response") is set out at Schedule 1.

II. RETAIL SUPPLY TO DOMESTIC CUSTOMERS

4. The PDR sets out the remedies the CMA considers are required to address the Domestic AECs and resultant consumer detriment provisionally identified in the CMA's PFs and Prepayment Addendum (and updated in certain respects in the PDR).
5. We responded in full to the CMA's provisional findings of Domestic AECs as set out in its PFs and Prepayment Addendum and we do not repeat our submissions here, which can be summarised as follows:
 - 5.1 RWE did not consider that the CMA had produced convincing evidence to support a provisional finding of an AEC of weak customer response, or that there was evidence of the existence or ability to exploit unilateral market power.
 - 5.2 RWE did 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 made the following key points: ¹
 - 5.2.1 First, that the CMA had overstated the level of any disengagement.
 - 5.2.2 Second, the CMA had failed to recognise the fact that suppliers are unable to differentiate in their pricing between customers who are "engaged" and customers who are "disengaged". [CONFIDENTIAL]
 - 5.2.3 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.
 - 5.2.4 Fourth, the "gains from switching" analysis undertaken by the CMA is unsupportable.
 - 5.2.5 Fifth, a finding of exploitation of unilateral market power is completely at odds with a properly drawn analysis of profitability.
 - 5.3 RWE agreed with the CMA's provisional finding that the RMR simpler choices rules reduce suppliers' ability to innovate in designing tariff structures to meet customer demand, and soften competition between PCWs. ² RWE considered that the CMA had understated the impact of RMR on price competition between suppliers, by limiting the ability of suppliers to target and trial products at different customer groups. ³
 - 5.4 RWE accepted that the gas settlement system may not be optimal, but considered that the concerns identified by the CMA will be largely addressed by implementation of Project Nexus. ⁴ RWE considered the CMA's concerns about the adjustment of annual quantities (AQs) to be a second order issue. ⁵
 - 5.5 RWE accepted 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. RWE considered that 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

¹ RWE's response to the Notice of Possible Remedies, pages 3-4, paragraphs 21.1-21.5.

² RWE's response to the Notice of Possible Remedies, page 4, paragraph 27.1.

³ RWE's response to the Notice of Possible Remedies, page 34, paragraph 1.1,

⁴ RWE's response to the Notice of Possible Remedies, page 6, paragraph 36.

⁵ RWE's response to the Notice of Possible Remedies, page 6, paragraph 37.

the use of half-hourly consumption data in settlement before it is able to be used effectively.⁶

- 5.6 In respect of the prepayment segment, RWE broadly agreed with the CMA's provisional finding that there are certain supply-side constraints and higher costs to serve prepayment customers that may have had an adverse effect on competition within the segment and/or given rise to a degree of consumer detriment. However, RWE considered that the CMA had underestimated the extent to which the technical constraint on tariff slots and the RMR simpler choices rules account for the differences in competition between the prepayment and credit meter segments.⁷

6. We remain concerned that the CMA's updated analysis in the PDR continues to:

- 6.1 **Overstate the extent of the gains from switching** and thus the likely magnitude of any search and switching barriers by wilfully and irrationally ignoring all of the evidence that (i) customers do not choose their energy supplier on price alone; and (ii) even active searchers and switchers do not necessarily choose the cheapest products available on the market or no doubt even the cheapest products listed on a price comparison website in front of them.

- 6.2 Presume that search and switching costs necessarily lead to an AEC in contradiction of the best available economic knowledge.

- 6.3 Fail to take proper account of the evidence on the way in which firms in the industry price and the implications of that pricing structure for a proper competition analysis. As a result the CMA simply does not deal appropriately with the important "waterbed" (or "see-saw" pricing) effects that are both predicted by economic theory and are central to domestic retail pricing in the energy supply industry. This failure permeates the CMA's current analysis. In particular, the CMA fails to take proper account of these waterbed effects in its key analyses of:

6.3.1 Gains from switching;

6.3.2 Net customer detriment;

6.3.3 Prepayment Price Cap benchmark calculation; and

6.3.4 Proportionality of remedies.

Indeed the CMA barely acknowledges the points that RWE has made and makes no attempt to explain why it believes they merit no substantive consideration.

- 6.4 **Fail to properly weigh the evidence of RWE's lack of profitability** which shows that, when actual costs are taken into account, RWE currently [CONFIDENTIAL]. Moreover, RWE is not inefficient in any relevant sense for a competition investigation. It simply made a rational economic decision to make a lumpy large-scale IT investment slightly after some of its competitors and in a manner which properly and rationally reflects the needs and the scale of its business – which is different both from the others of the Six Large Energy Firms ("SLEFs") and also from the mid-tier and smaller suppliers. The CMA will be aware that those IT investments are now beginning to pay off and RWE is able to plan to reduce its indirect costs/headcount considerably over the next few years as a result of those investments.⁸

7. We expand on these issues in the sub-sections that follow.

8. The reality is that RWE is [CONFIDENTIAL] – so it cannot, by definition, possibly be systematically overcharging its overall customer base. The CMA is refusing to accept that the current business model in the industry is for suppliers to offer substantial (and in some

⁶ RWE's response to the Notice of Possible Remedies, page 7, paragraph 39.

⁷ RWE's response to the Notice of Possible Remedies, page 42, paragraph 215.

⁸ [CONFIDENTIAL]

cases potentially loss making) discounts on certain fixed term (non-standard) tariffs in order to acquire customers. Suppliers make these offers in the expectation that a proportion of these customers will stay with them for a period once the fixed term (and the introductory discount) have expired, moving on to their (higher) standard tariffs at that point. RWE and other suppliers do not benefit from this pricing pattern overall – [CONFIDENTIAL]. As a business, the CMA correctly finds that [CONFIDENTIAL]⁹

9. RWE accepts that removing/reducing switching barriers and search costs – a suitable package of remedies along the lines that the CMA proposes, but without the Prepayment Price Cap – will act to allow a rebalancing of prices between the acquisition and retention markets. RWE recognises that the CMA may wish to see that rebalancing happen and even that it could be economically desirable to do this (although RWE does not consider the CMA analysis thus far has come anywhere close to showing that it would be a desirable move for the reasons given above).
10. [CONFIDENTIAL]
11. RWE therefore submits that the CMA should at this last hurdle reflect extremely carefully. It should, if it sees fit, progress with a suitable package of remedies aimed at removing (or reducing) barriers to search and switching. But it must recognise the shortcomings in its analysis to date, and cannot safely move to the imposition of extreme interventionist remedies such as the Prepayment Price Cap based on an unsustainable estimation of competitive benchmark pricing. Equally, RWE submits that if the CMA considers carefully the likely impact of the other remedies that it is proposing to introduce in order to remove some of the supply side constraints and to stimulate engagement it will conclude that the imposition of such a remedy would be wholly disproportionate.

The CMA overstates the extent of search and switching barriers

12. In its PFs the CMA identified, as features contributing to an AEC alleged to arise as a result of weak customer response (in turn giving rise to unilateral market power on the part of the SLEFs over SVT customers):
 - 12.1 customers' limited awareness of and interest in their ability to switch supplier; ¹⁰
 - 12.2 for certain customers, actual and perceived barriers to accessing and assessing information relating to domestic gas and electricity supply; ¹¹ and
 - 12.3 actual and/or perceived barriers to switching. ¹²
13. In the Prepayment Addendum, the CMA identified an additional, specific AEC relating to customers on prepayment meters. In its PDR, the CMA concludes that disengagement and weak customer response is a more significant problem among prepayment customers than it is for domestic customers on direct debit.¹³
14. Similarly in its PDR the CMA concludes that customers on restricted meters face particularly strong barriers to accessing and assessing information and barriers to switching supplier and/or tariff.¹⁴
15. In effect the CMA attributes weak customer response to customer inertia caused by barriers to search and switching.

⁹ PDR, page 546, footnote 1109.

¹⁰ PFs, page 332, paragraph 8.157(a).

¹¹ PFs, page 332, paragraph 8.157(b).

¹² PFs, page 332, paragraph 8.157(c).

¹³ PDR, page 144, paragraph 3.111.

¹⁴ PDR, page, 147, paragraph 3.121.

16. The CMA's gains from switching analysis implicitly assumes that the supply of retail domestic energy involves supplying a homogeneous product.¹⁵
- 16.1 If products were truly homogenous then the CMA would be right to believe that it could provide evidence of unexploited incentives to switch by examining differences in the prices of available products.¹⁶ The reason is that if energy products are entirely homogenous products (which RWE does not accept), then under the CMA's logic all of the observed price variation across products and suppliers would necessarily be caused by frictions – i.e. search and switching costs.
- 16.2 If instead however products are differentiated at least to some degree – whether because of brand loyalty, customer service, type of tariff offered, differences in the detailed contractual position offered or some other cause – then at least some of the observed variation in prices across products would in reality reflect differences in the attributes of the products. If so, then simply evidencing that customers are not always buying the cheapest product (as the CMA does in its gains from switching analysis) would **not** provide evidence of an actual incentive to switch but may instead simply provide evidence of a preference for a particular product other than the cheapest one on the market at the time. For example, if customers are not familiar and comfortable with an unknown supplier they may be prepared to pay a premium to buy a branded product.¹⁷
17. In reality, RWE submits that it cannot be the case that products are properly considered entirely homogenous. The CMA fails to explain or make any proper allowance for premia over the cheapest price that might be justified to reflect the non-price attributes of the products and tariffs that suppliers make available. This is important because the CMA's gains from switching analysis will overstate the actual incentive to switch or search as a result. Customers may appear inert because they are happy with their existing option (as indicated by the CMA's own customer survey). This in turn leads the CMA to overstate its estimate of the "direct" detriment associated with the current pricing models adopted in the industry.
- 17.1 The fact that there is price variation even across acquisition tariffs is unarguable – the CMA only needs to look at any price comparison website. However, the CMA's presumption that all of this price variation is due to search and switching costs is unreasonable. For example, the fact that the CMA observes price variation in the active part of the market (not just between SVT products) is not immediately consistent with the presence of large search and switching barriers: at a given point in time, individuals looking at a price comparison websites are, in reality, making decisions about which supplier to choose. Such observed price variation between acquisition tariffs on a PCW cannot easily be explained by different degrees of customer "lock-in" or inertia. The fact that suppliers continue to win customers through PCWs, even when they are not the number one product in the rankings, would seem to provide evidence that consumers value attributes other than price.
- 17.2 In the same vein, RWE has previously submitted that the behaviour of recent active switchers can give an insight into the value placed by consumers on the different products' non-price attributes.¹⁸ Its Authorised Advisers found that there is evidence that even active switchers do not all switch to the cheapest available product. If the CMA's analysis was correct, and the observed variation in prices simply reflected implied search and switching costs, the active switcher having searched would not "leave money on the table" but would

¹⁵ While the homogenous product assumption is consistent in a significant part of the CMA's position adopted in provisional findings, there are other places where it seems to argue the opposite. In particular, in relation to RMR the CMA considers that its removal will lead to greater product innovation – something which would be manifestly impossible were energy suppliers truly operating in a homogenous product market.

¹⁶ The CMA's Gains from Switching analysis has many intricate details, but in essence it simply considers whether there is a difference between the price of goods consumers are actually buying and the cheapest product available in the market.

¹⁷ We see such consumer behaviour in many apparently relatively homogenous product markets including petrol, milk, bottled water, butter and so forth. Indeed it is well known that private label and branded products sold in supermarkets are sometimes even produced in the same factories by the same manufacturer using the identical ingredients.

¹⁸ RWE's response to the Notice of Possible Remedies, page 22, paragraph 113.3.

instead switch to the cheapest product on the market. If there is any product differentiation at all, then the purported gains from switching the CMA is currently calculating will be – perhaps greatly – overstated. In short, the CMA has not controlled in its analysis of gains from switching at all for the implicit value of non-price attributes and so it will inevitably overstate the potential gains from switching and hence the implicit extent of search and switching costs.

- 17.3 RWE notes that the CMA attempts to rebut such an argument by saying that if consumers make switching mistakes then the evidence might show that active switchers “leave money on the table”. While RWE accepts that there is some logic to such an observation, RWE also note that this is expressly **not** the essence of the CMA’s AEC. Rather the CMA places heavy reliance on a concern that large numbers of customers are inert and so not actively switching or searching in sufficient numbers. The logic of the CMA’s concern is expressly not that customers who are actively searching are systematically making errors. If the CMA’s theory of harm were to change in this respect then RWE notes that the logic of both the CMA’s AECs and also its analysis of remedies would also necessarily change.
- 17.4 Thus the CMA inappropriately dismisses the evidence submitted by RWE’s Authorised Advisers by arguing it suffers from a variety of technical imperfections. Even if the CMA were right that in the short time available inside the disclosure room its Authorised Advisers did not produce a perfect methodology for adjusting for the CMA’s concerns now raised¹⁹, that does not explain why the CMA is ignoring the thrust of the submissions – that its own analysis suffers from a very much bigger problem. Specifically, the CMA entirely ignores all sources of product differentiation (and also differences in customer groups targeted by different products) that do in reality cause variation in observed prices. As a result, its own “gains from switching” analysis is significantly overstated. The CMA’s “gains from switching” analysis is in fact simply showing there is variation in prices.

The CMA incorrectly presumes that search and switching costs will restrict competition

18. In the Investigation the CMA has so far largely or even entirely ignored the economic literature on switching and search costs. That economic literature suggests that a reduction in search or switching costs will **not** necessarily lead to lower prices and may instead sometimes even lead to increased prices overall to customers.
19. The CMA currently jumps to a conclusion that search and switching costs are features of a market which cause an AEC which it then has a duty to tackle by way of intervention. The economic literature does not suggest that the presence of search and switching costs need necessarily have an AEC – they may sometimes even improve competition.
20. Specifically, the economic literature suggests that switching costs (for example) have two potentially offsetting effects on pricing incentives, which the literature terms a “harvesting effect” and an “investment effect”. While the presence of switching costs will allow firms to increase prices to those customers who are less active because of switching costs, the potential to win customers who are then relatively less active means that suppliers may nonetheless make significant investments in offering discounted acquisition prices in order to acquire customers. This is exactly what RWE has described affects the way in which it sets prices.
21. As a result of the ambiguity of these two effects (harvesting involves an incentive to increase prices while the investment effect provides an incentive to decrease prices), there are examples in the economic literature where a removal of switching costs has been found

¹⁹ RWE has decided not to invest yet more resources in rebutting the CMA’s criticisms of its submissions because the CMA does not appear to be taking account of RWE’s submissions. That should not however be mistaken for RWE accepting the points the CMA makes in appendix 6.3. That appendix amounts to a simple exercise in rejecting the evidence submitted – the CMA does not engage with the main points at all. The CMA is taking a profoundly disappointing approach.

to be likely to lead to an increase in average prices being paid by customers, not – as the CMA hopes will be the case – a decrease.²⁰

22. The CMA's analysis of these issues so far entirely ignores the rich framework provided by the economic literature for the analysis of search and switching barriers on product market outcomes. Instead the CMA proceeds as if it were sufficient in the economic literature to establish the presence of search or switching costs in order for there to immediately be a prevention, restriction or distortion of competition. The modern economic literature on search and switching costs does not suggest such presumptions are safe to make.²¹
23. Rather the modern economic literature on search and switching strongly suggests that whether the CMA can safely conclude that there are actually AECs in respect of search and switching barriers **should depend on the facts of this market**. The CMA should therefore consider the facts of this specific market before concluding whether search and switching barriers do actually result in an AEC. Such an analysis should consider in particular how much internal/external switching is "enough" for markets with acquisition discounting to be competitive, and also the role and effect of price discrimination between customers who engage with the market at different frequencies.²² The CMA needs to consider the differences between acquisition (non-standard) and retention (SVT) prices and also (i) the extent to which the discounts on acquisition products are dependent on the prices offered to SVT customers and (ii) the extent to which less frequently active SVT customers are actually protected by the significant volumes of customers who switch from SVT each year (which affects the price offered on SVT). In short, the CMA needs to properly establish whether there is actually an AEC from search and switching barriers (which in turn lead to

²⁰ The literature on switching costs is a large one and we have not sought to comprehensively survey it here. However, we do believe that among others it is important that the CMA consider in particular the theoretical results in Viard, B. (2007) "Do switching costs make markets more or less competitive: The case of 800-Number portability"; RAND Journal of Economics, Vol. 38, No. 1, pages 146-163 since he emphasises the theoretical ambiguity. And then also for example the more recent papers exploring how different models and assumptions can yield overall positive or negative impacts on consumers. For example, the empirical work in Dube, J-P., Hitsch, G. and Rossi, P. E. (2009) "Do Switching Costs Make Markets Less Competitive?" Journal of Marketing Research, Vol. XLVI (August 2009), 435–445 (available from <http://faculty.chicagobooth.edu/jean-pierre.dube/research/papers/43038368.pdf>) provides a careful empirical analysis which establishes the potential for empirical relevance of the ambiguity in the switching cost literature; and also the recent survey which also points out the theoretical ambiguity; Villas-Boas, J. M. (2015) "A Short Survey on Switching Costs and Dynamic Competition".

In addition we note that Cabral, L. (2015) "Dynamic Pricing in Customer Markets with Switching Costs" mimeo, New York University (available from <http://luiscabral.net/economics/workingpapers/scostsMar2015.pdf>) makes strong assumptions but produces an example of a model which is fully dynamic and has the property that it can predict either increasing or decreasing prices overall.

More generally, we would also point the CMA to the related literature on the impact of price discrimination on price levels in the presence of imperfect competition (since that literature also illustrates that charging different customer groups different prices can sometimes be associated with lower prices for all customers than would otherwise be the case). See in particular: Corts, K. (1998) "Third Degree Price Discrimination in Oligopoly: All-Out Competition and Strategic Commitment", the Rand journal of economics Vol. 29, No. 2 (Summer, 1998), pp. 306-323 (available from <http://www.jstor.org/stable/2555890>) and also Shaffer, G. and Zhang, Z. J. (2000) "Pay to Switch or Pay to Stay: Preference-Based Price Discrimination in Markets with Switching Costs" Journal of Economics and Management Strategy, Volume 9, Number 3, Fall 2000, pp397-424 (available from <http://www.simon.rochester.edu/fac/shaffer/Published/Pay%20to%20Switch.pdf>).

The key take-away for the CMA from this modern economic literature on switching costs (and relatedly the literature on price discrimination) is that the authors collectively illustrate that the details of the industry (in these papers captured through different assumptions in their models) will matter for whether the overall effect of switching costs on customer welfare is a net positive or negative. The economic literature therefore suggests that: (i) it is not enough for switching costs to be a feature leading to an AEC to establish the existence of a switching cost - since prices on average paid by customers cannot be assumed to increase in the presence of switching costs (or similarly for a search cost); and (ii) it is similarly not enough to argue that there are some customer groups paying higher prices than others for there to be actually some feature of the market which is preventing, restricting or distorting competition. The economic literature instead suggests that the facts in the specific case should matter for the CMAs assessment determining whether search and switching costs in this industry amount to a feature of the market which does (or does not) cause an AEC.

²¹ This is despite the results in some early papers in the literature.

²² While the CMA and RWE agree there are some customers who are active less frequently (and even some who are active infrequently), there are significant numbers of others who engage much more frequently.

customer inertia). The CMA needs to draw far more carefully the linkage between the facts of this case and the decision of whether there is, or is not, an AEC.

The CMA fails to take account of the way prices are set in the industry

24. Many of the CMA's remedies are directed towards attempting to reduce the search and switching barriers that it claims exist (and reduction of the implied costs that these barriers impose) and to the promotion of switching, in the expectation that reduction in search and switching barriers and increased switching will result in reduced price variation and mitigation of the AEC (i.e., the prices charged by the SLEFs will come down reflecting the fact that if costs of switching are reduced but prices remain the same, customers' incentives to switch will be increased).
25. Even if the CMA were right, and the removal of search and switching barriers would lead to a reduction of (RWE would say some) prices, in order to consider properly the scale of any detriment and the proportionality of remedies the CMA would need to take both industry pricing and the economic literature more seriously than it has so far.
26. In particular, in the CMA's analysis of retail energy markets it has thus far almost entirely ignored the way pricing actually works for acquisition products. For example, while the CMA does briefly consider the potential for waterbed pricing effects²³, and accepts the idea in principle, it quickly dismisses the idea in practice arguing that in the case of prepayment customers "*there is no evidence that this takes place*". However, RWE respectfully submit this is simply not the case for at least the following reasons:
 - 26.1 First, there is clear evidence that there is generally a waterbed effect between acquisition and standard pricing. RWE has described at length in previous submissions²⁴ [CONFIDENTIAL]
 - 26.2 Second, in terms of assessing the proportionality of the Prepayment Price Cap Remedy specifically, the CMA fails to recognise that it needs to consider whether there would be a relevant waterbed effect – if it went ahead with the other proposed elements of its remedies package – which does not currently exist given the specific barriers to offering acquisition products that the CMA has properly identified (and which RWE accepts). The relevant comparison for the CMA's analysis is not the world of today where (RWE agrees) there exists relatively poor choice of acquisition tariffs for prepayment customers, but rather the situation which would exist shortly after the introduction of some of the CMA's other remedies designed to remove certain supply side constraints in this segment, and to improve customer engagement. RWE submits that it is likely there would be suppliers offering prepayment acquisition tariffs and therefore a waterbed effect once the other elements of such a remedies package are in place. Adding a Prepayment Price Cap to the remedies package will lead to a rebalancing of prepayment prices between those customers who search and switch (are active in the acquisition market or are internal switchers) and those who do not (are likely to remain on the price capped tariff). Thus in the presence of a Prepayment Price Cap, discounts for prepayment customers who actively search will be lower than they otherwise would be.

The CMA's approach to profitability analysis remains flawed

27. The CMA's evaluation of the results of its own analysis of profitability is inconsistent and favours a finding of excess profitability. Without providing any justification, the CMA chooses to disregard the results of its own EBIT margins analysis which showed that profitability in the retail energy supply sector has been in line with a competitive level and instead places disproportionate weight on contrary evidence from its Return on Capital Employed ("ROCE") analysis.
28. The CMA's reliance on ROCE is despite the explanations repeatedly set out by the SLEFs – including RWE – for why it is not in principle a reliable measure and why the particular

²³ PDR, page 504, paragraph 7.261.

²⁴ RWE response to the CMA's Working Paper on Pricing Strategies, 2 March 2015; RWE response to the CMA's Updated Issues Statement, page 3, paragraph 17.1.

methodology adopted by the CMA tends to systematically and materially overstate profitability and, as a result, to conclude wrongly that the industry has earned excess profits.

29. Retail energy supply businesses are “asset-light”, in an accounting sense, which means that a significant proportion of the value of their economic capital employed exists in the form of unrecognised intangible assets. The CMA overstates ROCE because it systematically underestimates the economic value of these assets and adopts very restrictive criteria for the costs firms can legitimately recover, in spite of compelling evidence previously put forward by RWE and other parties that its approach is inappropriate. In particular, the CMA underestimates the value of firms’ notional capital, which they hold to mitigate the broad range of business risks they face. The CMA continues to refuse to acknowledge:
 - 29.1 that the SLEFs hold substantially larger amounts of capital than the mid-tier firms, meaning they operate with a significantly lower probability of default than those firms; and
 - 29.2 the risks borne by energy suppliers in relation to variability of costs and inability to pass through.
30. We consider that the CMA inappropriately places substantial weight on the business models of the mid-tier firms throughout its analysis. Other flaws in the CMA’s ROCE estimates include that it underestimates the value of firms’ customer bases and fails to recognise that firms should be allowed to recover the costs of repairing their legacy pension deficits.
31. Despite these significant flaws in the CMA’s ROCE analysis, which cause it to overstate the profitability of the industry as whole, it nevertheless finds that RWE [CONFIDENTIAL]. This adjustment substantially widens the gap that the CMA finds between some firms’ revenues and economic costs and compounds the one-sidedness of the CMA’s profitability analysis.
32. The CMA attempts to justify this step by claiming that a majority of the SLEFs (among which is RWE) has been economically inefficient²⁵. The CMA is therefore suggesting that some firms have earned revenues in excess of a competitive level, but have then squandered these potential economic rents through operational inefficiency. This hypothesis is not credible.
33. The CMA presents no objective or quantitative evidence to support its presumption of inefficiency, which appears to be based entirely on its observation that there is variation between the unit indirect costs of the SLEFs.
34. It is true that RWE (and, we understand, some other parties) has at various times during this Investigation accepted that it has higher unit indirect costs than some other retail energy supply firms. RWE continues to accept that is the case. However, the CMA’s presumption that this variation in unit costs reflects a lack of competition is incorrect and has no basis in economic theory. RWE’s higher indirect costs do not mean it is “inefficient” in a sense which is relevant for a competition investigation, nor do they imply that it is appropriate for the CMA to disallow our actual costs incurred in its “efficiency” calculations.
35. Rather, RWE’s internal papers which it has previously submitted to the CMA make clear that:
 - 35.1 Investments in new IT systems are²⁶ [CONFIDENTIAL]
 - 35.2 The payback of an investment in a major new IT system is realised through achieving lower unit indirect costs in the future, once the system is fully implemented;
 - 35.3 RWE’s decision to invest in a new IT system was – contrary to the CMA’s hypothesis – [CONFIDENTIAL]; and therefore

²⁵ PDR, page 172, paragraph 3.212.

²⁶ [CONFIDENTIAL]

- 35.4 Indirect costs are materially affected by where each company is in its [CONFIDENTIAL].
36. The evidence therefore shows that RWE has considered whether to make large IT investments on an entirely rational basis, [CONFIDENTIAL]. RWE submits that the CMA cannot legitimately adopt the view that RWE's higher unit indirect costs provide evidence of a lack of price competition or that it has not faced an economic incentive to become more cost efficient. Rather, its relative position reflects mainly that it made its large one-off investments in IT infrastructure later than some of its competitors and that the CMA's period of analysis covers the period prior to and during its implementation but does not capture the [CONFIDENTIAL].
37. In short, the flaws in the CMA's ROCE analysis cause it to pervasively and materially overstate ROCE and its efficiency adjustments are without basis in economic theory or evidence. After correcting the CMA's analysis for the important flaws we have outlined, a balanced interpretation of the full range of evidence on profitability would conclude that profitability (at least on the part of most of the industry – RWE is not able to judge whether the position is different for Centrica) is not excessive and that this cannot be a cause of consumer detriment.

Supporting documents:

[CONFIDENTIAL]

III. INDIVIDUAL REMEDIES

A. CFDs AEC

38. **The remedies package proposed to address the CfDs AEC and/or associated detriment is as follows: (a) a recommendation to DECC to undertake and consult on a clear and thorough impact assessment before awarding any CfD outside the CfD auction mechanism; (b) a recommendation to DECC to undertake and consult on a clear and thorough assessment of the appropriate allocation of technologies and CfD budgets between pots.**

Assessing the impacts of allocating CfD outside of the competitive auction process

- 38.1 As set out in previous submissions²⁷, RWE has concerns about the lack of transparency in the process to award a CfD outside of the auction mechanism and believes that this should only be permitted in very exceptional circumstances, when it can be evidenced that the benefits clearly outweigh the costs. Therefore RWE welcomes the proposed remedy to require consultation based upon a thorough impact assessment before contracts can be awarded. The requirement for a two stage consultation process (before negotiations based on broad industry data and again after negotiations with a party using site specific data) appears to be proportionate and should not create undue delay in the process. The requirement to set out incremental costs in terms of total cost (net present value), total annual cost and average impact on consumer bills also seems appropriate.

Allocation of technologies and budgets between pots for each auction

- 38.2 RWE welcomes the remedy to require clear assessment and consultation on the allocation of technologies and CfD budget between pots. However, if the remedy is to deliver the dual objectives of increasing transparency and improved decision making, DECC should be required to include within the impact assessment a comprehensive evaluation for any technology they intended to remove from the pots. For example, concerns have been raised by consumer groups about current plans to exclude onshore wind from future subsidies, with Citizens Advice calculating that it “could cost energy consumers at least £0.5 billion”²⁸ while DECC’s assessment to date of its plans to exclude onshore wind has focused only on the Renewables Obligation.

²⁷ RWE’s response to the Notice of Possible Remedies, response to remedy 2a, 5 August 2015.

²⁸ Citizens Advice full report is available [here](#). This research was supported with modelling work by NERA Economic Consulting.

B. LOCATIONAL PRICING AEC

39. **An order (the 'Locational Pricing Order') on National Grid (and amendments to National Grid's licence conditions) that would set out, among other things: (i) the formula to calculate the transmission loss factors (which ultimately feeds into the imbalance charges) for this purpose; (ii) an obligation on National Grid to create a load flow model; (iii) an obligation on National Grid to create a networking mapping statement and collect annually relevant network data; (iv) an obligation on National Grid to appoint third party agents to collect metered volumes data and to calculate annually the transmission loss factors pursuant to the principles set out in the order and using the models created, and information collected, pursuant to the order; (v) an obligation on National Grid to direct Elexon, as appropriate, to update the networking mapping statement and carry out other administrative tasks that are necessary to the calculation by the third party agents; and (vi) an obligation on National Grid to raise any consequential code modification.**

Proposals for the introduction of zonal transmission losses

- 39.1 RWE strongly supports the CMA's proposals for the implementation of locational adjustments for transmission losses. The allocation of losses has been the subject of much analysis and debate over a number of years. The last modification proposal (P229) aimed at implementing changes failed on grounds relating not to the anticipated competitive benefits of the proposals, but primarily due to secondary considerations unrelated to the proper functioning of the market. In this context we note Ofgem's evidence given in the CMA hearing on 31 March 2015, where it is stated that, "*Ofgem's previous decision not to accept the recommendation to account for losses should not be taken as indication of any future decision.*"²⁹ We consider that the case for the economic efficiency and competitive benefits of zonal losses has been made on a number of occasions during the last few years³⁰ and NERA has provided further evidence of the economic benefits that would arise.
- 39.2 RWE notes from Appendix 2.1 of the PDR that a number of parties consider that distributional impacts of the remedy should be taken into account in assessing proportionality.³¹ Such distributional effects among generators arise as a result of the current arrangements not taking into account costs that are incurred through transmission losses. RWE considers that the magnitude of such distributional effects among generators is an indication of the existing Adverse Effect on Competition (and of the cross-subsidisation that currently exists) and as such demonstrates the degree to which the existing arrangements are inappropriate. The fact that correcting a historically inefficient method for allocating losses may give rise to distributional effects among certain generators should not detract from the need to attribute losses in order to better reflect individual parties' impact on system costs and address the Adverse Effect on Competition that has been identified. Therefore, whilst we recognise that there may be a distributional impact on some generators, this is the inevitable consequence of addressing the historic cross-subsidisation that has taken place and of delivering an appropriate remedy to the AEC.
- 39.3 The provisional decision to allocate all losses to generators seems appropriate due to the fact that generators will generally be better able to respond to the locational signals arising from the allocation of losses. RWE understands from NERA's analysis that the benefits from a 100% allocation to generators are material and therefore agrees with the findings of the CMA on this matter. By contrast, the existing arrangements whereby suppliers are responsible for a share of total losses give rise to "embedded benefits" for some distribution connected generators as a result of their being able to reduce suppliers' losses. These benefits will be removed in the event of suppliers not being allocated locational losses, which will have a material impact on small and renewable embedded generators. Whilst RWE supports the proposed allocation of losses to generators as being proportionate (given the modelled economic benefits), this effect should be noted when the CMA makes its final

²⁹ https://assets.digital.cabinet-office.gov.uk/media/559cebb1e5274a155900001b/Summary_of_hearing_with_Ofgem_2.pdf

³⁰ RWE's response to the Notice of Possible Remedies, footnote 13, page 21.

³¹ PDR, Appendix 2.1, pages 2-3, paragraphs 9-11.

recommendations. Despite this, we consider the proposed allocation of losses to generators to be an effective and proportionate means of addressing the AEC identified by the CMA.

NERA analysis

- 39.4 The analysis provided by NERA is the latest of a number of reports that have found materially positive benefits arising from a more cost reflective treatment of transmission losses. As the report recognises, there are uncertainties meaning it is not possible to determine precise outcomes, but the conclusions are consistent with the simple but fundamental principle that a better allocation of costs will result in a more efficient outcome. As such, we do not consider that the use of approximations or assumptions undermines the main findings of the NERA analysis, which is that the proposed changes are beneficial overall. We note that the methodology was consulted on and, as far as we are aware, no party has taken up the CMA's invitation to provide alternative analyses. The CMA makes evidence-based decisions in reaching its conclusions and the available body of evidence, supported by the latest analysis by NERA, shows material economic benefits arising from a zonal losses scheme.³²
- 39.5 The approach of modelling seasonal loss factors is in line with the proposals under BSC Modification Proposal P229. This is an appropriate starting point for treating losses on a more cost reflective basis. RWE recognises that such an approach cannot perfectly reflect losses in each Settlement Period, but provides a better approximation than a flat allocation as is currently the case and this is evidenced by NERA's report as well as earlier analysis relating to zonal losses.

Implementation process

- 39.6 As has been pointed out on numerous occasions, the history of the various attempts to introduce locational transmission losses has been beset by delays and protracted debate, often not directly related to the economic merits of such an approach. It is therefore in the interests of an effective implementation for the CMA to require National Grid by means of an order to develop the proposals in a timely manner and RWE supports the aim of an implementation date of October 2017.
- 39.7 Once a locational losses scheme has been implemented in industry codes, there will be opportunities for modification proposals to be submitted aimed at improving the method by which the allocation of transmission losses is calculated. These will be assessed on their merits through normal code review processes and it is entirely plausible that the methodology will evolve over time. However, the potential for future developments in this area to fine tune the methodology should not be used as an excuse for delayed implementation of the proposals set out by the CMA. As demonstrated by the analysis provided by NERA as well as earlier assessments of P229, material benefits can be gained from a rapid implementation of a zonal losses scheme as described and we support the October 2017 implementation date.
- 39.8 RWE does not consider National Grid's outline of a potential market splitting approach to be a credible alternative at this stage and it is unlikely that any such change is capable of implementation in the short to mid-term. As is recognised by National Grid, the outlined process would need significant development before it could be implemented, which is likely to require at least as long as any previous change proposals in this area before possible implementation. It is also not clear whether the benefits of such a scheme would be comparable to those expected from a zonal losses scheme. Therefore, RWE does not consider that this alternative approach should delay the implementation of a zonal losses scheme as described.

³² PDR, Appendix 2.2, paragraph 5.

C. ELECTRICITY SETTLEMENT AEC

40. **A recommendation to DECC to consult on amending the provisions of the Smart Energy Code that prohibit suppliers from collecting consumption data with greater granularity than daily unless a customer has given explicit consent to do so.**

- 40.1 RWE supports the proposal to consult on amending the provisions of the Smart Energy Code that prohibits suppliers from collecting consumption data with greater granularity than daily unless a customer has given explicit consent to do so.
- 40.2 The current "opt in" requirement is a barrier to innovation and policy development including half-hourly settlement and demand side response. Without greater granularity of data, half-hourly settlement is not feasible. Furthermore, as the electricity market develops, greater data is essential to assist the transition from Distribution Network Operators to Distribution System Operators because with demand side response and greater take up of micro generation (e.g. solar panels, storage, heat pumps etc) Network Operators will require access to data to ensure security of supply.
- 40.3 RWE agrees with the CMA's finding in the PDR which states "*Further, the Smart Energy Code currently prohibits suppliers from collecting consumption data with greater than daily granularity unless a customer has given explicit consent to do so (opt-in). We believe that this opt-in clause effectively precludes mandatory half-hourly settlement (which by definition requires the use of all customer data for settlement, not just the data of those customers who have opted in) and is therefore a major barrier to the development of static and dynamic time-of-use tariffs.*"³³
- 40.4 RWE notes that the Smart Energy Code is not the only data obligation contributing to the existing restriction. Suppliers are ultimately bound by licence conditions that also restrict supplier access to half-hourly data without explicit consent from the customer. With this in mind, changes will be needed to the relevant licence conditions to enable suppliers to take the customer's half-hourly data for "regulatory" purposes. In paragraph 40.5 we set out the type of functions that should be included in the definition of regulatory purposes. RWE supports the proposal but would recommend the consultation covers all obligations impacting this issue, not just those in the Smart Energy Code.
- 40.5 The data consent review suggested by this proposal needs careful management to ensure the proposal is accepted by the wider public and does not hinder the Smart metering roll out. Data without explicit consent must be used for specific purposes only. To achieve the perceived benefits of half-hourly settlement, this should include other supplier functions besides settlement such as demand forecasting, hedging and product development.
- 40.6 It is also important to note that the data in question (the record of half-hourly electricity flow through the network into the meter) constitute the supplier's inventory. No interrogation of customer information is required to access this data and the current rules prohibit (other than opt-in) suppliers accessing the data about their own inventory.

³³ PDR, page 186, paragraph 4.16.

41. **A recommendation to Ofgem to: (i) conduct a full cost benefit analysis of the move to mandatory half-hourly settlement, including analysis of costs, benefits and distributional implications as well as mitigating measures; (ii) start the process of gathering evidence for the analysis as soon as practicable; (iii) consider the cost-effectiveness of alternative design options for half-hourly settlement such as a centralised entity responsible for data collection and aggregation; and (iv) consider options for reducing the costs of elective half-hourly settlement including (a) whether any of these options are likely to delay or accelerate the adoption of mandatory half-hourly settlement; and (b) any challenges that may arise or benefits that may accrue from the existence of two settlement systems, including in particular the possibility of gaming/cherry picking behaviour.**
- 41.1 First, RWE wishes to point out the change in our view of elective half-hourly settlement. In previous responses we noted we were in support of elective half-hourly settlement, however, having re-assessed the remedy we now feel elective half-hourly settlement would not be beneficial to the industry or customers. The reasons for this are explained more fully below.
- 41.2 RWE supports the proposal for Ofgem to conduct a full cost/benefit analysis of the move to half-hourly settlement. We welcome the recommendation that the analysis should also include elective half-hourly settlement although we feel that the analysis will demonstrate that elective half-hourly settlement would not be feasible. Ultimately, customers will bear the costs of implementing half-hourly settlement and RWE is concerned that customers who do not participate in elective half-hourly settlements will be burdened by the cost of enabling it. At a time of significant and costly industry change we do not believe it is appropriate or fair to load even further additional costs onto them.
- 41.3 The cost benefit analysis must also include the financial impact on customers. This should include the costs of industry wide system change as well as the perceived financial gains and should also include the financial impacts on those customers that, for various reasons, continue to be settled on a non-half-hourly basis. We suggest the analysis should also cover risks, issues, and unintended consequences; one such unintended consequence could see higher costs through Group Correction Factor for customers who have not elected for half-hourly settlement.
- 41.4 A further consideration for the cost benefit analysis should be the proposed harmonisation of the imbalance settlement period across Europe to 15 minutes. This potential reform creates uncertainty and risk at a level sufficient to create a barrier to half-hourly settlement. The cost benefit analysis should take account of this potential reform because moving towards 15 minute imbalance settlements will impact the design of Smart meters. The costs of changing the meters to be installed and those already installed along with other changes to processes and systems would be substantial, and would cost hundreds of millions of pounds. It is not efficient or cost effective to deliver both half-hourly settlement and a 15 minute imbalance settlement period.
- 41.5 Some parties have suggested there is merit in moving quickly to half-hourly settlement in order to minimise the costs of changing central systems and to reduce the time needed to run dual systems in parallel. RWE believes this does not take account of the potential disruption to suppliers', DECC's and Ofgem's change programmes. Whilst early migration to half-hourly settlement may reduce central parties' costs, it will cause considerable disruption to suppliers and to customers. There is no merit in moving towards half-hourly settlement quickly if in doing so, customers experience more disruption and inconvenience. Therefore, we would suggest timing of delivery should form part of the cost benefit analysis and be cognisant of other complex change going on within the industry.
- 41.6 RWE would also suggest the cost benefit analysis takes into account the likelihood of customers electing half-hourly settlement. We believe customers will incur higher costs for half-hourly settlement so customer research into half-hourly settlement will give a true indication of customer desire and perceived benefits.

42. **A recommendation to both DECC and Ofgem that they publish and consult on a plan setting out: (i) the aim of the reform for half-hourly settlement; (ii) a list of proposed regulatory interventions (including code changes, and the relevant entity in charge of designing and/or approving such interventions, that are necessary in order to implement the half-hourly settlement reform; (iii) an estimated timetable for the completion of each necessary intervention; and (iv) where appropriate, a list of relevant considerations that will be taken into account in designing each regulatory intervention.**
- 42.1 RWE supports the proposal for DECC and Ofgem to publish and consult on a plan setting out timescales and responsibilities relating to the introduction of half-hourly settlement and recommends that the move to mandatory half-hourly settlement take place only once the Smart rollout has been completed.
- 42.2 RWE supports the introduction of mandatory half-hourly settlement for profile classes 1–4 but believes that the plan for moving to half-hourly settlement, and the associated milestones timetable, must be pragmatic and deliverable across the market. In particular it will need to consider the scale of direct change that may be needed, as well as the capacity of customers to accept such change and of the market to deliver it.
- 42.3 The move to half-hourly settlement will impact the entire market including the customers it serves, and so, this is a change that should not be taken lightly. A process of careful planning and development therefore needs to be adopted before any large scale investment is made around half-hourly settlement whether elective or mandatory.
- 42.4 For universal half-hourly settlement to work effectively it requires the widespread deployment of meters capable of recording and storing half-hourly consumption data. Careful consideration should be given to both the timing of a move to mandatory half-hourly settlement and the approach undertaken to get there in order to optimise the substantial investment costs by industry parties, which will ultimately be borne by customers. For the avoidance of doubt we include Ofgem’s proposal on elective half-hourly settlements within that approach.
- 42.5 Ofgem has proposed that the development of a mandatory half-hourly settlement solution will happen at the same time as the move to faster reliable switching, the deployment of Smart metering and implementation of any CMA remedies.³⁴ These are all significant developments and will require investment and staff resource across the industry.
- 42.6 The additional costs and complexity, to an already busy change and transformation programme, will compromise the successful and timely delivery of all the programmes. We urge DECC and Ofgem to consider carefully the interaction of any changes for half-hourly settlement, both elective and mandatory, with the other major change programmes taking place at the same time.
- 42.7 If deployment is too hurried or takes place before there is the required customer demand there is a risk of compromising customer confidence in Smart metering. Furthermore if demand side products are forced on customers before they are ready to embrace them, either during the elective phase or through mandation, this could undermine customer enthusiasm to have a Smart meter fitted as they perceive their lack of capacity to manage their own demand leading to higher bills.
- 42.8 We urge DECC, Ofgem and the industry to learn from the experience of BSC Modification P272 (mandation of half-hourly settlement for profile classes 5-8) and ensure that the customer path to half-hourly settlement is fully supported by industry processes before introducing a deadline rather than after, so avoiding the risk of implementing changes in short order as witnessed with P272. For half-hourly settlement to be successful for

³⁴ Ofgem’s response to the Notice of Possible Remedies, page 5.

customers as well as the industry these changes need to be properly designed and delivered. This takes time but it is time which must be taken.

D. GAS SETTLEMENT AEC

43. A recommendation to Ofgem to ensure implementation of Project Nexus by 1 October 2016 through monitoring closely the progress made by the industry in meeting intermediate milestones and to take (where appropriate) further measures to achieve this objective.

- 43.1 RWE agrees with the proposed recommendation to Ofgem to ensure implementation of Project Nexus by 1 October 2016. We have for some time been concerned by the slow progress of Xoserve in delivering the central Nexus programme and the financial impact of this on suppliers and their customers. In RWE's response to the CMA Remedies Notice, RWE suggested that a licence condition should be placed on Gas Transporters to deliver Nexus by 1 October 2016 and that delivery should inter alia include central functionality considerations and the duties of the Gas Transporter in consultation with the industry. RWE also proposed that 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.³⁵
- 43.2 RWE welcomes the Uniform Network Code Panel's recent decision to recommend that Ofgem approves RWE's Uniform Network Code (UNC) Modification 550. RWE raised UNC Modification 550 to place a financial incentivisation mechanism on Gas Transporters to ensure delivery of Project Nexus on the revised date of 1 October 2016. We were unable to place such an incentive directly on Xoserve because they were neither a licensed entity nor a party to the UNC. We note that, in respect of the Industry Code Governance proposed remedies, the CMA has proposed that DECC initiate a legislative programme with a view to making the provision of code administration and delivery services activities that are licensed by Ofgem.³⁶ We further note that the CMA has recommended those licences should be subject to tender.³⁷ We would welcome clarification on the definition of delivery services but our assumption is that this would include Xoserve's delivery of gas settlements. It is our expectation that this will be too late to impact Project Nexus. However, RWE welcomes this move as we believe it will place greater incentives on delivery bodies to deliver similar programmes to time and specification in the future.
- 43.3 RWE does not agree with the CMA's suggestion that its modification proposal 550 was raised because certain Uniform Network Code parties, which have or may have incentives in postponing the implementation of Project Nexus (and the costs implied by it), may fail to take certain necessary steps and lobby Ofgem to obtain a further delay.³⁸ The rationale for this modification was not that relevant parties would intentionally seek to delay Project Nexus or were incentivised to do so, rather that they did not place sufficient pressure on Xoserve to deliver Project Nexus and so needed further incentive to do so.
- 43.4 RWE notes that, it is the CMA's opinion that, given recent developments, and in particular the establishment of a strong project governance under the supervision of Ofgem, the risk of Project Nexus not being delivered in a timely manner has significantly decreased.³⁹ In the light of the delays to Xoserve's User Acceptance Testing related to core and critical functions related to metering information and processes i.e. Revised Gas Metering Arrangements (RGMA), RWE does not agree with the CMA's assessment of risk. Recent discussions with Ofgem indicate that they too are extremely concerned. Ofgem has now intervened to attempt to get the central programme back on track to deliver the core Nexus programme on 1 October 2016. RWE remains hopeful that successful delivery will be met by Xoserve, by 1 October 2016 but Xoserve's performance to date suggests this may not be the case. Further, any attempt to implement an incomplete solution that does not meet industry needs will have a detrimental impact on suppliers and, inevitably, their customers. Therefore, Ofgem must also ensure that speed of delivery is not prioritised over quality of delivery.

³⁵ RWE's response to the Notice of Possible Remedies, page 118, paragraphs 1.1-1.3.

³⁶ PDR, page 728, paragraph 10.431.

³⁷ PDR, page 729, paragraph 10.436.

³⁸ PDR, page 245, paragraph 5.123.

³⁹ PDR, page 243, paragraph 5.117.

- 43.5 RWE is concerned that the CMA proposes that Ofgem should, *"if appropriate use its powers under section 28 of the GA86 to sanction gas shippers that neglect to take necessary steps (e.g. failing to set up necessary systems and carry out trials in line with the milestones)."*⁴⁰ This indicates a fundamental misunderstanding on the CMA's part in respect of the cause of delays to Project Nexus. For example, delays to Market Trials are a result of delays to Xoserve's User Acceptance Testing: shippers cannot trial processes that have not been adequately tested. As we have attempted to explain in the preceding paragraphs, responsibility for the delays to the Nexus programme sit with Xoserve in its role as the central delivery body.
44. **An order on gas suppliers (and amendments to gas suppliers' standard licence conditions) to submit all meter readings for non-daily metered supply points in GB to Xoserve as soon as they become available, and at least once per year, save for non-daily metered supply point with a smart or advanced meter, which must be submitted at least once per month.**
- 44.1 RWE believes that this remedy needs further consideration. Project Nexus will incorporate meter reading validation which will help to reduce erroneous meter reads. Project Nexus introduces four settlement product types, each with the concept of meter read frequency built into them. If this frequency of required reads is exceeded, then the Nexus system will not process them or utilise them in Settlement. Therefore, in order for this remedy to be effective Nexus needs to be designed so that it has the capacity to accept and process the number of meter reads suggested by the CMA – it is not clear at this stage of Nexus' development whether Nexus will be capable of this. RWE believes that meter read frequency targets should be set, monitored and maintained by a Gas Performance Assurance Framework and have advocated this approach in UNC workgroups.
- 44.2 Secondly, in order to avoid suppliers being compelled to submit meter readings that they know to be invalid to Nexus, we suggest that the CMA's proposed remedy be amended so that suppliers are only compelled to submit valid meter reads as defined by the UNC.
45. **A recommendation to Ofgem to: (i) take responsibility for the development and delivery of a performance assurance framework to increase accuracy of the gas settlement process as soon as reasonably practicable, and at the latest within one year of the CMA's final report; (ii) establish a project plan and allocate responsibility to Uniform Network Code parties to take actions for its implementation; (iii) supervise its implementation; and (iv) take appropriate steps to ensure that failure to meet targets under the performance assurance framework are sanctioned.**
- 45.1 RWE agrees with the proposed remedy. However, RWE notes that there is currently a Performance Assurance Workgroup ("PAW")⁴¹ under the Uniform Network Code which has already completed a considerable amount of work in this area. For example, the PAW has commissioned a study⁴² by an independent industry analyst to assess the areas of Gas Settlement that require performance measures to maintain settlement integrity. Accordingly, RWE considers that Ofgem should be compelled as part of the remedy to utilise and build upon the existing work of the PAW to avoid this work being wasted and to ensure that industry views are taken properly into account. It is also worth noting that the current Performance Assurance Framework is anticipated to go-live with Project Nexus Implementation.

⁴⁰ PDR, page 244, paragraph 5.118.

⁴¹ <http://www.gasgovernance.co.uk/PA>

⁴² <http://www.gasgovernance.co.uk/pa/IndRiskStudy>

E. PREPAYMENT AEC, RMR AEC AND DOMESTIC WEAK CUSTOMER RESPONSE AEC

46. Prepayment Price Cap Remedy

An order on gas and electricity suppliers (and amendments to suppliers' standard licence conditions) requiring suppliers to ensure that the annual bills paid by prepayment customers (assuming a pre-determined consumption level) do not exceed a specified benchmark reference level, for a period until the end of 2020.

Introduction

- 46.1 In broad terms, RWE agrees that there are certain supply-side constraints and higher costs to serve for prepayment customers that may have had an adverse effect on competition within the prepayment segment and/or given rise to a degree of consumer detriment. RWE considers also that the limited choice of tariffs available to prepayment customers is likely to have resulted in lower levels of engagement by prepayment customers.
- 46.2 However, RWE considers that the CMA has significantly overstated the scale of any detriment faced by prepayment customers. The benchmark used by the CMA to estimate the detriment – the “direct approach”, i.e. the weighted average prices paid by customers of First Utility and Ovo Energy – is inappropriate and suffers from several flaws. Most notably, it disregards the importance and effects of ‘waterbed’ pricing, the pricing strategy that is common across the Domestic retail supply markets. In doing so, the benchmark fails to take into account of the fact that First Utility and Ovo Energy are in a growth phase and, when compared to the Six Large Energy Firms, have a much higher proportion of newly acquired customers on discounted acquisition tariffs. RWE believes that, [CONFIDENTIAL], First Utility and Ovo Energy offer discounted acquisition tariffs in anticipation that at least a proportion of customers who benefit from those discounts subsequently transfer onto SVT. Since the firms are in a growth phase, the benchmark does not represent a sustainable average competitive price; it represents a snapshot of First Utility and Ovo Energy’s current pricing rather than pricing which would be sustainable over the longer term. The result of the CMA’s approach is that it significantly overstates the level of the detriment.
- 46.3 Through its advisers RWE has sought to gain a better understanding of the work that the CMA has done (and the work it has not done) in forming its conclusions as to the sustainability of First Utility and Ovo Energy’s pricing and the extent to which it has taken into account the possible implications for any competitive benchmark of the prevalence in the market of waterbed pricing and the extremely rapid growth of the benchmark companies. As of the date of this response, the CMA has confirmed that it has placed into the Post PDR Confidentiality Ring all relevant data and information considered by the CMA in its analysis of the sustainability of First Utility and Ovo Energy, and all data and information considered by the CMA in relation to this analysis. However, the CMA appears to have failed to obtain and consider the information and documents that RWE would have expected it to obtain and consider in order to ensure that its conclusions in relation to the suitability of First Utility and Ovo Energy as companies from which to construct the competitive benchmark are robust, and in order to ensure that appropriate adjustments have been made in the construction of the competitive benchmark. It does not seem to have obtained and considered documents relating to either company’s pricing strategy (and in particular whether this strategy may involve offering discounted acquisition prices and higher retention prices), growth plans (relevant to cycle in which these companies currently find themselves and the fact that this may mean the mix of customer and tariff types is inappropriate as a comparator) or future profitability. In short the CMA does not seem to have done the work that would be necessary in order for it to be able to rely on the competitive benchmark that it has suggested as a basis from which to calculate consumer detriment.
- 46.4 The CMA also significantly underestimates the extent to which the Prepayment AEC (and the Domestic Weak Customer Response AEC insofar as it applies to prepayment customers) will be addressed by the CMA’s package of other prepayment and engagement remedies. In RWE’s view, the package of other prepayment and engagement remedies will act to significantly increase competitive pressures within the prepayment segment within a very

short timetable, with many of the other remedies capable of taking effect immediately following the CMA's final report (and much sooner therefore than the Price Cap). The Prepayment Price Cap is therefore not necessary. In fact, as the CMA seems to accept, it will counteract the positive impacts of the other prepayment and engagement remedies, meaning that the package of remedies without the Prepayment Price Cap is more effective than the package of remedies including it.

- 46.5 The Prepayment Price Cap Remedy is onerous. In particular, it exposes suppliers to a significant risk of making a loss within the prepayment segment, but without the supplier being able to exit the segment (or even being able to choose not to take on new customers) unless the supplier exits the Domestic market entirely; the risk falls disproportionately on the SLEFs which account for the vast majority of prepayment customers. By contrast, the CMA's package of other prepayment and engagement remedies is more effective at quickly addressing the causes of any AECs affecting prepayment customers, yet the entire package is far less onerous than the Prepayment Price Cap Remedy. Moreover, if necessary, there are enhancements that could be made to the CMA's package of prepayment and engagement remedies that would improve its effectiveness (and avoid the adverse unintended consequences), such as implementing a variation on RWE's proposal to make optimal use of available tariff, and it would be still be less onerous than the Prepayment Price Cap Remedy.
- 46.6 Even if a remedy is required to address any residual detriment that might be faced by prepayment customers once the other prepayment and engagement remedies have been implemented, which we dispute, the Prepayment Price Cap Remedy is not the least onerous of the available alternatives. RWE's previous suggestion of requiring suppliers to make all products available to all payment types – which the CMA has summarily dismissed, incorrectly and without giving actual reasons – would be less onerous. Moreover, even if some form of price cap can be justified, which we strongly reject, the proposed remedy design is not the least onerous option. We explain below our very serious concerns with the design of the Price Cap and the distortions to competition it is likely to cause.
- 46.7 The Prepayment Price Cap also gives rise to significant adverse effects which are disproportionate to the aim pursued by the remedy. These are addressed at paragraphs 46.51-46.56.
- 46.8 In the case of an ordinary market investigation reference – and in the absence of any public interest intervention – the CMA is required to decide (only) whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition; and to take such action as it considers to be reasonable and practicable to remedy, mitigate or prevent the adverse effect on competition; and to remedy, mitigate or prevent any detrimental effects on customers resulting from the adverse effect on competition.⁴³ In other words, the CMA must ensure that all remedies it pursues are remedies which aim to eliminate or reduce identified adverse effects on competition or mitigate the detriment that results from those identified AECs.
- 46.9 Ofgem's statutory duties are wider, and it is important that the CMA does not simply adopt Ofgem's view of a well functioning market when it comes to identification of AECs and/or in its remedy design. For example in its State of the Market Assessment Framework Ofgem appeared to describe the features of a well-functioning market, but at the end included the following: "*Ofgem's view would also recognise that energy is an essential service, and that certain groups of consumers that are not able to engage in the market fully are not unduly disadvantaged*".⁴⁴ The CMA must be absolutely clear that the introduction of a price cap for prepayment customers is a remedy which addresses an identified AEC, and that it is not aimed at achieving any wider regulatory goal or indeed any other public interest issue. These are matters for Government.

⁴³ Sections 134 and 138 Enterprise Act 2002.

⁴⁴ Executive Summary, page 4.

The CMA's findings of AECs relating to prepayment customers and the scale of the detriment

Prepayment AEC and Domestic Weak Customer Response AEC applying to prepayment customers

- 46.10 The CMA provisionally finds that there are certain features of the market that give rise to an adverse effect on competition in the prepayment segment (the "Prepayment AEC"):
- 46.10.1 Supply-side constraints affecting customers on 'dumb' prepayment meters; specifically, the limitation on the number of tariffs that suppliers can offer due to the limited number of gas and electricity tariff slots. The CMA provisionally finds that these supply-side constraints have a significantly greater impact on smaller suppliers wishing to offer gas or dual fuel tariffs⁴⁵. The CMA considers that the removal of the four tariff rule would make it easier for a supplier to compete by having prepayment specific tariffs, but that the limitation on the number of tariff slots – together with SLC 22B.7 which requires any difference in charges between payment methods to be applied in the same way to all domestic customers (i.e. a supplier with regional pricing of credit tariffs must also price prepayment tariffs on a regional basis) – would continue to operate as a constraint⁴⁶.
- 46.10.2 Softened incentives for all suppliers, and in particular new entrants, to compete to acquire prepayment customers due to actual or perceived higher acquisition costs and the low prospect of successfully completing the switch of indebted customers. The CMA provisionally finds that there are higher costs to serve prepayment customers, relating *inter alia* to the administration of the Debt Assignment Protocol and costlier acquisition channels used to target prepayment customers, which the CMA considers have a greater impact on the incentives of the independent suppliers than the Six Large Energy Firms⁴⁷.
- 46.11 The CMA also provisionally finds that the Domestic Weak Customer Response AEC applies to prepayment customers. The CMA finds that prepayment customers overall are less engaged than direct debit customers (but not standard credit customers), particularly in terms of whether they have ever considered switching or are likely to consider switching in the next three years, and their awareness of their ability to switch⁴⁸. The CMA considers that this lower level of engagement may be explained by restrictions faced by prepayment customers on accessing and assessing information about switching and the demographic characteristics of prepayment customers⁴⁹.
- 46.12 In broad terms, RWE agrees that there are certain supply-side constraints and higher costs to serve prepayment customers that may have an adverse effect on competition and/or cause consumer detriment within the prepayment segment. RWE considers also that the Prepayment AEC identified by the CMA is likely to have resulted in lower levels of engagement by prepayment customers.
- 46.13 RWE considers that the main features having an adverse effect on competition in the prepayment segment are the technical limitation on the number of tariff slots and the RMR four tariff rule. We agree that the technical constraint is likely to have had an even greater impact on new entrants and may explain the lack of entry by the smaller suppliers into the prepayment segment.
- 46.14 We consider however that the CMA continues to underestimate the extent to which this technical constraint accounts for the differences in competition in the prepayment and credit

⁴⁵ PDR, pages 132-133, paragraphs 3.71-3.73 and Addendum to provisional findings, page 3, paragraph 7.

⁴⁶ PDR, page 133, paragraph 3.72.

⁴⁷ PDR, page 134, paragraph 3.74.

⁴⁸ PDR, page 143, paragraph 3.109.

⁴⁹ PDR, pages 143-144, paragraph 3.110.

meter segments, i.e. the extent to which it accounts for the lack of discounted fixed term acquisition tariffs available to prepayment customers. As the CMA is aware, upon the introduction of SLC 25A (non-discrimination – now lapsed), across the credit segments there was a significant move towards using discounted fixed term acquisition tariffs to acquire and retain customers (RWE introduced around 50 electricity tariffs during 2015 – taking into account both unrestricted and E7 variants but not including regional variants). However, within the technical limitations of the dumb prepayment meter infrastructure, it is simply not practicable for suppliers to offer fixed term tariffs to prepayment customers as they do to credit meter customers. The CMA seems to acknowledge this in reaching its provisional finding of a Prepayment AEC, but the significance of this constraint is not properly reflected in the CMA’s proposed package of prepayment remedies.

- 46.15 RWE agrees also that there are higher costs to serve prepayment customers and any supplier wishing to target its tariffs at prepayment customers would be subject to the costlier acquisition channels associated with this. We note also that the CMA has not explored why it is necessary to use costlier channels to target prepayment customers; in our view, this is because thus far the lack of offers available to prepayment customers has meant there is less financial incentive for prepayment customers to explore offers available on the market via PCWs. We consider that the actual or perceived higher acquisition costs are addressed by the CMA’s proposed remedies relating to the Debt Assignment Protocol and the RMR changes and other remedies that will stimulate price competition, attracting customers to PCWs and allowing PCWs to drive competition.
- 46.16 As regards the level of engagement by prepayment customers, given the limited tariffs available to prepayment customers resulting from the technical constraints and RMR rules, it would not be surprising if prepayment customers were less engaged than direct debit customers. However, we remain concerned that the CMA places too great an emphasis on inter-supplier switching as an indicator of engagement (see further Section II above). Additionally, the CMA has not properly investigated the *causes* of any disengagement. The CMA assumes that this can be explained by a lack of information and the demographic characteristics of prepayment customers, but does not properly take into account the extent to which disengagement might be caused by the Prepayment AEC itself, i.e. by the lack of offers available to prepayment customers. We would expect engagement by prepayment customers to increase significantly once the technical and RMR constraints are removed, allowing suppliers and PCWs to compete more effectively for prepayment customers. Our own experience is that when we have recently offered discounted prepayment tariffs, [CONFIDENTIAL].⁵⁰

Extent of the detriment faced by prepayment customers

- 46.17 The CMA’s assessment of the detriment faced by prepayment customers focuses on “excessive prices”⁵¹. The CMA assesses the extent to which Domestic customers face excessive prices through its “direct approach”, which involves comparing average bills between the Six Large Energy Firms and two of the Mid-tier Suppliers, Ovo Energy and First Utility, using the latter as the competitive benchmark; and its “indirect approach” which involves assessing suppliers’ profitability and cost efficiency⁵². Of these two approaches, the CMA largely disregards the results of the indirect approach which (notwithstanding its own significant flaws) shows lower detriment than the direct approach⁵³.
- 46.18 In respect of prepayment prices, the CMA finds that *“we note that for dual fuel and single fuel electricity, the difference between the benchmark and what customers pay is biggest for customers on prepayment meters (15% for dual fuel and 13% for single fuel electricity), followed by standard credit customers (11% for both dual fuel and single fuel electricity), and then direct debit customers (10% for dual fuel and 9% for single fuel electricity). For*

⁵⁰ In the period January 2015 to March 2016, when we have offered only a prepayment SVT, [CONFIDENTIAL] in Q1 2015 we offered a prepayment fixed term contract at an average 4% discount to SVT, [CONFIDENTIAL] from September to November 2015 we offered a prepayment fixed term contract at an average 8% discount to SVT, [CONFIDENTIAL].

⁵¹ PDR, page 157, paragraph 3.154.

⁵² PDR, page 157, paragraph 3.155.

⁵³ PDR, page 177, paragraph 3.266.

*single fuel gas, the difference between payment methods is somewhat smaller than in the case of dual fuel and single fuel electricity (18% for direct debit; 17% for prepayment and 16% for standard credit)."*⁵⁴

- 46.19 RWE considers that the CMA has significantly overstated the scale of any detriment faced by prepayment customers.
- 46.20 The direct approach suffers from significant flaws. In particular:
- 46.20.1 RWE submits that when calculating the overall detriment from the current pricing structure the CMA overstates the detriment enormously because it ignores the discounts offered to customers on non-standard products. As RWE has previously explained repeatedly, energy suppliers discount their acquisition tariffs (fixed term tariffs) to win customers in the anticipation that at least some of those customers will remain with them after the end of their introductory discounted period.
 - 46.20.2 This 'waterbed' critique affects the CMA's detriment calculation (which is based primarily on a comparison of prices for direct debit dual-fuel customers) – and which sets the (according to the CMA disastrous⁵⁵) backdrop for the CMA's remedies analysis. While RWE accepts that the extent of discounting on acquisition for prepayment customers is limited currently by the barriers the CMA identifies, RWE submits that such waterbed effects are nonetheless to be expected and therefore highly relevant to an assessment of whether the Prepayment Price Cap Remedy is a part of a proportionate remedies package. The reason is simply that, once the CMA has introduced the other elements of its remedies package, RWE believes there will be a market to attract prepayment customers and that market is likely to involve discounting to acquire prepayment customers.
 - 46.20.3 In terms of the CMA's actual detriment calculation, the CMA's inexplicable failure to appreciate the basic feature of the industry pricing model – which so very clearly involves offering discounts to acquire customers which are not sustainable without at least some customers subsequently transferring onto standard tariffs – means that its price benchmark is inappropriate. In particular:
 - 46.20.3.1 First Utility and Ovo Energy are in a different position to the SLEFs – they are in a growth-phase, i.e. a period where they are dramatically increasing their customer numbers (at the expense of the SLEFs);
 - 46.20.3.2 The consequence is that the CMA benchmark – the weighted average price paid by customers of First Utility and Ovo Energy – is an average price which is distorted by the over-influence of the current large number of discounts offered by First Utility and Ovo Energy. RWE submits that these discounts are offered in the anticipation of future growth of their customer base (both in general and on standard variable tariffs in particular).
 - 46.20.4 RWE notes that the CMA's failure to accept that there are 'waterbed' effects and so its failure to allow for such effects in its various methodologies is in spite of the fact that RWE has repeatedly provided the CMA with very clear evidence that there is a waterbed effect at work in its own pricing. The CMA's position – the CMA appears in at least one place to accept a waterbed in principle but then suggests there is no evidence of it – is entirely untenable. There is clear

⁵⁴ PDR, page 164, paragraph 3.183.

⁵⁵ See e.g. PDR, page 13, paragraph 59 where the CMA estimates the detriment "to be about £1.7 billion a year on average over 2012 to 2015...reaching almost £2.5 billion in 2015".

evidence of a waterbed effect for at least RWE.⁵⁶ For convenience, we include in Annex 1 to this response a summary illustration of evidence previously provided by RWE which shows that the [CONFIDENTIAL]. RWE submits that the CMA cannot legitimately continue to ignore RWE's evidence that waterbed effects are important for a proper competition analysis of pricing in this industry.

- 46.20.5 The implication of waterbed pricing is that the CMA is using an inappropriate price benchmark so that its detriment calculation is significantly overstated:
- 46.20.5.1 When calculating the competitive benchmark the CMA uses a weighted average price for First Utility and Ovo Energy whose customer bases are much more heavily weighted towards customers who are newly arrived and so benefitting from short-term discounts (in expectation of profits once some proportion of those customers move onto higher priced standard products);
- 46.20.5.2 The SLEFs in general (and RWE in particular) have a different mix of customers and so the CMA inevitably finds that their average prices (across customers on acquisition and standard products) are higher than its competitive benchmark (which is constructed using the fast growing First Utility and Ovo Energy weighted average prices);
- 46.20.5.3 In order to ensure a like-for-like comparison, the CMA should at least make the comparison across SLEFs and its benchmark companies (First Utility and Ovo Energy) holding the mix of customer types the same.
- 46.20.6 The CMA suggests that First Utility and Ovo Energy are sustainable at its calculated benchmark prices⁵⁷. RWE is surprised that this could be the case and notes that the CMA accepts that Ovo Energy currently makes a loss while it finds that First Utility currently does not⁵⁸. In respect of that evidence, RWE notes that First Utility's and Ovo Energy's costs will inevitably appear artificially lower than the SLEFs' in the CMA's data because of their artificially reduced policy costs – a situation which will not survive into the future given their growth.
- 46.20.7 More generally, RWE submits that the CMA has not provided anything like a proper analysis of the likely future profitability of First Utility or Ovo Energy before concluding their current prices are sustainable. And furthermore the CMA has not considered how their average prices would evolve longer-term as they gradually convert customers acquired at significant discounts to be profitable customers on their standard tariffs. We understand from the CMA that it has not at this stage even considered whether First Utility and/or Ovo Energy use a waterbed pricing strategy, yet we note that the fact that both First Utility and Ovo Energy discount to acquire customers can be observed by comparing their fixed price and standard products using publicly available data.
- 46.20.8 Neither has the CMA properly considered:
- 46.20.8.1 The appropriate treatment of exogenous costs such as obligation costs and payment type differentials – see further our detailed submissions in paragraphs 46.69-46.70 and 46.71-46.105;

⁵⁶ RWE believes it would be very odd if there weren't also a waterbed effect for other suppliers – since it would contradict the clear incentives at play - but obviously RWE does not have access to the documentary and other evidence that the CMA has on other suppliers pricing strategies.

⁵⁷ PDR, pages 167 and 168, paragraphs 3.193 and 3.196.

⁵⁸ PDR, pages 167 and 168, paragraphs 3.193 and 3.195.

- 46.20.8.2 The fact that the products included in its analysis are different. For example, First Utility and Ovo Energy tend to offer shorter duration fixed price products on discount;
- 46.20.8.3 The impact of the fact that RWE believes that First Utility and Ovo Energy use a shorter-term hedging strategy. Such a short hedging strategy is of course highly profitable in a period where wholesale costs have fallen. However, RWE notes that the CMA needs to consider much more seriously the fact that the out-turn profitability numbers might look very different in a rising market.
- 46.21 The CMA's "indirect" estimate of detriment, based on its analysis of the profitability and cost efficiency of the Six Large Energy Firms, relates to the domestic segment as a whole⁵⁹. The CMA is not able to use this methodology separately to calculate any detriment suffered only by prepayment customers. RWE also considers that the CMA's indirect approach significantly overstates the level of detriment – see further Section II above.
- 46.22 However, RWE agrees that, when properly performed and interpreted, profitability analysis may provide evidence about whether or not the economic returns in a market are in line with a competitive benchmark and, therefore, whether or not prices paid by consumers are in excess of a "competitive" level. RWE notes that there are well-established frameworks for the analysis of economic profitability and there is precedent from previous CMA investigations for the use of several approaches to examining profitability. By contrast, for the reasons set out above, RWE does not consider that the CMA's "direct" approach can provide any robust or reliable evidence for any detriment that may have arisen to customers in the UK retail energy market as whole, or for any particular group of customers.

Proportionality of the Prepayment Price Cap Remedy

- 46.23 The CMA provisionally considers that the proposed remedies set out in sections 5 and 6 of its PDR will be effective in addressing the features contributing to each of the Domestic Weak Customer Response AEC and the Prepayment AEC⁶⁰. However, it is concerned that the remedies will take time to implement. Therefore the CMA considers whether there is "the need" to intervene to address domestic customer detriment directly in the transitional period and concludes that the Prepayment Price Cap Remedy would be effective in meeting this need/achieving this aim⁶¹.
- 46.24 In considering the need to address interim detriment, the CMA's Guidelines for Market Investigations state: "The clear preference of the CMA is to deal comprehensively with the cause of causes of the AECs wherever possible, and by this means significantly increase competitive pressures in a market within a reasonable period of time"⁶². Wherever possible, a package of remedies should therefore address the root cause of any AEC, i.e. the technical and regulatory constraints, the weaker incentives on suppliers to compete for prepayment customers and any lack of engagement by prepayment customers.
- 46.25 The CMA accepts that the price cap does not address the cause of any AEC – either in terms of the Prepayment AEC or any broader Domestic Weak Customer Response AEC applying to prepayment customers. In fact, as the CMA seems to accept, a price cap directly counteracts the other remedies aimed at encouraging customers to engage and suppliers to compete (see further below).
- 46.26 Thus the questions the CMA sets itself in its guidance are whether (i) the proposed remedies package (absent the cap) will act to "significantly increase competitive pressures in a market", and (ii) whether it will do so "within a reasonable period of time"⁶³. In this case, the CMA has concluded that the package of prepayment and engagement remedies, absent

⁵⁹ PDR, page 4, paragraph 3.155.

⁶⁰ PDR, page 487, paragraph 7.188.

⁶¹ PDR, page 487, paragraphs 7.188 and 7.189.

⁶² Competition Guidelines for Market Investigations, page 70, paragraph 330.

⁶³ Competition Guidelines for Market Investigations, page 70, paragraph 330.

the Prepayment Price Cap Remedy, will be fully effective by the end of 2020 because of the completion of the roll-out of smart meters, but that this package “may not fully address the detriment arising from the Prepayment AEC” until then⁶⁴.

- 46.27 In fact, the CMA has not properly considered whether its package of prepayment and engagement remedies absent the price cap will act to “significantly increase competitive pressure” in the prepayment segment, but considers only whether it will “fully address the detriment”⁶⁵. RWE submits that the package will significantly increase competitive pressure, and indeed that many of the remedies can be implemented sooner than the price cap could. RWE considers therefore that the package of prepayment and engagement remedies can significantly reduce any detriment faced by prepayment customers within a very short timescale.
- 46.28 Even if this were not the case, RWE submits that three years and nine months for the complete effectiveness of a remedies package clearly meets the “reasonable period of time”⁶⁶ standard the CMA sets (the CMA believes the price cap would be in force from April 2017) and would not be out of line with the CMA’s previous practice (and indeed in some market investigations the timeframe for full effectiveness of the package of remedies has been quite significantly longer than this).
- 46.29 Furthermore, even if the package of prepayment and engagement remedies (absent the price cap) is not fully effective until the end of 2020, it will clearly have some positive impact on the prepayment segment in the meantime. The CMA has failed to make any attempt to assess what that impact might be and how much these other remedies will reduce the prepayment customer detriment. In order to justify an interim remedy as intrusive as a price cap, it is essential that the CMA estimates the residual detriment once its other prepayment and engagement remedies have started to take effect. In fact we consider that any residual detriment will be small and, to the extent that any interim remedy is required at all, there are options much less onerous than the Prepayment Price Cap Remedy that could address the detriment in the meantime.
- 46.30 On a related point, the CMA accepts that the detriment the Prepayment Price Cap seeks to address will have gone away by the end of 2020. Since the CMA also accepts that there are disadvantages of a Prepayment Price Cap, it cannot possibly be proportionate to keep the cap as the end of 2020 approaches. Another significant question the CMA has not yet addressed is when, during the period between April 2017 and end of 2020, the forward looking benefits that the CMA claims derive from the Prepayment Price Cap stop outweighing the forward looking disadvantages of the Prepayment Price Cap. It is essential that the CMA considers this issue at this stage in order to consider the duration (if any) for which the Prepayment Price Cap can be justified. Given that any detriment will reduce progressively over the duration of the Prepayment Price Cap Remedy, the CMA should also incorporate into the remedy a ‘glide path’ allowing for the gradual withdrawal of the Price Cap. (The CMA does refer to a glide path but without making clear what is meant by this.)
- 46.31 Additionally, in order to comply with the EU Energy Directives we consider it is necessary for the CMA to build into the Prepayment Price Cap Remedy a regular review process, reviewing not only the level of the Price Cap but also the ongoing need for the Price Cap Remedy; the *Federutility* case referred to by the CMA makes clear that under Article 3(2) of the EU Energy Directives, the need for a price cap needs to be re-examined “at close intervals”. In this regard, we do not consider that the mid-term review proposed by the CMA is sufficient, providing for a review in January 2019 and possible early termination of the Prepayment Price Cap Remedy “In the event that the roll-out of SMETS 2 smart meters is materially ahead of schedule”⁶⁷. In our view, an annual review is required, which considers more generally whether the Price Cap continues to be justified, i.e. whether it continues to meet the test applied by the CMA in the PDR.

⁶⁴ PDR, page 437, paragraph 7.9.

⁶⁵ Competition Guidelines for Market Investigations, page 70, paragraph 330 and PDR, page 487, paragraphs 7.188 and 7.189.

⁶⁶ Competition Guidelines for Market Investigation, page 70, paragraph 330.

⁶⁷ PDR, pages 484 and 485, paragraph 4.180.

The Prepayment Price Cap Remedy is not an effective remedy

- 46.32 The CMA considers the Prepayment Price Cap Remedy to be 'effective' because it reduces bills of prepayment customers⁶⁸, i.e. the price cap has a narrow aim of reducing the detriment faced by prepayment customers (the CMA considers that the reductions will be smaller than the 'detriment' calculated by the CMA).
- 46.33 As explained above, RWE considers that the CMA has grossly overstated the extent of the aggregate consumer detriment by (at least):
- 46.33.1 Not properly weighing the clear evidence in front of it that there is a waterbed effect relating to SVT and acquisition prices. RWE's supply business made losses of £99 million in 2015 so it cannot, in reality, be systematically causing consumer detriment through high prices.
- 46.33.2 Not properly accounting for the effects of its other prepayment and engagement remedies in reducing consumer detriment.
- 46.34 Moreover, the CMA itself does not consider that the Prepayment Price Cap Remedy will actually be effective in reducing the detriment:
- 46.34.1 The price cap will not be in place before April 2017⁶⁹. In considering this date, the CMA does not allow for any appeals process – which it should undoubtedly expect given the highly intrusive nature of such a remedy.
- 46.34.2 The CMA accepts that there are trade-offs in designing a price cap and also accepts the principle of the need for headroom in the Prepayment Price Cap so that it will not be effective in addressing the detriment the CMA identifies.
- 46.35 In fact, as the CMA seems to accept, a price cap directly counteracts the other remedies aimed at encouraging customers to engage and suppliers to compete, meaning that the package of remedies including the Prepayment Price Cap Remedy is likely to be less effective than one without a price cap⁷⁰. The Price Cap would also undermine competition between suppliers on wholesale costs, and the interaction between wholesale costs and the annual recalculation of the Price Cap may further dampen competition in the prepayment segment. We explore these issues further below in our comments on unintended consequences.
- 46.36 The Prepayment Price Cap Remedy will require significant ongoing monitoring and/or enforcement by Ofgem. For example, Ofgem will need to determine the updated level of the Price Cap; and CMA envisages that suppliers will be required to provide information to Ofgem, and might be required to provide a rebate. In fact, owing to the significant flaws in the remedy design, we consider that the CMA materially underestimates the ongoing work that will be required of Ofgem to update the level of the Price Cap – see further our comments in paragraphs 46.57-46.141.

The Prepayment Price Cap Remedy is more onerous than required

- 46.37 RWE submits that it is not necessary to introduce a remedy aimed at mitigating interim consumer detriment, when the broader package of competition enhancing remedies is an effective package and directly addresses the features of the market giving rise to any Prepayment AEC and the broader Domestic Weak Customer Response AEC in a timely manner, i.e. the other remedies go to the cause of any AECs and can be implemented quickly. The other remedies, as an entire package, are also far less onerous than the Prepayment Price Cap Remedy.

⁶⁸ PDR, page 487, paragraphs 7.188 and 7.189.

⁶⁹ PDR, page 488, paragraph 7.194.

⁷⁰ PDR, pages 499 and 500, paragraphs 7.238 to 7.243.

- 46.38 We explain above and in our response to the CMA's Addendum to Provisional Findings that we consider the key feature of the prepayment segment giving rise to the Prepayment AEC is the technical constraints on the dumb prepayment infrastructure. We consider that this feature will be largely addressed by the combination of the CMA's remedies aimed at making better use of the available gas tariff codes and the relaxation of SLC 22B.7 so as to allow for regional pricing of prepayment tariffs. To the extent that these changes do not fully address the technical constraints, RWE's alternative solution (see below) would be effective.
- 46.39 This, combined with the removal of the RMR simpler choices rules, will remove the technical and regulatory constraint on the products suppliers may make available to prepayment customers. Currently the four tariff rule has a particular impact on the prepayment segment, given that it discourages suppliers from targeting offers at niche customer segments. The removal of this rule will mean that suppliers can appropriately prioritise tariffs targeted at niche segments such as the prepayment segment. Similarly, the ban on almost all cash discounts prevents suppliers offering prepayment customers discounts such as cashback, which could otherwise provide a means of competing more effectively even within the existing technical constraints. The removal of these rules will therefore have a particularly beneficial impact on the prepayment segment.
- 46.40 The CMA's proposal relating to the DAP will also remove a possible barrier to switching for prepayment customers. As noted in our response to the DAP remedy, we do not consider that the limit of £500 on the debt that can be transferred under the DAP should be increased, as an increase could lead to this operating as a barrier particularly to new entrants to the prepayment segment. We comment above that the need to use costlier acquisition channels to target prepayment customers results from the lack of offers available to prepayment customers meaning there is less financial incentive for prepayment customers to explore offers available on the market via PCW. We consider therefore that the actual or perceived higher acquisition costs are addressed by the CMA's proposed remedies relating to the Debt Assignment Protocol (which must be mandated for all suppliers without exception) and the RMR changes and other remedies aimed at allowing PCWs to drive competition. To the extent that there may remain higher costs to serve prepayment customers relative to direct debit customers, we do not consider that these will constrain competition for prepayment customers, but rather these will (justifiably) need to be taken into account in the tariffs offered to prepayment customers.
- 46.41 The competition enhancing remedies can be expected to take effect more quickly than estimated by the CMA and/or implementation of certain of these remedies could be brought forward.
- 46.42 The CMA believes (in RWE's view, optimistically) that the Price Cap would be in force from April 2017⁷¹. Certain of the other competition enhancing remedies can take effect without delay following publication of the CMA's final report and stand to have an immediate impact in reducing any detriment (or in any case before the Price Cap is due to come into force). To the extent that the following remedies require changes to Standard Licence Conditions, and in order that suppliers may rely on the relaxation of the rules immediately following the CMA's final report, RWE would be content for Ofgem to put out guidance stating that it will not enforce against breaches of these SLCs prior to their repeal:
- 46.42.1 Freeing up of tariff slots (a program of efficient slot allocation has already been initiated on a voluntary basis);
 - 46.42.2 Repeal of the RMR simpler choices rules including the four tariff rule, which will allow for innovation in product offerings and more innovative pricing (e.g. cashbacks);
 - 46.42.3 Relaxation of SLC 22B.7 so as to permit grouping of regional costs in the pricing of prepayment tariffs, which will lessen the impact of the technical constraints on tariff slots;

⁷¹ PDR, page 488, paragraph 7.194.

- 46.42.4 Allowing PCWs the ability to negotiate exclusive deals with suppliers, which will increase PCWs' commercial incentives to negotiate *inter alia* exclusive prepayment tariffs and thereby to drive competition in the prepayment segment;
 - 46.42.5 Removal of the Confidence Code requirement on PCWs to show whole market view, which could take effect simultaneously with permitting PCWs to negotiate exclusive deals with suppliers;
 - 46.42.6 PCWs having access to Midata. In principle this could take place by the end of 2016 although we note that the CMA suggests some slippage.
- 46.43 Even if an interim remedy were to be justified to address any "residual" detriment that may subsist until the package of prepayment and engagement remedies has bedded in (and/or until the rollout of Smart meters is substantially complete), that remedy would need to be proportionate to the level of the residual detriment, which the CMA has not sought to assess. We set out below the alternative remedies that we consider could reduce any residual AEC/detriment which would be less onerous than the Prepayment Price Cap.

It is not the least onerous out of the alternatives that would be effective

- 46.44 To the extent that the CMA has any doubts as to the effectiveness of its remedy in relation to the 'liberation' of tariff slots which drives it towards the need for an additional protection for prepayment customers in the form of a Prepayment Price Cap Remedy, the CMA could improve this remedy by following the common slots suggestion previously made by RWE. This will enable suppliers to offer a huge number of additional prepayment tariffs, many more than would be available under the CMA's remedy design. The additional access should expand choice and competition significantly and allow the prepayment segment to work in the same way that acquisition tariffs generally work, removing the need for additional protection. We have included in our response to the tariff slots proposed remedy a modified version of our common slots suggestion to show how effective this could be as a solution to the technical constraints identified by the CMA.
- 46.45 But even if the CMA has residual concerns and still considers it necessary to create an additional constraint on actual prepayment price levels, a less onerous way of doing this would be using RWE's previous suggestion of requiring suppliers with 50,000 or more customers to make all products available to all payment types combined with RWE's remedy to make optimal use of liberated tariff slots (with the regulatory regime continuing to require cost reflectivity across payment types). This would ensure that there is a (cost reflective) prepayment variant of all new non-standard tariffs and would not produce any of the adverse consequences that would result from the Price Cap.
- 46.46 The CMA summarily dismisses the proposals by RWE and Ovo Energy around cost reflectivity by reference to concerns as to the effects of the introduction of the non-discrimination requirement contained in SLC 25A (as was): "*We expect therefore that, in the case of the PPM Price Cap Remedy, preventing discrimination in prices paid by prepayment and non-prepayment customers would result in an increase in prices paid by non-prepayment customers and reduce the scope for suppliers to target particular tariffs at one segment or another.*"⁷² We do not agree with this. The two situations are not comparable.
- 46.46.1 First, there is already intense competition between suppliers (both SLEFs and smaller suppliers) in relation to non-standard fixed term acquisition tariffs, and this will only increase once the CMA's package of Domestic remedies is implemented. Suppliers will not be able simply to increase pricing across all acquisition tariffs in order to circumvent a remedy directed at the (smaller) prepayment segment. Indeed, the remedy would have the potential advantage of leveraging the intense competition for non-standard products into the prepayment segment.

⁷² PDR, pages 451 and 452, paragraph 7.65.

- 46.46.2 Second, the CMA's other prepayment and engagement remedies will simultaneously result in a significant increase in competition in the prepayment segment itself, meaning that suppliers will need to ensure their prepayment tariffs are competitive. We would expect the price differential between prepayment and other credit tariffs to reduce even absent this proposed alternative remedy.
- 46.47 Even if some form of price cap can be justified, the proposed remedy design is not the least onerous option and will have a disproportionate impact on larger suppliers. A Prepayment Price Cap is a particularly onerous remedy, when its design does not guarantee that a supplier will recover its costs. If there are any errors in the calculation of the Price Cap, or if costs increase during period of the Price Cap, a supplier could make a loss in supplying prepayment customers. The 'headroom' included within the Price Cap design is explicitly stated to allow for competition on pricing and not to allow for errors in the calculation of a price cap, or indeed for the possibility of cost increases. It is relevant in this context that a supplier cannot exit the prepayment segment without exiting the whole market (a point that the CMA acknowledges elsewhere in its analysis⁷³): any supplier with more than 50,000 customers is required under SLC 27.1 to offer all payment types and cannot refuse to accept new prepayment customers. Moreover, the SLEFs, for historic reasons and as a result of the lack of entry into this market segment (arguably as a result of the regulatory regime relating to RMR and the allocation and administration of tariff slots) account for the vast majority of prepayment customers, and so to the extent that the price cap could cause suppliers to incur losses on prepayment customers, this burden would fall disproportionately on the SLEFs.
- 46.48 The CMA must consider the requirements of Article 3(2) of the EU Energy Directives in relation to non-discrimination. This means not only considering whether a measure might be discriminatory on its face, but also whether it would be discriminatory in practice. In the current context the CMA must have regard to the fact that suppliers below the 50,000 customer threshold would be able in the face of a price cap that required it to make losses on prepayment customers to pull out of the prepayment segment, whereas this option would not be available to others. Similarly, the CMA must have regard to the distribution of prepayment customers in considering whether the SLEFs are subjected to a risk by virtue of the imposition of the Prepayment Price Cap that other suppliers are not subject to.
- 46.49 Indeed, RWE would argue that even if a supplier is inefficient and as a result it cannot recover its costs, that supplier should be able to exit the prepayment segment, whereas under the SLCs the supplier cannot do so unless it is prepared to exit the domestic retail supply market entirely. RWE submits that the CMA should require that Ofgem amend SLC 27.1 such that, at least when faced with the risk of making a loss, a supplier can choose not to offer prepayment terms. Additionally or alternatively, the CMA should require that Ofgem remove the exemption under SLC 27.2 that allows a supplier with less than 50,000 customers to choose not to offer all payment types. RWE would note however that the latter amendment would not address the issue of a supplier potentially being forced to make a loss on prepayment tariffs, nor would this address the issue that the burden of the Prepayment Price Cap Remedy falls disproportionately on the Six Large Energy Suppliers.
- 46.50 The design of the Prepayment Price Cap Remedy also gives rise to significant cost risks for suppliers:
- 46.50.1 Our initial high level calculations for 2017 (which naturally are based on numerous assumptions, not least as to the level of the Price Cap) indicate that [CONFIDENTIAL]. This is before even taking into account any unexpected increases to wholesale and other costs during the period of each Price Cap.
- 46.50.2 As regards wholesale energy costs, RWE estimates a 1 in 20 probability of a c. [CONFIDENTIAL] increase [CONFIDENTIAL] in wholesale costs at typical consumption levels over the course of the Price Cap year. We set out below in

our comments on adverse consequences the impact we would expect the Prepayment Price Cap Remedy to have on the wholesale markets.

- 46.50.3 As regards other costs, RWE estimates a 1 in 20 probability of a c. [CONFIDENTIAL] over the course of the Price Cap year. RWE's calculations are in relation to wholesale and other costs are set out in the two attached spreadsheets entitled "CMA – Shaping Costs – Confidential and legally privileged no macro summary" and "CMA Non-Commodity Cost Risk (values) high level".
- 46.50.4 The CMA proposes to include headroom of £25 per fuel (£50 for dual fuel) to allow for competition between suppliers beneath the price cap as a means of mitigating the competition suppressing effects that a remedy of this nature can be expected to produce⁷⁴. The CMA makes no allowance in its remedy design for errors on its part in calculating the initial (period 0) level of the price cap (or indeed the indexation formula). But even if the CMA were to make no such errors, RWE's estimates of the probabilities of adverse movements in wholesale and other costs means that there is a real prospect of the headroom being eliminated or a supplier that chooses to price at below the level of the cap making a loss as a result of cost movements, and the CMA should take full account of this when considering both the likely effectiveness of the remedy and the adverse effects that it can be expected to produce.
- 46.50.5 See further our detailed comments in section 4 as to why the Price Cap remedy design will result in a price cap that is too low.

It produces adverse effects which are disproportionate to the aim pursued

- 46.51 The CMA has not properly taken into account the significant adverse consequences that would result from this remedy.
- 46.52 The Prepayment Price Cap Remedy will negate the significant benefits that can be expected to result from the CMA's other prepayment and engagement remedies, thus the package of remedies including the Price Cap is likely to be less effective than the package of remedies without it.
- 46.52.1 Indeed, numerous respondents, including not only suppliers but also Ofgem and consumer body Which? have commented on the negative impact a price cap would have on customer engagement⁷⁵. The CMA acknowledges the risk that the Price Cap will reduce customer engagement; that some customers may feel they benefit sufficiently from the Price Cap such that there is no need to investigate alternative tariffs in the market⁷⁶. The CMA dismisses this on the basis that currently there is little engagement so any impact is likely to be marginal⁷⁷. This of course disregards altogether the CMA's other prepayment and remedies.
- 46.52.2 Respondents also raised concerns that a price cap is likely to deter other suppliers from entering this segment⁷⁸. In our view, this effect will be particularly severe if the Price Cap makes it difficult for those smaller suppliers that focus almost exclusively on the prepayment segment, such as Utilita, to operate a commercially viable business subject to the Price Cap. If effective competition is to develop in this segment, it is essential to create an environment in which where smaller suppliers can enter the market; this will stimulate competition as seen in the credit segment.

⁷⁴ PDR, page 214, paragraph 4.131.

⁷⁵ PDR, pages 441 and 442, paragraph 7.25.

⁷⁶ PDR, page 499, paragraph 7.238.

⁷⁷ PDR, page 499, paragraph 7.239.

⁷⁸ PDR, pages 448 and 449, paragraph 7.54(a).

- 46.52.3 The Prepayment Price Cap Remedy will clearly also dampen price competition between existing suppliers in the prepayment segment. Again, the CMA acknowledges that the Price Cap might result in suppliers competing less in the prepayment segment. In fact the CMA goes as far as to recognise that in the medium term, prices under the Price Cap may be higher than they would be in a non-price regulated market, but the CMA summarily dismisses this concern on the basis of the timetable for implementation of other remedies versus the lifetime of the Price Cap⁷⁹. This ignores the fact that some of the other prepayment and engagement remedies may even take effect before the Price Cap does (see above).
- 46.52.4 The CMA asserts that any negative impact will not persist beyond the duration of the Price Cap; it is unclear on what basis that CMA has reached this view. In fact we would expect the negative impact on customer engagement to persist after the Price Cap is removed. In any case the Price Cap is due to be in effect for almost four years, and for this entire period it will negate the positive impact of the CMA's other remedies on the prepayment segment.
- 46.53 The CMA considers that its Prepayment Price Cap will not affect innovation to non-prepayment customers. Whether or not this is correct, there is a clear risk that the remedy will dull innovation within the prepayment segment, to the further detriment of prepayment customers.
- 46.54 The proposed Price Cap would undermine competition between suppliers on wholesale costs:
- 46.54.1 Under the CMA's methodology, a price cap would be set for the following 12 months based on the prescribed cost index approach. The actual cap level may be published some months prior to its implementation to enable suppliers to give customers notice of price changes and to take appropriate action to adjust prices in line with subsequent cap constraints.
- 46.54.2 As per previous submissions by RWE, it can be expected that suppliers will prioritise the delivery of wholesale costs that are no higher than the wholesale element of the proposed cost index. To achieve this, suppliers will tend to adopt very similar hedge strategies (and therefore commodity costs), purchasing all forecast volume for the following 12 months at the point at which the cap is announced/(re)set each year, based on their forecast customer number and consumption forecasts.
- 46.54.3 This lack of (wholesale) cost variety is clearly at odds with the idea of competition in the prepayment market which the CMA is trying to foster, damaging the ability of suppliers to compete on wholesale price and thus offer a better prepayment tariff to customers.
- 46.55 Additionally, the interaction between wholesale costs and the annual recalculation of the Price Cap may further dampen competition in the prepayment segment:
- 46.55.1 In a rising market scenario, the proposed annual recalculation of the Prepayment Price Cap limits incentives for incumbent and new suppliers to acquire customers once the wholesale cost is set:
- 46.55.1.1 Existing market participants would be forced to either acquire prepayment customers at a loss against wholesale market prices, potentially incurring a loss on an outright basis, inclusive of headroom, or being faced with reduced incentives to replace credit meters with prepayment meters (which may be to the detriment

of consumers where prepayment is the more appropriate payment method).

- 46.55.1.2 New entrants to the prepayment market after the price cap has been determined may face wholesale prices above the level used in setting said price cap. These new entrants will have a maximum of £50 headroom (assuming costs at parity to those of First Utility/Ovo Energy), upon which these higher wholesale costs will encroach. As such, increasing wholesale costs diminish the incentive for new suppliers to enter the market.
- 46.55.2 In a falling market, incentives on suppliers may mean retail prices do not fall until the cap is reset, undermining competition in the prepayment segment. In addition, the concept of fixed term products – and with it, competition to acquire customers using discounted acquisition products – is severely damaged (this is addressed in more detail in Annex 1).
- 46.55.2.1 For existing suppliers, to gain an additional customer once the market is set they may choose to:
- (a) not change the price of their SVT prepayment tariff (taking an increased margin as a result) and acquire the customer; or
 - (b) reduce the price of the SVT prepayment tariff to reflect the proportion of customers acquired above forecast, at a lower prevailing wholesale cost; or
 - (c) offer the new customer a lower priced fixed term prepayment tariff based upon the lower wholesale costs.
- 46.55.2.2 RWE believes a supplier will tend to choose the first option above, as the other options are constrained by an annual calculation methodology on wholesale costs. As a specific example: if a fixed term prepayment tariff is launched 3 months after the effective date of the Price Cap to take advantage of lower wholesale costs, but these costs continue to fall through to the next Price Cap recalculation, the fixed term prepayment tariff will be subject to the next Prepayment Price Cap recalculation and a price cut may apply. This could result in a supplier either only offering very short term fixed price products (which would need to comply with the CMA's remedy on ease of comparability of tariffs) – so they can be re-priced at the next assessment period, or withdrawing from fixed term products altogether. It is unlikely a supplier would ever choose to launch long term fixed price products when the price may be subject to reassessment within the "fixed price period", meaning they are unable to secure commodity costs against that product. The closer we are to the end of one Price Cap period and the start of another, the less inclined a supplier will be to launch a fixed price product.
- 46.55.2.3 New entrants to the prepayment segment after the price cap has been set will be faced by wholesale prices below the level used to determine the price cap, so could theoretically reflect these lower wholesale costs in prepayment products that are priced below the incumbent suppliers' prepayment products (assuming comparable other costs) to gain customer numbers and grow their business, or match existing cap prices and earn additional profit margin.
- 46.55.2.4 However, RWE believes that a post-cap reduction in wholesale costs would not result in a raft of additional products from these new entrants due to the risk (described above) that wholesale prices would continue to fall and a previously "cheap" fixed

product would exceed the price cap at the next recalculation point (as well as the more general barrier to entry resulting from this highly onerous remedy).

- 46.56 The Prepayment Price Cap Remedy may act as a *de facto* price cap for non-prepayment tariffs.
- 46.56.1 Article 3(7) of the EU Energy Directives requires that Member States shall take appropriate measures to protect final customers including, at least as regards domestic customers, the measures set out in Annex I. Paragraph 1(d) of Annex I of the EU Energy Directives states that Member States must ensure that *"customers are offered a wide choice of payment methods, which do not unduly discriminate between customers. Prepayment systems shall be fair and adequately reflect likely consumption. **Any difference in terms and conditions shall reflect the costs to the supplier of the different payment systems.** (...)"* (emphasis added). Article 3(7) is incorporated into UK law under SLC 27.2A which requires that *"Any difference in terms and conditions as between payment methods...shall reflect the costs to the supplier of the different payment methods."*
- 46.56.2 This provision of the EU Energy Directives might be regarded as requiring any differences between the pricing of prepayment tariffs and non-prepayment tariffs (i.e. direct debit and standard credit/receipt of bill) to be cost reflective. I.e. cost reflectivity between the price-capped prepayment tariffs and non-prepayment prices which are not intended to be subject to price regulation. In short, the prepayment price cap could operate as a *de facto* cap on the pricing of non-prepayment tariffs. Since the costs of serving direct debit customers are clearly (based on our own analysis and the CMA's) lower than the costs of serving prepayment customers, this implies that direct debit tariffs would need to be priced at below the price-capped equivalent prepayment tariffs.
- 46.56.3 This would clearly be a disadvantage that is wholly disproportionate to the aim of the Prepayment Price Cap Remedy, which is to address residual detriment faced by prepayment customers. The CMA has already considered and rejected the need for a price cap across all SVT customers on the basis that this would be a disproportionate remedy: *"the costs of attempting to address the detriment of all SVT customers through a price cap would likely be disproportionate"* and would *"run excessive risks of undermining the competitive process, potentially resulting in worse outcomes for customers in the long run"*.⁸⁰ In fact, the requirement for cost reflectivity would potentially go even further and impose a *de facto* price cap on both SVT and non-standard prices.
- 46.56.4 In the alternative, if the CMA does not regard the Prepayment Price Cap as imposing a *de facto* price cap on non-prepayment tariffs, then the Prepayment Price Cap is potentially inconsistent with the requirements of Article 3(7) of the EU Energy Directives.
- 46.56.5 This issue was raised by SSE in its Response to the Addendum to Provisional Findings and Second Supplemental Notice of Possible Remedies.⁸¹ The CMA has failed properly to address the point. The CMA refers to Ofgem's open letter and guidance in relation to SLC 27.2A.⁸² We do not consider it adequate for the CMA to refer to (non-binding) Ofgem guidance setting out Ofgem's enforcement priorities – the CMA must carry out its own analysis and satisfy itself as to the requirements of the EU Energy Directives. In any case, the CMA should consider, even if permissible under the EU Energy Directives and SLC 27.2A to charge prepayment and standard credit customers the same prices notwithstanding a higher cost to serve prepayment customers (i.e. to protect customers on more

⁸⁰ PDR, page 439, paragraph 7.17.

⁸¹ SSE's Response to the Addendum to Provisional Findings and Second Supplemental Notice of the Possible Remedies, page 29. paragraph 6.4(e) and footnote 73.

⁸² PDR, pages 490 and 491, paragraph 7.203.

expensive payment types), whether it would be permitted for a supplier to charge prepayment customers a lower (price capped) price than the supplier charges customers on other payment types despite the higher costs to serve prepayment customers (which would clearly go beyond protecting customers on more expensive payment types).

- 46.56.6 It is essential that prior to issuing its final report the CMA properly considers this issue and clarifies: (i) whether it considers that the Prepayment Price Cap Remedy imposes a *de facto* price cap on non-prepayment tariffs; (ii) if so, how this Remedy can be proportionate notwithstanding the CMA's provisional decision not to impose a price cap across SVT customers (leave aside in respect of non-standard customers); and (iii) if not, how this is consistent with the requirements of the EU Energy Directives.

Specific concerns with the Prepayment Price Cap Remedy design

- 46.57 Notwithstanding our view that the proposed price cap remedy is not proportionate because it: (i) would not be effective; (ii) is more onerous than necessary to achieve its aim; (iii) is not the least onerous of alternative remedies; and (iv) produces adverse effects, RWE considers that there are serious weaknesses in the design of the proposed price cap. RWE comments on the design of the proposed price cap without prejudice to its view that the CMA should not adopt a price cap in any form.
- 46.58 The CMA's general framework for setting the proposed price caps is to estimate what it considers to be the "competitive" benchmark price for supplying direct debit customers, then to add to this: (i) network costs; (ii) an estimate of the additional costs of supplying prepayment customers; and (iii) "headroom", which it intends would stimulate price competition for supplying prepayment customers.⁸³
- 46.59 In this section, RWE sets out its serious concerns in relation to the following issues:
- 46.59.1 the benchmark price based on two mid-tier firms' tariffs is inappropriate and creates a risk that the price cap will be set too low;
- 46.59.2 the proposed uplift for the additional costs of supplying prepayment customers is materially understated;
- 46.59.3 the proposed headroom is insufficient to stimulate increased competition for prepayment customers;
- 46.59.4 the proposed indexation methodology is inappropriate and the CMA has not proposed any mechanism for "recovery" of differences between *ex ante* forecast costs and *ex post* realised costs; and
- 46.59.5 there are other important weaknesses in the design of the proposed price cap which the CMA has not considered.
- 46.60 RWE will be happy to engage with CMA to explain in more detail any of its concerns regarding the design of the proposed Price Cap which we set out in this section.

The benchmark price based on two mid-tier firms' tariffs is inappropriate and creates a risk that the Price Cap will be set too low

- 46.61 RWE considers that the CMA's proposed price benchmark creates a risk that the Price Cap will be set too low because it:
- 46.61.1 fails to take account of the relationship between standard and non-standard prices and will stifle the development of discounted acquisition tariffs;

⁸³

PDR, pages 456, 458, 459, 460 and 481, paragraphs 7.85, 7.92, 7.94 and 7.165.

- 46.61.2 does not account for any windfall the benchmark mid-tier suppliers may have received due their short hedge position; and
- 46.61.3 does not consider whether the pricing strategy of the benchmark mid-tier suppliers may reflect transitional incentives created by obligation thresholds.
- (i) *The CMA fails to take account of the relationship between standard and non-standard prices and will stifle the development of discounted acquisition tariffs*
- 46.62 The benchmark proposed by the CMA for setting the Price Cap is a “hybrid reference price” based on the CMA’s estimated benchmark for a competitive prepayment tariff. The competitive benchmark used by the CMA is the average direct debit prices of Ovo Energy and First Utility, adjusted to take account of the additional costs of serving prepayment customers.
- 46.63 As the CMA recognises, Ovo Energy and First Utility are competing primarily through acquisition tariffs, meaning that their average direct debit prices is weighted predominantly towards discounted fixed term (non-standard) acquisition prices.
- 46.64 By contrast, the prepayment segment comprises predominantly standard tariffs, since the supply-side constraints identified by the CMA have prevented the development of non-standard acquisition tariffs in the prepayment segment. As explained in Section II, the removal of the supply-side constraints will allow for the proliferation of discounted fixed term acquisition prepayment tariffs. However, setting the Price Cap based (predominantly) on discounted acquisition prices will stifle this development.
- 46.65 As RWE sets out in more detail in paragraphs 46.20.1 to 46.20.5 above, it is not appropriate for standard and non-standard tariffs to be considered in isolation, as pricing for standard and non-standard customers is interrelated through a “waterbed” effect, and customers move between the two tariff types.
- 46.66 This means that, in the current market, suppliers offset the effect of low “acquisition” tariff prices on which they may not, in isolation, earn a sustainable return with higher standard prices. Therefore the average prices of the benchmark mid-tier suppliers, which are currently growing rapidly, principally reflect these low acquisition tariffs rather than the mix of acquisition and legacy customers which a firm would expect to have in “steady state”. These benchmarks therefore do not provide an appropriate reference level for a long run sustainable return for a firm in “steady state”. Using a benchmark based predominantly on low acquisition tariffs which may not in isolation be sustainable, without appropriate adjustment, would result in a price cap which is set too low.
- (ii) *The CMA does not account for any windfall the mid-tier suppliers may have received due their short hedge position*
- 46.67 As RWE sets out in paragraph 46.20.8.3 above, it also considers that the prices of the benchmark suppliers could reflect the one-off benefits from having short hedge positions in a market with falling wholesale prices. If this is the case, it would have allowed them to offer relatively lower prices, compared to firms with longer hedge strategies. However, the price differential would represent a one-off transient factor which would artificially depress its price benchmark. RWE further notes that the converse would apply in a market with rising wholesale prices.
- 46.68 RWE considers that the CMA must control for any such one-off cost factors which may distort the benchmark price in order to ensure that its price benchmark is not artificially depressed, resulting in it setting a price cap which is too low.
- (iii) *The CMA does not consider whether the pricing strategy of the benchmark mid-tier suppliers may reflect transitional incentives created by obligation thresholds*
- 46.69 RWE highlights that the construction of the ECO obligation is such that there is a double obligation at the margin, between about 250,000 and 500,000 accounts (the regime is set

by TWh rather than accounts). As a result mid-tier suppliers around that threshold face an incentive to try to break through the double marginal cost region.

- 46.70 Therefore, this could have driven them to (further) artificially reduce prices (below a long run sustainable level) to gain scale quickly and avoid this unfavourable obligation impact. If this were the case, it could cause some of the tariffs within the cost benchmark to be artificially depressed. RWE considers that the CMA should investigate whether this is the case and, if necessary, control for it. Otherwise, it risks setting a price cap based on a benchmark which is too low.

The proposed uplift for the additional costs of supplying prepayment customers is materially understated

- 46.71 The CMA proposes that it costs £54 per year more to supply a dual-fuel customer with a prepayment meter, compared to a direct debit ("DD") customer (comprising £22 for electricity and £32 for gas).⁸⁴ The CMA has selected this point-estimate from a range of £50 to £66, comprising £19 to £29 for electricity and £31 to £38 for gas.⁸⁵

- 46.72 RWE considers that the CMA's proposed cost uplift materially understates the costs of supplying prepayment customers in the following respects:

- 46.72.1 the CMA fails to consider the material cost differential arising from obligation costs;
- 46.72.2 the CMA makes inconsistent and selective use of evidence on the cost differential and its methodology for selecting its cost estimate range is opaque;
- 46.72.3 the CMA understates some of the costs in its bottom-up calculation; and
- 46.72.4 it is inappropriate and imprudent for the CMA to select a value from the bottom end of the range for cost it has estimated.

(i) The CMA fails to consider the material cost differential arising from obligation costs

- 46.73 As discussed in the preceding subsection, the CMA proposes to use the DD tariffs charged by two mid-tier firms⁸⁶ to establish its price benchmark for the Prepayment Price Cap which it proposed would apply to all suppliers, including the SLEFs. Therefore, the prepayment uplift must include a complete and accurate set of adjustments for all differences between the costs to the SLEFs of supplying prepayment customers and the costs to the two benchmark mid-tier firms of supplying DD customers. This is because these additional costs will not be reflected in the prices set by the benchmark mid-tier suppliers.

- 46.74 The CMA is aware there are numerous formal and informal obligations for which the two benchmark mid-tier firms have partial or total exemptions.⁸⁷ The two most significant formal obligations are the Warm Homes Discount ("WHD") and the Energy Companies Obligation ("ECO"). Therefore, the CMA's proposed prepayment uplift must include an adjustment for the additional costs associated with these obligations which are incurred by the SLEFs, based on a proper allocation of these costs between tariff types, respecting the different competitive dynamics, for example between SVT and non-standard tariffs.

⁸⁴ PDR, page 457, paragraph 7.86.

⁸⁵ PDR, Appendix 3.6, page A3.6-24, paragraph 88(d) and 90. We note that the sum of £29 and £38 is £67, not £66. We assume that this discrepancy is due to rounding.

⁸⁶ Ovo Energy and First Utility.

⁸⁷ In addition to the formal obligations to which they are subject, some but not all suppliers incur substantial costs from obligations that are informal, in the sense that they are not enshrined in legislation, but which they are clearly expected to meet by stakeholders such as the regulator or consumer bodies. These include, for example: the contribution of unallocated refunds to departed customers to funds for fuel-poor and vulnerable customers; practices for DD such as mandatory annual bank account credits of account balances in credit as low as £5; and switching guarantees. The cost of all such obligations should be properly reflected in adjustments to the price benchmark.

- 46.75 RWE does not have the information required to estimate precisely the magnitude of the uplift that should be allowed for these costs. However, indicatively, we consider that this is likely to be material. RWE observes that, as recorded in its submitted financial information, in 2014 it incurred obligation costs amounting to [CONFIDENTIAL] per domestic customer.⁸⁸ By contrast, the mid-tier benchmark firms do not incur material costs in respect of these obligations. We therefore consider that a substantial proportion of this additional cost per customer should be included within the CMA's calculation of prepayment uplift.
- 46.76 We emphasise that, in calculating the magnitude of the uplift for obligation costs, the CMA must have particular regard to:
- 46.76.1 the pricing strategy of the mid-tier firms, which may not fully price-in expected ongoing costs of obligations;
 - 46.76.2 the distortion of the average cost per customer of obligations that results from changes in market share; and
 - 46.76.3 the (typically) 18 month lag between when an obligation gives rise to a liability for the supplier and the actual date when the cost is crystallised.
- 46.77 We expand below on the impact of these first two factors on the difference between the obligation costs per customer for the benchmark firms compared to the SLEFs.
- 46.78 First, RWE operates on the assumption that environmental obligations will continue indefinitely, consistent with established precedent.⁸⁹ RWE considers that suppliers such as the two mid-tier benchmark suppliers are not likely to have considered in detail the successive nature of such obligations and have therefore not fully priced-in their effect.
- 46.79 Second, different obligation costs crystallise at different times in the obligation-setting year, with costs crystallising either throughout the year, where the obligation is based on share of market TWh supplied, or at the end of the year, where the obligation is based on customer numbers. This means that, where a supplier's market share has increased over a year, it will generally underpay obligation costs in the relevant supply year (and vice versa). Therefore, if the CMA bases its calculation of the obligation cost differential on the costs actually incurred by firms, it should control for the firms' growth.
- (ii) *The CMA makes inconsistent and selective use of evidence on the cost differential and its methodology for selecting its cost estimate range is opaque*
- 46.80 The CMA identifies the following four sources of evidence for the prepayment cost differential:⁹⁰
- 46.80.1 the average (restated) cost differentials of the Six Large Energy Firms: £62;
 - 46.80.2 the lowest cost differential of the Six Large Energy Firms [CONFIDENTIAL]: £54;
 - 46.80.3 the cost differential of Utility Warehouse, which is the mid-tier firm with the largest number of prepayment customers: £42; and
 - 46.80.4 its bottom-up cost calculation: £50 to £66.
- 46.81 The CMA considers a range for the cost uplift of £50 to £66. The CMA does not explain how it has derived this range, however we observe that it corresponds to the range it estimates from its bottom-up approach. We therefore infer that the CMA places primary weight on

⁸⁸ Based on calculation from public CSS.

⁸⁹ Environmental schemes for which this assumption has been correct include: EESOPs, EECs, CERT, CESP, and ECOs.

⁹⁰ PDR, Appendix 3.6, page A3.6-24, paragraphs 88(a) to 88(d).

this approach, rather than the other sources of evidence. We do not consider that this is justified or appropriate.

- 46.82 We consider that the average cost differential of the Six Large Energy Firms provides particularly reliable and relevant evidence. This estimate covers the right scope of costs and is based on data from large stable businesses which have been supplying a substantial proportion of prepayment customers over the longer term.
- 46.83 By contrast, we consider that it is inconsistent and selective for the CMA to place any weight on the lowest cost differential of the Six Large Energy Firms. The CMA has not adduced any evidence that this firm's differential is a better estimate of the cost differential that should receive any greater weight than the others of the Six Large Energy Firms. In fact, publicly available evidence suggests that EDF Energy has among the highest unit costs of the Six Large Energy Firms.⁹¹ Given that in its assessment of "efficiency", the CMA has suggested that all but the lowest cost firms are "inefficient",⁹² it would be inconsistent and inappropriate for it to place reliance on a cost differential derived from "inefficient" costs.
- 46.84 We also consider that it is inconsistent for the CMA to place weight on the cost differential of Utility Warehouse in setting the prepayment uplift when this firm's prices are excluded from its calculation of the prepayment price benchmark. Given that the CMA sets out that no reliance can be placed on the cost differentials of the other mid-tier firms,⁹³ we consider that it should place no weight on a single, inconsistent comparator.
- 46.85 In conclusion, we consider that the most reliable evidence for the cost differential is provided by the average of the Six Large Energy Firms' differentials. The CMA's bottom up assessment may provide a cross-check to this average, if properly performed based on a balanced assessment of the evidence. We expand on this in the following subsection.

(iii) The CMA understates some of the costs in its bottom-up calculation

- 46.86 RWE considers that the CMA understates the differentials in respect of the following elements of costs in its bottom-up calculation:
- 46.86.1 cost to serve;
 - 46.86.2 bad debt costs;
 - 46.86.3 costs of additional working capital;
 - 46.86.4 prepayment meter infrastructure provider ("PPMIP") costs; and
 - 46.86.5 meter maintenance costs.
- 46.87 We explain below how the CMA has underestimated each of these cost categories.
- 46.88 First, the CMA concludes that differences in the costs to serve prepayment and DD customers are likely to be very small.⁹⁴ As previously explained to the CMA, RWE estimates that prepayment customers account for [CONFIDENTIAL] although they form only approximately [CONFIDENTIAL]. Further, prepayment calls are more complicated and take longer than calls from other customer types. RWE's previous cost allocation assessments calculated a weighting of costs to prepayment customers of [CONFIDENTIAL] those of DD

⁹¹ Based on analysis of the Consolidated Segmental Statements.

⁹² PDR, Appendix 3.5, page A3.5-10, paragraph 28.

⁹³ PDR, Appendix 3.6, pages A3.611 and A3.6-12, paragraphs 47 and 48.

⁹⁴ PDR, Appendix 3.6, page A3.6-20, paragraph 75.

customers.⁹⁵ The CMA appears to have disregarded RWE's evidence while placing primary weight on contrary evidence from other suppliers.⁹⁶

- 46.89 RWE has not had the opportunity to review or comment upon other firms submitted analysis of differences in the costs to serve prepayment and DD customers. It continues to consider that its submitted analysis is robust and that the cost to serve prepayment customers is materially higher.
- 46.90 Second, several parties – including RWE – have previously set out in their submissions to the CMA that a proportion of bad debt costs should be allocated to prepayment customers, because some prepayment customers have accrued debts which energy supply businesses do not fully recover and therefore incur costs associated with write-offs. The CMA has rejected that an uplift should be allowed for these costs on the grounds that these debts were accrued when these customers were previously on credit meters.⁹⁷
- 46.91 We consider that the CMA's proposed allocation is demonstrably incorrect in three respects:
- 46.91.1 it implies that prepayment customers do not drive bad debt costs. The CMA therefore wrongly implies that different tariff types are associated with distinct groups of customers. In fact, a proportion of retail energy customers are moved from credit meters to prepayment meters precisely because they have accrued arrears on their credit tariff payments. The installation of a prepayment meter for such customers is a legitimate and reasonable step which retail energy supply businesses take to limit their exposure to the risks that they will not recover the cost of the energy these customers consume, however it does not guarantee that the debt can be recovered. Therefore, a proportion of retail energy supply firms' bad debt costs (and other costs associated with debt) are demonstrably associated with customers on prepayment meters. This assumption is also inconsistent with the operation of the Debt Assignment Protocol, as we explain below;
- 46.91.2 the CMA's proposed allocation would therefore not be cost-reflective because it would load all firms' bad debt costs on to customers on credit tariffs, although a proportion of the customer base which gives rise to bad debt costs are in fact on prepayment meters; and
- 46.91.3 the CMA's proposed allocation would be contrary to standard industry cost-allocation practice among retail energy supply firms⁹⁸ and implies that the CMA considers firms' cost allocation principles are wrong. RWE considers that the Six Large Energy Supply Firms are best placed to identify their cost drivers.
- 46.92 In addition, the CMA fails to recognise that the Debt Assignment Protocol operates in a way that means firms acquiring prepayment customers may incur bad debts costs which relate solely to a prepayment customer who has never had a credit meter (with that supplier). This is because, when a new supplier acquires a prepayment customer with an accumulated debt, it takes on that new bad debt, which it may never recover. That customer's previous supplier receives a payment equal to only 90% of the value of the debt. If the rate of supplier switching for prepayment customers increases in the future – which the CMA has concluded is desirable⁹⁹ – then the proportion of energy suppliers' total bad debt relating to prepayment customers who have never been on a credit meter with that supplier will increase. The CMA has failed to take this into account.

⁹⁵ RWE Responses to Indirect Costs follow up questions, dated 17 December 2015 and 8 January 2016.

⁹⁶ PDR, Appendix 3.6, page A3.6-20, paragraph 75. The CMA states that it received "little evidence to support" two firms' submissions that prepayment customers are higher cost, but refers extensively to a single piece of analysis prepared by EDF Energy.

⁹⁷ PDR, Appendix 3.6, page A3.6-23, paragraph 85.

⁹⁸ In the PDR, Appendix 3.6, page A3.6-23, paragraph 85, the CMA states that: "*Several suppliers suggested that bad debt costs related to PPM meters as the customers with these meters had previously had a poor payment record when they had a credit meter.*"

⁹⁹ PDR, page 6, paragraph 27, pages 9 and 10, paragraph 40, page 19, paragraph 88 and page 20, paragraph 91.

- 46.93 As set out in paragraph 46.56 above, we also consider that the established interpretation of SLC 27.2A in the industry supports that a proportion of bad debts should be allocated to prepayment customers.
- 46.94 Third, the CMA has concluded that prepayment customers “*should require no working capital since they pay for their energy before consumption*”.¹⁰⁰ This is incorrect. As RWE has explained above, it is economically logical and consistent with the operation of the Debt Assignment Protocol that a proportion of customer debts should be allocated to prepayment customers. Debts give rise to a working capital requirement. Therefore, the CMA should allow an additional cost uplift to reflect the additional working capital that firms must hold in respect of the debt allocated to these customers.
- 46.95 RWE observes that the average debt per prepayment customer as at the end of February 2016 was [CONFIDENTIAL]. (The average repayment period for prepayment customer debts is around [CONFIDENTIAL].) RWE considers that allowance should be made for the additional working capital which firms have to hold against prepayment customer debt. RWE calculates that the annual working capital cost of prepayment customer debt is approximately [CONFIDENTIAL] per customer.¹⁰¹ The CMA should take this into account in its calculation of working capital cost differential in respect of prepayment customers.
- 46.96 Fourth, the CMA assesses the uplift required in respect of PPMIP costs based on the total amounts charged to the SSLEFs (excluding E.On) in 2014, spread over the average number of prepayment customers.¹⁰² PPMIP costs include charges for changes of supplier and changes of occupier. Therefore, the CMA’s approach will underestimate the PPMIP cost differential if, as the CMA intends, the average rate of supplier switching among prepayment customers increases from its current level.
- 46.97 Finally, the CMA considers ranges for the additional costs to maintain prepayment meters in the range £3 to £5 for electricity and £3 to £8 for gas prepayment meters. The CMA concludes that the bottom of these ranges reflects an efficient level of costs, however it does not explain what analysis it has undertaken to make this conclusion.¹⁰³ RWE’s own data show that, in 2014, the additional costs of maintaining both electricity and gas prepayment meters was approximately [CONFIDENTIAL] compared to credit meters.
- 46.98 RWE considers that its costs are efficient, but cannot comment on the factors that may cause other suppliers to have higher cost differentials. Therefore, RWE considers that the CMA should consider ranges for the cost differentials of [CONFIDENTIAL] for electricity and [CONFIDENTIAL] for gas. We do not consider that there is any evidence to justify adopting an estimate other than the mid-point of these ranges and it would be imprudent for the CMA to do so. Therefore, the CMA should allow a cost uplift in respect of meter maintenance of at least £10.50 for a dual-fuel prepayment customers.
- 46.99 In conclusion, RWE considers that the CMA’s proposed range for the uplift based on its bottom-up estimate of the cost differential to service prepayment customers compared to DD customers is too low. The CMA should revise upwards its bottom-up estimate to take account of the additional cost differentials which RWE has outlined.

(iv) *The CMA is wrong to select an estimate from the bottom end of the range*

- 46.100 RWE considers that it is inappropriate to select a point estimate for the uplift from the lower end of the estimated range. In estimating a range of possible values for the difference in the cost of supplying prepayment customers, the CMA acknowledges that the “true” value

¹⁰⁰ PDR, Appendix 3.6, pages A3.6-22 and A3.6-23, paragraph 84.

¹⁰¹ This is calculated as the average debt per PPM customer of [CONFIDENTIAL], multiplied by the cost of capital calculated by the CMA for a standalone retail energy supply business of 10%.

¹⁰² PDR, Appendix 3.6, page A3.6-21, paragraph 77.

¹⁰³ PDR, Appendix 3.6, page A3.6-22, paragraph 81.

of the cost differential is uncertain and that it may equally lie at the upper end of its range.¹⁰⁴

- 46.101 This being the case, by selecting a value from within the bottom half of the range, the CMA creates the risk that it may set a price cap which is too low. This would make the CMA's remedy not only ineffective, but would in fact generate significant potential adverse effects for prepayment customers as firms would be dis-incentivised to attract or retain any customers in this segment. RWE considers that there is a significant risk because, for the reasons we have set out above, the CMA's estimated range for the cost uplift is itself too low and therefore its point estimate from the bottom end of the range is significantly too low.
- 46.102 We highlight that, if the true cost differential was £66 (the top of the CMA's very conservative range), rather than £54, this policy error would reduce the "headroom" from £50 to £38 (a reduction of 24%). As RWE explains in the following subsection, the headroom should not be treated as providing a margin of error to deal with uncertainty in the CMA's calculation and, in fact, even £50 of headroom is likely to be too low to stimulate increased price competition.

(v) *Conclusion*

- 46.103 In summary, RWE considers that the CMA's estimate of £54 for the cost uplift is materially understated because it is drawn from an inconsistent and selective assessment of evidence which places disproportionate weight on less reliable evidence which implies a lower cost differential. In particular:
- 46.103.1 it is substantially below the average cost differential of the Six Large Energy Firms (of £62), which is the most reliable evidence available to the CMA and based on an appropriate scope of costs (other than the obligation costs differential);
- 46.103.2 it lies at the bottom end of the range implied by a flawed bottom-up cost assessment which: (i) does not properly incorporate the principle of cost-reflectivity; and (ii) understates important elements of the cost differential; and
- 46.103.3 it is drawn from the bottom end of the CMA's overall estimated range for the cost differential (the derivation of which is opaque), although there is no evidence presented that it is a better estimate than any other value within the range.
- 46.104 This understated proposed cost uplift therefore creates a substantial risk that the Price Cap would be set too low, with the result that credit customers would likely end up cross-subsidising prepayment customers through their tariffs, which would be unfair and contrary to the principle of cost reflectivity.
- 46.105 RWE considers that a balanced and reasonable estimate of the prepayment uplift would place primary weight on the average cost differential of the Six Large Energy Firms of £62 and would use an even-handed bottom-up assessment, based on an appropriate scope of costs, as a cross-check.

The proposed headroom is insufficient to stimulate increased competition for prepayment customers

- 46.106 If a regulated price is set too low this will be detrimental to consumers' long-term interests as efficient investment may not occur and incentives to compete will be reduced. For competition to develop, regulated retail prices must be set at a level to allow suppliers to efficiently enter the market and compete for customers. As the CMA correctly states the inclusion of explicit headroom within the Price Cap "... will mitigate the risk that the cap

¹⁰⁴ PDR, Appendix 3.6, pages A3.6-24 and A3.6-25, paragraph 90.

does not allow for the recovery of efficient costs and help ensure that competition in the prepayment segments can coexist with the cap.”¹⁰⁵

- 46.107 RWE also considers that the inclusion of headroom is vital to providing incentives for customers to switch to a lower priced tariff. The inclusion of headroom must be to stimulate effective competition and engagement and not to provide a margin of error to deal with uncertainty in the CMA’s benchmark calculation.
- 46.108 RWE is concerned that the level of headroom the CMA has provisionally proposed is too low to encourage effective competition and consumer engagement.
- 46.109 In 2013, RWE engaged Bain and Company to provide independent analysis and advice on, amongst other things, its domestic pricing strategies. Bain and Company considered survey evidence from Alphawise and Morgan Stanley, which showed that [CONFIDENTIAL] was considered by a reasonable proportion of consumers [CONFIDENTIAL] to be sufficient to make switching supplier worthwhile, this figure had reduced to [CONFIDENTIAL]. Increasingly customers were responding that they would need up to [CONFIDENTIAL], or in some cases [CONFIDENTIAL], to make it worthwhile to switch.¹⁰⁶
- 46.110 RWE considers this trend to have continued since 2011. An explicit headroom of just £50 for the dual fuel prepayment benchmark will have the unintended consequence of reducing switching rates and impeding the impact of the other remedies proposed by the CMA to encourage customer engagement and stimulate competition.

The proposed indexation methodology is inappropriate and the CMA has not proposed any mechanism for “recovery” of differences between ex ante forecast costs and ex post realised costs

- 46.111 The CMA has expressed the expectation that: *“the process for updating the level of the cap ... would be simple, with the update being observed and introduced into the price cap by Ofgem following a mechanical and objective process.”*¹⁰⁷ RWE understand that the CMA is seeking to demonstrate that its proposed remedy is not unduly onerous and therefore will not require substantial ongoing effort from Ofgem and energy suppliers to implement and monitor. However, RWE emphasises that a robust price control design is required to achieve this. RWE does not consider that the CMA’s current proposal adequately takes account of all relevant factors.
- 46.112 RWE considers that, as outlined, the CMA’s proposed *ex ante* price indexation approach creates a significant risk that firms would not be allowed to collect sufficient revenue to cover increases in their actual costs. This is principally because:
- 46.112.1 its benchmark consumption levels create a downward bias in the Price Cap and would not appropriately control for consumption trends;
- 46.112.2 it has not proposed any mechanism for “recovery” of differences between *ex ante* forecast costs and *ex post* realised costs; and
- 46.112.3 its proposed indexation factors for some cost components are not appropriate.
- (i) *The CMA’s benchmark consumption levels create a downward bias in the Price Cap and would not appropriately control for consumption levels*
- 46.113 The CMA’s Price Cap is to be set based on three Ofgem Typical Domestic Consumption Value (“TDCV”) volume levels. RWE emphasises that these are notional *ex ante* levels, based on evolving median and not actual *ex post* consumption levels. Therefore, the use of these values introduces two potential downside biases to the calculation: (i) that the median understated average volume levels because it disregards very high volume consumers; and

¹⁰⁵ PDR, page 214, paragraph 4.131.

¹⁰⁶ [CONFIDENTIAL]

¹⁰⁷ PDR, page 489, paragraph 7.196.

(ii) outturn average volumes consumed are systematically higher than those assumed by the TDCV.

- 46.114 The CMA also has not demonstrated that its proposed approach would create appropriate volume forecasts for customers with two/multiple meters (e.g. Economy 7 tariffs). Any price cap must be based on robust *ex ante* volume forecasts and an appropriate mechanism to adjust the price cap for variations of *ex post* volumes against forecast.

(ii) *The CMA has not proposed any mechanism for "recovery" of differences between ex ante forecast costs and ex post realised costs*

- 46.115 RWE is very concerned that the CMA has not articulated any mechanism for firms to recover any such shortfall in their allowed revenues that results from *ex post* realised costs being higher than the *ex ante* forecast costs which were reflected in the price control. RWE notes that there is established precedent in price regulation that regulated business should be allowed to "recover" such a shortfall. RWE considers that any proposed price cap must include a mechanism of this nature.

(iii) *The CMA's proposed indexation factors for some cost components are not appropriate*

- 46.116 RWE agrees with the CMA that costs should be indexed on an annual basis. Further, RWE emphasises that if the CMA were to move away from this approach, this would introduce substantial further complexity as further adjustments would be required for seasonality and other factors.

- 46.117 RWE believes the proposed decomposition of costs is reasonable, however, the CMA must note that suppliers are exposed to a number of additional costs which are not currently reflected in the chosen categories and would need to be taken into account in any indexation process.

- 46.118 RWE notes the proposed methodology suggested by the CMA for the calculation of wholesale energy costs. RWE is concerned that the proposed methodology does not properly consider the fact that, for electricity, prices are not just composed of peak and off-peak prices, but are in fact subject to complex price movements over time at sub peak /off-peak level. Prices for products beyond peak and off-peak products are periodically observable in the wholesale market. A simple weighting between peak and off-peak prices would not properly reflect the demand shape of prepayment customers on average, thus it potentially risks mis-pricing wholesale energy costs for suppliers, either to their benefit or detriment. Indexation would need to reflect the final methodology and would need to be based on relevant published data.

- 46.119 RWE believes that the proposed indexation methodology for network costs is flawed since it focusses only on revenue changes for Transmission and Distribution Network Operators. Allowed Revenues are only one of the drivers affecting Regulated Network tariffs. Changes to the Network Charging methodologies – either through model inputs or through charging methodology changes - can have significant impact on the tariffs.

- 46.120 A recent example of this is the implementation of CMP224 where, to comply with European Legislation, the TNUoS charging methodology was changed to cap generator payments at EUR 2.50. The result of this has been that suppliers tariffs are now based on a larger share of the revenue i.e. prior to implementation of the modification, suppliers paid 73% of the total revenue, post implementation, suppliers are now paying more than 80% share. Therefore, even if total revenue remained the same over a 2 charging year period, supplier TNUoS tariffs would increase. This would not be captured by the proposed indexation approach.

- 46.121 It is currently unclear from the CMA's proposed methodology what version of Allowed Revenues will be used for the assessment of costs, and what is included or excluded. Specifically, for example, it is unclear whether Offshore TOs are included in the Transmission cost assessment. The timing of when a snapshot view is taken is also important since there can be large changes between 'best view' forecasts of revenues.

- 46.122 For electricity transmission, RWE is concerned that the indexation methodology does not reflect the way that tariffs are calculated in the CUSC Charging methodology. Indexation treats National Grid and the two Scottish Transmission Operators' revenues separately. It also assumes that the 12 regions in the National Grid area take an equal share of any change. This does not happen in practice. In the TNUoS Charging Methodology, all Allowed Revenues are added together, along with OFTO Allowed Revenues. The charging methodology is applied, and will apply different zonal weightings. This means that the charging cap will be out of line with the actual networks tariffs across different regions.
- 46.123 The CMA should consult the industry much further on developing a methodology for benchmarking networks costs in an appropriate way, which would not create significant uncertainty and potential windfall gains or losses purely as a result of a methodological choice. This should also then consider appropriate indexation methodology.
- 46.124 RWE believes that the methodology for assessing Policy costs proposed by the CMA is incomplete and faces creating windfall gains and losses for suppliers.
- 46.125 The proposed mechanism covers some policy costs, but fails to mention costs associated with Smart, BSUoS, HDCA (Hydro Benefit) and the Capacity Mechanism. These costs would need to be included in any indexation arrangement, so the current proposed methodology is incomplete.
- 46.126 In addition, the indexation methodology does not allow for the introduction of other, as yet unknown, policy costs and charging methodology changes and how these would be included in the cost base. The CMA should set out a complete framework for developing a methodology of assessing these costs as they may be introduced. This is a particularly acute concern when changes are immediately implemented such was the case with the 2015 change in Levy Exemption Certificate rules.
- 46.127 The CMA methodology does not discuss indexation of national demand forecasts. The costs of policy obligations are set by forecasting costs and then dividing those costs by the demand base that they need to be recovered from. National demand levels for gas and electricity have been falling over recent years resulting in increased pricing for individual units of energy even in the absence of increased costs in total.
- 46.128 The method of cost allocation to suppliers also differs between the various mechanisms. These effects do not seem to be fully considered by the CMA but are critical to correctly reflect the cost per unit of metered consumption for a domestic consumer.
- 46.129 A recent example of this would be in relation to Energy Intensive Industry exemptions for RO, EMR CfD and FiT. These exemptions change the effective demand over which suppliers can recover these costs. Introduction of these exemptions has thus increased costs per unit to non-exempt counterparties. The RO exemption scheme was announced in the autumn statement and the industry immediately re-priced on this basis. Different schemes use different definitions of demand to allocate costs. Each of these definitions would have different indexations. A within year variation in the customer mix over which costs may be recovered may result in significant impacts on the incentives on suppliers to market prepayment tariffs.
- 46.130 Policy costs, particularly Smart, EMR CfD and EMR Capacity Market are growing rapidly. The levels of indexation adjustments will therefore be high, putting significant stress on the accuracy of the indexation calculation. This is particularly true where there are anticipated step changes in the level of costs. Capacity Market costs are close to zero at the moment but are estimated to step up to around 4% of the total cost base of electricity supply for a domestic customer in October 2017. EMR CfD costs are also currently low and will step up suddenly if and when the Drax biomass unit receives State Aid clearance.
- 46.131 For the indexation of indirect costs and prepayment uplift, RWE considers that the CMA should adopt RPI consistent with a number of other energy price controls.

There are other important weaknesses in the design of the proposed Price Cap which the CMA has not considered

46.132 RWE also identifies the following further concerns it has about the design of the proposed Price Cap:

46.132.1 the non-linear structure of the Price Cap would distort tariff-setting and introduce complexity to the market;

46.132.2 the proposed approach for setting regional price caps would create distortions in certain supply areas; and

46.132.3 the CMA has not considered how its proposed price-cap achieves cost-reflectivity in the standing charge.

46.133 We expand on each of these points in the remainder of this sub-section.

(i) *The non-linear structure of the Price Cap would distort tariff-setting and introduce complexity to the market*

46.134 In terms of the remedy design, the CMA proposes that the Prepayment Price Cap will be non-linear.¹⁰⁸ As suppliers cannot know in advance the volumes that customers on any given tariff will consume, they will be forced to take a distorted approach to tariff setting. In order to stay below the Price Cap at each consumption level, suppliers will either have to price significantly below the cap for higher consuming customers or they will have to adopt multiple unit rates and/or multiple standing charges in order to flex tariffs to accommodate the non-linear tracking of the cap. Multiple rates are currently disallowed by Ofgem and multiple standing charges would incur significant cost reflectivity issues.

46.135 The former would be distortionary, and would de facto remove a significant proportion of the headroom that the CMA acknowledges is required in order to preserve an element of competition (or to put it another way for higher consuming customers the cap will be artificially suppressed and illusory rather than real). The latter would introduce into the market greater complexity (not only for prepayment customers to understand but also for suppliers to support given the current prepayment infrastructure), threatening the engagement that the CMA's other remedies are designed to promote. In applying the Price Cap at three different volume levels, the CMA constrains the standing charge that suppliers can apply. The CMA then has to face the choice between cost reflectivity (and consistency with EU legislation) and deliberate avoidance of socially regressive effects (higher standing charges being felt the most by low consumption customers, who are more likely to be vulnerable).

(ii) *The proposed approach to for setting regional price caps would create distortions in certain supply areas*

46.136 The CMA proposes to sets out a methodology to calculate network costs on a regional basis in order to set its regional price controls.¹⁰⁹ Variations in regional costs in electricity correspond to Public Electricity Suppliers ("PES") areas, however regional gas costs vary with Local Distribution Zone ("LDZ") areas, which do not directly align to PES areas.

46.137 To simplify the pricing tables on Price Comparison Websites and general communication, RWE and other suppliers tend to align gas prices to PES rather than LDZ areas. However, if a price control for gas were set based on PES areas, this would create an incentive for suppliers to target customers in some particular PES/LDZ area combinations, while avoiding others. This would distort the market as well as likely disadvantaging some prepayment customers. The CMA must ensure that it calculates the Price Caps in a way that does not introduce such a distortion.

(iii) *The CMA has not considered how its proposed price-cap achieves cost-reflectivity in the standing charge*

¹⁰⁸ PDR, page 470, figure 7.2 and page 471, figure 7.3.

¹⁰⁹ PDR, pages 458-460, paragraphs 7.92-7.93 and 7.97-7.98.

- 46.138 Suppliers charge a Standing Charge ("SC") and Unit Rate ("UR"). Currently, under RMR only a single UR is allowed. Although the Prepayment Price Cap foresees that the RMR restriction will be lifted, nevertheless both the structure of URs and the transition from single UR to multiple URs is not straightforward in execution or policy.
- 46.139 CMA proposes to set a bill cap based on high medium and low consumption levels. If the relationship between bill and volume is linear then this sets both SC and UR caps for single rate. However, if the relationship is non-linear, suppliers will be forced to adopt multiple SCs or URs. The benchmark suppliers should not be assumed to scale both their standing charges and unit rates in a cost reflective manner in setting their prices.
- 46.140 However multiple SCs would not be cost reflective and the bill becomes more complicated with more than one UR as it has to be apportioned. Generally speaking regulators set SC below cost reflective level as a high SC causes high unit costs for volume low consumers (which is regressive).
- 46.141 Any price control that is not cost reflective has knock on distortions and other consequences that are not all easy to spot ex ante.

Supporting documents:

1. [CONFIDENTIAL]

Proposed Remedies Specific to the Prepayment AEC

47. A recommendation to Ofgem to:

- (i) **modify suppliers' standard licence conditions to introduce an exception to SLC 22B.7(b) so as to allow a supplier to set prices to prepayment customers on the basis of grouping regional cost variations which are applied to other payment methods within the same core tariff;**
- (ii) **deprioritise potential enforcement action pending the modification of SCL 22B.7(b) against any supplier to a prepayment customer that sets prices to prepayment customers on the basis of grouping regional cost variations which are applied to other payment methods within the same core tariff;**
- (iii) **take responsibility for the efficient allocation of gas tariff pages.**

The acceptance of undertakings from the Six Large Energy Firms or, absent such undertakings, [a new licence condition] including the following three components:

- (i) **a cap on the number of gas tariff pages that any supplier can hold (at 12);**
- (ii) **an obligation for suppliers to provide relevant information for Ofgem to monitor the allocation of the gas tariff codes; and**
- (iii) **a condition that allows Ofgem to mandate the transfer of one or more gas tariff pages to another supplier.**

Absent such undertakings, the CMA would recommend that Ofgem introduces a new licence condition in suppliers' standard licence conditions to include the three components set out above.

Introduction

- 47.1 As set out in RWE's response to the Second Supplemental Notice of Possible Remedies ("SSRN"), we accept that there are certain features of the prepayment segment, in

particular the “dumb” meter technical constraints, which may limit the choice of products available to prepayment customers and create a barrier to entry and expansion within the segment.

- 47.2 However, the CMA has suggested that removing technical barriers may not lead to the lowering of prices within the prepayment segment¹¹⁰. The CMA notes that despite an increase in the share of independents within the Smart meter prepayment segment which are not constrained by these technical limitations, there has not been any significant decrease in prices. As the CMA acknowledges¹¹¹, Smart meter penetration is low at 9% and, given the RMR four tariff rule which makes it very difficult for a supplier to target a tariff at a niche segment, RWE would suggest that it is perhaps not surprising that Smart metering has not led to significant price reductions whilst it remains small scale. RWE considers that it is incorrect to conclude that the evidence gathered in a market where technical constraints still impact 91% of prepayment customers can be applied to a market where the technical constraints identified by the CMA have been largely removed for all prepayment customers. RWE agrees that the CMA’s remedy to manage tariff slots more effectively will greatly reduce the technical constraints identified by the CMA. However, the CMA should not base a conclusion as to how this will impact the market on the experience and evidence gathered from small scale Smart meter installations where the four tariff rule prevails. The freeing up of tariff slots, together with the repeal of the four tariff rule, will have a much more significant positive impact on competition between existing prepayment suppliers as well as the new entrants whose entry into the segment these remedies will facilitate.
- 47.3 RWE considers that the CMA’s combination of proposed remedies including grouping of regional costs differences and a cap on the number of tariff pages at 12 pages will greatly reduce the technical constraints that exist within the prepayment market and which have the effect of restricting competition as identified by the CMA. In addition, RWE understands that Siemens and the Network Service Providers are due to expand the number of gas tariff pages available from 117 to 179 in Q4 2016 which should significantly reduce any remaining technical constraints faced by new entrants and independent suppliers when seeking to acquire gas tariff pages. RWE believes that this package of remedies, supported by other competition enhancing remedies, will successfully stimulate competition in the prepayment market.

Softening SLC22B.7(b)

(i) A recommendation to Ofgem to modify suppliers’ standard licence conditions to introduce an exception to SLC 22B.7(b) so as to allow a supplier to set prices to prepayment customers on the basis of grouping regional cost variations which are applied to other payment methods within the same core tariff;

(ii) A recommendation to Ofgem to deprioritise potential enforcement action pending the modification of SCL 22B.7(b) against any supplier to a prepayment customer that sets prices to prepayment customers on the basis of grouping regional cost variations which are applied to other payment methods within the same core tariff.

- 47.4 RWE agrees with the CMA that by modifying suppliers’ standard licence conditions to introduce an exception to SLC22B.7(b) (and in the meantime recommending that Ofgem deprioritises enforcement action) suppliers may be able to offer more prepayment tariffs by using their tariff codes more efficiently¹¹². Since suppliers’ prepayment products will not be constrained by the pricing strategy for credit meter customers, this will enable suppliers to be more efficient in their use of the limited tariff slots without being concerned about breaching SLC 22B.7(b).

¹¹⁰ PDR, pages 210-211, paragraph 4.119.

¹¹¹ PDR, page 135, paragraph 3.78.

¹¹² PDR, page 265, paragraph 5.211.

- 47.5 However, to maximise effectiveness, RWE considers that this remedy should be introduced promptly and in conjunction with the redistribution of unused gas tariff codes.
- 47.6 In addition, the CMA's proposed remedy envisages relaxing SLC 22B.7(b); RWE believes that the CMA should consider whether there is a need to make consequential amendments to other SLCs, such as SLC 22B.7(d).

Redistributing unused gas tariff codes

The acceptance of undertakings from the Six Large Energy Firms or, absent such undertakings, [a new licence condition] including the following three components:

(i) a cap on the number of gas tariff pages that any supplier can hold (at 12);

(ii) an obligation for suppliers to provide relevant information for Ofgem to monitor the allocation of the gas tariff codes; and

(iii) a condition that allows Ofgem to mandate the transfer of one or more gas tariff pages to another supplier.

Absent such undertakings, the CMA would recommend that Ofgem introduces a new licence condition in suppliers' standard licence conditions to include the three components set out above.

- 47.7 RWE considers the redistribution of gas tariff codes, when combined with the softening of SLC22B.7(b), will enable more new entrants and existing independent suppliers to compete within the prepayment segment. The removal of the four core tariff rule will encourage competition by enabling more prepayment tariffs to be offered to customers with "dumb" prepayment meters ahead of the rollout of Smart meters.
- 47.8 The proposal will effectively lead to independent suppliers having two gas tariff pages (22 slots). When combined with the softening of SLC 22B.7(b), if a supplier priced its tariffs using three geographical regions then it could offer one SVT and six 12-month fixed term contracts (FTC) per year, i.e. one FTC product launch every two months. Similarly, if a supplier priced its tariffs nationally, then it could offer one SVT and 21 12-month FTCs per year, i.e. an average of 1.75 FTC product launches every month.
- 47.9 As discussed above, RWE understands that Siemens and the Network Service Providers are continuing to test their joint developments to expand the number of gas tariff pages available from 117 to 179. With an additional 62 pages (682 tariff slots) available for Ofgem to allocate to new entrants or existing independent suppliers from Q4 2016, the impact of the technical constraints currently faced by independent suppliers when acquiring gas pages will be significantly reduced, which should enable new entrants and existing suppliers to compete more effectively for prepayment customers by offering an expanded range of prepayment tariffs.
- 47.10 However, the effectiveness of this remedy to encourage competition within the prepayment segment will be negated if the CMA's proposed introduction of a Prepayment Price Cap is implemented. All suppliers will be discouraged from entering a market where a regulated price exists, particularly under the mechanism currently proposed by the CMA which introduces cost risks that suppliers simply cannot manage. See further our response to the Prepayment Price Cap Remedy.

Managing gas and electricity tariff codes centrally

A recommendation to Ofgem to take responsibility for the efficient allocation of gas tariff pages.

- 47.11 RWE agrees Ofgem is best placed to take responsibility for the ongoing management of reallocating unused tariff pages to ensure suppliers hold no more than 12 gas tariff pages.

As the CMA has recognised¹¹³ both Ovo Energy and Robin Hood have previously encountered difficulties when they have tried to acquire tariff pages. Ofgem will be able to allocate available codes on needs-based criteria, making tariff slots available to suppliers that can satisfy Ofgem that the slots will be used promptly and correctly rather than held unused for an extended period.

Making better use of the available tariff codes

- 47.12 RWE considers that the proposed combination of remedies is likely to be effective in ensuring the gas tariff codes are used and allocated more efficiently, and will address to a significant extent the technical constraints in the prepayment segment for customers with "dumb" meters that the CMA has identified as giving rise to the Prepayment AEC. However, RWE believes the common slots proposal as set out in its response to the SSRN represents a better way in which the 22 pages of currently unused codes could be utilised. If the CMA continues to consider that the proposed package of prepayment and engagement remedies (without the Prepayment Price Cap Remedy) will not significantly increase competitive pressure within a reasonable timeframe, then RWE submits that this package of remedies could be supplemented by our tariff slot proposal (or an amended version), and this would enhance the effectiveness of the package of remedies in a manner far less onerous than (and without the adverse consequences of) the Prepayment Price Cap Remedy.
- 47.13 We have further developed our common slots proposal to illustrate how it could operate in conjunction with 20 of the 22 imminently available pages to allow an unlimited number of suppliers access to common tariff slots, allowing for more granular pricing. Unlike the CMA's proposal, this would allow the market to offer FTCs similar to those in the credit segment. This proposal focuses only on the gas market, as the constraint is not as profound in the electricity market. In the interests of providing a simple explanation of the concept the charges and bill values cited in the following summary are all exclusive of VAT.
- 47.14 Table 1 details the prepayment tariffs on sale in mid-March 2016. The majority of suppliers' prices are clustered together, with daily standing charges (DSC) largely falling between 20-30p per day (as shown in Chart 1) and unit rates largely falling between 3p-5p p/kWh (as detailed in Chart 2).

Table 1: Gas prepayment tariffs on sale in min-March 2016

Supplier	Tariff	Daily Standing Charge	Unit rate (p/kWh)	Annual bill exc. VAT (consumption 12500kWh)
npower	Standard	27.40	4.083	610.39
British Gas	Fixed Price July 2018 v2	24.77	3.596	539.87
British Gas	Standard	24.77	3.828	568.89
Eon	E.ON Energy Plan Prepay	30.00	3.734	576.25
eDF	Blue +Fixed Prepay February 2018	25.00	3.733	557.88
eDF	Standard	25.00	3.870	575.00
Scottish Power	Prepay Help Beat Cancer Fixed Price Energy Nov 2017	26.09	3.897	582.29
Scottish Power	Standard	26.09	3.762	565.42
SSE	Standard Pay As You Go	26.10	4.115	609.64
OVO	Smart PAYG Energy v5 (all Online)	22.31	3.019	458.84
utilita	Smart Energy v11	24.63	3.537	532.03
Robin Hood Energy	Evergreen (P'less)	23.81	3.641	542.05
Spark	Saver Fixed (March 2018)	22.00	3.550	524.05

¹¹³ PDR, page 269, footnote 395.

E Energy	1 Year Fixed Price Spring 2017	23.81	3.743	554.76
Green Star Energy	Rate Watch Pay as you Go	24.61	3.449	520.91
Coop	Prepayment	22.11	3.850	561.96
Economy energy	Economy	24.76	3.857	572.51
ecotricity	Prepayment	24.74	4.006	591.02
First Utility	iSave Everyday Prepayment v3	39.25	3.101	530.90
Utilita	Premium Energy (2016) v2	27.10	3.891	585.25
Spark	Tenant Saver (Variable) v1	34.80	4.040	632.02
Utility Warehouse	Value v3	20.55	4.337	617.11
Extra Energy	Standard Variable Price v1	19.81	4.770	668.56
Economy energy	EverGreen	26.00	4.362	640.15
EBIco	Equidual	0.00	4.950	618.75
Minimum		0.00	3.019	
Maximum		39.25	4.95	

Chart 1: Daily standing charges of gas prepayment tariffs on sale in mid-March 2016

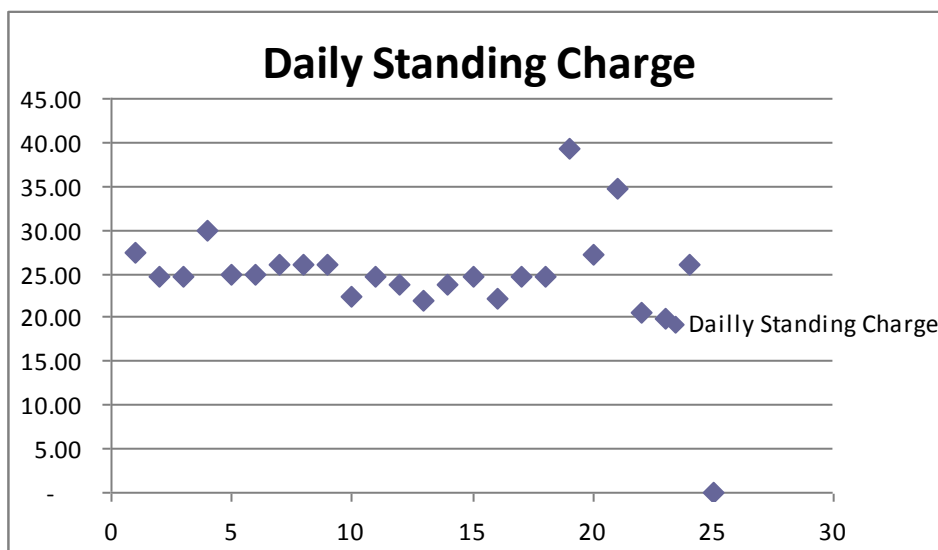
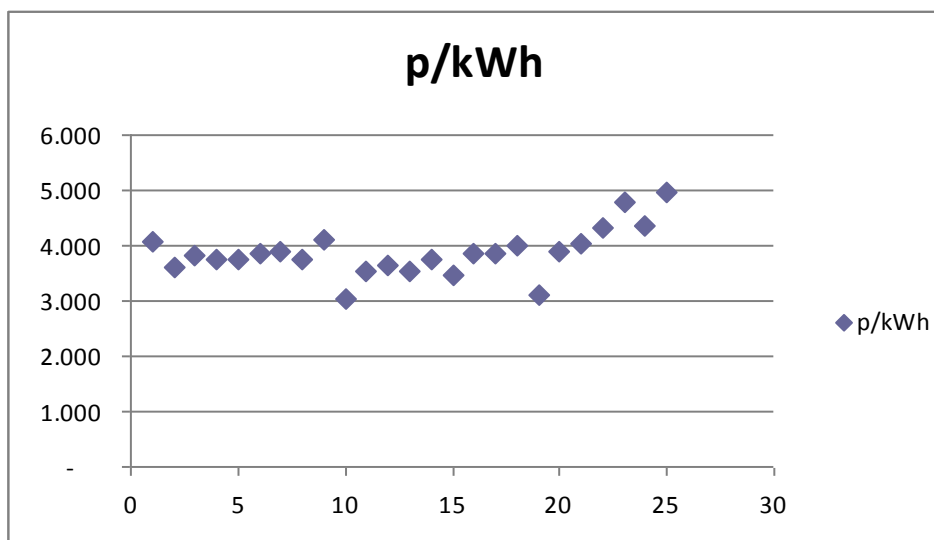


Chart 2: Unit rates (p/kWh) of gas prepayment tariffs on sale in mid-March 2016



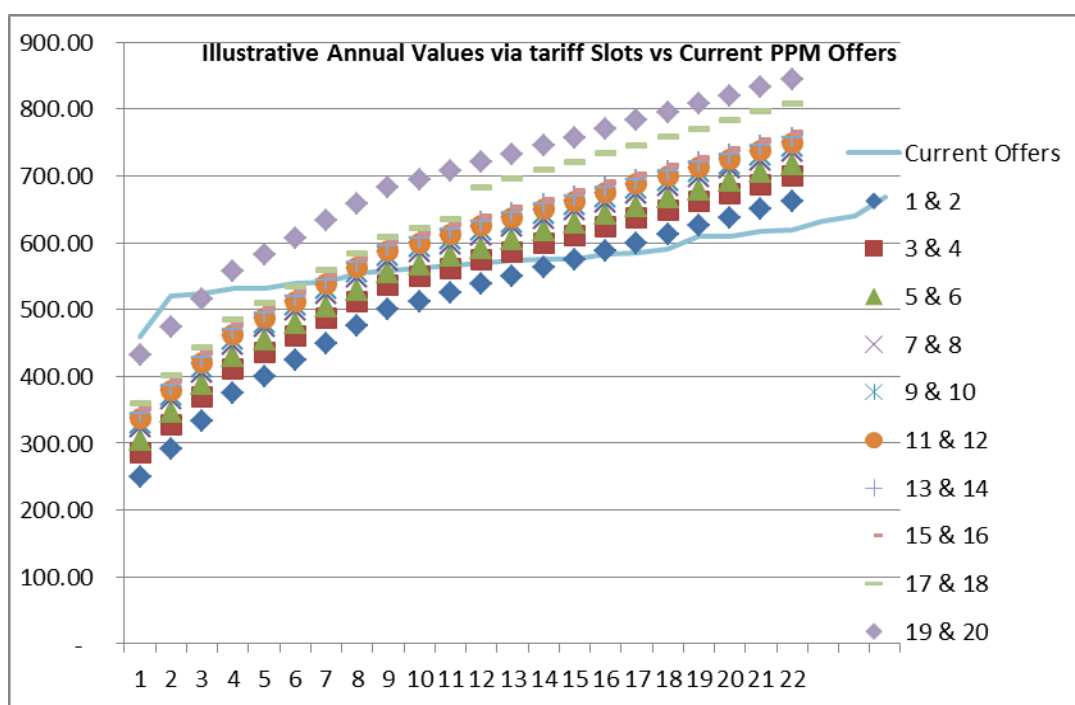
- 47.15 20 of the 22 available gas pages could be configured in pairs to support combinations of daily standing charge and unit rate (p/kWh). In deciding how to set prices, suppliers would have a choice of 10 different daily standing charges and 22 different p/kWh rates (using the 11 slots per page) enabling them to support a wide range of offers which could be targeted at different customer groups. An example of pages 15 and 16 in such a configuration is shown in Table 2 (for details on all pages in this configuration please see the attached spreadsheet entitled “Common gas PPM tariff slots 20160323”).

Table 2: Illustrative common gas tariff slot pages 15 and 16

15		16	
DSC	p/kWh	DSC	p/kWh
28	2.00	28	4.30
28	2.33	28	4.40
28	2.67	28	4.50
28	3.00	28	4.60
28	3.20	28	4.70
28	3.40	28	4.80
28	3.60	28	4.90
28	3.80	28	5.00
28	4.00	28	5.10
28	4.10	28	5.20
28	4.20	28	5.30

- 47.16 These two pages support a DSC of 28p/day. Each of the 22 slots on these two pages then supports a different p/kWh. The increments between those slots are very small – from 4.00p/kWh to 5.3p/kWh – recognising that most suppliers’ unit rates fall in that range and so it is more important to provide greater granularity at that level rather than below 3p/kWh. The table in the attached spreadsheet (“Common gas PPM tariff slots 12500 kWh”) shows that the same range of kWh values can be supported in each pair of pages, allowing suppliers to first select the DSC they wish to collect and then select the p/kWh rate.
- 47.17 Chart 3 compares the annual “medium user” bill values for current prepayment offers in the market with the annual values collected by the alternative tariff page combinations. All current offers (which range between £458 and £669) could be supported and suppliers would have the choice of several DSC/unit combinations to support their offers. The median bill value of £572/p.a. could be supported by DSC/unit rate combinations on every pair of pages.

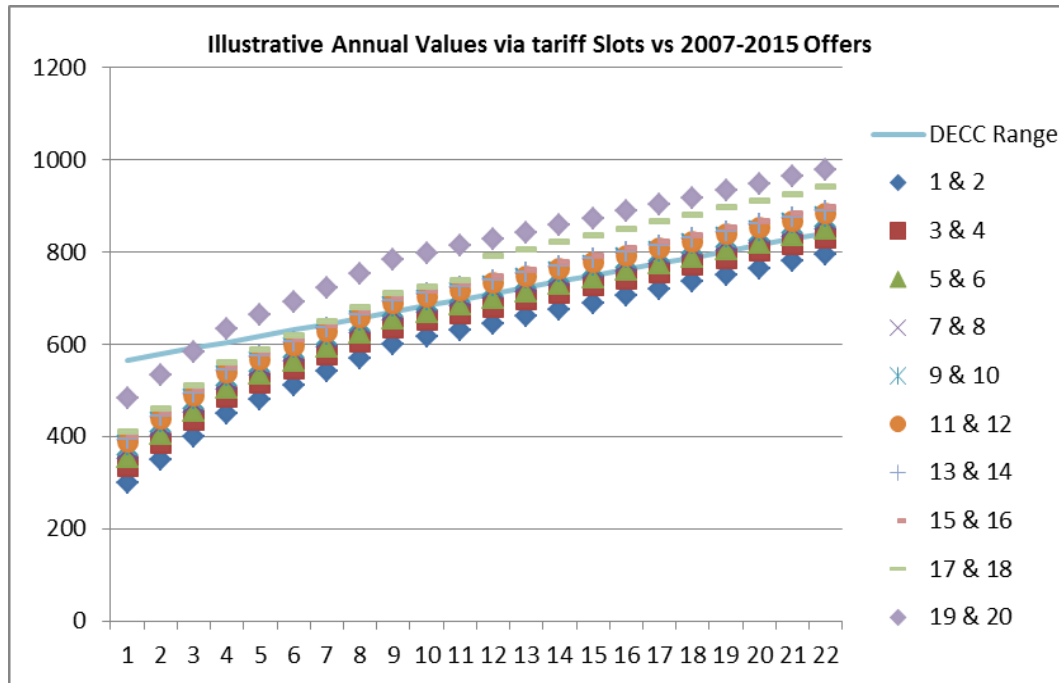
Chart 3: Illustrative annual values using common tariff slots versus gas prepayment offers on sale as at mid-March 2016



47.18 The illustrative values in RWE' common tariff slots illustration would also have supported offers in earlier years. According to DECC's "Quarterly Energy Prices"¹¹⁴ during 2007-2015 annual prepayment gas bills ranged between £565-£841 based on a consumption level of 15,000kWh. The DSC and p/kWh values shown in the attached spreadsheet ("Common gas PPM tariff slots 12500 kWh") would have supported annual bills based on the higher consumption levels of between £300 and £977 as shown in Chart 4.

Chart4: Illustrative annual values using common tariff slots versus gas prepayment offers on sale 2007-2015

¹¹⁴



47.19 Suppliers apply two fundamental tests as they decide how to set new prices:

47.19.1 Bottom Up – cost-stacks are constructed for the projected fixed and variable costs the supplier expects to face. A margin may then be added to one or both elements. This approach would lead to putative levels for the DSC and kWh rate.

47.19.2 Top Down – the supplier will consider the annual consumption volumes they can expect from their target customers and what annual bill level they seek to set to attract/retain customers.

47.20 The supplier would use the putative DSC and kWh values to calculate whether the resulting annual bill at their target kWh level was as competitive/profitable as they sought. They might then adjust the DSC and/or kWh rate to arrive at a final result.

47.20.1 For example, a gas supplier targets “medium users” (12,500 kWh/p.a.) and calculates that they seek a DSC of 24p/day to cover the fixed costs and a unit price of 3.9p to cover the variable cost they expect to incur. These charges would produce a medium user annual bill of £575.10. If the supplier is satisfied that such a bill would be competitive and profitable, they could then review the available tariff slot options to set the collection settings on the prepayment meters of customers taking up this tariff.

47.20.2 If the exact combination of DSC and kWh they seek is not available, but there are slots either side of their target kWh, this will result in suppliers under- or over-collecting from the prepayment meter. In the scenario above, on an annual basis, for a medium user a slot set at 3.8p/kWh would under collect £12.50, while a slot set at 4.0p/kWh would over collect £12.50.

47.20.3 The supplier can choose to proceed with the prices exactly as planned and have the customer’s prepayment meter set to either of the rates, knowing that a reconciliation will be required to collect or refund the small balance. Alternatively the supplier can adjust its desired DSC/unit price combination to better fit the available tariff slot collection rates in order to produce an annual bill and collection regime closer to the target bill level.

47.21 It is important to recognise that the charges levied by a supplier to a prepayment meter on the customer’s statement must exactly match the rates in the contract agreed with the

customer. The collection settings on the customer's prepayment meter may exactly match the rates charged on the statement, but this is not necessarily always the case. Reconciling for the balances that arise between charges for energy used and monies collected via the prepayment meter are routine; for example, when a prepayment customer leaves a home supplied via a prepayment meter, there will often be an unused credit on the prepayment meter from the customer's most recent credit top-up.

- 47.22 As set out in our response to the CMA's PPM request for information¹¹⁵, electricity suppliers have previously used shared collection slots and selected the slot closest to their charges.
- 47.23 Under the above illustration, it should be noted that all existing tariff slots remain in use by the respective suppliers and these can continue to collect at exactly the rates prescribed by each supplier.
- 47.24 Further slots could be used to increase the range and/or granularity of the DSC and p/kWh rates supported. Further slots could be added when Siemens extends the current slots in late 2016 and/or if suppliers agree to release further unused slots. Once a range of common slots is established, RWE believe that suppliers will be more prepared to release unused slots as they would better understand how their future prepayment offers could be supported using the range of common slots. When current mid-tenor fixed term prepayment tariffs reach the end of their respective tenors, suppliers could be encouraged to release those slots for use in the common slot portfolio.
- 47.25 RWE considers these remedies could be implemented within a reasonable timeframe and notes that Siemens has already asked the relevant suppliers to relinquish the tariff slots identified voluntarily; there should be little hesitation in acceding to that request and RWE has already ready done so. This would maximise the customer benefit being realised before the national rollout of Smart meters has been substantially completed¹¹⁶, when RWE agrees that these proposed remedies should fall away.
- 47.26 RWE agrees that the cost to implement these remedies by both Ofgem and suppliers is likely to be low. RWE considers that these remedies, when combined with the proposed remedy to remove the simpler choices rules of RMR and with other competition enhancing remedies, will encourage competition within the prepayment segment as suppliers have the opportunity to offer more tariffs choices to prepayment customers leading to increased engagement. RWE therefore considers the combination of these remedies to be effective and proportionate to address the AECs affecting prepayment customers identified by the CMA.

Supporting document:

1. Common gas PPM tariff slots 20160323

48. **A recommendation to Ofgem to take appropriate steps to ensure that changes to the Debt Assignment Protocol are implemented by the end of 2016, and in particular in areas relating to objection letters, complex debt and issues relating to multiple registrations; including setting out clear objectives and a timetable with appropriate milestones, supervising progress against such objectives and milestones, and to take all steps, if any when necessary, to ensure delivery of these changes.**

Introduction

¹¹⁵ RWE's response to the CMA's request for information on prepayment meters dated 16 November 2015.

¹¹⁶ PDR, page 280, paragraph 5.275.

- 48.1 The CMA has identified there are softened incentives for suppliers, and new entrants, to compete to acquire indebted prepayment customers, as there is a low prospect of successfully completing the switch of indebted customers to the new energy supplier¹¹⁷.
- 48.2 In our response to the SSRN, we detailed our commitment to working with Ofgem to continue to develop the Debt Assignment Protocol ("DAP") process with a view to facilitating switching for indebted prepayment customers¹¹⁸. Improving the process will have positive implications for both prepayment customers and suppliers, incentivising suppliers to compete for prepayment customers.
- 48.3 Whilst the proposed changes to the DAP only affect a small proportion of switches, RWE believes they will have the benefit of removing, in part, the perceived barriers to switching for indebted prepayment customers.
- 48.4 RWE considers that in revisiting the complex debt to reduce the instances in which a switch will be disallowed, the CMA should not consider increasing the level of debt suppliers need to automatically accept, as this would increase the upfront acquisition costs of all suppliers which may act as a disincentive, particularly for small suppliers, to compete within this segment.
- 48.5 RWE believes if the DAP process was mandated for all suppliers this would also have the benefit of reducing the perceived barriers to switching for indebted prepayment customers by ensuring a consistent process across suppliers.

Changes to the Debt Assignment Protocol

- 48.6 RWE broadly supports the proposed changes to the DAP process:
- 48.6.1 We agree that by changing the "objection letter" sent by an incumbent supplier, so that it does not confuse customers regarding their right to switch and makes it clear that the switch will continue, will address in part the perceived barriers to switching these customers have.
- 48.6.2 We consider that when revisiting the aspect of 'complex debt' of the DAP, the level of debt the suppliers automatically accept without objection should not be increased above £500. Whilst increasing this limit could potentially allow more customers to benefit from the DAP, it may act as a disincentive for suppliers to compete within the prepayment segment due to it increasing their upfront costs as a result of the debt transfer process; it could act as a particular barrier to entry for smaller suppliers as it increases their upfront acquisition costs. RWE would therefore not support increasing the limit above £500 as it would be a disproportionate change.
- 48.6.3 RWE believes customers with multiple registrations should receive an objection letter per fuel, as a dual fuel customer may only have one fuel in debt therefore the transfer of the fuel without a debt would proceed without objection.
- 48.7 As set out in our response to the SSRN¹¹⁹ we consider that in part some of the issues identified by the CMA are the result of the DAP process not being mandated for all suppliers. We believe it is in the customers' best interest for the switching process to be the same regardless of which supplier they may choose. RWE agrees with the CMA's recommendation that, should an industry-led change not deliver a satisfactory solution by the end of 2016, a licence modification should be introduced which would mandate all suppliers to follow the process.
- 48.8 In order to increase the effectiveness of this remedy, RWE considers that the CMA's proposals could go further by obligating all suppliers to highlight the DAP process within

¹¹⁷ PDR, page 284, paragraph 5.295.

¹¹⁸ RWE's response to the SSRN, page 13, paragraph 54.

¹¹⁹ RWE's response to the SSRN, page 13, paragraph 52.

their communications to prospective prepayment customers. This could be supported by an Ofgem led information campaign to increase customer understanding that debt can be transferred between suppliers.

- 48.9 RWE believes that the CMA's proposed remedy in respect of the DAP, when combined with the package of proposed competition enhancing remedies that can be implemented quickly, will increase competition within the prepayment segment as suppliers compete for customers and will remove some of the issues that cause the Prepayment AEC.

Proposed Remedies Concerning the RMR AEC

49. **A recommendation to Ofgem to**

(i) modify gas and electricity suppliers' standard licence conditions to remove the following conditions (the "Conditions"):

- **the ban on complex tariffs (SLC 22A.3(a) and (b));**
- **the four tariff rule (SLC 22B.2(a) and (b));**
- **the ban on certain discounts (SLCs 22B.3-6 and 22B.24-28);**
- **the ban on certain bundled products (SLCs 22B.9-16 and 22B.24-28);**
- **the ban on certain reward points (SLCs 22B.17-23 and 22B.24-28);**
- **the prohibition against tariffs exclusive to new/existing customers (SLC 22B.30 and 22B.31); and**
- **make any necessary minor consequential amendments.**

(ii) introduce an additional standard of conduct into SCL 25C that would require suppliers to have regard in the design of tariffs to the ease with which customers can compare value-for-money with other tariffs they offer.

A recommendation to Ofgem to deprioritise potential enforcement action pending the removal of the Conditions against any supplier that operates in breach of the Conditions.

- 49.1 RWE agrees that the proposed remedy will be effective in promoting competition and innovation by allowing suppliers to offer a wider range of tariffs and products designed to appeal to different customer groups. When combined with the removal of the whole of market view restrictions this will also incentivise PCWs to compete by allowing them to negotiate exclusive tariffs and to offer discounts funded by the commissions they receive from suppliers.
- 49.2 RWE considers that the proposed remedy would be effective in addressing the AEC the CMA has provisionally found in relation to the "simpler choice" component of the RMR rules ("the RMR AEC") and in addition would also address, in whole or in part, the AEC the CMA has provisionally found in respect of weak customer response (the Domestic Weak Customer Response AEC), particularly in the prepayment segment.
- 49.3 The four tariff rule has a particular impact on the prepayment segment, given that it discourages suppliers from targeting offers at specific customer segments. Similarly, the ban on almost all cash discounts prevents suppliers offering prepayment customers discounts such as cashback, which could otherwise provide a means of competing more effectively even within the existing technical constraints of the prepayment segment. The removal of these rules will therefore have a particularly beneficial impact on competition within the prepayment segment.

- 49.4 The CMA's recommendation to Ofgem to deprioritise potential enforcement action pending the amendment of the licence conditions should allow suppliers to react swiftly to these proposals resulting in competition being quickly stimulated within the prepayment segment negating the need for price control. However, in order that suppliers may rely on the relaxation of the rules immediately following the CMA's final report, RWE would suggest that Ofgem put out guidance explicitly stating that it will not enforce against breaches of these SLCs prior to their repeal.
- 49.5 RWE also notes that this remedy is further complemented by principles based regulation (an amended SLC 25C) requiring a supplier to have regard for comparability across tariffs offered by that supplier.
- 49.6 Finally, RWE agrees with Ofgem that if this proposed remedy is implemented, the methodologies for calculating the "Tariff Comparison Rates", "Personal Projections" and "Cheapest Tariff Messaging" would need to be revisited to ensure that the tools continue to serve their policy intent. These tools were not designed to accommodate multi-tier tariffs.
50. **A recommendation to Ofgem to remove the Whole of the Market Requirement in the Confidence Code and introduce a requirement for PCWs accredited under the Confidence Code to be transparent over the market coverage they provide to energy customers.**
- 50.1 RWE's response to this remedy is included below in paragraph 52 ("Remedy package aimed at enhancing the incentives and ability of PCWs to engage customers").

Proposed Remedies Concerning the Prepayment AEC and the Domestic Weak Customer Response AEC

51. **A recommendation to Ofgem to establish an ongoing programme (the 'Ofgem-led programme') to identify, test (through randomised controlled trials, where appropriate) and implement (for example, through appropriate changes to gas and electricity suppliers' standard licence conditions) measures to provide domestic customers with different or additional information with the aim of promoting engagement in the domestic retail energy markets, including a recommendation to conduct randomised controlled trials concerning the following shortlist of measures:**
- (i) changes to the information in domestic bills and how this is presented including a market-wide cheapest tariff message;**
- (ii) changes to the specific messaging that domestic customers receive in bills once they move, or are moved, on to an SVT and/or other default tariffs; and**
- (iii) changes to the name of the default tariffs.**
- Either the acceptance of undertakings from gas and electricity suppliers to participate in the Ofgem-led programme, or, absent a satisfactory number of undertakings being agreed with suppliers, either:**
- (i) a recommendation to Ofgem to modify gas and electricity suppliers' standard licence conditions to introduce an obligations on suppliers to participate in the Ofgem-led programme or requiring the provision of prescribed information;**
- (ii) an order on gas and electricity suppliers to participate in the Ofgem-led programme or requiring the provision of prescribed information (including associated amendments to suppliers' standard licence conditions); or**

(iii) a recommendation to DECC to introduce legislation imposing a requirement on suppliers to participate in Ofgem-led research programmes.

Introduction

- 51.1 RWE welcomes the CMA's proposal recommending Ofgem establish a programme to identify, test and implement measures to provide domestic customers with different or additional information to increase awareness and promote engagement. RWE would also support changes that have been robustly trialled to ensure they are within the customers' best interests, reflect changing market conditions and implemented through the most appropriate channel for the customer.
- 51.2 As set out in our response to the CMA's Notice of possible remedies¹²⁰, we consider 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. Whilst we agree that Ofgem is best placed to lead the type of programme envisaged by the CMA in this proposed remedy, we suggest that the CMA also recommends that suppliers and other parties (such as consumer groups) are consulted on the content of the trials to ensure the best result for customers. Further, the trials should test a principle with a view to providing suppliers with a framework and some flexibility in how the change is implemented rather than prescribing exactly how to implement the change. In addition, we believe it is vitally important that Ofgem identifies, tests and implements measures which support digital innovation, as we consider that digital channels and services are becoming increasingly important for driving engagement, providing customers with the information and tools to take control of their energy usage and costs.

Randomised Controlled Trials ("RCTs")

- 51.3 RWE notes that the CMA has proposed a recommendation that Ofgem conduct RCTs concerning a shortlist of three measures. We comment on each of these measures in turn below.

(i) changes to the information in domestic bills and how this is presented including a market-wide cheapest tariff message;

- 51.3.1 In our response to the CMA's Notice of possible remedies¹²¹, we commented that our own customer research indicated that whilst customers found some of the new information prescribed under RMR 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.
- 51.3.2 RWE would ask the CMA to recommend to Ofgem that the recommendations from the trials should avoid being too prescriptive and that the output provides a framework for suppliers to implement the information within principles based regulation.
- 51.3.3 RWE 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 might rely on their supplier to conduct a search on their behalf and provide them with the results. This could lead to poor choices. The lowest price may only be fixed for a short period where the customer may favour some stability in price. The proposal to test market-wide cheapest tariff messaging on bills does seem at odds with the removal of the 'simpler choices' component of RMR, as this is likely to result in an increased number of tariff choices for customers therefore making the inclusion of this information on the bill a complex calculation due to the number of tariff options available. RWE therefore believes it is appropriate for the CMA to recommend

¹²⁰ RWE's response to the CMA's Notice of possible remedies, page 70 paragraph 1.1.

¹²¹ RWE's response to the CMA's Notice of possible remedies, page 70 paragraph 1.1.

that Ofgem should consider how suppliers would implement such as proposal, in addition to robustly testing if including average savings stimulates engagement.

(ii) changes to the specific messaging that domestic customers receive in bills once they move, or are moved, on to an SVT and/or other default tariffs;

- 51.3.4 RWE agrees it is appropriate to test this proposal. However, RWE notes that in our response to the CMA's Notice of possible remedies¹²², we highlighted that, whilst adding an additional message to the bill 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. RWE would ask that the proposed trial consider this option.

(iii) changes to the name of the default tariffs.

- 51.3.5 RWE supports the CMA's proposal to test through RCTs any change of name to the default tariff. As set out in our response to the CMA's Supplemental Notice of Possible Remedies¹²³, we believe the name should be neutral so that it does not cause the customer distress, and research should seek to understand customer responses to the tariff name to ensure it is not automatically considered as the best tariff option for the customer.

Other trials in consideration

- 51.4 RWE also notes that the CMA has also considered other areas which Ofgem may wish to consider for testing within the context of this programme.¹²⁴ We comment on each of the areas in turn below:

(a) The form of information that could be presented to prepayment customers to address their lack of awareness and understanding of available options would be information with respect to security deposits; and

- 51.4.1 RWE supports trials to increase awareness and engagement within this segment.

(b) The form and frequency of marketing communications by rival suppliers in the context of the Database remedy.

- 51.4.2 Whilst RWE supports Ofgem testing the format of the initial 'Opt-out' letter, we are concerned that the suggestion that the programme also tests "*the form and frequency of marketing communications by rival suppliers in the context of the Database remedy*" suggests that these communications will be prescribed and therefore at odds with principles based regulation.

Implementation

- 51.5 RWE believes that it is in suppliers' interests to participate in the trials programme to ensure the information they provide to customers promotes engagement and reflects the changing market conditions. However, to be effective in addressing (in whole or part) the feature the CMA has identified, that certain customers face actual and perceived barriers to accessing and assessing information, we believe all suppliers should participate in the programme of trials (although not necessarily in every trial) to ensure all suppliers have the opportunity to develop their communications effectively and are able to implement changes in a timely manner.

¹²² RWE's response to the CMA's Notice of possible remedies, pages 72-73, paragraph 2.18.

¹²³ RWE's response to the CMA's Supplemental Notice of Possible Remedies, page 14, paragraph 56.

¹²⁴ PDR, page 328, paragraph 6.15.

- 51.6 RWE acknowledges that without suppliers accepting undertakings to take part in the trials programme Ofgem will be required to modify gas and electricity suppliers' standard licence conditions to oblige participation.

Timescale

- 51.7 RWE considers that the proposed implementation timescale would be appropriate to ensure the ongoing development of customer communications to increase awareness and engagement providing this is implemented using principles based regulation rather than prescriptive regulation.

52. Remedy package aimed at enhancing the incentives and ability of PCWs to engage customers.

Introduction

- 52.1 As set out in our response to the CMA's Notice of possible remedies¹²⁵, 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.
- 52.2 RWE considers that the package of remedies the CMA proposes to enhance the incentives and ability of PCWs to engage customers will act to quickly enhance customer engagement and competition amongst suppliers.

The Confidence Code

(i) A recommendation to Ofgem to remove the Whole of the Market Requirement in the Confidence Code and introduce a requirement for PCWs accredited under the Confidence Code to be transparent over the market coverage they provide to energy customers.

- 52.3 RWE supports the removal of the requirement to show the whole of market view within The Confidence Code. This, combined with the proposal for the removal of the simpler choices component of the RMR rules, will encourage and enable PCWs to negotiate exclusive offers with suppliers, thereby driving competition between suppliers to the benefit of domestic consumers. As set out in our response to the CMA's Notice of possible remedies¹²⁶, RWE also believes if customers were able to filter the choices on PCWs by different tariff attributes during the quotation process then this could help identify the most appropriate offer for them and would further encourage engagement. With the potential increase in offers available to customers following the removal of the simpler choices component of RMR, RWE believes the CMA could also recommend to the Ofgem 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 for Ofgem to provide clear guidelines on how the value of any bundle or incentive is displayed.

Providing PCWs with access to the ECOES and SCOGES databases

(ii) An order on Genserv to give PCWs access upon request to the ECOES database on reasonable terms and subject to satisfaction of reasonable access conditions.

(iii) An order on Xoserve to give PCWs access upon request to the SCOGES database on reasonable terms and subject to satisfaction of reasonable access conditions.

¹²⁵ RWE response to the CMA's Notice of possible remedies, page 6, paragraph 35.

¹²⁶ RWE's response to the CMA's Notice of possible remedies, page 36, paragraph 2.10.

- 52.4 RWE agrees with the CMA that providing PCWs with more access to customer data could improve the switching process and facilitate ongoing customer engagement. As detailed in our response to the CMA's Notice of possible remedies¹²⁷ we believe PCWs should be given access to the ECOES database. We also support the CMA's proposal to extend PCWs' access upon request to include the SCOGES database to help to improve the switching process for both fuels for customers.
- 52.5 RWE notes that the CMA has provisionally decided not to be prescriptive as regards the terms and conditions for PCWs to be given access, to allow for Gemserv and Xoserve to refuse applications and change access conditions over time.¹²⁸ RWE agrees in principle with this approach but believes that Gemserv and Xoserve should be directed to consider, when setting the terms and conditions, the general principles of: protecting customer data through constraining PCWs in their use of the databases in the same way that suppliers are constrained (i.e. to use the data only for particular restricted purposes); the need for PCWs to be assessed to ensure that they have appropriate organisational and technological processes and procedures in place to keep the data secure.
- 52.6 RWE agrees with the CMA that the proposed remedy could reduce actual and perceived barriers to switching resulting from erroneous transfers and failed switches.¹²⁹

Revising the Midata programme

A recommendation to DECC to make the following changes to the current specifications of Midata phase two:

- (i) Participation in Midata is mandatory for all gas and electricity suppliers.**
 - (ii) The scope of Midata is expanded to include the following data fields: meter type, Warm Home Discount indicator, consumption data and time-of-use for those customers on Economy 7 meters or other time of use tariffs.**
 - (iii) PCWs are given the ability seek customer consent on the frequency with which they can access the customer's data through Midata; are required to present at least two options to a customer when seeking consent to access Midata (including oen option concerning access on an annual or ongoing basis); and are given the ability to send updated tariff comparison information based on any subsequent access granted to a customer's Midata.**
- 52.7 As set out in RWE's response to the CMA's Notice of possible remedies¹³⁰ we agree that PCWs should be able to access customer data and use this data at a future point in time to be able to provide customers with an updated estimate on the potential savings available to them, if a customer has specifically provided ongoing permission. This will help to facilitate ongoing engagement in the market. It is important however that there are clear rules which consider the relevant comparators when providing customers with savings advice. For example, RWE would suggest that a simple projection of available savings over a 12 month period would not be appropriate for a customer that was currently supplied on a long term fixed product.
- 52.8 Prior to the roll-out of Smart meters, RWE agrees that the expansion of the data items within the MiData programme could help domestic customers make informed choices about their energy tariff and simplify the search and switching process. Whilst RWE considers the inclusion of the WHD indicator will help PCWs to promote the best offers to customers (as some small suppliers will not give the WHD) this may limit the tariff choices for these customers.

¹²⁷ RWE response to the CMA's Notice of possible remedies, page 7, paragraph 43.3.

¹²⁸ PDR, pages 379-381, paragraphs 6.179 and 6.184.

¹²⁹ PDR, page 381, paragraph 6.187.

¹³⁰ RWE's response to the CMA's Notice of possible remedies page 43, paragraph 2.5.

- 52.9 RWE agrees with the CMA's proposal to mandate all suppliers to participate in MiData, this should help to ensure a successful implementation of Phase 2 of the programme as all suppliers and third parties will need to work together to build and deliver the technical solution to ensure the data provided helps customers to more easily access quotes and comparisons using consistent information.
- 52.10 RWE considers the package of remedies to give PCWs access to more data will ensure PCWs drive competition within the market and will be successful in addressing some of the features that lead to the Domestic Weak Customer Response AEC and when combined with the other 'competition enhancing' remedies will lead to more competition in the prepayment segment (as well as credit market).

Interaction between this package of remedies and the proposed Prepayment Price Cap Remedy

- 52.11 RWE considers that the PCW remedies, together with the other competition enhancing remedies, can be expected to have a positive impact on customer engagement and competition between suppliers and can take effect very quickly after the CMA issues its final report.
- 52.12 However, within the prepayment segment, the positive impact of the PCW remedies (and the competition enhancing remedies more generally) will be negated by a Price Cap, which will significantly reduce prepayment customers' incentives to engage and therefore will reduce PCWs' incentives to drive competition within the prepayment segment.

53. **An order on gas and electricity suppliers requiring the disclosure to Ofgem, subject to certain use restrictions, of (i) certain details (the Domestic Customer Data) of their domestic customers who have been on one of their standard variable tariffs (or any other default tariff) for three or more years (the Disengaged Domestic Customers), and (ii) updated Domestic Customer Data every six months, for the purposes of creating, operating and maintaining a secure cloud database containing the Domestic Customer Data and allowing rival suppliers to access and use the data for the purpose of postal marketing. The order would also require suppliers, prior to disclosing the Domestic Customer Data to Ofgem, to send a prescribed letter to each Disengaged Domestic Customer, explaining the proposed use of the customer's details, and including an opt-out mechanism for the domestic customer, at any time, to object to and prevent the proposed disclosure and use of their details.**

A recommendation to Ofgem to (i) create, operate and maintain a secure cloud database for the purposes of holding the Domestic Customer Data; (ii) hold the Domestic Customer Data; (iii) enter into agreements with suppliers including access to and use restrictions concerning the Domestic Customer Data; and (iv) provide access to the Domestic Customer Data by any rival supplier that has entered into such an agreement.

Introduction

- 53.1 RWE broadly supports the CMA's proposed database remedy subject to assurances from the Information Commissioner's Office (ICO) that the sharing of information complies with the Data Protection Act (DPA) and Privacy and Electronic Communications Regulations (PECR).
- 53.2 In our response to the SSRN¹³¹, we set out our concerns regarding assumed consent. It remains RWE's view that the CMA's suggestion that all customers whose data would be shared with Ofgem (and potentially a third party acting on Ofgem's behalf in maintaining the database) and other energy suppliers would be deemed to have opted in unless they

¹³¹ RWE's response to the SSRN, page 5, paragraph 16.

contacted their supplier, goes against best practice guidance by the ICO that people should be required to opt in to marketing communication.¹³²

- 53.3 RWE notes that the CMA has said that in developing this remedy they have drawn on their discussions with the ICO. We consider that the ICO's response¹³³ to the proposal ("*... any sharing of information must be done within the requirements [of] DPA and PECR. We have made this clear to the CMA.*") makes it clear that they still have concerns as they stressed that this may require either "*individual consent*" or "*additional legal requirements*".
- 53.4 RWE considers that prepayment customers could potentially benefit most from this remedy when combined with other 'competition enhancing' remedies proposed by the CMA. However, any benefit will be negated by the proposed Prepayment Price Cap, which will significantly reduce prepayment customers' incentives to engage and therefore will reduce the effectiveness of the shared data to increase engagement within the prepayment segment.

Data protection

- 53.5 RWE believes customer data should only be shared where the customer has given explicit consent to their supplier to do so, and considers that the approach proposed by the CMA will be not be effective in increasing engagement and could potentially disengage customers. Such an approach:
- 53.5.1 risks undermining trust in the industry through large amounts of unsolicited and unwelcome marketing activity;
 - 53.5.2 increases the cost of sales to a supplier using the list compared with an opt in approach;
 - 53.5.3 an opt out approach will lead to lower quality data than if customers were to opt in; and
 - 53.5.4 is at odds with the core of current and emerging UK and European legislation on marketing consent and may be unlawful.
- 53.6 If a CMA order places suppliers under a legal obligation to share the data with Ofgem, RWE considers this shifts the onus of gaining customer consent onto Ofgem rather than removing the requirement.
- 53.7 If the CMA is minded to proceed with this proposal based on assumed customer consent the 'Opt-out letter' would need to make it clear this consent was different to the consent the customer's supplier operates to market their own products and services. Failure to do so may well have an adverse impact on individual suppliers own marketing consents levels as a customer who does not like the presumption that they can be marketed to is likely to not only opt out of the shared database but also opt out of receiving marketing information from their current supplier.
- 53.8 To protect customers' data, the data sharing agreement in place with Ofgem, and all the other suppliers/parties who have access to the data, would need to set out how the data sharing arrangement would work and how opt outs are dealt with. There would also need to be clear standards to deal with vulnerable and elderly customers who may not realise

¹³² ICO Direct Marketing Guidance – paragraph 58, page 16 "*However, organisations cannot rely on 'implied consent' as a euphemism for ignoring the need for consent, or assuming everyone consents unless they complain. Even implied consent must still be freely given, specific and informed, and must still involve a positive action indicating agreement (eg clicking on a button, or subscribing to a service). The person must have understood that they were consenting, and exactly what they were consenting to, and must have had a genuine choice – consent cannot be a condition of subscribing to a service.*"

¹³³ <https://ico.org.uk/about-the-ico/news-and-events/news-and-blogs/2016/03/ico-statement-in-relation-to-competition-and-markets-authority-report/>

that they need to actively opt out of receiving marketing using the database and then get sent multiple letters “selling” them energy.

- 53.9 In our response to the SSRN¹³⁴, we expressed concern that by including consumption data in the database, suppliers would effectively “cherry pick” which customers to target. This could result in the “more profitable” customers being contacted multiple times whilst customers that may be viewed as “less profitable” may receive limited contact, which would not achieve the overall aim of the remedy, as these customers could still be considered as having limited awareness of their ability to switch supplier.
- 53.10 As we set out in our response to the SSRN¹³⁵ we consider that data sharing of this kind would require an industry PIA (privacy impact assessment) looking into the impact on customers in having data shared in this way.

Prepayment

- 53.11 The CMA has identified that within the prepayment segment, 45% of prepayment customers have not considered switching versus 26% direct debit customers.¹³⁶ Notwithstanding our concerns regarding assumed consent, RWE considers that prepayment customers could potentially benefit most from this remedy when combined with other ‘competition enhancing’ remedies proposed by the CMA.
- 53.12 We acknowledged in our response to the SSRN¹³⁷ that there are steps that can be taken to encourage engagement by prepayment customers. An Ofgem survey¹³⁸ in 2015 highlighted that prepayment customers are not as informed as direct debit customers on their right to switch supplier or tariffs. As such, RWE considers that additional prompts to these customers, who have consented to receive them, could be effective in increasing awareness and encouraging engagement within the prepayment segment.

Restricted meters

- 53.13 RWE is concerned that by including customers with non-E7 restricted hours meters within the database there is a risk that customers will not be provided with accurate savings comparisons since suppliers, PCW and Citizens Advice calculators do not currently support multi-rate versus single rate comparisons. This may lead to suppliers actively deselecting customers with these metering configurations for fear of mis-selling since the customer may be unable to make informed choices by their energy tariff.
- 53.14 RWE acknowledges that, if consumption data is included in the database, suppliers would need to provide additional information for restricted meter customers who have been on SVT for three or more years in order that rival suppliers can understand the consumption patterns of these customers and market to them appropriately.

The French competition authority’s successful application for an interim order requiring Engie (formerly GDF Suez) to disclose details of its customers on regulated gas tariffs to other suppliers

- 53.15 The CMA stated that the proposed remedy “is modelled on the French competition authority’s successful application for an interim order requiring Engie (formerly GDF Suez) to disclose details of its customers on regulated gas tariffs to other suppliers”¹³⁹. The CMA should exercise caution in relying on the GDF Suez decision of L’Autorité de la Concurrence in the design of the proposed remedy. This is because, as the CMA itself noted in the PDR¹⁴⁰,

¹³⁴ RWE’s response to the SSRN, page 4, paragraph 10.

¹³⁵ RWE’s response to SSRN, page 4, paragraph 11.

¹³⁶ PDR, section 3, page 29, paragraph 3.91.

¹³⁷ RWE’s response to the SSRN, page 5, paragraph 12.

¹³⁸ IPSOS MORI survey for OFGEM (Customer Engagement with the Energy Market: Tracking survey 2015) reports that 63% of PPM customers knew it was possible to switch to a different gas or electricity supply, compared to 80% of DD customers.

¹³⁹ PDR, page 515, paragraph 8.30.

¹⁴⁰ PDR, page 398, paragraph 6.240

this decision was issued in the context of an investigation into the abuse of a dominant position by GDF Suez, therefore in very different circumstances to the ones under investigation by the CMA. The interim order imposed by L'Autorité de la Concurrence was in response to exclusionary behaviour by GDF Suez, which was impeding the ability of other gas suppliers to penetrate the market. In the context of the present investigation, the CMA has not evidenced the existence of an exclusionary behaviour of energy suppliers. Accordingly, the design of the measure in the context of the French competition authority's investigation into abuse of dominance is not necessarily appropriate as a basis for the design of the remedy proposed by the CMA.

- 53.16 It is also worth noting that the French competition authority's measure was an interim emergency measure pending the decision on the merits, and introduced to alleviate 'fuel poverty' as winter was approaching and customers had to urgently be made aware of the most competitive offers. The CMA's proposed remedy, on the other hand, is envisaged to be maintained for up to 5 years. Therefore, the impact of the proposed remedy will potentially be on an entirely different scale compared with the impact of the French measure and, as such, the CMA should exercise caution in modelling the proposed remedy on the French measure.
- 53.17 Finally, the CMA stated in the PDR that *"Although a number of Disengaged Domestic Customers may choose to 'opt out' of the proposed disclosure, we consider based on the opt-out rate for the similar measure implemented in France, that many customers would not and suppliers would therefore be able to contact a large proportion of Disengaged Domestic Customers to prompt them to engage"*.¹⁴¹ RWE does not believe it is appropriate for the CMA to conclude that the opt-out rate from customers will be low because the opt-out rate in relation to a *"similar measure implemented in France"* was low. In the absence of any other evidence as to the expected low opt-out rate, RWE believes that the CMA's conclusion that this remedy would be effective is consequently unsubstantiated.

Costs

- 53.18 In its assessment of the cost to implement this remedy the CMA has not acknowledged the ongoing cost to suppliers of mailing the 'Opt-out letter' which, as set out in our response to the SSRN¹⁴², RWE believes would need to be sent every six months. RWE suggests these costs could be reduced by allowing suppliers to issue the 'Opt-out letter' via email, subject to customer consent. This will enable suppliers to track 'bounce-backs', opened/unopened mails and reduce some of the customer service costs that suppliers would face when writing to large numbers of customers in a compressed period.

54. **Restricted Meters Remedy Package**

54.1 *Executive summary*

- 54.1.1 RWE acknowledges that some customers with restricted meters face higher barriers to accessing and assessing information, and higher actual and/or perceived barriers to switching.
- 54.1.2 RWE is unable to provide a view on the effectiveness or proportionality of the package of remedies described in paragraph 11(10)(h) of the PDR at this stage due to the lack of clarity around the change of occupier and tariff end processes (please see below). RWE is unclear whether the CMA proposes that the metering configuration should continue to determine the deemed tariff in a change of occupier scenario or at fixed term contract tenor end or whether the CMA proposes to change this approach such that, after the incumbent customer elects

¹⁴¹ PDR, page 515, paragraph 8.30

¹⁴² RWE's response to the SSRN, page 8, paragraph 27.

to take up a single-rate fixed term contract offer, the site should be treated thereafter as if a single-rate meter is in situ.

54.2 *Specific points on the CMA's proposed revised remedy package*

An order on gas and electricity suppliers with more than 50,000 domestic customers (and amendments to suppliers' standard licence conditions) (i) requiring such suppliers to make all their single-rate electricity tariffs available to all (existing and new) domestic electricity customers on restricted meters, and (ii) prohibiting such suppliers from making their single-rate electricity tariffs available to domestic electricity customers on restricted meters conditional upon the replacement of their existing meter.

Removing the barriers to switching

54.2.1 RWE agrees that the proposed remedy requiring suppliers to make all their single-rate electricity tariffs available to all (existing and new) electricity customers on restricted meters should apply to all gas and electricity suppliers with more than 50,000 domestic customers.

54.2.2 To ensure restricted meter customers are able to access and assess the relevant information in order to make informed decisions about their choice of tariff, PCWs and Citizens Advice will need to substantially develop their price calculators to ensure they can accommodate multi-rate tariffs. Any comparison must reflect in the calculation of the customer's current restricted meter tariff charges the customers' consumption at different time of use tariff rates, as aggregating total consumption would not provide an accurate bill value to compare with the prospective single-rate offer.

Change of occupier

54.2.3 The CMA needs to consider the rules regarding deemed tariffs when a new customer moves into a property with a restricted meter as currently the metering configuration determines the default deemed tariff which would be a multi-rate tariff not a single-rate tariff (see further below in relation to tariff end).

54.2.4 RWE's systems cannot currently register new customers with restricted meter properties and therefore a system development will be required once the CMA has confirmed the change of occupier process.

Tariff end

54.2.5 RWE assumes that once a restricted meter customer has switched to a single-rate tariff they will not be able to switch back to a preserved restricted meter tariff (although they could switch to another restricted meter tariff if a suitable tariff is available in the market). We would ask that the CMA make this point clear.

54.2.6 This is particularly relevant in the case of tariff end. Currently, SLC 23 requires that a customer be moved onto the cheapest evergreen tariff for that customer's circumstances. In the case of a restricted meter customer that has chosen to move to a single-rate fixed term tariff, under the current proposal it is unclear whether SLC 23 would require the supplier to move the customer onto single-rate SVT or onto a restricted meter tariff. We assume that once a customer has chosen to move onto a single-rate tariff, they should thereafter be treated as a single-rate customer and should be moved onto a single-rate SVT at the end of a fixed rate tariff. From a technical perspective, this is important: if a customer moves onto a single-rate fixed term tariff with a different supplier, that supplier may not be able to support the metering configuration for that customer and would therefore not have a multi-rate tariff for a customer to default on to. We would ask that the CMA should make clear what a supplier's obligation pursuant to SLC 23 would be under the CMA's proposed remedy.

An order on gas and electricity suppliers (and amendments to suppliers' standard licence conditions) requiring suppliers to (i) remind their domestic electricity customers on restricted meters, in their regular communications with them, that they have the option to switch supplier or to switch to a single-rate tariff without having to change their meter or incur replacement costs, (ii) provide their domestic electricity customers on restricted meters contract details for Citizens Advice, and (iii) provide on a timely basis, Citizens Advice with the information it may reasonably require concerning customers on restricted meters in the format specified by Citizens Advice.

A recommendation to Citizens Advice to become a recognised provider of information and support to domestic electricity customers on restricted meters.

Access to information and advice

- 54.2.7 RWE acknowledges that in order to reduce the barriers to accessing and assessing information some restricted meter customers face, suppliers will need to ensure their regular communications reminding customers of their right to switch tariff and/or supplier, and include contact details for Citizens Advice.
- 54.2.8 RWE agrees Citizens Advice is better placed than Ofgem to provide customers on restricted meters with additional information and support to understand how tariffs and bills might compare. This will require Citizens Advice to develop their price comparison calculators based on suppliers providing information on their restricted meter tariffs in a timely manner.
- 54.2.9 As the CMA has identified, many restricted meter customers have remained with their incumbent supplier¹⁴³ and as such may require additional support to compare their existing multi-rate tariffs with the increased number of single-rate tariff options the other competition enhancing remedies are expected to deliver.

F. MICROBUSINESS WEAK CUSTOMER RESPONSE AEC

55. Introduction

- 55.1 The PDR sets out the remedies the CMA considers are required to address the Microbusiness Weak Customer Response AEC provisionally identified in the CMA's PFs and the resultant consumer detriment as updated in the PDR.
- 55.2 We responded in full to the CMA's provisional finding of Microbusiness Weak Customer Response AEC as set out in its PFs and we do not repeat our submissions here, which can be summarised as follows:
- 55.2.1 In RWE's view there are fundamental differences between the microbusiness and domestic segments of the retail market, which the CMA failed to recognise.
- 55.2.2 RWE did not consider that the CMA had produced evidence to support a provisional finding of an AEC of Microbusiness Weak Customer Response, or that the CMA adduced reliable evidence of the existence, or ability on the part of suppliers to exploit, unilateral market power. RWE considered:
- 55.2.2.1 First, that the CMA had overstated the level of any disengagement. In particular, since this remains especially pertinent to the CMA's proposed remedies, RWE did not accept that microbusiness customers face actual or perceived barriers to accessing and assessing information in order for them to access better deals.
- 55.2.2.2 Second, that a finding of ability to exploit unilateral market power was completely at odds with a properly drawn analysis of profitability.
- 55.2.2.3 Third, RWE recognised that aspects of TPI conduct and the continuation of auto-rollover in some quarters could be expected to be detrimental to engagement.
- 55.3 RWE is disappointed that the CMA has made little attempt to update the analysis underlying its provisional finding of a Microbusiness Weak Customer Response, despite the fact that its Microbusiness analysis at the time of publishing PFs lagged some way behind the rest of the CMA's analysis.
- 55.4 The CMA has made some updates to its analysis of detriment in the PDR, but has failed to conduct a robust assessment. For the Microbusiness segment, the CMA uses the "indirect approach", based on its analysis of profitability of the SLEFs. The CMA estimates that the lower bound for the detriment arising in the Microbusiness segment is approximately £230 million per year (without efficiency adjustments).¹⁴⁴
- 55.5 RWE considers that the CMA's profitability analysis significantly overstates the level of detriment. RWE's concerns about the fundamental flaws of the CMA's profitability assessment are explained further in Schedule 1 and we do not repeat these here. In short, the CMA bases its conclusions solely on its ROCE calculations, and the CMA continues to overstate ROCE because it understates the economic value of key components of capital employed.
- 55.6 Given that RWE does not consider that the CMA has properly made out the existence of a Microbusiness Weak Customer Response AEC or properly assessed any detriment that might result from such an AEC, RWE would question whether any remedies for the Microbusiness segment can be justified. Without prejudice to these points, RWE is broadly supportive of measures aimed at driving microbusiness engagement, provided that these

¹⁴⁴ PDR, page 546, paragraph 9.16.

measures are implemented in a manner that does not impose undue costs on suppliers or give rise to material adverse consequences.

- 55.7 RWE is however particularly concerned that the price transparency remedy, if it is not carefully designed, will have the unintended consequence of undermining customer choice and product innovation which are enabled through TPI and telesales channels.¹⁴⁵ RWE is of the view that the current TPI market and telesales channels benefit customers by proactively stimulating engagement and offering a broad choice of deals to suit customers. Any price transparency remedy should build on existing drivers of competition and not narrow the range of products available to customers. RWE notes that the CMA states there is "*limited TPI penetration in the microbusiness segment*"¹⁴⁶ with 11% microbusinesses having bought their current energy contract through a broker. This is contrary to RWE's direct experience where [CONFIDENTIAL].¹⁴⁷¹⁴⁸ The CMA risks under estimating the positive role TPis play in the market. RWE considers it to be essential that any price transparency remedy allows the offline sales channels to continue to thrive and stimulate customer engagement. If it does not, it risks limiting customer choice and customer benefits will be lost as a consequence.

56. The Price Transparency Remedy

An order on gas and electricity suppliers (and amendments to suppliers' standard licence conditions):

- (i) **requiring suppliers to disclose the prices of all available acquisition and retention contracts to non-domestic customers falling within a defined category (the 'Proposed Segment') either through an online quotation tool made available on their website, or through one or more third party online platforms (and including a web link on their own website to direct non-domestic customers to such third party online platform(s)); and**
- (ii) **requiring suppliers to disclose the prices of all their out of contract and deemed contracts on their websites.**

- 56.1 RWE notes that as currently drafted the price transparency remedy is open to a wide range of interpretations and it is essential that the remedy is more specific in a number of areas in order that implementation across all suppliers is smooth, consistent and easy for customers to understand and navigate.

- 56.2 RWE sets out below a range of constructive clarifications and modifications to the design of the price transparency remedy with the aim of producing a workable remedy which is easy for customers to use and maintains the positive features of the current TPI and telesales channels.

- 56.3 In order to set these comments in context, we first set out our high level understanding of the remedy as set out in the PDR:

- 56.3.1 Suppliers shall enable customers to obtain quotes for all acquisition products and retention products that are **available** to them online after inputting two **primary** pieces of information. The primary pieces of information are their postcode (not full address) and their consumption; although suppliers can also ask for their MPAN/MPRN and spend (£). The prices quoted shall be transactable, subject to passing a **credit check**.

¹⁴⁵ RWE Response to A request for information from the CMA on Remedy 7a, 8 October.

¹⁴⁶ PDR, page 611, paragraph 9.278.

¹⁴⁷ RWE operational sales reporting, February 2016.

¹⁴⁸ RWE Response to Notice of Possible Remedies, Remedy 7b, Paragraph 1.1.

- 56.3.2 Suppliers may apply any number of relevant secondary criteria to filter these offer prices to identify which of them best fits the customer's needs but will not be permitted to increase the price of a quote after the initial quote based on the customer's primary information inputs.
- 56.3.3 Suppliers must signpost the online quotation tool (OLQT) prominently on their websites and ensure it is easy for customers to navigate such that customer can find and use it easily.
- 56.3.4 Customers, suppliers and TPIs shall be free to negotiate bespoke products and prices outside the OLQT.
- 56.3.5 Suppliers shall publish "out of contract" prices on their websites. RWE understands this to specifically refer to two circumstances: the charges applied to customers who have terminated their contract but are still on supply after their Contract End Date (RWE product description is Default); and charges applied to customers who move into premises already supplied by RWE but who have yet to agree a contract (RWE product description is Deemed).
- 56.3.6 The OLQTs will be available from June 2017.

Primary Information Inputs

- 56.4 If it is the CMA's intention to provide an OLQT which would provide a customer with a single price for a small number of options for fixed term contracts (FTCs) and variable price contracts to easily compare, then some additional design features are required. This is because the current design with two **primary information inputs** does not deliver a small number of results. As currently drafted the customer is likely to be confronted with a very large table of multiple products, features and benefits which they would have to filter themselves unless they choose to provide the secondary inputs. RWE therefore proposes the following modifications:
 - 56.4.1 First, the postcode input should include full address, since postcode alone is not enough to allow the supplier to identify the supply address.
 - 56.4.2 Second, RWE believes increasing the primary inputs from 2 to 4 will significantly reduce the number of potential options presented to customers, thereby increasing the ease of use and ensuring the customer only sees products that are relevant to them and that they can transact upon. The two additional primary inputs – contract start date and credit check – are explained in more detail below.
- 56.5 The omission of the contract start date from the primary information inputs is a serious omission and a key driver of the large number of quotes that would result. Many microbusiness customers agree energy contracts up to 6 months ahead of their existing contract end date and therefore the OLQT would need to set out quotes for products with start dates from the day of the quote to 6 months ahead in order for the customer to select the start date appropriate to them. RWE suggests that including the contract start date in the primary information inputs would avoid presenting the customer with quotes that are not relevant to their circumstances.
- 56.6 Similarly RWE remains concerned that CMA is suggesting that quotes are transactable subject to a credit check. This implies that credit checks are seen as a post-sale activity with the consequence that customers may see quotes for products that in reality are not available to them and that they may attempt to purchase products which are subsequently withdrawn. RWE confirm that it is possible for a credit check to be carried out at the point of sale and that this will not slow down the immediacy of the OLQT.
- 56.7 RWE notes that suppliers' credit policies differ so the consequences of excluding credit check information from the primary inputs may be misleading price comparisons. If credit checks were included in the primary stage of quote generation then customers would have a more

reliable view of the actual price to them and so be in a better position to choose between suppliers and/or products.

- 56.8 As stated in RWE's response to the CMA on remedy 7a¹⁴⁹, prices quoted without a credit check would lead either to prices being higher as a result of the increased risk of not being able to ascertain a business customer's credit worthiness or to a high number of product offers being withdrawn following the credit check. The impact of the former is that those businesses with a good credit history would not necessarily be getting the best price available to them, whereas the impact of the latter would likely be customer frustration and increased customer disengagement.
- 56.9 RWE understands that under the remedy suppliers are allowed to take account of the specific attributes of a renewing customer and (since we cannot currently refuse supply) to offer them transparent prices for online contracts that are available to them specifically, which will include/exclude certain products as necessary to take account of their payment history and demand profile. The CMA is asked to make this clear.

Definition of Available Products

- 56.10 RWE believes that an expansion of the requirement to provide online quotes for products not available to a particular customer or for products not intended for sale by the online channel will risk substantially complicating the OLQT and reducing the ease of use and usefulness to customers.
- 56.11 It is essential that the design is clear about when a product is **available** to be quoted online. The remedy design should make clear that where a product has been designed to be sold exclusively offline, such as the bespoke negotiated products sold through telesales or through TPIs, these products need not be listed on the OLQT, as the prices agreed with the customers are subject to obtaining further information from them and will be bespoke to them. The negotiated aspect of such products means that OLQT could not offer these products.
- 56.12 RWE notes that TPIs (as a 'push' channel) actively stimulate engagement of customers in the market. This existing competition will be further enhanced through the other measures the CMA sets out in the PDR. RWE is concerned that should the price transparency remedy force suppliers to include offline products on the OLQT (which RWE understands is not the CMA's current intention) this would have the effect of removing the negotiated bespoke nature of TPI sales and undermine the vital role of TPIs in stimulating the development of products tailored to particular customers and so reduce customer choice and a key driver of customer engagement.
- 56.13 In addition, RWE agrees there should be no requirement to provide renewal price quotes to newly acquired customers or renewal quotes for potential future customers who have yet to be acquired as these products are not available to them. The CMA acknowledges that a supplier should not be required to offer renewal quotations to customers that recently started an FTC (e.g. on day 2 of its three-year FTC)¹⁵⁰; in fact RWE assumes that a supplier would not be required to provide a customer on an FTC with a renewal quotation for a product until a time close to the contract end date e.g. within six months of the CED.

Like for Like Comparison

- 56.14 The CMA indicates a wish to make it easier for customers to compare prices¹⁵¹. RWE is concerned that the remedy is silent on the need for quotations to be inclusive of all charges. The remedy does cover hidden charges but not charges that may be explicitly excluded. For example, one of the SLEFs currently offers contracts for microbusiness that are subject to pass-through of Feed In Tariffs and capacity charges, and provides details of these charges for year one only, even if the contract is for more than one year. RWE is concerned

¹⁴⁹ RWE Response to a Request for Information from the CMA on remedy 7a, question 9a, 8 October 2015.

¹⁵⁰ PDR, page 562, paragraph 9.74.

¹⁵¹ PDR March 2016, Section 9, paragraph 9.74.

that customers may be misled if the basis of comparisons is not clear and not “like for like”. RWE contracts for microbusiness are fully inclusive and RWE suggests that this should be the basis of the quotes given by the OLQTs from all suppliers.

Sunset Clause

- 56.15 RWE notes that half-hourly settled customers are excluded from this remedy¹⁵² (and agrees with this). RWE expects that as half-hourly settlement enables the development of time of use tariffs and demand side response product, any kind of simple quotation tool would be less relevant as customer consumption shape data would be needed to assess the suitability of different products and to quote them. The nature and operation of such quotation tools would be very different to the OLQT proposed by the CMA. As the proportion of customers choosing demand side response products increases, the OLQT will become less used. RWE believes the CMA should make clear how the remedy would be changed in these circumstances and that this be cross-referenced with the remedy for a defined timetable for the introduction of mandatory universal half-hourly settlement; for example, RWE would support a “sunset” clause providing for the expiry of the OLQT remedy which aligns with the introduction of mandatory universal half-hourly settlement.

Implementation Timescales

- 56.16 On the basis that the remedy is as described in paragraph 56.3 above, RWE will be able to comply with the requirement to implement the price transparency remedy by June 2017. However, should the requirements be different RWE will need to reassess whether it is possible to deliver in these timescales. [CONFIDENTIAL]

57. **The Auto-rollover Remedy**

An order on gas and electricity suppliers (and amendments to suppliers’ standard licence conditions):

- (i) prohibiting the inclusion of conditions in their existing and future auto-rollover contracts with microbusiness customers that:**
 - **prohibit the microbusiness customer from giving a termination notice up to the last day of the initial fixed-term period;**
 - **prohibit the microbusiness customer from giving a termination notice up to the last day of the fixed-term roll-over period; and**
 - **impose a termination fee and/or no-exit clause for the roll-over period;**
- (ii) prohibiting the transfer of microbusiness customers that have given a termination notice during the rollover period of an auto-rollover contract to a higher priced contract during the notice period; and**
- (iii) prohibiting the inclusion of a condition in their existing and future out-of-contract, and evergreen contracts with microbusiness customers that include termination fees.**

- 57.1 RWE supports this remedy. As previously reported to the CMA¹⁵³, after ending auto-rollovers RWE saw higher rates of customer engagement. RWE therefore considers that ending auto-rollovers by all suppliers across the industry will be an effective way of increasing customer engagement.

¹⁵² PDR March 2016, Section 9, paragraph 9.59, footnote 1147.

¹⁵³ RWE Follow up actions from CMA/RWE hearing, Changes in Customer Behaviour, Paragraph 13.

57.2 RWE considers itself fully compliant with the proposal as set out in the PDR.

58. **The Ofgem Programme to Promote Microbusiness Customers Engagement**

A recommendation to Ofgem to establish an ongoing programme to identify, test (through randomised controlled trials, where appropriate) and implement measures to provide microbusiness customers with different or additional information with the aim of promoting engagement in the microbusiness segments of the SME retail energy markets.

58.1 RWE considers that the CMA has not made out the case for this remedy: the CMA itself notes that it has less evidence that ineffective microbusiness information is as big a problem as the CMA finds it to be in the Domestic segment, and the CMA does not consider the proposed remedy to be critical to the success of its proposed package of remedies.¹⁵⁴

58.2 That being said we agree that all retail energy suppliers should take reasonable steps to prompt customers who are on default tariffs to engage in the market¹⁵⁵ where default tariffs are auto-rollover, deemed, out of contract and evergreen tariffs. RWE would remind the CMA about the measures we have taken to promote engagement with our customers as set out in the "Follow up actions" from the CMA/RWE Hearing.¹⁵⁶

58.3 We support non-mandated supplier involvement in the Ofgem led programme. However where the programme demonstrates effective measures, these should apply to all suppliers.

58.4 As set out in our response to the Domestic Ofgem Programme to promote customer engagement, whilst RWE agrees that Ofgem is best placed to lead the programme, we consider that suppliers and other parties such as business groups are consulted on the content of the trials to ensure the best result for customers. The trials should test a principle with a view to providing suppliers with a framework and some flexibility in how the change is implemented rather than prescribing exactly how to implement it. Since involvement in the Ofgem led programme will not be mandated but compliance with the outputs of the programme may well be, it is essential that the CMA follows a fair process, including that it consults prior to each trial on the purpose and subject matter of the trial, as well as during each trial; and that industry participants may opt into or out of each trial at appropriate stages.

58.5 In addition, we believe it is vitally important that the regulatory framework supports digital innovation since we consider digital channels and services are becoming increasingly important for driving engagement, providing businesses with the information and tools to take control of their energy usage and costs.

59. **The Database Remedy**

An order on gas and electricity suppliers requiring the disclosure to Ofgem, subject to certain use restrictions, of (i) details of certain of their microbusiness customers that have been on a default contract for three or more years (the 'Microbusiness Customer Data'); and (ii) updated Microbusiness Customer Data every six months, for the purposes of creating, operating and maintaining a secure cloud database containing the Microbusiness Customer Data for the purpose of postal marketing.

A recommendation to Ofgem to (i) create, operate and maintain a secure cloud database for the purposes of holding the Microbusiness Customer Data; (ii) hold

¹⁵⁴ PDR, pages 594-595, paragraph 9.210.

¹⁵⁵ RWE Response to Notice of Possible Remedies, Remedy 10, SME Response, Paragraph 3.1, 5 August 2015.

¹⁵⁶ RWE Follow actions from CMA/RWE hearing, Changes in Customer Behaviour, Paragraph 13.

the Microbusiness Customer Data; (iii) enter into agreements with suppliers including access to and use restrictions concerning the Microbusiness Customer Data; and (iv) provide access to the Microbusiness Customer Data by any rival supplier that has entered into such an agreement.

- 59.1 RWE broadly supports the principle of the CMA's proposed database remedy. However, there are a number of design features which need to be included in order to address the issues which RWE has identified, as set out further below. These largely relate to data protection concerns and issues.
- 59.2 Microbusinesses are a heterogeneous group and consist of sole traders, partnerships and limited companies. Data Protection legislation affords sole traders and partnerships the same protection as Domestic customers whereas it applies in a different way to limited companies. Consequently the remedy needs to be designed in two sections: sole traders and partnerships; and limited companies. Where the supplier does not know which category applies, RWE considers the rules for sole traders and partnerships should apply.
- 59.3 While RWE supports measures to promote customer engagement, as drafted, the database remedy risks encouraging suppliers to contact customers on the database in an uncontrolled way, with the unintended consequence of potentially inundating customers with white mail. Although intended as a postal campaign resource it is not clear how the CMA intend to prevent or control associated or "follow on" campaigns via telephone calls and even door to door sales approaches. All of this activity will be in addition to the additional communications which will result from the Ofgem programme.
- 59.4 RWE considers this will be exacerbated by an opt-out approach and therefore proposes an opt-in approach. This is because an opt-out approach:
 - 59.4.1 risks undermining trust in the industry through large amounts of unsolicited and unwelcome marketing activity;
 - 59.4.2 increases the cost of sales to a supplier using the list compared with an opt in approach;
 - 59.4.3 leads to lower quality data than if customers were to opt in, where "ghost" microbusinesses (i.e. those we have on our records but which no longer exist) would be automatically be excluded; and
 - 59.4.4 is at odds with the core of current and emerging UK and European legislation on marketing consent and may be unlawful.
- 59.5 Furthermore, RWE suggests the CMA amend or consider further:
 - 59.5.1 Clauses which clearly identify what the information in the database can be used for, that is, solely for the purposes of postal marketing and that it should not be used in other activities such as walk books for door to door sales;
 - 59.5.2 How it is consistent with new European Data Protection legislation in 2018;
 - 59.5.3 Details of how suppliers shall obtain consent and, for example, whether this is done at each point of refreshing the database;
 - 59.5.4 Details of who can gain access to the customer information in the database and the agreements to which they must be party in order to gain access. In order to protect customers these agreements should include mechanisms which prevent the abuse and inappropriate use of the data, quality standards such as complaint levels and triggers and processes for disqualification;
 - 59.5.5 Suppliers should not be required to provide fixed telephone numbers because this is superfluous to the purpose of postal marketing and in some cases we may not have telephone numbers for the customer; and

- 59.5.6 Details of data security measures required by Ofgem to ensure that they have the appropriate technical and organisational processes in place. RWE has concerns about the data being held in the cloud because this could mean that it is actually held out outside of the European Economic Area.
- 59.6 Finally, RWE notes that the CMA states that details of microbusinesses on default contracts "*(eg auto-rollover, evergreen, deemed and/or OOC contracts) for 3 or more years*" should be on the Ofgem database.¹⁵⁷ RWE supports this definition.
60. **The TPI Information Disclosure Remedy (not being pursued)**
- 60.1 RWE is concerned that the CMA has underestimated the scale and importance of TPIs for microbusinesses in the market. Our direct experience differs markedly from that reported in the PDR¹⁵⁸. The Ofgem survey reports that only 11% of microbusiness customers procured their current energy contract with the help of a broker [CONFIDENTIAL].¹⁵⁹
- 60.2 We remain concerned that customers buying through a TPI do not have assurances around the breadth of search, nor the fees they are being charged for the service and have limited right of redress if they feel they have not been served well. In this regard, we note that the Price Transparency Remedy targets the smaller microbusiness customers with the most straightforward requirements, whereas we would expect the larger microbusiness customers and/or those with more complex requirements to continue to utilise TPIs.
- 60.3 Therefore we continue to consider that there is a need for formal regulation of TPIs, either through requiring TPIs to be licensed by Ofgem or requiring any TPI wishing to operate within the microbusiness segment to comply with a mandatory Code of Practice.

¹⁵⁷ PDR, page 599, paragraph 9.232.

¹⁵⁸ PDR March 2016, Section 9, paragraph 9.278.

¹⁵⁹ RWE operational sales reporting.

G. GOVERNANCE AEC

61. A recommendation to DECC to initiate a legislative programme with a view to:

- (i) deleting paragraph 1C from both sections 4AA of the Gas Act 1986 and 3A of the Electricity Act 1989; and**
- (ii) set up a clear and established process for Ofgem to comment publicly, by publishing opinions, or all draft legislation and policy proposals which are relevant to Ofgem's statutory objectives and which are likely to have a material impact on the GB energy markets.**

61.1 RWE was in agreement with the CMA's proposed remedies in respect of Remedies 16 and 17 as set out in the CMA's provisional notice of remedies.¹⁶⁰ We shared 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. We also shared the CMA's concerns that institutional pressure from DECC on Ofgem to implement particular policies reduces transparency and accountability.

61.2 RWE welcomes the CMA's proposals to 're-set' the governance of the regulatory framework and recalibrate the roles and responsibilities of Ofgem, DECC and industry participants to ensure that there is a clearer focus on competition and the interests of consumers combined with measures to improve robustness and transparency in regulatory decision-making. RWE stands ready to play its part in bringing the CMA's recommendations in this area to fruition.¹⁶¹

61.3 RWE supports these proposals and agrees that there is a need to remove constraints created by EA10 and amend Ofgem's duties in the Gas Act 1986 and the Electricity Act 1989 to bring clearer focus to Ofgem's primary objective of meeting the needs of consumers through promoting competition.

61.4 RWE supports the recommendation that Ofgem should comment publicly on draft legislation and policy proposals that are relevant to its statutory objectives and believe that Ofgem should be clear to make objective rather than normative statements about the policy of elected government. This will increase transparency and promote consistency and efficiency in the development of policy. However, it is important to ensure that there is clarity on the scope of Ofgem's ability to comment to ensure that there is no intrusion into elected government responsibility for setting policy objectives. It is important that this new process is given effect through legislation, as proposed, to provide this clarity and to ensure that formal and public fora for airing differences of views are indeed used. RWE supports the introduction of this measure in tandem with the change to Ofgem's duties and considers that the two together will deliver a more effective regulatory regime able to promote effective competition and promote the interests of consumers.

62. A recommendation to DECC and Ofgem to publish detailed joint statements concerning proposed DECC policy objectives that are likely to necessitate parallel, or consequential, Ofgem interventions, setting out (i) a proposed action plan for the regulatory interventions needed and responsibility for these, (ii) an estimated timetable, and (iii) where appropriate, a list of relevant considerations in designing the policy.

62.1 RWE supports the proposal for DECC and Ofgem to publish detailed joint statements concerning proposed DECC policy objectives that are likely to necessitate parallel, or consequential, Ofgem interventions.

¹⁶⁰ Notice of Possible Remedies, page 41, paragraphs 113 and 115.

¹⁶¹ PDR, page 622, paragraph 10.3.

- 62.2 RWE considers that detailed joint statements, including action plans, with a clear delineation of responsibilities (between DECC, Ofgem and the industry) and appropriate expert input, could facilitate a greater awareness of the scale of change facing the industry and help to improve the change management process, by facilitating early identification of the interdependencies and congestions on the main regulatory work streams and aiding prioritisation.
- 62.3 However, the joint statements will only deliver these benefits if they (i) include a clear delineation of responsibilities between DECC, Ofgem and the industry and (ii) benefit from appropriate industry expertise early on in the development of the action plans.
- 62.4 The CMA has proposed that DECC/Ofgem consult on the statements, which we welcome. In addition to broad industry consultation on the statements, RWE recommends that that DECC/Ofgem be required to engage in early consultation with industry experts when developing the action plans, as this will be invaluable in identifying interdependencies, contingencies and congestions and setting workable timetables. We believe that this could be facilitated through the establishment of change management forum or panel with appropriate expert industry representation.
- 62.5 Appropriate programme management expertise will be required to ensure that the action plans and timetables are robust and implementable. To the extent that Ofgem or DECC do not have the appropriate skill sets internally, they should seek external, or recruit such, expertise.
63. **A recommendation to Ofgem to (i) publish annually a state of the market report (the 'State of the Market Report') which would provide analysis regarding issues such as (i) the evolution of energy prices and bills over time, (ii) the profitability of key players in the markets (eg the Six Large Energy Firms), (iii) the social costs and benefits of policies, (iv) the impact of initiatives relating to decarbonisation and security of supply, (v) the trilemma trade-offs, and (vi) the trends for the forthcoming year.**
- 63.1 RWE supports the proposal for a new 'Office of the Chief Economist' unit within Ofgem to publish an annual state of the market report, providing clear and trusted evidence on recent performance of government policies.
- 63.2 We agree that a regular, technical assessment of the evolution of energy prices and bills, social costs and benefits of policies, impacts of initiatives on decarbonisation and security of supply and the trilemma trade-offs could help to improve policy making and increase trust in the market.
- 63.3 To maintain the credibility and trust of the analysis by all stakeholders, assessments undertaken by the new unit should be factual, without any normative statements or value judgements. The focus should be to keep an account of the recent performance of government policies individually and collectively, against an agreed set of parameters.
- 63.4 An effective assessment of the state of the market, including the proposed analysis of the profitability of market participants, must include all players in the market, particularly in light of the growth in market share of a number of smaller players. The overall health and sustainability of the market can only be effectively evaluated if all market players are considered.
64. **A recommendation to Ofgem to create a new unit (eg an office of the chief economist) within Ofgem, which would build expertise across the different areas of the energy markets with a view to publish annually the State of the Market Report.**

- 64.1 While RWE continues to believe that an institution separate from both DECC and Ofgem is the best way to avoid conflicts of incentives and ensure impartiality, we support the CMA's proposed remedy to create an Office of the Chief Economist within Ofgem, particularly in light of proposals to strengthen the independence of the regulator.
- 64.2 RWE supports the objectives of the new unit to enhance confidence by providing trusted and clear energy analysis to 'enable policy makers to make more effective assessment of the performance of policy objectives' and to 'help them communicate any trade-offs to stakeholders.'
- 64.3 To ensure the effectiveness of the new unit, it will need a clear Terms of Reference, which clearly defines the roles and responsibilities of DECC, Ofgem and other institutions and provides clarity on the relationship between the new unit and existing institutions (such as the National Infrastructure Commission and the Committee on Climate Change). In order to be effective, the unit will require the appropriate resource and technical expertise to judge and synthesise data, as well as skills to communicate clearly to a wide range of stakeholder interests (media, politicians, consumer and industry associations, energy firms).
- 64.4 We believe DECC, as the representative of elected officials, should continue to be responsible for setting policy objectives and determining the policies to achieve these objectives. However, in this context we believe that regular, technical assessment which focuses on accounting for recent energy system performance and providing transparent analysis, will aid in the development of better policy implementation.
65. **A recommendation of Ofgem to modify the licence conditions of the Six Large Energy Firms' generation and supply licences by introducing requirements to:**
- (i) report their generation and retail supply activities on market rather than divisional lines;**
 - (ii) report a balance sheet as well as profit and loss account separately for their generation and retail supply activities;**
 - (iii) disaggregate their wholesale energy costs for retail supply between a standardised purchase opportunity cost and a residual element; and**
 - (iv) report prior year figures prepared on the same basis.**

Introduction

- 65.1 The CMA has proposed changes to the financial reporting of the SLEFs the purpose of which is to provide sufficient *"information that will allow it to provide a clear and trusted assessment of the GB energy markets...This in turn will inform the public debate and enhance government's ability to design and implement appropriate policies."*¹⁶²
- 65.2 The CMA's changes *"will require the Six Large Energy Firms to:*
- (a) report their generation and retail supply activities on market rather than divisional lines;*
 - (b) report a balance sheet as well as a profit and loss account separately for their generation and retail supply activities;*
 - (c) disaggregate their wholesale energy costs for retail supply between a standardised purchase opportunity cost and a residual element; and*

¹⁶² PDR, page 674, paragraph 10.216.

(d) *report prior year figures prepared on the same basis.*¹⁶³

- 65.3 In line with previous responses, RWE is supportive of current segmentation of performance and activities (but not separation of activities) and transparency of profitability in its Generation and Supply businesses. Through this segmentation of performance and activities, RWE already operates its divisions (including Trading) on an arm's length basis. Our Consolidated Segmental Statements ("CSS") financials are also directly reconcilable to the IFRS numbers reported in the RWE Accounts. In addition, the CSS is audited for arm's length operation by external auditors, a new requirement from 2015 (reporting on 2014 results).
- 65.4 It is RWE's view that the current disclosure requirements in the CSS provide appropriate transparency. Any further disclosure for the purpose of analysing profitability would, in RWE's view, fail to provide beneficial information and in some cases could provide misleading information.
- 65.5 The CMA's proposed remedy in relation to financial reporting is flawed because it:
- 65.5.1 seeks to facilitate the future measurement of profitability using a ROCE approach which is inappropriate for retail suppliers;
 - 65.5.2 applies a wholesale cost benchmark for SVT tariffs which does not represent a prudent risk management approach; and
 - 65.5.3 gives rise to practical challenges of producing further segmented results/balance sheets which will provide an incomplete view of the market because the requirements only apply to the Six Large Energy Firms.
- 65.6 We discuss each of these three areas in turn.

ROCE is not an appropriate measure of profitability

- 65.7 The CMA states that additional financial information would enable Ofgem to "*undertake an analysis of the profitability of the Six Large Energy Firms' generation and supply activities, which would involve calculating the return on capital earned by such firms and comparing that return to a benchmark 'normal' rate of return*".¹⁶⁴
- 65.8 We consider that ROCE is not an appropriate measure of profitability for a retail supply business. RWE has stated this position in all its previous responses in relation to the CMA's profitability analysis, and the CMA's use of ROCE applied throughout the Investigation has been strongly disputed by all of the SLEFs. As RWE has explained previously:
- 65.8.1 the results of ROCE analysis for an asset-light industry are inherently volatile both because: (i) the capital employed denominator is low and small variations in the numerator lead to material fluctuations in ROCE; and (ii) total capital employed is highly sensitive to the valuation of intangible assets and notional capital, which are difficult (but necessary) to estimate, given that neither are valued for financial reporting purposes;¹⁶⁵
 - 65.8.2 although there is significant regulatory precedent for the use of ROCE analysis in asset-intensive industries, the use of ROCE to set regulated prices in asset-light industries is less frequent and secondary to the margin approach. UK competition authorities have previously attributed high ROCEs to the limitations in the valuation of capital employed used and recent price controls by UK utility

¹⁶³ PDR, page 694, paragraph 10.294.

¹⁶⁴ PDR, page 681, paragraph 10.242.

¹⁶⁵ RWE's response to ROCE working paper, 2.6.1.

regulators have used measures of profitability that do not depend upon the valuation of assets;¹⁶⁶

- 65.9 The CMA recognises ROCE analysis is unreliable unless proper adjustments are applied when it states that *"analysis of the ROCE of asset-light firms in the FTSE100, performed by RWE (and the similar analysis undertaken by E.ON), does not seek to adjust the capital employed figures for the various types of intangible assets that we have sought to identify and recognise in our analysis. Hence, we do not consider that this provides evidence that ROCE analysis, properly conducted, is unreliable"*.¹⁶⁷
- 65.10 While ROCE is more appropriate for energy generation, an asset intensive industry, even for this business, simplistic ROCE calculations performed on statutory accounts will be inaccurate unless appropriate adjustments are made. In particular, *"distortions in measured ROCE caused by long asset lives and an ageing generation fleet, the relatively short length of the Relevant Period compared to the whole economic cycle and the impact of other one-off factors affecting the industry"*.¹⁶⁸
- 65.11 Should the CMA continue to calculate a profitability measure on an ongoing basis, we recommend profitability measures *"should place primary weight on a proper margin analysis, and significantly less weight on its ROCE analysis"*.¹⁶⁹
- 65.12 In any event, any approach must recognise that *"a firm's profitability may fluctuate over time and have periods of lower and higher profitability, which on average is not excessive and therefore reviewing a limited period of time might not yield robust results"*.¹⁷⁰ To avoid presenting a misleading view of industry profitability because of high annual volatility, any profitability results should be an average over a long period of time.

The wholesale cost benchmark will misrepresent hedging behaviour

- 65.13 The CMA seeks to develop *"a common measure of wholesale energy costs that can be applied across the Six Large Energy Firms. This would make the relationship between wholesale and retail prices more transparent"*,¹⁷¹ in order *"to address the persistent question as to why retail prices for some domestic and small business consumers appear not to have tracked changes in prevailing wholesale energy prices"*.¹⁷²
- 65.14 To do so, the CMA establishes the concept of 'opportunity cost' in relation to wholesale energy procurement. It states *"Businesses tend only to commit to deliver goods or services at a future point in time for an agreed price if they are also able to purchase their major inputs for meeting this commitment at the same time. Such an approach affords businesses a degree of confidence about the profit margins"*.¹⁷³ *"By purchasing forward when taking on a commitment to supply their customers on a particular tariff at a given price, retail suppliers minimise their exposure to subsequent movements in wholesale energy costs"*.¹⁷⁴ *"We describe the cost of purchasing in line with this approach...as the purchase 'opportunity cost', rather than a historical or current ('spot') cost"*.¹⁷⁵
- 65.15 The CMA applies the 'opportunity cost' concept to wholesale cost procurement by *"standardising the point ahead of delivery at which it is deemed that the Six Large Energy Firms take on the commitment to supply. This point would be the point at which each of the Six Large Energy Firms becomes contractually committed to supply energy on a*

¹⁶⁶ RWE's response to ROCE working paper, 2.6.3.

¹⁶⁷ PDR, Appendix 3.4, page A3.4-8, paragraph 19.

¹⁶⁸ RWE's response to Generation ROCE working paper, 2.3.

¹⁶⁹ RWE's response to ROCE working paper, 2.6.

¹⁷⁰ RWE's response to profitability methodology, 2.4.1.

¹⁷¹ PDR, page 685, paragraph 10.256.

¹⁷² PDR, page 683, paragraph 10.248.

¹⁷³ PDR, page 685, paragraph 10.258.

¹⁷⁴ PDR, page 686, paragraph 10.261.

¹⁷⁵ PDR, page 686, paragraph 10.262.

*particular tariff at a given price for the volumes that the customer will demand. For example, for a one-year fixed-term fixed-rate tariff, this point would currently be roughly two weeks before the start of the 12-month. For the SVT, this point would be approximately a month ahead of delivery”.*¹⁷⁶

- 65.16 RWE agrees that the reporting of wholesale costs should be comparable across suppliers. We therefore agree that suppliers should apply arm’s length transfer pricing, that the same definitions should be employed and that the same reporting period would aid this comparability.
- 65.17 However, RWE rejects the CMA’s hypothetical ‘opportunity cost’ approach because it is detached from reality, and therefore would be misleading. It could also lead to adverse consequences for consumers who are likely to be exposed to additional price risk.
- 65.18 Further, we consider that any increases in detail or granularity could reduce competition as a result of revealing confidential supplier hedging strategies. We believe that current CSS reporting provides sufficient transparency of suppliers’ wholesale energy costs.
- 65.19 In this subsection, we outline:
 - 65.19.1 why the CMA’s application of ‘opportunity cost’ for an SVT tariff fails to represent the actions of a prudent supplier;
 - 65.19.2 how any profitability results using the CMA’s proposed approach would be misleading;
 - 65.19.3 how the wholesale cost items are derived from the proposed benchmark and how they are material;
 - 65.19.4 how the CMA’s application of ‘opportunity cost’ for a Fixed Price tariff might fail to represent the reality of a supplier’s hedging approach; and
 - 65.19.5 why further disclosure of wholesale hedging behaviour is commercially sensitive and could result in reduced competition.

The CMA’s application ‘opportunity cost’ for an SVT tariff fails to represent the actions of a prudent supplier and at worst could influence the hedging actions of suppliers to the detriment of competition and customers

- 65.20 The CMA’s ‘opportunity cost’ states that suppliers hedge their SVT purchase requirement one month ahead of delivery. Application of this approach would substantially contradict the CMA’s notion of a ‘prudent’ supplier.
 - 65.20.1 The CMA rejects the use of a ‘spot’ market benchmark because *“for a retail supplier to purchase all the volumes it requires at, or near the time of delivery, could constitute an imprudent approach to managing the risk of adverse price movements concerning wholesale energy”.*¹⁷⁷ However, the wholesale price volatility at one month ahead is large and similar in magnitude to spot market volatility. This is because weather drives short to medium term prices. Figure 1 below demonstrates this empirically using historic volatility of standard gas and power products.
 - 65.20.2 By purchasing all volumes at one month ahead, a supplier would introduce significant and unpredictable volatility into its wholesale costs, consequently creating significant movements in profitability.
 - 65.20.3 Further, we would expect the frequency of SVT tariff price changes would increase dramatically. If a supplier truly believed that its contracted position was

¹⁷⁶ PDR, page 686, paragraph 10.265.

¹⁷⁷ PDR, page 686, paragraph 10.263.

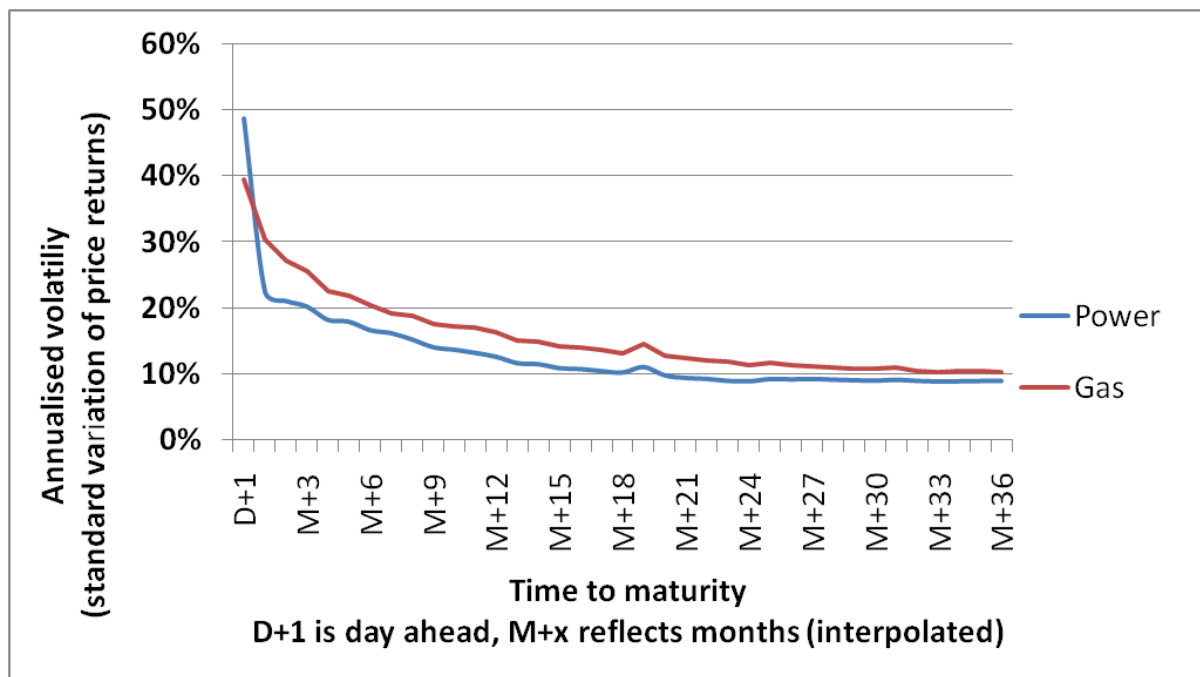
one month, then all commercial evaluation would occur at this tenor, including hedging and pricing. We would therefore observe seasonal fluctuations in SVT prices equivalent to launching successive one month fixed deals. This would result in a transfer of wholesale price risk from energy suppliers to consumers. We consider that energy suppliers are better placed than consumers to manage energy price risk.

65.20.4 The CMA recognises that some suppliers may choose to smooth out commodity purchases by utilising a greater portion of the forward market, which could result in smoother SVT tariff changes.¹⁷⁸ We agree that hedging facilitates offering SVT tariffs that do not change too regularly, for greater customer convenience. Therefore, attempts to measure hedging performance of smoother purchases relative to a volatile benchmark will result in misleading results.

65.20.5 Liquidity in retail purchases at one month ahead is enabled via willing sellers (generation businesses) being active in the market. Generation businesses currently hedge volume up to three years in advance of delivery. At one month ahead there may be little volume available because output would already have been committed to other counterparties in earlier trades.

65.21 A one month ahead strategy is therefore not reflective of the behaviour that should or would be expected of a supplier hedging SVT. Further, the CMA should consider whether the likely consequences of such a benchmark, more regular SVT price changes and a transfer of wholesale price risk to consumers, would be suitable. Therefore, we consider a month ahead strategy should not be used as a benchmark cost profile.

Figure 1: Illustration of the term structure of UK power and gas forward contracts as a function of the time to maturity. This demonstrates how one month volatility is significantly higher than a typical SVT hedging profile with an approximate weighted average time to maturity of 12 months ahead of delivery.



Source: RWE's response to the CMA Electricity Spot Price Scenario, Figure 1

¹⁷⁸ PDR, page 686, paragraph 10.271.

Note: Standard traded forward contracts (months, quarters, and seasons) have been interpolated into a monthly price resolution. Volatility for a given time to maturity is calculated from a time series of historic daily forward price (log)-returns.

Any results using the proposed SVT tariff benchmark would be misleading

- 65.22 We identified that for an SVT tariff, a one month ahead hedging benchmark would be misleading depending on the underlying wholesale price trend. We illustrate this with an example of a wholesale market with a falling price trend and then a rising price trend.
- 65.23 In a falling market where a supplier has purchased for example using a 12 month linear profile ahead of delivery in order to offer longer term price stability:
- 65.23.1 The supplier will achieve a higher average wholesale cost than using a month ahead strategy.
- 65.23.2 The supplier's wholesale costs would be higher than the month ahead "prudent" strategy, and therefore draw undue and unnecessary attention to the supplier's cost base, suggesting that they should have bought on a shorter strategy, or are inefficient.
- 65.23.3 The SVT product is not intended to follow the shorter term fluctuations in market movements, and therefore any comparison to such a strategy is misleading and meaningless.
- 65.24 In a rising market where a supplier has purchased for example using a 12 month linear profile ahead of delivery in order to offer longer term price stability:
- 65.24.1 The supplier will achieve lower than average wholesale cost than using a month ahead strategy.
- 65.24.2 The one month ahead strategy is presented as the "prudent energy supplier", and the supplier's cost is presented as lower than this. This may lead to an interpretation that this supplier should be able to make a price cut, when in fact their prices were never raised, as the forward purchasing allowed them to absorb the rising market more effectively.

The CMA's benchmark excludes a number of material cost items

- 65.25 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.
- 65.26 We would like to stress the level of assumptions that will be required in order to form the view of opportunity costs by product launch, which would be required in order to build up a view of supplier opportunity costs by market segment. These assumptions are likely to be significant and variable between suppliers. Additionally, the calculation of any cost allocation of Shape (shape is the cost of transforming a block of seasonally or monthly purchased volume into the half-hourly consumption profile actually used by customers), Weather and Imbalance (actual or opportunity cost) is likely to require a significant number of assumptions, regardless of the granularity desired. These assumptions may rightly be different between suppliers, or by product within each supplier, but may introduce further elements that reduce the intended comparability of the data.
- 65.27 For example, the CMA does not consider that the costs of shaping a customer's demand are material, but fails to justify its position.¹⁷⁹ On average we estimate that shaping a flat monthly commodity purchase into a half-hourly shape will add 5-7% to the commodity cost for Profile Class 1 and negative (2-4%) for Profile Class 2. RWE considers that this range is

¹⁷⁹ PDR, Appendix 10.3, page A10.3-15, paragraph 49.

material, given that commodity costs represent half of total tariff costs and the low margins of retail supply. Therefore, cost items not accounted for in standard products should be incorporated into a total wholesale cost benchmark.

The CMA's Fixed Term benchmark may not be fully representative

- 65.28 Regarding Fixed Term Contracts ('FTCs'), it is possible for customers to exit these in a variety of ways (with no exit fee, with exit fee, product transfer, moving home etc). Therefore, the CMA's assumption of 100% hedge to termination date may be misleading because customer attrition occurs over the life of the contract. The attrition rate is affected by a number of factors include wholesale prices, tariffs discounts, tariff types, industry churn rates and internal customer relationship activities.
- 65.29 Further, hedging of a product's wholesale price risk is based on forecasts of customer numbers and their expected energy demand, which changes over the life of the product depending on the attrition rates. The further from delivery, the more error we are likely to observe between forecast and actual.¹⁸⁰ In order to minimise this risk, suppliers regularly re-forecast and re-hedge positions throughout the term of the product, to reflect the most up to date view of volume and costs. Implicit in the CMA's "opportunity cost" calculation is an assumption that a prudent supplier only reforecasts its position once, just prior to delivery, which we believe is false. The CMA should account for the costs of ongoing hedging activity undertaken to minimise the risk of forecasting error.

Disclosure of confidential wholesale hedging behaviour could reduce competition and is commercially sensitive

- 65.30 We believe market segment granularity would be sufficient to allow Ofgem to assess retail profitability, without jeopardising the confidentiality of specific supplier hedging strategies relating to individual tariffs or tariff groups. These bespoke and diverse hedging strategies drive the cost variations which stimulate and drive competition. Any such efforts to publicise specific commercial strategy; such as information pertaining to competitor hedging strategies, is likely to drive convergence in strategy, and a reduction in the overall level of wholesale cost competition.
- 65.31 We believe wholesale cost information, of a nature which is more granular than that compiled in the current CSS, is commercially sensitive and should not be publicly available. We believe that this issue would relate to all of the SLEFs. This requirement would reveal individual company hedge strategies and will reveal the potential competitive responses of RWE npower to changes in the market. It is not publicly available information and if disclosed it could confer an inappropriate commercial advantage on RWE npower's competitors, put RWE npower at a competitive disadvantage and harm RWE npower's legitimate business interests. Such disclosure could also distort competition and would therefore be contrary to the public interest.

Practical challenges of producing further segmented results / balance sheets

- 65.32 In this subsection, we outline our concerns with a number of other aspects with the financial reporting remedy which include:
- 65.32.1 the difficulties that exist in the measurements of individual segments;
 - 65.32.2 challenges with reconciliations to other statutory reporting;
 - 65.32.3 our concern with the exclusion of independent suppliers from the need to report financial information in the same format; and
 - 65.32.4 the cost of additional financial reporting requirements.

¹⁸⁰

For example, RWE's one month ahead forecasting performance targets are within a couple of percentage points.

Difficulties in measurement

- 65.33 The CMA proposes to report by market activities. These would consist of wholesale gas markets, wholesale electricity markets, domestic electricity supply, domestic gas supply, SME electricity supply and SME gas supply.¹⁸¹
- 65.34 Any allocation along market activities will require arbitrary allocations of profit, cost and balance sheet items, for example, splitting balance sheet items such as cash and the profitability by fuel type in our generation business. Consequently, results will become less robust as levels of segmentation are increased. The CMA fails to propose an allocation methodology and we consider there would be significant challenges in the practical application of this.
- 65.35 In particular, RWE questions the relevance of providing a pan-generation and pan-supply balance sheet as a comparator across firms due to the significant potential differences in non-operational balances. These would include, but are not limited to, items such as goodwill, deferred tax and loan balances, some of which by their very nature (e.g. tax) only relate to a legal entity and not any business segment. We consider that an arbitrary allocation process is likely to hinder the comparability of reporting between firms.
- 65.36 It is RWE's view that the current disclosure requirements in the CSS for policy costs related to the Generation segment, provide appropriate transparency of the impact of government regulation. Any further disclosure in RWE's view would be impossible due to the complexity of aspects such as, but not limited to, the impact on wholesale power prices of regulatory changes.

Reconciliation within and to other financial accounts

- 65.37 We consider that while a reconciliation to supply and generation segments within RWE AG reporting is possible for the profit and loss account, no such reconciliation would be possible for the balance sheet. Such a process is not required by IFRS and there is no requirement to produce local consolidated accounts, which would not "map" to pan-supply or pan-generation in CSS terms.
- 65.38 Furthermore it is suggested that the P&L would need to include all items that are currently out of scope of the CSS to ensure reconciliation to the balance sheet. This appears in conflict with the CMA's proposal to include domestic and SME markets¹⁸² and therefore exclude the I&C segment from the profit and loss account. In order to achieve reconciliation to the balance sheet, such segmental exclusions would need to be added back.
- 65.39 RWE also notes that where subsidiaries are not consolidated for internal reporting within the Supply/Generation segment by RWE but costs/revenues are recorded within the CSS then additional reporting work would be required to bring their assets and liabilities onto the balance sheet.

Exclusion of Independent suppliers

- 65.40 The CMA acknowledges that only the SLEFs (as ex-incumbent, vertically integrated operators) are required to prepare CSS information, and does not propose to widen the definition to all suppliers¹⁸³, because of the disproportionate burden it would place on them.¹⁸⁴
- 65.41 Given the purpose of financial reporting is to provide a transparent view of the energy marketplace, RWE considers that CSS reporting should be the standard requirement for all suppliers in the industry subject to a *de minimis* limit of 250,000 customers. The CMA has provisionally found that vertical integration is not a feature of the market that gives rise to

¹⁸¹ PDR, Appendix 10.3, page A10.3-6, paragraph 19.

¹⁸² PDR, Appendix 10.3, page A10.3-6, paragraph 19.

¹⁸³ PDR, page 675, paragraph 10.218.

¹⁸⁴ PDR, Appendix 10.3, page 10.3-22, paragraphs 74 and 75.

an AEC. Therefore retaining “vertical integration” as a criterion for publication has no justification.

Additional financial reporting would incur significant additional cost

- 65.42 RWE considers that the costs of imposing such a remedy would typically comprise system development costs, additional employees in the accounting and regulatory departments and increased audit fees.
- 65.43 Further, the CMA’s requirement that prior year (and, therefore, current year) figures are in line with the new proposals will incur significant further costs. RWE believes that further costs would be incurred to ensure prior year figures are in line with requirements.
- 65.44 With regard to wholesale costs, reporting actual and therefore residual costs in any more granularity than market segment would require significant apportionment assumptions to be made as the costs of Shape, Weather impacts and Imbalance are traded as a portfolio exposure. In addition, the ex post disaggregation of hedges for the sole purpose of CSS is not only burdensome but approximate and different suppliers would certainly do this differently.
- 65.45 Given that this additional granularity would provide very limited relevant information, we do not consider that the benefits of requiring this granularity are sufficient to warrant the additional costs of providing it.

H. CODES AEC

66. Executive summary

- 66.1 RWE was broadly in agreement with the CMA’s proposed remedies in respect of Remedies 18a, 18b and 18c as set out in the CMA’s provisional notice of remedies¹⁸⁵, although we had suggested a more radical change, particularly in respect of an independent code adjudicator supported by our proposed Industry Change Governance Company (ICGCo) which has three functions: Change Overview Board, Design Authority and Single Code Administrator.
- 66.2 RWE recognises that the CMA has taken what it believes to be a pragmatic and cost reflective approach to a future code governance framework and as such are committed to working collaboratively with Ofgem, DECC and the wider industry to embed the CMA’s recommendations and ensure the outcomes are positive for the industry and ultimately consumers.

67. Specific points on the CMA’s proposed revised remedy package

A recommendation to Ofgem to:

(i) publish a cross-cutting strategic direction for code development (the ‘Strategic Direction’) and

(ii) oversee the annual development of code-specific work plans for the purpose of ensuring the delivery of the Strategic Direction;

- 67.1 RWE supports these proposed new responsibilities for Ofgem. As RWE has previously pointed out, in its response to the CMA’s additional request for information on industry codes¹⁸⁶, the level of change in the industry now, and the level of change anticipated in the

¹⁸⁵ PDR, pages 43-45, paragraphs 122-130.

¹⁸⁶ RWE’s response to CMA’s request for information on code governance, page 5, paragraph 4.1.

next five years, is unprecedented. It is vital that large scale changes fit into a delivery horizon that avoids pinch points and congestion.

- 67.2 A steer from Ofgem on the general direction of travel it expects the industry codes landscape to take, in the light of technology and policy developments, would be helpful. This strategic direction along with code-specific work plans will provide greater transparency and clarity of priorities and should help with industry planning. We consider the content should include the direction of energy policy as set by the DECC as well as expected European Union and market changes. Where possible it should also include an expected timeframe in which the codes should develop and the probability, in Ofgem's view, of the technology and policy developments actually occurring.
- 67.3 The code specific work plans will be ineffective if they each provide silo views of their individual codes without reference to, or taking account of, the wider code change landscape. Production of a consolidated cross-code strategic work plan is critical to optimise efficiency and to minimise risks, conflicts and costs resulting from an overloaded industry change programme.
- 67.4 Ofgem must be clear on how it makes its decisions on strategic direction and changes related to this direction should have a robust cost benefit analysis which should recognise the effect of implementation timing on cost. In its response to the CMA's Notice of Possible Remedies¹⁸⁷ RWE flagged the need for a clear and concise strategic vision of the development for the industry from Ofgem that has hitherto been lacking. This was specifically in relation to the proposals on universal half-hourly settlement. However, it is applicable to all change. Strategic changes are generally large scale changes that require major capital investment, resource and systems capacity and as such need to be planned as far in advance as possible.
- 67.5 Many large scale changes span a relatively long timeframe therefore, to be effective, the strategic direction and work plans must incorporate a sufficiently broad time horizon. RWE believes this should be 5 plus years rather than the CMA's recommended 3 plus years.
- 67.6 Given the significant level of expected industry change and market development now and in the future a regular briefing, or update to the strategic direction and work plans, will be essential to provide practical value. We would suggest a quarterly briefing/update.
- 67.7 Content should not include prescriptive direction on how to develop the codes to achieve those ends. This should be left to the industry to determine unless Ofgem determines that exceptional circumstances force them to take control.
- 67.8 We suggest that the CMA should, after a sufficient 'bedding in' period, re-consult with the industry on the success of the strategic direction and work plans and whether they could be improved. At the very least, such a review should be carried out by Ofgem.

(iii) establish and administer a consultative board that would bring stakeholders together for the purpose of discussing and addressing cross-cutting issues;

- 67.9 In RWE's response to the CMA's request for further information on industry codes, RWE proposed the introduction of an Industry Change Governance Company (ICGCo) which has three functions: Change Overview Board, Design Authority and Single Code Administrator. RWE proposed a central independent body such as the Change Overview Board that would make recommendations on when and how changes are implemented taking into account the entire regulatory and industry change landscape. Whilst not entirely in line with our preferred approach, the introduction of a consultative board could go some way to addressing our concerns regarding the congested delivery horizon. Therefore RWE broadly supports this recommendation.
- 67.10 With the above point in mind, the consultative board should not be seen just as a stakeholder management tool for Ofgem. It has the potential to play a more fundamental

¹⁸⁷ RWE's response to the PFs, page 123, paragraph 2.5.

role in the delivery of strategic change and could support Ofgem with the essential expertise that it, and to some extent the code administrators, lack.

- 67.11 RWE agree that a consultative board would be able to provide valuable input to the strategic direction and work plans. If the constituency is the right one it should provide experienced and knowledgeable advice that would support greater consistency across codes; better co-ordination of cross-code change; and improved management of the industry change landscape.
- 67.12 RWE agrees that the consultative board should include industry representation. These representatives should be independent experts with the relevant knowledge and skills to understand the level of change and delivery timescales required for code parties. The terms of reference should make clear whether they are to act independently or as representatives of their constituent/s.

(iv) initiate and prioritise modification proposals that, in its view, are necessary for the delivery of the Strategic Direction;

- 67.13 Ofgem's current role in code governance can sometimes act against the interests of consumers. Its broad set of statutory objectives often lead to Ofgem's inefficient and confusing use of the industry codes in pursuit of multiple goals. 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. Therefore, RWE remains uneasy about Ofgem having the powers to specifically initiate code changes. However the proposed change in Ofgem's duties to focus on the promotion of effective competition goes some way to alleviate these concerns. The criteria that Ofgem and other parties use to recommend/decide in code fora should be the same. Therefore if Ofgem invokes wider objectives than technical and economic efficiency within the specific domain of the code, then the relevant criteria must be made clear in advance to all parties.
- 67.14 RWE welcomes the fact that, should Ofgem initiate a code change, it would trigger an obligation for the relevant stakeholders (eg the relevant code administrator and code panel) to develop and submit an end-to-end project management plan (including both the development and implementation stages) to Ofgem. This plan should take into account the wider industry change landscape when determining key milestones and implementation dates.
- 67.15 RWE also welcomes the proposal to include the recommended consultative board in discussions on the delivery of that plan subject to our suggestions on the use and constituency of that board.
- 67.16 Assuming the proposed powers are granted to Ofgem, it would be sensible for it to also have the ability to bestow 'strategically important status' on any ongoing modification proposal initiated by another stakeholder that it considers to be strategically important in the light of the strategic direction and that such a modification proposal would be subject to the same enhanced project management process as Ofgem initiated proposals. In these cases, Ofgem must be clear on how and why it has made the decision that such a proposal has met the strategically important criteria.
- 67.17 RWE agrees that Ofgem should have the power to prioritise code changes for the purpose of delivering strategic important changes where appropriate. Where it does so, it should have already made it clear to the industry that these changes are strategically significant. This could be done, for example, via the code-specific and consolidated cross-code work plans.

(v) in exceptional circumstances, intervene to take substantive and procedural control of an ongoing strategically important modification proposal, as appropriate;

- 67.18 In the light of the recent events related to Project Nexus, RWE sees benefit in granting Ofgem the ability to provide input directly into a specific aspect of the modification

processes to ensure the timely and effective delivery of its strategic direction where necessary. If this input is in the form of “signals” or directions they must be clear and consistent to ensure that the parties responsible are in no doubt as to their meaning.

- 67.19 Furthermore, again given recent experience of Project Nexus, RWE agrees that Ofgem should be granted the powers to ‘call in’ an ongoing strategically important modification proposal in certain exceptional circumstances with the caveat, as proposed by the CMA, that such use of such powers should be subject to robust procedural and judicial safeguards. RWE agrees that the costs of such an exercise should be met by the licensees at fault.
- 67.20 RWE agrees that in certain circumstances, Ofgem should proactively consider whether it is appropriate to commission an independent third party to provide additional project management for large scale or cross-code changes. If Ofgem has ‘called in’ a proposal, or more likely a project with a number of proposals, we would envisage additional third party project management would be necessary since it would be highly likely that the current project management framework has failed.
- 67.21 With greater powers for Ofgem comes greater responsibility to uphold the structures of governance. In particular, there should be enshrined processes for appeals, on grounds of both process and merit, within the governance framework without the need for judicial review.

(vi) modify the licence conditions of code administrators to introduce the ability for the administrator to initiate and prioritise modification proposals that, in its view, are necessary for the delivery of the Strategic Direction or to improve the efficiency of governance arrangements.

- 67.22 Code administrators are the central hub in the industry change processes. Their core functions are to facilitate, guide and communicate and they should perform these functions independently. If they were to initiate industry impacting modifications their independence is compromised and trust in them would be diminished therefore we remain uneasy that code administrators should have the powers to initiate strategic code changes. With this in mind RWE agrees that Ofgem should monitor code administrators’ performance in relation to the initiation of changes and also to ensure that their traditional responsibilities are not compromised.
- 67.23 RWE agrees that code administrators should have the power to prioritise code changes for the purpose of delivering Ofgem’s strategic direction providing they have received clear signals or direction from Ofgem to do so. The grounds for prioritisation must be clear and subject to the proper vires. For example, the code administrators should not opine on policy priorities but should be concerned principally with the practicalities of implementation – in particular, congestion and inter-dependencies between different action streams.
- 67.24 RWE notes that the CMA recommends this task be given to code administrators “*where such project management is appropriate in the light of the complexity of the task and/or the substantive impact that the proposal may have on competition and consumers.*”¹⁸⁸ RWE does not believe that all code administrators have the necessary skills to project manage large scale industry change and/or changes to the systems of processes of individual industry participants: code management and project management are not the same thing and require different knowledge and skill sets. Some will need to buy in specific resource therefore further consideration is required to understand how this proposed new task would be successfully applied. With that in mind, we agree that Ofgem should also consider granting itself some means to overrule code administrators’ use of this power (eg a binding direction) where appropriate.
- 67.25 Some large scale changes are cross-code changes. In this event, a decision will need to be taken on which code administrator would be chosen to manage the project. To ensure the decision to hand over management of a specific project is taken on a consistent and objective basis, we suggest a set of criteria should be developed that would provide a

¹⁸⁸ PDR, page 723, paragraph 10.411.

framework for deciding when to use a code administrator, and if so which one to use, and when to bring in a third party.

A recommendation to DECC to initiate a legislative programme with a view to:

(i) giving Ofgem the power to modify industry codes in certain exceptional circumstances;

- 67.26 As previously mentioned RWE recognises the need for Ofgem to have the ability to 'call in' failing projects. This should only be in exceptional circumstances with decisions to do so based on clear, consistent, objective and transparent rationale.
- 67.27 Ofgem has not historically focussed on project management. These skills need to be developed as well as general knowledge in respect of the practical elements of such changes. We agree they should be able to appoint third party experts to support ongoing delivery of such changes
- 67.28 It is not clear whether this recommendation proposes to substitute or complement the Significant Code Review ("SCR") process therefore more clarity is needed. We believe that the SCR process can be effective in grouping together code modifications for achieving substantive changes.

(ii) making the provision of code administration and delivery services activities that are licensed by Ofgem and specifying that such licence conditions will include appropriate targets to incentivise code administrators to take on an expanded role to be able to deliver pursuant to the Strategic Direction;

- 67.29 RWE agrees 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.
- 67.30 In previous responses¹⁸⁹ RWE has raised concerns about the 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. Therefore we welcome the recommendation that Ofgem considers whether it is appropriate to modify the licence conditions of certain code parties as an additional means to incentivise the behaviour of code bodies that would be licensed pursuant to this remedy (ie those code parties which are responsible for funding code administrators and which may seek to influence their actions).
- 67.31 RWE has previously flagged the lack of consistency amongst code administrators, particularly in respect of the Critical Friend role. This remedy should enable Ofgem to monitor performance of all code administrators, ensuring consistency and best practice across all codes. Monitoring will highlight poor performance that may exist today but should also draw out code administrators that are struggling with their new responsibilities.
- 67.32 RWE supports the idea of a competitive tender regime as an additional means to ensure that code administrators meet the necessary requirements for independence, expertise and resource capacity. RWE agrees with the CMA that effective competition within the market for code administration (and delivery) services would lead to some consolidation as the tendering process would enable efficient entities to take on additional roles and responsibilities. Over time this could move code administration of several codes closer to the single code administrator model which, in our view, would lead to greater efficiencies and lower costs. It may be appropriate for a greater degree of separation between the

¹⁸⁹ RWE's response to CMA's request for Information on code governance. Introduction, pages 1-3, and Appendices 1 and 2, page 12.

functions of pure secretariat, ie. general administration of the code, and of the more technical and project management aspects of code modifications.

- 67.33 The remedy proposes that both code administrators and code delivery bodies should be licensable activities. Clarity is required on what is meant by code delivery bodies. For example, does this include Elexon and Xoserve in their respective roles as settlement agents? If so, then further analysis will be required by the Xoserve Funding, Governance and Ownership programme to understand the full implications on its future deliverables.

ANNEX 1

(TO PARAGRAPH 46: PREPAYMENT PRICE CAP REMEDY)

IMPORTANCE OF WATERBED EFFECTS, INCLUDING SUMMARY OF EVIDENCE PROVIDED PREVIOUSLY BY RWE

1. RWE considers that the CMA has not fully considered the evidence already provided by RWE on waterbed pricing. RWE has previously set out its view that prices within the energy market reflect 'waterbed' pricing strategies, with acquisition tariffs offered at a discount to standard (retention) tariff prices. RWE has also provided details of its non-standard pricing models which directly include a waterbed pricing mechanism.
2. RWE has consistently argued that the price of its non-standard tariff is linked to the price of its standard tariff and if the standard tariff is reduced, for example as a result of a price cap, then RWE's non-standard tariff offers will have to rise. RWE notes that the CMA appears to conclude that there is no evidence that there is a waterbed effect in relation to the discounted prices offered to attract customers and as such does not believe that any relevant customer benefits will be lost as a result of the implementation of the Prepayment Price Cap. RWE consider this is at odds with the evidence it has provided.
3. In this Annex, RWE briefly set out the arguments made to the CMA previously and provide further detail on RWE's non-standard pricing models.

Previous submissions to the CMA

4. In RWE's response to the CMA's Working Paper on Pricing Strategies¹⁹⁰ RWE outlined its pricing model, which uses discounted prices to attract new customers, some of which will be expected to move to the Standard Variable Tariff (SVT) when that initial discount contract expires while others will be expected to either switch to another non-standard contract or switch supplier.
5. As outlined in RWE's response to the CMA's Updated Issues Statement¹⁹¹ RWE has to offer competitive introductory discounts (relative to its SVT) to attract and retain customers. RWE knows it will lose a proportion of its customers every year and needs to recruit new customers in their place. Therefore RWE invests significantly in customer acquisition and marketing in order to compete in the market. RWE must recoup its acquisition and overhead costs and can only do this if a sufficient proportion of customers move to SVT for a period once the introductory discount has ended. RWE's incentive is to ensure that its non-discounted products are competitive in order for sufficient customers to remain on them for sufficiently long and not to squander the investment it has made in acquiring them.
6. RWE's price for a non-standard tariff on offer today has an impact on the demand for SVT in future. In the same way the price that RWE chooses for its SVT tariff may also have an impact on the demand for its non-standard tariffs. SVT tariff pricing affect the rate of internal transfers from non-standard to SVT products and also the rate of customer losses. Therefore it is not appropriate to consider SVT and non-standard prices separately, as this takes no account of the customer journey where customers will move from non-standard to standard prices and back. RWE is not able to price non-standard products without reference to SVT or vice versa, as prices and volumes of sales for the different tariffs are interdependent. RWE believes the level of discount is driven by the level of competition in the market.
7. [CONFIDENTIAL].
8. RWE noted that this type of pricing strategy was not confined to the Six Large Energy Firms, rather it is followed by all suppliers in the market. Furthermore, business models involving

¹⁹⁰ RWE's response to the CMA's Working Paper on Pricing Strategies (2 March 2015).

¹⁹¹ RWE's response to the CMA's Updated Issues Statement.

introductory discounts are common across many retail markets, including mobile telephony, pay TV, mortgages and insurance.

9. Given the customer journey, the way in which RWE prices energy, and the inter-dependence of SVT and non-standard products, it makes no real sense to consider profitability for these products in isolation, as this does not consider the acquisition costs at the outset and the discount customers receive during the duration of the non-standard product. RWE continues to believe that loss of Relevant Customer Benefits, by way of higher acquisition prices, should be considered when assessing detriment.

Non-standard pricing model

10. As set out above, it is not appropriate for standard and non-standard tariffs to be considered in isolation, as pricing for standard and non-standard products is inter-linked, and customers move between the two tariff types.
11. The inter-link between RWE's standard and non-standard tariff prices can be seen directly from RWE's non-standard pricing models.
12. [CONFIDENTIAL].
13. [CONFIDENTIAL].
[CONFIDENTIAL]
14. [CONFIDENTIAL].
15. [CONFIDENTIAL].

Table 1: [CONFIDENTIAL]

16. [CONFIDENTIAL]. If the margin that RWE is able to earn on its standard products is reduced, for example by way of a price cap, then in order for non-standard acquisition products to be viable the level of discount to standard will need to be reduced.
17. Whilst the model and examples above are based on credit customers, RWE would expect to see a similar relationship between standard and acquisition prepayment tariffs once the CMA's proposed remedies to stimulate the prepayment acquisitions market come into effect.

SCHEDULE 1

RESPONSE TO THE CMA'S UPDATED ANALYSIS OF RETAIL ENERGY SUPPLY PROFITABILITY

1. Introduction

- 1.1 In this document, RWE sets out its comments on the Competition and Market Authority's ("CMA") approach and findings in relation to profitability in retail energy supply using the 'Indirect' method, as set out in its report on its Provisional Decision on Remedies ("PDR").
- 1.2 The CMA's methodology for assessing the profitability of retail energy supply businesses has evolved through the course of this investigation and RWE has submitted responses at every stage. The CMA has successively updated its methodology and the results of its analysis through the course of these documents, which comprise:
 - 1.2.1 its proposed approach (December 2014);
 - 1.2.2 four working papers published between March and April 2015, comprising: one paper on margins and one paper on ROCE and one paper on the relevant competitive benchmark for each measure; and
 - 1.2.3 its Provisional Findings ("PFs") in which it updated some of the analysis from its working papers, published in July 2015.
- 1.3 In the PDR, the CMA presents further updated profitability analysis – based only on ROCE – in which it appears to take account of some of the parties' responses to the analysis it presented in the PFs.
- 1.4 However, despite the successive updates the CMA has made to its methodology, 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. We explain our concerns in this response which is structured as follows:
 - 1.4.1 in Section 2, we summarise RWE's views on the CMA's profitability analysis;
 - 1.4.2 in Section 3, we explain that the CMA has not addressed evidence that ROCE is not a reliable measure of profitability in retail energy supply;
 - 1.4.3 in Section 4, we explain that the CMA fails to correctly assess firms' notional capital requirements;
 - 1.4.4 in Section 5, we set out other respects in which the CMA overstates ROCE; and
 - 1.4.5 in Section 6, we explain that the CMA's efficiency analysis remains flawed; and
 - 1.4.6 in Section 7, we explain that, notwithstanding its material theoretical and methodological flaws, the CMA has not placed an appropriate interpretation on its results.

2. Summary of RWE's views on the CMA's analysis

- 2.1 RWE agrees that, when properly performed and interpreted, profitability analysis may provide evidence about whether or not the economic returns in a market are in line with a competitive benchmark and, therefore, whether or not prices paid by consumers are in excess of a "competitive" level. RWE notes that there are well-established frameworks for the analysis of economic profitability and there is precedent from previous CMA investigations for the use of specific approaches to examining profitability.

- 2.2 The CMA estimates that the detriment arising in the Domestic segment is £241 million per year before efficiency adjustments¹⁹² or £659 million per year after efficiency adjustments.¹⁹³ RWE considers that the CMA's profitability analysis significantly overstates the level of detriment, principally for the following reasons:
- 2.2.1 the CMA bases its conclusions solely on its ROCE calculations, while abandoning its EBIT margins analysis which showed that industry margins were in fact in line with the CMA's (conservative) competitive margin benchmark. The CMA provides no explanation for its change of position and in fact misrepresents its EBIT margin findings as consistent with its ROCE results;
 - 2.2.2 the CMA continues to overstate ROCE because it understates the economic value of key components of capital employed. The most material of these is notional capital which firms require to hold to mitigate the broad range of business risks which they face. Although the CMA's understanding has improved, it still: (i) fails to appreciate that the Six Large Energy Firms hold relatively larger amounts of capital because they operate with a lower probability of default than the mid-tier firms, which ultimately benefits consumers; (ii) underestimates the total costs of trading services; and (iii) understates regulatory collateral. In addition to notional capital, we consider that the CMA understates the value of firms' customer base because it adopts an unnecessarily restrictive definition of the costs to acquire customers and underestimates average customer life; and
 - 2.2.3 the CMA materially overstates the extent of the indirect cost inefficiency (if any) of the Six Large Energy Firms, because its benchmark imposes a presumption that, on average, the Six Large Energy have been inefficient. The CMA has no objective or quantitative evidence to support this presumption and it has failed to conduct robust analysis to control for other drivers of cost differences. The CMA has failed to apply any of the established methodologies typically used by economic regulators to assess cost efficiency. Further, its calculation of detriment is not balanced because it fails to give appropriate credit for the lower costs incurred by super-efficient firms which surpassed its (aggressive) benchmark.
- 2.3 Finally, in interpreting the results of its flawed analysis, the CMA has failed to consider the argument previously put forward by RWE that the economic profits earned by Centrica in excess of its cost of capital account for a very significant proportion of the industry total calculated by CMA. RWE considers that this is likely to remain the case in the CMA's updated analysis. The CMA has not considered the implications of this for how competition operates in the retail energy supply market or the source of any detriment which may arise to consumers.
- 2.4 RWE submits that, after taking into account these factors, any reasonable interpretation of the CMA's profitability analysis would conclude that the returns of at least five of the Six Large Energy Firms have not exceeded a competitive benchmark over the period 2007 to 2014. Therefore, there is in fact no evidence that profitability (at least on the part of most of the industry – RWE is not able to judge whether the position is different for Centrica) is excessive and therefore that this is a cause of consumer detriment.
3. **The CMA has not addressed evidence that ROCE is not a reliable measure of profitability in retail energy supply**
- 3.1 In the PDR report, the CMA relies on its ROCE analysis to support its finding that firms have earned profits in excess of the cost of capital. This is in spite of the explanations repeatedly set out by the Six Large Energy Firms – including RWE – for why it is not in principle a reliable measure. Furthermore, why the particular methodology adopted by the CMA tends to systematically and materially overstate profitability and, as a result, leads the CMA to conclude wrongly that the industry has earned excess profits.

¹⁹² PDR, Table 3.12.

¹⁹³ PDR, Table 3.14.

- 3.2 RWE does not consider that the CMA has a robust evidential basis to support its adoption of ROCE as its primary measure of profitability. In particular, the CMA:
- 3.2.1 has disregarded without explanation the results of its own EBIT margins analysis which showed that profitability in the retail energy supply sector has been in line with a competitive level; and
 - 3.2.2 has not made a balanced assessment of those weaknesses of ROCE which it has acknowledged.

The CMA has disregarded without explanation the results of its own EBIT margins analysis

- 3.3 In the PFs, in addition to its ROCE analysis, the CMA presented analysis of EBIT margins which showed that industry margins were in fact in line with its (conservative) competitive margin benchmark.¹⁹⁴ These results were therefore inconsistent with its ROCE analysis. RWE explained that this provides evidence that the CMA's ROCE analysis is flawed and unreliable.
- 3.4 In the PDR report, the CMA abandons its margins analysis. It only briefly mentions that this analysis was even conducted and, where it does refer to it, the CMA misrepresents its results as being consistent with its ROCE analysis.
- 3.5 In the PDR, the CMA states that: "[t]he results of this [ROCE] analysis are broadly consistent with the analysis we carried out on margins, as set out our assessment of retail profit margin analysis."¹⁹⁵ Elsewhere, the CMA states that its "ROCE analysis indicates that energy suppliers require an EBIT margin of just under 1.5% in order to make a reasonable return on capital employed."¹⁹⁶
- 3.6 The CMA does not acknowledge that an EBIT margin of 1.5% is in fact substantially below its own competitive benchmark for margins, which it calculates to be up to 3.0%.¹⁹⁷ RWE is clear that such an EBIT margin would be far below the level which is sustainable for a business operating in the highly competitive retail energy supply sector, given the substantial risks and high operational leverage faced by the business. Further, RWE considers that the CMA's choice of the competitive benchmark margin was unduly low and that a balanced assessment of available evidence suggested that an EBIT margin of around 5.0% would represent a reasonable competitive benchmark.¹⁹⁸
- 3.7 The CMA thus both fails to accurately represent the results of its margins analysis – which are in fact inconsistent with its ROCE analysis – and fails to provide any explanation for why it now appears to place no weight on it.
- 3.8 The inconsistency between the results of the CMA's different analyses of profitability provides evidence of the serious weaknesses of its ROCE analysis. RWE considers that the CMA's reliance on ROCE while disregarding its margins analysis – which showed contrary results – is an example of the CMA making selective use of evidence to try to support a flawed hypothesis of unfavourable outcomes in this market.

¹⁹⁴ The CMA found that total supply businesses of the Six Large Energy Firms earned average EBIT margins of 2.8% from 2007 to 2013 (CMA PFs, Appendix 10.2, Figure 4) and that evidence from mid-tier suppliers suggested that a competitive EBIT margin might be up to 3.0% (CMA PFs, Appendix 10.6, 17). RWE considers the CMA's benchmark for EBIT margins to be highly conservative on the basis set out in its response to the CMA's working paper.

¹⁹⁵ PDR, Appendix 3.4, paragraph 145.

¹⁹⁶ PDR, paragraph 3.193.

¹⁹⁷ In Appendix 10.6 to its Provisional Findings, the CMA states that: "it is our preliminary view that comparators within the GB energy retail supply markets are likely to be more informative than those outside the GB energy retail markets" (paragraph 16) and "In relation to EBIT margins, the ... evidence from independent suppliers suggests to us that competitive EBIT margins in energy supply are relatively low and likely to be 3% or less depending on the level of investment and the level of cost efficiency" (paragraph 17(a)).

¹⁹⁸ Schedule 2 to RWE's Response to the PFs, paragraph 173.

- 3.9 It is our clear view that the CMA must satisfactorily reconcile or resolve the inconsistency between the results of its different analyses of profitability and revise its conclusions accordingly, before its assessment of any detriment may be considered robust.

The CMA has not made a balanced assessment of weaknesses which it has acknowledged

- 3.10 The CMA's decision to place primary evidential weight on its ROCE analysis places it substantially at odds with the submissions of all of the Six Large Energy Firms, each of which has raised concerns about the serious shortcomings of ROCE for assessing the profitability of asset-light retail energy supply businesses.¹⁹⁹ We consider that the CMA must give due regard to the unanimity of the views of the Six Large Energy Firms in relation to the weaknesses of ROCE.
- 3.11 First, the CMA does not agree "*that a low level of capital employed, in itself, makes a ROCE analysis less meaningful*".²⁰⁰ It rejects the evidence put forward by RWE (and others) that asset-light businesses in the FTSE 100 earn higher ROCEs when measured using accounting asset values on the grounds that this analysis does not incorporate adjustments for intangible assets as the CMA has done in its ROCE analysis in this investigation. The CMA has entirely misunderstood RWE's argument that it is precisely the need to make such adjustments – which are inherently complex and judgemental – which makes applying ROCE analysis less reliable when applied to an asset-light business. As the proportion of a firm's economic capital employed that is estimated based using inherently imprecise and judgemental approximations increases, ROCE becomes increasingly sensitive to these adjustments and therefore less reliable.
- 3.12 Second, the CMA accepts that "*in a relatively asset-light business, such as energy retail supply, the level of ROCE can fluctuate significantly year on year and across firms in response to movements in working capital*" but considers that this weakness is overcome by calculating average returns over several years and examining the absolute level of returns.²⁰¹ RWE disagrees. It is a very well understood tenet of basic statistics that the confidence interval around an estimated parameter (such as a mean) of any data series will be wider for a data series with higher volatility. Thus, because ROCE is volatile year-on-year, an estimate of (long-run) annual average ROCE based on eight samples (i.e. years) cannot provide a robust estimate of the true long-run average.
- 3.13 Further, RWE notes that calculating averages over several years does not reduce the sensitivity of the calculated ROCE to alternative inputs and assumptions where these alternatives have an equivalent impact on all years' ROCE.
- 3.14 In addition, calculating the absolute amount by which returns have exceeded, or fallen short of, the cost of capital is simply a presentational change which does no more than obscure the significant fluctuations in estimated ROCE.
- 3.15 Finally, the CMA continues to place significant evidential weight on Centrica's limited use of measures similar to ROCE for internal purposes.²⁰² The weight the CMA places on this evidence is disproportionate because:
- 3.15.1 it is apparently contrary to Centrica's own submissions. The CMA states that Centrica has explained that it uses economic profit only as one measure for the remuneration of staff and does not use it as an indicator of its absolute or relative commercial performance;²⁰³ and
- 3.15.2 the CMA disregards evidence from RWE that it uses the Return on Risk Adjusted Capital to measure its commercial rate of return internally.

¹⁹⁹ PDR, Appendix 3.4, paragraph 17.

²⁰⁰ PDR, Appendix 3.4, paragraph 19.

²⁰¹ PDR, Appendix 3.4, paragraph 21.

²⁰² PDR, Appendix 3.4, paragraph 22 and 23.

²⁰³ PDR, Appendix 3.4, paragraph 23.

- 3.16 The CMA appears to be selectively focussing on its ROCE evidence which, because of various shortcomings, supports its finding that the Six Large Energy Firms have earned excessive profits, while disregarding other contrary evidence from its own analysis. It is unclear how the CMA is complying with its duty to make a balanced assessment of all relevant evidence.
- 3.17 RWE continues to consider that EBIT margins provide a more robust measure of profitability for a retail energy supply business. Using this approach, the CMA's own analysis has shown that outturn levels of profitability from 2007 to 2013 are in line with – or below – the CMA's own benchmarks for the margins that would be expected in a competitive market. There is no evidence from this analysis that energy customers have suffered any material detriment. Therefore, this analysis provides evidence that the more intrusive remedies proposed by the CMA cannot be justified on grounds of proportionality, and without prejudice to RWE's view that they also would not be effective, as we explain above.
4. **The CMA fails to correctly assess firms' notional capital requirements**
- 4.1 Although we consider that the CMA has improved its theoretical understanding of notional capital we consider that it fails to appropriately apply this understanding. Notably, the CMA now:
- 4.1.1 separates its notional capital adjustments into three categories of trading collateral, regulatory collateral and risk capital rather than conflating the categories;²⁰⁴
 - 4.1.2 recognises that regulatory collateral is required to be posted by supply businesses;²⁰⁵
 - 4.1.3 confirms that risk capital is required to be held by energy suppliers to ensure they have a reasonable level of resilience in the face of one-off losses, and implies that not all of an energy supply firm's risks are reflected in the WACC;²⁰⁶
 - 4.1.4 considers a wider set of business risks rather than just wholesale price risk;²⁰⁷ and
 - 4.1.5 no longer implies that the Independents have superior operational procedures than the Six Large Energy Firms, which reduce business risks. In fact, the CMA now identifies that some risks, for example demand forecasting, are likely to be higher per customer for Independent firms than the Six Large Energy Firms.²⁰⁸
- 4.2 However, we consider that the CMA continues to significantly understate the level of notional capital because:
- 4.2.1 the CMA fails to control for the choice that energy suppliers have in relation to the level of risk capital that they hold, which affects their probability of default;
 - 4.2.2 it refuses to recognise that the Independents fail to hold sufficient risk capital relative to the business risks they face, which results in a probability of default that is above optimal for consumers, it is therefore inappropriate for the CMA to use the Independents as a benchmark for required notional capital across the entire industry;
 - 4.2.3 notwithstanding the failure to appropriately account for the probability of default, the CMA's method to measure risk capital through supplier's cash holdings is flawed because it is based on a single observation of a US supply company which

²⁰⁴ PDR, Appendix 3.4, paragraph 106.

²⁰⁵ PDR, Appendix 3.4, paragraph 128.

²⁰⁶ PDR, Appendix 3.4, paragraph 117.

²⁰⁷ PDR, Appendix 3.4, paragraph 106.

²⁰⁸ PDR, Appendix 3.4, paragraph 37.

is not subject to the same environmental and regulatory pressures as the GB market;

4.2.4 the trading fee applied to estimate trading collateral requirements is understated because it fails to account for the value of the charges and warrants transferred to the trading intermediary from the Independent suppliers; and

4.2.5 the level of regulatory capital is understated because the CMA fails to account for: (i) the lower credit quality of a hypothetical large stand-alone supplier which would need to post more collateral for the same energy volume relative to one of the Six Large Energy Firms; and (ii) the level of cash that suppliers post as regulatory collateral.

4.3 In the remainder of this section, we provide further detail regarding RWE's concerns with the CMA's approach to trading collateral, risk capital and regulatory capital. Note that we refer to 'notional capital' to represent the collective set of the three sub categories, in line with the CMA's approach and definitions.²⁰⁹

Trading collateral

4.4 We consider that the CMA's approach of applying costs of a 'fee-arrangement' through a trading intermediary is broadly equivalent to the costs of posting collateral directly. As explained previously:

"The CMA's 'fee-arrangement' approach only provides the Independents with a route to market by avoiding their need to post trading collateral.²¹⁰... we consider the CMA's fee is not unreasonable (i.e. compared to the cost RWE npower would incur to outsource this service)"²¹¹

4.5 Nevertheless, we consider that the magnitude of the CMA's trading fee understates the true cost to a firm should it apply this trading collateral approach. The fee does not include the charges over the Independent's assets held by the trading intermediary and the warrants that Independents transfer to the trading intermediary. We comment on the value of the charges and the value of the warrants separately.

Value of charges over assets held by the trading intermediary

4.6 As we previously explained, the charges that the trading intermediary has over assets have an economic cost to the Independents and this should be added to the basic trading fee percentage, to calculate the true cost of the 'fee arrangement'.

"The Independents are therefore effectively pledging the assets of their business as collateral to secure the credit offered by the Trading Intermediary. These charges are an economic cost to the firm because of the transfer of assets and/or equity that would occur should an Independent default on the agreement.

The CMA is therefore wrong when it asserts that: "[t]he fee incorporates the riskiness of the supplier and therefore encapsulates default/insolvency risks." Standard finance theory would suggest that the Trading Intermediary's assessment of the economic value of the commercial arrangement will take account of both the value of the expected cash inflows from the fee and the expected value of the assets pledged as security which it will receive in the event of a default. The charge over the Independents' assets is therefore a fundamental element of the economic value

²⁰⁹ PDR, Appendix 3.4, paragraph 106.

²¹⁰ RWE's response to CMA working paper: Analysis of retail energy supply profitability – ROCE, paragraph 5.3.4.

²¹¹ RWE's response to CMA working paper: Analysis of retail energy supply profitability – ROCE, paragraph 5.4.2.

*of the arrangement to the Trading Intermediary and therefore of the economic cost of the arrangement to the Independents' investors."*²¹²

- 4.7 The CMA rejects the cost attributed to the charges by suggesting that the assets to which the trading intermediary holds a charge over has already been included within the capital employed of the energy supplier and that the "*opportunity cost to the business of doing this* (granting charges over assets and limiting the ability to issue debt) *is already reflected in the cost of capital that we have estimated* (by assuming 100% equity finance)".²¹³
- 4.8 We disagree with this position, even in the case of 100% equity finance, because should a supplier break the covenants within the trading agreement, the trading intermediary has contractual access to assets at lower levels of financial distress than levels that would trigger insolvency without a charge over the assets.²¹⁴ The contractual covenants are therefore likely to accelerate insolvency proceedings and it increases the risk for energy supply firms.
- 4.9 In this case, the CMA's premise that an equity investor would be indifferent between investing in a company with a charge over its assets and an identical company without a charge over its assets does not hold. In practice, it is clear that an investor would prefer to invest in the company without a charge over its assets because of the additional risks that the restrictions bring.

Value of warrants held by the trading intermediary

- 4.10 We consider that the CMA should quantify the value of the warrants to a supply business and add this to the existing trading fee. The CMA acknowledges that "*Shell held warrants that would give it a stake in First Utility of up to 8%*".²¹⁵ We therefore propose that the value of the warrants are likely to be material and significant due to the large portion of equity into which the warrants could be converted.²¹⁶

Risk capital

- 4.11 RWE estimates risk capital for its supply business using a 'bottom up' approach. It considers the potential magnitude of loss for each individual risk factor. RWE aggregates the factors to create a range of risk capital levels that can protect against business risks. The CMA adopts a different approach to assessing risk capital. The CMA uses a 'top down' approach where it identifies cash on the balance sheet, which the CMA considers is available to finance any adverse shocks to a supply business.
- 4.12 We consider that there are a number of flaws with the CMA's approach. Importantly, assessing the magnitude of risk capital is underpinned by the assumptions made on the probability of default for energy supply businesses. We consider that the CMA makes a subjective judgement on the appropriate probability of default but fails to provide evidence to justify its position. In this subsection, we:
- 4.12.1 discuss the impact the probability of default has on an assessment of risk capital;
 - 4.12.2 explain RWE's 'bottom up' approach to estimating risk capital; and
 - 4.12.3 identify the flaws in the CMA's 'top down' cash approach.

Risk capital and the probability of default

²¹² RWE's confidential (redacted version) supplementary response to the CMA on the analysis of ROCE in energy supply, 2 October 2015, paragraph 9 and 10.

²¹³ PDR, Appendix 3.4, Annex A, paragraph 63.

²¹⁴ PFs, Appendix 10.3, Annex A, paragraph 115(c).

²¹⁵ PDR, Appendix 3.4, Annex A, paragraph 25.

²¹⁶ To accurately value the warrants, further details would need to be considered such as the strike price, underlying price and expiration date.

- 4.13 An energy supply business has a choice over the amount of risk capital it holds in case of adverse shocks. For example, one supply business might secure access to large amounts of risk capital in order to have high protection against shocks. While another supply business, of equal size and risk exposure, might choose to hold smaller amounts of risk capital and consequently have lower protection. Each business will have a different probability of default. To properly assess the level of risk capital, the CMA must first establish an optimum probability of default, which the CMA has not done.
- 4.14 In RWE's Response to Provisional Findings, we set out a number of comments in relation to the probability of default:
- 4.14.1 *"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";²¹⁷*
- 4.14.2 *"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";²¹⁸²¹⁹*
- 4.14.3 *"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";²²⁰*
- 4.14.4 *"RWE commented that the CMA should investigate what the appropriate probability of default for suppliers should be. 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".²²¹*
- 4.15 The CMA has failed to engage on these topics and we reiterate that it is essential to do so, to properly assess the level of risk capital. We do however, note that the CMA has identified that imprudent risk management "has been a major contributory cause of several retail suppliers, both small and large, going bankrupt"²²² and refer to a list of suppliers including Independent Energy, Atlantic Electric and Telecom Plus.²²³ Clearly an optimum level of risk capital is required otherwise there is significant risk of default and this is a major risk to consumers.

RWE's risk capital estimate ('bottom up approach')

- 4.16 RWE explained its risk capital methodology in RWE's Response to CMA working paper: "Analysis of retail energy supply profitability – ROCE"²²⁴ and how its risk capital calculations are grounded in standard financial theory which "outlines that a business should have a

²¹⁷ RWE's response to CMA PFs, paragraph 47.1.

²¹⁸ RWE's response to CMA PFs, paragraph 47.3.

²¹⁹ We also note recent comments from Luke Watson, Founder of GB Energy Supply, 31 March 2016, "the challenge for independent suppliers will come when there is volatility in the wholesale market. That is when the hedging strategy comes into play, and we are very conscious of that because it is our biggest risk at the moment"

²²⁰ RWE's response to CMA PFs, paragraph 47.4.

²²¹ RWE's response to CMA PFs, paragraph 47.5.

²²² PDR, paragraph 10.253.

²²³ Appendix 3, Exits from the supply markets since 2000 (to 2006), of Supplementary evidence submitted by Energywatch to the Select Committee on Business and Enterprise, dated 28 July 2008.

²²⁴ Appendix A. Overview of RWE npower's estimation of risk/notional capital.

sufficient level of risk capital to ensure solvency up to the point that it considers an appropriate probability of default". The appropriate level of default is "inferred by using the business' credit rating and through Credit Default Swap pricing".²²⁵ In RWE's case, its credit rating, as assessed by an independent credit rating agency²²⁶ corresponds to an expected probability of default of 0.5%.

- 4.17 The CMA considers RWE's approach to calculating risk capital as being "excessively conservative".²²⁷ The CMA fails to provide sufficient evidence to justify its conclusion, which contradicts the approach used in standard financial theory. Further, RWE's risk capital assessment is consistent with methods used by regulators to calculate the required risk capital within the banking and insurance industry (Basel III and Solvency II respectively). It is also consistent with how RWE runs its supply business through the application of Return on Risk Adjusted Capital ('RoRAC') principles.

*"Application of risk capital principles occur within the banking industry and the insurance industry through Basel III and Solvency II, respectively. We consider that the risk capital principles adopted in the insurance industry, are more applicable to the energy industry... Within Solvency II, the anticipated liabilities on underwriting activities are modelled to assess the risk of default over a one year time horizon and at a threshold, as detailed in the standard methodology above, set at P99.5 which is equivalent to the default risk of a business with a BBB credit rating."*²²⁸

- 4.18 The CMA suggests that RWE's approach is unsuitable and supports this observation by looking at the outturn losses for certain risk factors over the Relevant Period which lasts only eight years. The CMA recognises that the P99.5 level corresponds to "*level of capital that would be required to cover shocks...in 199 out of 200 cases*"²²⁹. The CMA is inappropriately drawing a conclusion using a small number of data points when assessing outcomes that occur very infrequently (i.e. in the tails of a distribution). Estimates of infrequent events require larger sample sizes in order to draw inferences. The CMA should apply caution when using eight data points.

- 4.19 We consider that RWE's methodology applies a prudent approach to estimating infrequent events, which will result in a low risk capital number. RWE applies a standard normal distribution when it scales P95 estimates to P99.5 levels which correspond to its probability of default of 0.5%. A standard normal distribution has less variation in outcomes relative to the true distribution of risks faced by energy suppliers which is likely to have "*true fat tails*".²³⁰ If the true distribution had been applied, our risk capital estimates would be larger.

- 4.20 Further, RWE's approach is consistent with the other Six Large Energy Firms who all use a 'bottom up' approach to calculating risk capital rather than applying a cash percentage. It is therefore not clear why the CMA has diverged from what is clearly the industry norm for assessing risk capital.

CMA's cash estimate for supply businesses ('top down approach')

- 4.21 The CMA bases its risk capital estimate on the level of cash held by the US energy firm, Just Energy, being 2% of its cost of sales. Notwithstanding the CMA's flawed approach, which fails to control for the optimum probability of default for supply firms, we consider this level of cash holding is insufficient to "*provide a reasonable buffer against the various business risks faced by a large, stand-alone supplier*".²³¹

²²⁵ RWE's response to CMA working paper: Analysis of retail energy supply profitability – ROCE, Appendix A, A2

²²⁶ RWE AG's current credit rating as determined by the credit rating agency, Standard & Poor's, is BBB as of 23 October 2015

²²⁷ PDR, Appendix 3.4, paragraph 124.

²²⁸ RWE's response to CMA working paper: Analysis of retail energy supply profitability – ROCE, Appendix A, A3 and A4

²²⁹ PDR, Appendix 3.4, paragraph 123.

²³⁰ Taleb, The American Statistician, August 2007, Black Swans and the Domains of Statistics.

²³¹ PDR, Appendix 3.4, paragraph 124.

- 4.22 First, the cash pooling structures of the Six Large Energy Firms mean it is impossible to identify risk capital on the balance sheet. The CMA's approach is unusable when making observations for the companies that hold the vast majority of business supply risk across the industry.²³² [CONFIDENTIAL]. Clearly, the CMA's adjustment of cash at 2% of the cost of sales completely ignores the additional risk capital provided by the RWE group. We consider it is therefore materially understated and similar in nature for the other Six Large Energy Firms.
- 4.23 Second, it is inappropriate for the CMA to use the decision taken by just one firm to establish a benchmark for the entire industry yet disregard the risk capital estimates of the Six Large Energy Firms. As we explained above, the level of risk capital to be held is a choice for a business. The CMA's observation could be of a supplier who has chosen to hold less risk capital but which accepts a higher probability of default. The CMA acknowledges that some firms apply such risk management practices which can lead to business failure (as discussed in paragraph 4.15), but fails to consider the possibility that Just Energy could be using a similar approach.
- 4.24 Third, Just Energy is a US energy supply company and is clearly not representative of any of the current market participants on which the CMA performs its profitability analysis. The CMA has failed to provide evidence to justify why Just Energy is an appropriate comparator for the GB energy market, despite significant differences in market design and regulatory constraints. Further, we note that Just Energy's diversified portfolio, across 20 markets in the US and Canada, creates a risk profile that is more similar to RWE AG group, rather than that of RWE npower or an Independent supplier.
- 4.25 The CMA's choice of observed cash holdings as a risk capital benchmark is discussed in further detail in the Confidential Submissions of RWE's Authorised Advisers to the CMA's Provisional Decisions.
- 4.26 RWE considers that the CMA should place more weight on the bottom up approaches adopted by the Six Large Energy Firms. However, if the CMA continues with its 'top down' approach, we consider it needs to establish appropriate benchmark firms. These businesses should use a risk management approach that meets the CMA's optimal probability of default and operate within the GB energy market environment.

RWE's proposed amendments to risk capital

- 4.27 In summary, we consider that:
- 4.27.1 the CMA should establish an optimum probability of default for energy supply firms using an evidence based approach, which recognises the costs for consumers of a systemic default of energy suppliers;
 - 4.27.2 the CMA should calculate risk capital using the 'bottom up' approach as validated by standard finance theory and used by the Six Large Energy Firms;
 - 4.27.3 if the CMA continues to use a 'top down' method, it should apply a robust method to identify cash holdings which controls for differences in probability of default between supply firms and operate in the GB market; and
 - 4.27.4 the CMA should ensure that the 'top down' and 'bottom up' risk capital estimates reconcile.

Regulatory collateral

- 4.28 The CMA fails to appropriately adjust for the cost of posting regulatory collateral. First, the CMA's adjustment assumes that all regulatory collateral is posted as a Letter of Credit ('LOC'). This is inconsistent with evidence from historical posting of regulatory collateral, as recorded by the recipients of collateral, where a portion is in cash. Based on our review

²³² PFs, Appendix 10.3, paragraph 81.

of the actual collateral postings for 2011 to 2013 (see Table 4.1), cash is held against every major code. In some cases, suppliers post as much as 15% in cash for regulatory collateral. The CMA needs to account for a proportion of cash in suppliers posting of regulatory capital through an adjustment in capital employed.

- 4.29 Second, the CMA applies a regulatory capital posting "*mid-point estimate of around £300 million (from Centrica, EDF Energy, RWE, SSE) ... for all of the Six Large Energy Firms, giving an annual cost of £6 million for letters of credit*". It applies the same cost for all of the Six Large Energy Firms because the regulatory collateral estimates "*did not appear correlated with the volume of business undertaken*".²³³ The CMA fails to make any adjustment to reflect the differences in regulatory collateral posted for a stand-alone supplier, which would have lower credit quality relative to the Six Large Energy Firms.²³⁴
- 4.30 We consider the CMA's approach is likely to be flawed because the CMA failed to control for differences in credit quality between the Six Large Energy Firms. In general, the level of regulatory collateral is a function of the volume of energy and the credit quality of the firm. If the CMA only considered postings of regulatory collateral against energy volumes, the larger firms with larger energy volumes are likely to have better credit ratings. These are offsetting factors. A large stand-alone supply firm with similar energy volumes to the Six Large Energy Firms, but a lower credit rating, would be required to post a relatively higher amount of regulatory collateral. We therefore consider that the CMA needs to use a larger quantity of posted regulatory capital than the £300 million²³⁵ of LOCs currently applied.

²³³ PDR, Appendix 3.4, paragraph 128.

²³⁴ We assume the stand-alone supplier would have a lower credit quality because it would not have the support a wider corporate group and the diversification of different business activities.

²³⁵ PDR, Appendix 3.4, paragraph 128

Table 4.1: Features of collateral posted to the major energy codes

Code	Purpose	Accepted collateral	Posted collateral, annual average 2011 to 2013
Balancing and Settlement Code ('BSC')	Trading parties may have debts (or be due payments) in respect of trading imbalance charges incurred, on average, over the previous 29 days. The imbalance relates to being over or under a parties' pre contracted obligation	LOCs Cash	£387 million (85% LOCs, 15% cash)
Connection and Use of System Code ('CUSC') – TNUoS and BSUoS	To cover unsecured losses from non-payment of transmission use (TNUoS) and balancing (BSUoS) charges; to recover funds from the termination of a party's participation in CUSC	LOCs Cash PCGs Unsecured credit	£611million (0.5% LOCs, 0.5% cash , 99% PCGs)
Connection and Use of System Code ('CUSC') – Generator User Commitment credit parameters	To recover costs of stranded investments	LOCs Cash PCGs Unsecured credit	£432 million (29% LOCs, 4% cash , 66% PCGs)
Distribution and Use of System Code ('DCUSA')	Security for payments of charges under DCUSA relating to distribution network use	LOCs Cash PCGs Unsecured credit	£436 million (44% LOCs, 12% cash , 45% PCGs)
Uniform Network Code ('UNC') - balancing	To cover the risk of payment default on UNC energy balancing charges	LOCs Cash	£345 million (87% LOCs, 13% cash)
Uniform Network Code ('UNC') - transmission and distribution	To ensure gas network operators have access to working capital to cover non-payment of gas network use charges in the event of a user failure	LOCs Cash PCGs Unsecured credit	£1370 million (34% LOCs, 0.7% cash , 66% PCGs)

Sources: Cornwall Energy Credit and collateral in the GB energy markets, Phase 1, Volume 1 - main report, Section 2, June 2014.

Notes: Annual average between 2011 and 2013

5. The CMA's other assumptions lead it to further overstate ROCE

5.1 In this section, we explain the elements of the CMA's methodology, other than its treatment of notional capital, which lead the CMA to further overstate ROCE. These comprise:

- 5.1.1 goodwill and brand value;
- 5.1.2 start-up costs;
- 5.1.3 customer base value; and
- 5.1.4 pension deficit repair costs.

Goodwill and brand value

5.2 The CMA has excluded the value of purchased goodwill and brand value from its estimates of retail energy supply firms' capital employed.²³⁶ The CMA should include these values within capital employed – at least as a sensitivity – and should properly consider the evidence they provide that it has understated the total value of firms' intangible assets.

5.3 The CMA accepts that *"when purchasing a business, at least some of the goodwill balance may represent the value of intangible assets not capitalised on the business's balance sheet"*.²³⁷ The only explanation that the CMA provides for excluding these items is that it *"avoids the risk of capitalising the value of any excess profits that the business is able to generate, which may be reflected in the purchase price and hence the purchased goodwill"*.²³⁸

5.4 However, the CMA adopts very conservative estimates of the value of separately identifiable intangible assets, as we describe in relation to notional capital in Section 4 and in relation to the customer base in the following subsection. The CMA fails to acknowledge that, by adopting these very conservative valuations, it materially increases the likelihood that the goodwill balances it excludes will wholly or partially reflect the value of intangible assets which it has not separately recognised in its analysis.

5.5 RWE considers that the CMA should take into account capitalised goodwill in its analysis by calculating as a sensitivity the implied ROCE/excessive profit when at least a proportion of firms' capitalised goodwill is included within capital employed, in order to quantify the importance of this assumption.

Start-up costs

5.6 The CMA accepts that, in theory, start-up costs incurred by firms entering the market would represent an intangible asset, in that these losses are incurred in order for the business to earn future profits. Based on evidence from the mid-tier firms, the CMA determines that the size of the start-up costs is "relatively limited" and therefore that adjusting for them would not make a "material" difference to its calculations.²³⁹

5.7 The CMA does not adequately articulate the quantitative analysis it has performed. RWE's view remains that these costs are likely to be material and that the CMA should take them into account in its analysis, at least qualitatively.²⁴⁰

Customer base value

5.8 In its ROCE analysis, the CMA estimates a value for the customer bases of the Six Large Energy Firms and includes this value within its estimates of capital employed. The CMA

²³⁶ PDR, Appendix 3.4, paragraph 59.

²³⁷ PDR, Appendix 3.4, paragraph 60.

²³⁸ PDR, Appendix 3.4, paragraph 60.

²³⁹ PDR, Appendix 3.4, paragraph 62.

²⁴⁰ RWE response to the CMA profitability methodology, paragraph 5.6.4.

estimates the value of the customer base using a bottom-up approach based on an estimate of the firms' costs to acquire customers and the average "life" of a customer i.e. the average period for which a customer will remain with the business. RWE considers that the CMA's estimates of the value of customer base are understated because its criteria for capitalising costs are too restrictive and the customer life it chooses is inappropriately short.

Cost to acquire customers

- 5.9 The CMA rejects evidence put forward by RWE (and other parties) that it has underestimated the cost to acquire customers based on:
- 5.9.1 the value of customers implied by market transactions; and
 - 5.9.2 additional costs that parties assert arise from acquiring customers and are not included within the CMA's bottom-up based valuation.
- 5.10 The CMA rejects evidence put forward by RWE (as well as Scottish Power and E.On) from market transactions relating to mid-tier firms that the cost to acquire customers is higher, on the basis that the profits a purchaser expects to earn from a purchased customer may be very different from the cost of acquiring that customer "organically". The CMA attempts to support this based on transactions from the US energy market which imply lower values per customer and asserts that differences between the US and GB energy markets could not explain the differences in the implied value per customer.²⁴¹ The CMA's assertion is unsubstantiated.
- 5.11 The CMA's reasoning is theoretically flawed. In a competitive market, the value which a rational investor would place on the present value of expected future profits from a customer would be equal to the cost of replacing that customer, all else being equal. If this were not the case, it is evident that new entrants would have the incentive to enter the market because they could target new customers whose present value would exceed the cost of acquiring them i.e. the entrant could earn an economic rent. These values would only systematically diverge in a market in which this rent-seeking process cannot operate. Thus, to reject market evidence based on transactions in mid-tier firms, the CMA must make a presumption that the mid-tier firms are earning excessive profits. Although the CMA has stated that it is concerned that the market values of the Six Large Energy Firms may reflect any excessive profits that (it believes) they may be earning, the CMA has repeatedly previously cited the mid-tier firms as a competitive benchmark.²⁴²
- 5.12 In addition to these market transaction issues, the CMA rejects arguments that it should include certain costs in its bottom-up estimates of cost to acquire, such as costs to discount, general marketing expenses (e.g. sponsorship) and any expenditure on retaining customers. It does so on the basis that these costs are generally indistinguishable from the day-to-day costs of providing good customer service or, in the case of discounting costs, not distinguishable from the price.²⁴³
- 5.13 We consider that this reasoning is conceptually flawed. The key economic characteristic of these costs is that RWE incurs them today with the expectation that they will give rise to future inflows of economic benefits from retaining these customers or different tariffs in future years. In the absence of the expected future economic benefits, it would not be rational for RWE to incur these costs (or offer these discounted tariffs).
- 5.14 The CMA's excessively restrictive criteria for the recognition of intangible assets therefore causes it to systematically underestimate the total costs of acquiring customers. The values implied by market transactions provide evidence to support that this is the case and the CMA's basis for disregarding this evidence is flawed, for the reasons we have set out above.

Average customer life

²⁴¹ PDR, Appendix 3.4, paragraph 67.

²⁴² PFs, Appendix 10.6, paragraph 17(a).

²⁴³ PDR, Appendix 3.4, paragraph 69.

- 5.15 In the PDR, the CMA has reduced the assumed average customer life to six years, from the eight years it previously used in its PFs analysis. This reduces the average value of the customer base in each year. The eight year frequency is based on DECC domestic customer switching data, whereas six years is based on the Six Large Energy Firms aggregate switching rates for their whole customer base.²⁴⁴
- 5.16 We consider that the justification for this change of assumption is very weak, because the average switching frequency should be weighted according to the proportion of costs which relate to the acquisition of customers in different segments. In fact, the majority of customer acquisition costs relate to the acquisition of domestic customers and this proportion of the costs should be amortised over the average life of a domestic customer.²⁴⁵ Therefore, we consider that the CMA should return to the eight year average life assumption (based on the domestic switching rate implied by DECC data) which it adopted in its analysis presented in the PFs. This point is also addressed in the Confidential Submissions of RWE's Authorised Advisers.

Pension deficit repair costs

- 5.17 The CMA continues to exclude RWE's costs of repairing its pension deficit from its calculation of RWE's adjusted EBIT. RWE considers that the CMA's approach disregards economic reality and wrongly implies that it is reasonable and sustainable to expect the Six Large Energy Firms to earn less than their economic cost of capital. The CMA should allow RWE (and others of the Six Large Energy Firms) to recover these costs.
- 5.18 In the PDR, the CMA rejects RWE's argument that it should be allowed to recover its pension deficit repair costs on the grounds that these do not "*represent costs that an efficient entrant would need to incur in order to operate in the industry*".²⁴⁶
- 5.19 RWE agrees that a hypothetical entrant would not incur deficit repair costs associated with legacy pension schemes. However, for the reasons RWE has previously explained, it is not theoretically appropriate to apply the benchmark of a hypothetical entrant to assess whether firms should be allowed to recover these costs.
- 5.20 By not deducting these costs from firms' adjusted EBIT, the CMA is implicitly making a commercially unrealistic assumption that either:
- 5.20.1 it is reasonable to expect businesses facing normal commercial incentives in a competitive market to earn less than a fair economic return; or
 - 5.20.2 these costs could be avoided if new entrants were to replace the Six Large Energy Firms.
- 5.21 RWE does not consider either of these assumptions to be appropriate. If new entrants were to replace the Six Large Energy Firms, the costs of legacy pensions would still need to be covered, either by the industry or the government. As RWE has previously pointed out, there is precedent from price control determinations in the regulated industries for allowing firms to recover the on-going cost of pension deficit repair.²⁴⁷ RWE further notes that, in order to complete the privatisation of Royal Mail, the government was required to take on its legacy pension scheme, which faced a deficit of approximately GBP 10 billion.²⁴⁸
- 5.22 If regulators do not allow firms to recover these costs, RWE and others of the Six Large Energy Firms will not be able to earn an economic return commensurate with that of a hypothetical entrant which did not face these costs. This would threaten the long-term stand-alone finance ability of the established retail energy supply businesses.

²⁴⁴ PDR, Appendix 3.4, paragraph 72 and 73.

²⁴⁵ Based on RWE's submitted data, we observe that on average 77% of RWE's annual customer acquisition costs relate to the acquisition of domestic customers (based on RWE's data submitted in response MFQ G49).

²⁴⁶ PDR, Appendix 3.4, paragraph 133.

²⁴⁷ Ofgem. 2014. Resetting pension deficit funding allowances and our reasonableness review.

²⁴⁸ <https://next.ft.com/content/b753bdb8-c485-11e2-9ac0-00144feab7de>

6. The CMA's efficiency analysis remains flawed

6.1 RWE welcomes some of the updates that the CMA has made to the efficiency analysis it previously presented in the PFs, in particular its recognition that it is not appropriate to benchmark wholesale costs and capital charges, or to apply benchmarks to unit costs in the SME segment.

6.2 Nevertheless, RWE considers that important flaws remain in the CMA's analysis in respect of:

6.2.1 the reasons for variations in firms' indirect costs per customer;

6.2.2 the CMA's calculation of the detriment arising from inefficiency;

6.2.3 the CMA's choice of benchmark for indirect costs; and

6.2.4 the internal consistency of the assumed value for systems/billing software.

The reasons for variations in firms' indirect costs per customer

6.3 The CMA interprets the variation in firms' indirect costs per customer as evidence of inefficiency. On this basis, it adjusts firms' actual costs incurred to a level which it deems "efficient", calculates the resulting reduction in total industry costs and adds this to its estimate of total detriment. This adjustment substantially widens the gap that the CMA finds between some firms' revenues and economic costs.

6.4 It is true that RWE (and, we understand, some other parties) has at various times during this investigation accepted that it has higher unit indirect costs than some other retail energy supply firms. We continue to accept that is the case. However, the CMA's presumption that this variation in unit costs reflects a lack of competition is incorrect and has no basis in economic theory. RWE and the others of the Six Large Energy Firms have previously explained that a number of other factors – not related to efficiency – explain the observed variation in indirect costs.

6.5 The CMA considers, but ultimately rejects, these explanations. It therefore suggests that some firms have earned revenues in excess of a competitive level, but have then squandered these potential economic rents through operational inefficiency. RWE does not consider that this hypothesis is credible.

6.6 RWE now restates the explanation for why indirect costs per customer vary between firms over the CMA's period of analysis and explains the further analysis and evidence that the CMA would need to present before the application of an "efficiency benchmark" could be justified.

6.7 First, the CMA rejects parties' suggestions that differences in costs could reflect the timing of investment cycles on the grounds that it considers eight years "*to be sufficiently long for differences in the timing of investment cycles across the Six Large Energy Firms to even out*".²⁴⁹ This is an entirely qualitative judgement, for which the CMA presents no supporting evidence. In fact, RWE's considers that it has higher indirect costs than the average of the Six Large Energy Firms over the period for precisely this reason. However, this does not mean RWE is "inefficient" in a sense which is relevant for a competition investigation, nor does it imply that it is appropriate for the CMA to disallow our actual costs incurred in its "efficiency" calculations.

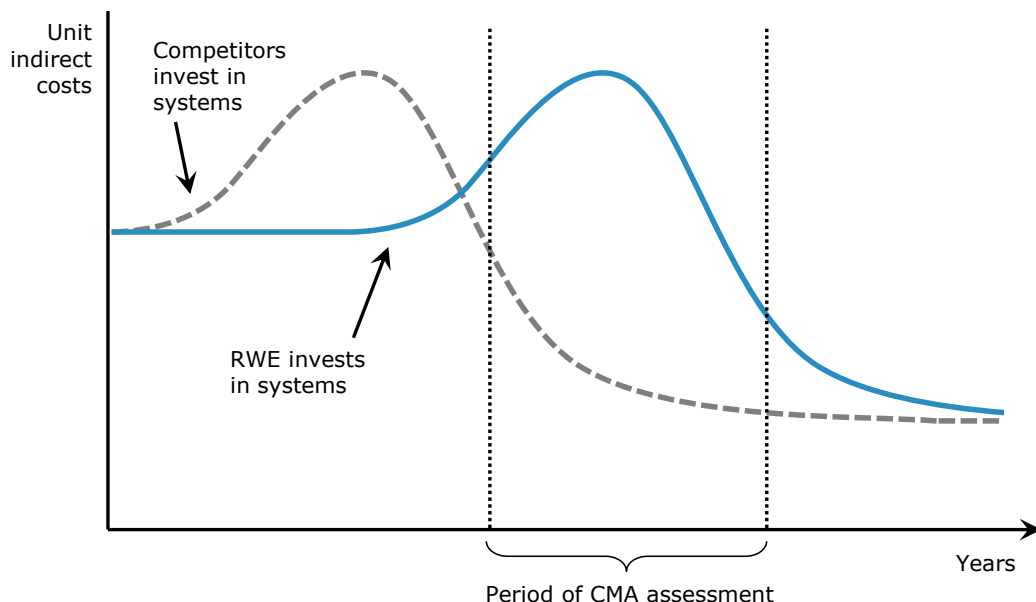
6.8 RWE's internal paper make clear that:²⁵⁰

²⁴⁹ PDR, Appendix 3.5, paragraph 15.

²⁵⁰ [CONFIDENTIAL]

- 6.8.1 investments in new IT systems are [CONFIDENTIAL]²⁵¹;
- 6.8.2 the payback of an investment in a major new IT system is realised through achieving lower unit indirect costs in the future, once the system is fully implemented;
- 6.8.3 RWE's decision to invest in a new IT system was – contrary of the CMA's hypothesis – actively in response to its serious concerns around the presence of intense price competition and its ability to compete on price in the future, recognising that some of its competitors were likely to achieve lower unit indirect costs; and therefore
- 6.8.4 indirect costs are materially affected by where each company is in its IT investment cycle to other companies and RWE considers that, over the period of the CMA's analysis, it has lagged some of its competitors.
- 6.9 The evidence therefore shows that RWE has considered whether to make large IT investments on an entirely rational basis, driven by an expectation of future price competition. RWE submits that the CMA cannot legitimately adopt the view that RWE's higher unit indirect costs provide evidence of a lack of price competition or that it has not faced an economic incentive to become more cost efficient. Rather, its relative position reflects mainly that it made its large one-off investments in IT infrastructure later than some of its competitors and that the CMA's period of analysis covers the period prior to and during its implementation but does not capture the subsequent reductions in unit indirect costs that RWE is now realising and which will continue to improve.
- 6.10 Figure 6.1 below shows illustratively how RWE considers that unit costs might evolve over time following a major investment in new systems and how this would give rise to the dispersion in cost per customer which the CMA has observed.

Figure 6.1: Illustrative evolution of unit indirect costs following investments in systems



- 6.11 Second, the CMA rejects other drivers of cost differences put forward by parties, stating that they are “*not the main reason[s] for the cost differences*” and that adjusting for these factors “*would be likely to increase rather than reduce the observed differences*”.²⁵² The

²⁵¹ [CONFIDENTIAL].

²⁵² PDR, Appendix 3.5, paragraph 16.

CMA considers only differences in customer/tariff mix and examines their impact only on an indicative basis.

- 6.12 RWE considers that there are a number of important drivers of costs, other than the IT systems investment cycle which the CMA should control for in its analysis, including: customer mix; tariff type mix; firm scale; geographical differences; and one-off and firm-specific factors.
- 6.13 As RWE has previously explained, a number of established methodologies exist for undertaking robust efficiency assessments which control for such factors and are typically used by economic regulators. These approaches include international benchmarking, econometric analysis, Total Factor Productivity, support cost benchmarking and functional benchmarking. The CMA has chosen not to undertake robust analysis using such established methodologies.
- 6.14 Third, the CMA rejects parties' contention that differences in costs may be efficient, because it considers that this cannot be the case for a homogenous product.²⁵³ However, (without prejudice to submissions made by RWE in response to PFs that energy products are not homogenous) this argument is predicated on the CMA's conclusion – which is not based on any evidence – that cost differences do not reflect other factors such as the timing of investment cycles or other differences in cost drivers. As explained, RWE considers that the CMA has not adequately investigated to what extent these factors drive costs and therefore considers this theoretical argument does not lend any support to its efficiency benchmarking approach.
- 6.15 Finally, the CMA rejects that cost differences could reflect the outcome of routine innovation by firms in a competitive market. In a footnote, the CMA explains that: *"It is common for firms, in the ordinary process of competition, to identify potential efficiency improvements that would allow them to reduce their cost base and, in so doing, either lower prices and/or increase their profits. However, in a well-functioning market, we would expect such cost-savings to be incremental in nature, rather than the significant cost-savings that have been identified in this market."*²⁵⁴
- 6.16 The CMA does not put forward any economic logic to support its statement that costs savings should be "incremental" in nature in a "well-functioning market". Further, the CMA does not explain or quantify how it has assessed that the level of (potential) cost-savings is "significant" and in excess of that which it would expect in a "well-functioning market". RWE considers that the CMA's theoretical framework is deeply flawed and that it has presented no evidence to support its qualitative conclusions.

The CMA's choice of benchmark for indirect costs

- 6.17 The CMA has revised its approach to benchmarking indirect costs from the analysis it previously presented in the PFs. RWE considers that the CMA's revised benchmarking remains flawed, because the CMA still imposes a presumption which is not supported by any empirical evidence, that the Six Large Energy Firms combined were on average inefficient over the period.
- 6.18 The CMA has accepted that no firm could have achieved the benchmark it previously proposed over the period.²⁵⁵ The CMA now considers two benchmarks:
- 6.18.1 the lower quartile of the average indirect cost per customer of the Six Large Energy Firms over the period; and
 - 6.18.2 a much more aggressive (and more inappropriate) benchmark equal to the costs of the most efficient firm in the industry, over its period of analysis.

²⁵³ PDR, Appendix 3.5, paragraph 17.

²⁵⁴ PDR, Appendix 3.5, footnote 11.

²⁵⁵ PDR, Appendix 3.5, paragraph 20.

- 6.19 Both these benchmarks therefore continue to impose a presumption that the average firm was inefficient over the period. The CMA has still presented no empirical evidence to support this major presumption and appears to rely on its flawed and unsupported conclusion that differences in cost must reflect inefficiency and a qualitative comparison with the indirect costs of mid-tier firms.
- 6.20 In relation to its more aggressive proposed benchmark, the CMA reasons that “*it would be reasonable to take the most efficient firm in the industry as the benchmark against which to evaluate the other operators – given the similarities in the products they sell and their market positioning, as well as the large differences between them*”.²⁵⁶
- 6.21 RWE strongly disagrees with the CMA’s basis for adopting either benchmark for the reasons set out in the preceding subsection. In particular, because it has not obtained sufficient evidence or adopted a robust methodology to assess efficiency, it cannot have the information to robustly distinguish between a firm that has been efficient and a firm that has been “super-efficient”. Therefore, there can be no evidential support for its more aggressive proposed benchmark.
- 6.22 In conclusion, RWE considers that there is no empirical support for CMA’s conclusion that the Six Large Energy Firms’ costs were inefficiently high over the period. Therefore, there is no support for its proposed benchmarks and the case for its more aggressive benchmark is particularly weak. The CMA’s simplistic analysis should therefore be disregarded.

The CMA’s calculation of additional detriment arising from inefficiency

- 6.23 The CMA concludes that firms “*which ‘beat’ the benchmark can be considered to be reasonably efficient, but should not necessarily be considered ‘super-efficient’*”²⁵⁷ and therefore sets their cost inefficiency to zero in its analysis i.e. it does not give any credit for any firm achieving greater efficiency than could be expected of an average firm.
- 6.24 The CMA presents no evidence to support its judgement and RWE does not consider that it is logical. There is no reason to treat the efficiency benchmark as a simple threshold and to consider all firms which have reached it to be equivalent. A super-efficient firm which has exceeded the benchmark is in a different competitive position to a firm whose costs are only in-line with the benchmark. A super-efficient firm’s greater cost advantage gives it a stronger competitive position because it can compete more strongly on price, which will benefit all consumers in the industry through additional downward competitive pressure on price. RWE considers that any calculation of the net cost efficiency of the industry must give credit for firms that have achieved costs below the benchmark.

The internal consistency of the assumed value for systems/billing software

- 6.25 RWE has previously explained that modern billing and customer management systems are required to achieve operational efficiency in line with the best performers in the industry. Therefore, there is a relationship between the replacement value of systems and the indirect costs per customer that a firm can achieve.
- 6.26 When the CMA adjusts indirect costs per customer to its “efficient” benchmark, to be internally consistent it must therefore also adjust the value of billing systems within capital employed to a value which reflects the replacement cost of a system which is able to deliver leading operational performance efficiency.

7. The CMA does not properly interpret its results

- 7.1 Notwithstanding our view that ROCE analysis is not appropriate for assessing the profitability of retail energy supply businesses, we also consider that the CMA has failed to consider some important implications of its results.

²⁵⁶ PDR, Appendix 3.5, paragraph 20.

²⁵⁷ PDR, Appendix 3.5, paragraph 27.

- 7.2 RWE previously set out in its response to the PFs how the CMA's finding that the Six Large Energy Firms had earned profits in excess of their cost of capital is principally driven by the financial performance of Centrica alone. Centrica has – by some margin – the largest market share, particular in Domestic and Microbusiness gas supply.
- 7.3 The CMA has not acknowledged this fact, nor has it explained whether or how it has considered its implications for its AEC findings and its provisional remedies. RWE considers that the very large share of profits which the CMA calculates have been earned in excess of the cost of capital which is attributable to Centrica provides important evidence about the functioning of the retail energy supply market.
- 7.4 RWE considers that the CMA's AEC findings and proposed remedies must take into account the implications of this result.