

**Energy Market Investigation  
Statement of Issues  
Response of E.ON**

## **1 INTRODUCTION**

1. This document represents the response of E.ON (the "**Issues Response**") to the Energy Market Investigation Statement of Issues (the "**Issues Statement**") published by the Competition and Markets Authority ("**CMA**") on 24 July 2014.
2. We comment below specifically and in turn on each of the high level theories of harm identified at this stage by the CMA. We reserve the right to submit further comments on the Issues Statement, including taking account of comments made by third parties, if E.ON considers it appropriate to do so. We would also wish to comment on some of the introductory context set out by the CMA (we will also comment in more detail on the background and market characteristics in our initial submission to the Authority (the "**Initial Submission**") which we will submit in due course.

## **2 EXECUTIVE SUMMARY AND CONCLUSIONS**

3. **E.ON supports the CMA Investigation:** E.ON supports the investigation by the CMA into the energy market, which is something we have been calling for since 2011. We view this as a key step towards customers and stakeholders regaining full confidence in the operation of the electricity and gas markets. Events and rhetoric of the last few years have had a negative impact on the standing of the energy industry and on the perception of the UK as a positive place to invest. Our hope is that this independent investigation will draw a line under this and create a new paradigm against which the industry can be viewed.
4. **We are committed to ensuring the CMA understands the market:** We welcome the opportunity to comment on the Statement of Issues. We note the view which has been expressed that the Issues Statement so far has been largely based on evidence contained in Ofgem publications and that it is important that the CMA's analysis and report should be and be seen to be independent of Ofgem and should also reflect, for example, the views of market

participants<sup>1</sup>. Therefore, with our response we have included some of our views of the market and evidence for our views, at this early stage of the investigation. E.ON has a natural interest that this investigation should focus on the truly relevant features of the market and the appropriate parts of regulation. We want to help the CMA getting to an appropriate understanding of the relevant market characteristics.

5. **The investigation is appropriately scoped but E.ON does not believe the theories of harm apply:** E.ON believes that the market investigation is appropriately scoped. However, based on the information available to us, E.ON has a different view on a number of features the CMA has preliminarily identified as potentially harmful to competition. E.ON experiences strong competition for customers every day.
6. **Factors such as intrusive regulation and the political climate should be considered as an additional theory of harm:** We appreciate that the CMA acknowledges the substantial regulatory change and political uncertainty to which both gas and electricity markets have been subject in recent years. E.ON believes that, in fact, it would be appropriate to treat these factors as an additional theory of harm, in terms of their impact on the market, including looking at the ever increasing scope of obligations and the way costs of obligations are recovered through energy bills. The (larger) energy companies in Great Britain seem to have been put into a role of delivering solutions for Government, often implemented and enforced through regulation, rather than performing their market roles. In recent times, policies have gone further and have begun to directly interfere with the functioning of the market, for example through the Government's retrospective changes to obligations and the Labour Opposition's proposed price freeze. Investors have begun to note the increasing regulatory and political risk in the market. In stark contrast to past perception, there is evidence that the UK now tops the political risk table, ahead of Spain, Germany, and Italy.
7. **This changed role of energy suppliers contributes to public mistrust and the perceived complexity of the energy business:** Regulatory change, including politically driven regulatory change, has added further complexity to the energy market. This has been added to by the approach sometimes seen from the regulator and some politicians.

---

<sup>1</sup> Former GB Energy Regulators' Evidence to the CMA, 7 August 2014.

8. **Wholesale prices are not opaque; liquidity is not at a level that would create a barrier to entry:** E.ON considers that liquidity in wholesale electricity markets is sufficient and does not create a barrier to entry. Nevertheless, E.ON supports any measures to further increase liquidity, as E.ON's business model is based on independently managed businesses trading at arm's length and operating in liquid wholesale markets across Europe. E.ON's model is more likely to promote and increase liquidity in wholesale markets. Vertical integration need not result in lower liquidity but arrangements, whether through vertical integration or otherwise (e.g. by contract) which result in generation or supply not being made available to the wholesale market, will impact market liquidity. Wholesale prices are not opaque and the growth in volumes day ahead is producing an increasingly robust reference price.
9. **Vertically integrated businesses do not harm the competitive position of non-integrated businesses:** It is wrong to attribute market foreclosing conduct to market participants purely on the basis of their structure. E.ON's trading business trades substantial amounts externally – both in terms of "buy" trades and of "sell" trades, i.e. whether E.ON's trading business is trading with non-E.ON suppliers or non-E.ON generators. E.ON's business model is based on independently managed businesses trading at arm's length and operating in liquid wholesale markets across Europe. It is possible, however, that some companies may be choosing to give more favourable prices to their own downstream operations, cross-subsidising from their upstream businesses and this aspect is worth exploring.
10. **We do not believe that there is evidence of market power in generation which could lead to higher prices:** E.ON does not believe that market power exists in generation markets which can be used to raise prices, whether across the market as a whole or at certain times or in specific locations.
11. **The energy retail market is highly competitive and energy suppliers are incentivised to compete on both price and non-price factors:** E.ON believes in a free and competitive market for energy, which has a structure to allow for competition on price as well as non-price means, whilst also having some consumer protection for those who do not fully participate in the free market, and that the combination of these three features should lead to the best outcome for customers.

12. **Inactive customers do not reduce incentives to compete, as a supplier cannot rely on a customer who might currently not be active in the market continuing to be so:** Merely looking at and judging this question by external switching rates oversimplifies the picture in failing to take account of other factors such as customer satisfaction and internal switching within companies. Lower levels of customer switching may well be entirely consistent with, and indicative of, the existence of an intensely competitive market.
13. **We do not coordinate, tacitly or otherwise with our competitors:** Rather it is the case that strong competitive market forces push us to take account of competitors' behaviour, as well as that of customers. The GB energy markets lack a number of the fundamental characteristics of market(s) which may be conducive to coordination and the conduct of suppliers in the market is not consistent with coordination. In a competitive market like the GB energy markets, one might expect a supplier to take account of likely pricing initiatives of other suppliers and its own competitive positioning compared with other suppliers when determining its own prices.
14. **Some regulatory interventions do lead to distortions in competition:** In particular, the exemptions of some suppliers from certain obligations (including the Energy Companies Obligation ("**ECO**") and Warm Homes Discount ("**WHD**") distorts the burden of paying for those obligations between the customers of obligated and non-obligated suppliers and provides an unjustified subsidy to those suppliers. In addition, some interventions, e.g. around price discrimination, may change the nature of competition, lessening the concentration on new customers alone. However, we also believe that some such measures can be in the interests of customers, using competitive forces to benefit the average customer, through more effective overall competition.

### **3 E.ON'S RESPONSE ON ISSUES RAISED BY THE CMA**

#### **3.1 Background and market characteristics**

15. The CMA acknowledges the challenges faced by the energy market in terms of the substantial regulatory change, political uncertainty and what it describes as a "notable lack of trust between operators and customers". We would like to comment upon each of these elements.

16. In relation to **regulatory change**, the substantial nature of it really cannot be overplayed. It is worth reflecting initially upfront how very far away the industry is from where the authors of privatisation and liberalisation thought we would be at this point. The accepted vision in 1990 was that, over time, economic regulation by Ofgem would fall away, with energy being more like any other market, and recourse being had to consumer protection and competition law to protect the position of consumers and govern the offers made to them. (This, of course, was with the exception of the situation relating to the network companies which, as natural monopolies, were always likely to stay regulated.) Indeed, in 2001, a former Ofgem Chief Executive, Callum McCarthy commented: "The focus of Ofgem's work going forward will increasingly be on monitoring competition and using competition law to tackle market abuse."
17. Instead, we find ourselves in a situation where regulation has been layered upon regulation and the supply licence, instead of shrinking, has more than doubled in recent years. It is now more than 400 pages long, larger than it was at privatisation. In that context, the legal advisers to Energy UK commented in the context of the recent Retail Market Review ("**RMR**") draft licence modifications that:
- "There are over 100 pages of dense legal drafting, including ten entirely new conditions and six substantially amended conditions. They include over 110 new defined terms. If implemented, they would increase by more than 50% the consolidated text of the existing standard conditions of gas and electricity supply.*
- Clearly, the RMR policy proposals are lengthy, complex, detailed and prescriptive. Any new licence drafting which gives effect to them will also therefore have an irreducible level of length, complexity and detail. The licence conditions could not realistically be expected to be succinct or simple when the policy to which they are designed to give effect is neither"<sup>2</sup>*
18. In addition to RMR, there are obligations around Feed-in Tariffs, Smart metering, Green Deal, ECO (and before that, the Carbon Emissions Reduction Target (known as "**CERT**") and the Community Energy Savings Programme (known as "**CESP**"), WHD, the Renewables Obligation, Theft of energy and the Carbon Reduction Commitment. Electricity Market Reform ("**EMR**") will bring further changes, both upstream in generation and downstream, in terms of

---

<sup>2</sup> Wragge & Co LLP, The Retail Market Review Draft Licence Conditions, Legal Opinion for Energy UK, 23 April 2013.

obligations on the supply companies effectively to collect the funds to pay the generators.

19. In a recent open letter on regulatory compliance issued by Ofgem<sup>3</sup>, it is notable that the example they chose for removal of regulation, namely the cessation of price controls on supply companies, dated back some 13 years to 2001. The greater part of this regulation has been imposed upon the downstream supply companies, which started off as simple sellers of electricity and gas.
20. **Political uncertainty** is a developing aspect of the market, which we pick up below. We consider that the extent to which the industry has become a political "football", with parties vying with each other as to who can appear toughest, is at least a little surprising.
21. It is regrettable that such political intervention has occurred at a time when the industry has found itself in a "perfect storm" of change where:
  - the UK moved from being self-sufficient in gas, to becoming a net importer of gas in 2004 and thus subject to world gas prices, just at a time when they became increasingly volatile and rose considerably;
  - the EU decided to adopt its 20:20:20 package for energy, including, for the UK, a target of 15% of total energy requirements being met from renewables by 2020 – bringing with it both the need for fundamental changes to the electricity system (massive investments in new plant and networks to meet this challenge);
  - concerns began to be raised about the impact of climate change on the environment, leading the UK to adopt the Climate Change Act 2008, with very stretching emissions reduction targets which led to a revisiting of technologies like nuclear power, which had not been considered seriously in the UK for a couple of decades;
  - EU environmental legislation like the Large Combustion Plant Directive ("**LCPD**") and the Industrial Emissions Directive ("**IED**") beginning to bite and actually leading to plant closures, some of which plant will need to be replaced; and

---

<sup>3</sup> Open letter on regulatory compliance of 28 March 2014.

- linked to the above points, concerns beginning to be raised around security of supply, in terms of an over-dependence on gas, and therefore a need to pursue alternative sources of energy. Traditionally, this might have been coal as an alternative to gas but the factors described above made this a practical impossibility<sup>4</sup>.
22. The industry was not quick enough to explain the impact of these changes on end customer prices which has meant that the complex reality of the situation has become somewhat obscured and the issues and difficulties have been publicly presented by some others as being ALL the industry's fault.
23. This leads to the third point highlighted by the CMA, around **trust between operators and customers**. According to Ofgem, 44% of household customers distrust energy companies to be open and transparent in their dealings with consumers<sup>5</sup>. However, similar research commissioned by Energy UK showed that only 15% of customers did not trust their energy supplier to be open and transparent in their dealings with them<sup>6</sup>. There was a difference between the two surveys, in that the Energy UK one related to the customer's own supplier, whereas Ofgem asked about suppliers in general. It might be suggested that a response to the latter question would be more influenced by political rhetoric and media comment, whereas a response to the former might better reflect a customer's own experience with their supplier. Somewhat ironically, according to a YouGov poll reported on 6 June 2014, only 12% of the public trust politicians to effectively play their part in the energy market and nearly half of *MPs* polled had little or no trust in politicians to effectively play their part in the energy market<sup>7</sup>.
24. The CMA identifies certain key characteristics of energy markets, especially electricity markets, in the Issues Statement and asks for observations on these and whether there are others it should consider. Fundamentally we agree that the CMA has correctly scoped out the reference and the issues to be considered. We would, however, highlight **two additional points** in particular.

---

<sup>4</sup> As E.ON found with its proposed Kingsnorth project, which it had to abandon.

<sup>5</sup> Ofgem, Ipsos Mori Customer Engagement with the Energy Market - Tracking Survey 2014.

<sup>6</sup> Energy UK, Consumer Experience with the Energy Market, May 2014 p 25 <http://www.energy-uk.org.uk/publication/finish/5-research-and-reports/1111-ipsos-mori-report-consumer-experiences-of-the-energy-market.html>.

<sup>7</sup> <http://research.yougov.co.uk/news/2014/06/06/energy-trust/>.

25. The first point is the **prevalence of regulation**, which we have already discussed in paragraphs 16 to 19 above.
- a. Energy companies in Great Britain, or at least the larger energy companies, appear to have been put into a role of delivering solutions for Governments, often implemented and enforced through regulation, which has moved them a long way from their traditional role. Examples of these have already been given above and they span both the environmental sphere, such as administration of Green Deal and Feed-in Tariffs, recovery of funds to meet Renewables Obligation payments and an obligation to offer a Power Purchase Agreement of last resort to renewables generators, through social obligations, such as the WHD payment to vulnerable customers and fulfilment of the ECO. Regulation is therefore ever more prevalent than before, more intrusive and in wider areas than merely the detailed market rules that are required to underpin liberalised wholesale energy markets or similar "traditional" regulation.
  - b. This links in with the CMA's point about the external costs of climate change where, as it comments, the costs are largely borne by energy customers. This is true but not well understood by energy customers, who will not usually distinguish between rising costs within and outside the control of energy companies. Although, as the CMA comments, a well-functioning energy market might generally be expected to require some form of regulatory intervention, it might equally be questioned whether in the GB market the balance has tipped too far towards loading a wide variety of obligations on to the larger energy companies to deliver for Government and the regulator.
26. The second point is the **extent of political and regulatory risk**. Commentators have begun to note the increasing regulatory and political risk in the market and its impact on the standing, and in some cases the share prices, of companies within the sector<sup>8</sup>. We would suggest that political and regulatory risk and risk of intervention has itself potentially become a barrier to competition.

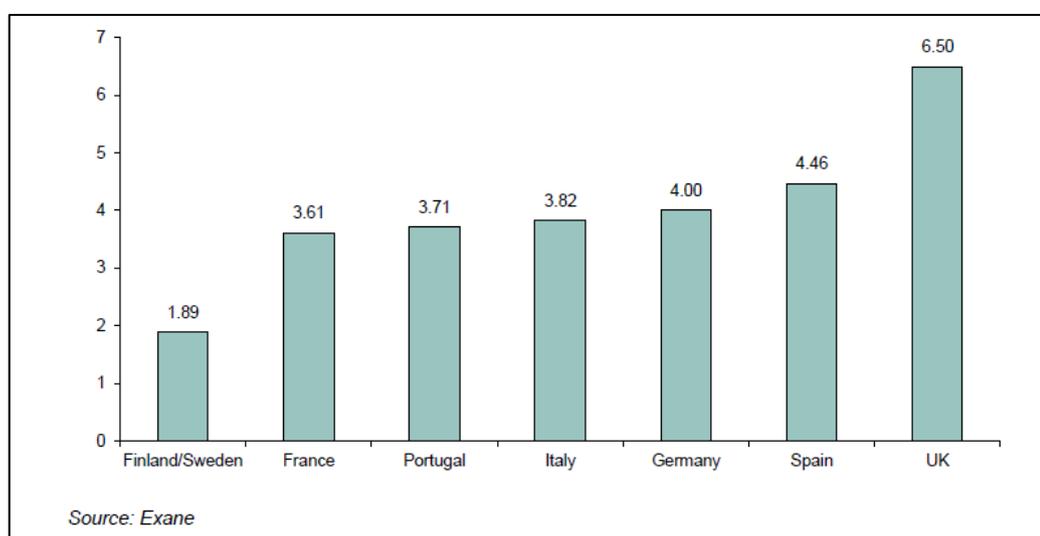
---

<sup>8</sup> For Investors, U.K. Political Risk Comes Early, Wall Street Journal, 1 December 2013 <http://online.wsj.com/news/articles/SB10001424052702304355104579231902259694762#http://tags.bluekai.com/site/4454?>; Political risk on agenda in UK Board rooms, FT, 9 March 2014 <http://www.ft.com/cms/s/0/68f93da8-a762-11e3-9c7d-00144feab7de.html> "In the UK, Utilities Face Rising Regulatory and Political Risk and Flat Power Price Environment", Moodys, 2 July 2014 [https://www.moodys.com/research/Moodys-UK-utilities-face-rising-regulatory-and-political-risk-and--PR\\_303208](https://www.moodys.com/research/Moodys-UK-utilities-face-rising-regulatory-and-political-risk-and--PR_303208).

We believe that the CMA should consider whether this should be viewed as an additional theory of harm.

27. For the last two decades the GB market had been viewed by investors and other stakeholders as one of the attractive markets in which to do business. At the heart of this argument was the view that there was a broad political consensus in energy policy over this period, resulting in low political risk.
28. However circumstances have fundamentally changed over the last twelve to eighteen months. Both the Coalition Government and Labour Opposition have either implemented (e.g. Government's retrospective scaling back of the energy efficiency programme under the Energy Companies Obligation) or put forward (e.g. Labour's 20 month Price Freeze) proposals which have damaged investor confidence and increased political risk in the GB market. This will have a knock on effect on the cost of capital.
29. A recent investor survey by Exane highlights how things have changed markedly. The UK now tops the political risk table, ahead of Spain, Germany, and Italy.

**Figure 1:** Ranking of political risk



Source: Exane European Utilities Q2 2014 Investor Survey<sup>9</sup>

30. Equally, the State of the Market Assessment ("**SMA**") itself also suggested that some potential new entrants have been reluctant to enter the market due some of the broader stakeholder risks including political risk. It says:

<sup>9</sup> See also, UBS UK Utilities Freezing Energy Tariffs without the gimmicks, page 12.

*"In addition to the regulatory barriers to entry, the industry is affected by a high degree of policy change, political and media scrutiny, and negative publicity. As part of our assessment, we spoke to a number of firms that had previously considered entering the retail energy market. A consistent reason for not entering was the political environment surrounding the energy market and uncertainties surrounding the future course of policy."*<sup>10</sup>

### 3.2 CMA theory of harm 1: Opaque prices and low levels of liquidity

31. The CMA suggests that opaque prices and low levels of liquidity in wholesale electricity markets create barriers to entry in retail and generation, perverse incentives for generators and/or other inefficiencies in market functioning. It puts forward two potential hypotheses:

- a. Hypothesis 1a: The **market rules** lead to opaque price and low liquidity in wholesale electricity markets, creating barriers to entry in retail and generation, perverse incentives for generators and/or other inefficiencies in market functioning.
- b. Hypothesis 1b: **Vertical integration** leads to opaque price and low liquidity in wholesale electricity markets, creating barriers to entry in retail and generation, perverse incentives for generators and/or other inefficiencies in market functioning.

#### 3.2.1 Summary of E.ON's view

32. E.ON considers that the available evidence, in terms of new entry into both supply and generation, suggests that liquidity in wholesale electricity markets is sufficient and does not create a barrier to entry into either market or give rise to significant perverse incentives for generators or other significant inefficiencies in market functioning<sup>11</sup>. Nevertheless, E.ON supports any measures to further increase liquidity, particularly away from the day-ahead market, provided they do not give rise to other distortions or adverse effects.

<sup>10</sup> SMA, 27 March 2014, para.1.35.

<sup>11</sup> As noted in the Former GB Regulators' Evidence to the CMA, *op. cit.* footnote 1, factors such as liquidity and generator market power are apparently not causes of harm in supply to larger business customers.

33. The E.ON group has chosen to structure our business in such a way as to be dependent on liquidity in wholesale markets. Our generation businesses and supply business each trade with the wholesale market via our European trading business, but our generation businesses do not sell their capacity or output to the trading business on the same timescale as our supply business buys electricity in order to cover its customers' requirements. As our trading business has limits placed on it regarding the size of the open positions which it can hold (including with internal counterparties), this means that it must trade with the wholesale market in order to remain within those limits. Our structure would **not** work without a sufficiently liquid market; we believe the fact that we have adopted such a structure and operating model is itself evidence of our own faith in the market's liquidity.

### 3.2.2. CMA Hypothesis 1a: Market rules as a source of opaque prices and poor liquidity

34. The market rules do not directly regulate the transparency of prices and levels of liquidity in wholesale electricity markets; however, they should provide the framework upon which the wholesale traded market delivers such transparency and support the development of trading in standard wholesale market products. Whilst factors other than the market rules will often dictate the levels of liquidity for different products and the degree to which prices are transparent and accessible to different parties, badly designed market rules can lead to adverse effects in respect of liquidity and competition.
35. One way in which the market rules can impact on liquidity and competition is via the extent and frequency of changes to these rules. Clearly, some degree of change is necessary in order to ensure that rules remain fit for purpose in a rapidly evolving market. However, change which occurs too often, or for little apparent justification, can undermine the confidence of potential investors and new entrants. An example of excessive regulatory change is the methodology for determining costs for companies who secure too little or too much generation to cover their customer demand (imbalance costs). These costs are fundamental to the nature of the market as all trading is effectively a hedge against them.
36. There have however been three major reviews by the regulator of these costs in the 13 years since the introduction of NETA. Additionally, there have been around ten changes to the methodology, most of which have had an impact on the level or volatility of prices. Further proposals are being progressed at

present which, if implemented, will mean another fundamental change to the charging regime. As almost every one of these changes will have influenced, to a greater or lesser extent, the requirement of all generators and suppliers to trade, the lack of stability in imbalance costs is likely to have had some negative impact on liquidity.

37. Government policy and regulation can also have a direct impact on liquidity. The most obvious example of this is the Carbon Price Floor ("CPF") implemented by the Treasury through alterations to the Climate Change Levy as applied to the input fuels for power generation. Irrespective of its intent, the implementation of this policy damaged power market liquidity in two distinct ways. The first arises through uncertainty as to the level of the tax which is set in each year's Budget for the tax year two years ahead. This means that generators have to take a much higher risk in selling their output more than two years ahead, thus requiring a significant risk premium to sell output forward and also dampening the incentive for any supplier to buy on this timescale. The second is through the distortion the tax has caused in the differentials in costs between generation in the GB and Continental Europe, which has impacted flows across the interconnector.

### **3.2.3 CMA Hypothesis 1b: Vertical integration as a source of opaque prices and poor liquidity**

38. The CMA, in its draft questionnaires, defined vertical integration to mean "where both the Supply Business and the Generation Business are ultimately held under common ownership". This is clearly a wide definition, which takes no account of how those businesses may be operated – which may be separately and independently, under distinct management teams or may be effectively in common cause, as an operationally integrated undertaking. We would suggest that it is the latter characterisation that most commentators think of when they use the term "vertical integration" or "VI".
39. As regards E.ON, our gas exploration and production business activities, generation business activities, trading business and retail business (electricity and gas) for Great Britain are operated by companies that ultimately are held under the common ownership of E.ON SE.
40. E.ON is not however vertically integrated in how we manage our operations. Our supply and generation businesses are separately and independently managed, with different management teams,

prepare separate profit and loss accounts<sup>12</sup> and report to a different E.ON SE Management Board director. They operate in the market as if they were independent of each other and each trades independently and at market reflective prices with our Düsseldorf based trading business, E.ON Global Commodities SE ("**EGC**"), which operates and trades worldwide. Our generation businesses (both conventional and renewables) are managed and operated on a European wide basis<sup>13</sup>; our supply businesses across Europe tend to be run on a regional unit by regional unit basis. Therefore, in the UK we have Regional Unit UK, responsible for the supply of electricity and gas and heat to end customers<sup>14</sup>; there is a similar regional unit business in Sweden, for example.

41. In other words, although the E.ON corporate group includes GB supply and generation businesses, they are managed separately and operate independently of each other in the market.
42. E.ON would suggest that the real issue here is not one of vertical integration per se, but rather whether entities have arrangements in place by which they bypass the market, resulting in generation capacity and output not being made available. Such an approach would reduce market liquidity. These arrangements may be classic VI arrangements or they may be through contract. Any off-market arrangement that, for example, Drax had for its generation would remove some 4% of capacity<sup>15</sup> and 10% of output<sup>16</sup> from the market.
43. E.ON trades volumes that are greater than 100% of our generation and 100% of our supply. This means that through our traded volumes we buy more than we supply to our customers or than we

---

<sup>12</sup> The legal structure, as opposed to the operating structure, reflects the origins of E.ON UK plc as the generation company Powergen, which acquired interests in supply. The main E.ON generation licence in GB is therefore held by E.ON UK plc on whose board are a number of Regional Unit UK ("**RU UK**") Board members. However, the generation business is not run through this company. The main supply licence in GB is held by E.ON Energy Solutions Limited, and other RU UK Board members sit on that Board. The CEO and CFO sit on both. However, again, the supply business operations are not run through that Board.

<sup>13</sup> E.ON SE recently announced its "NextGen" project, which is a proposal to combine the conventional generation and renewables businesses, previously run separately, into one pan-European business.

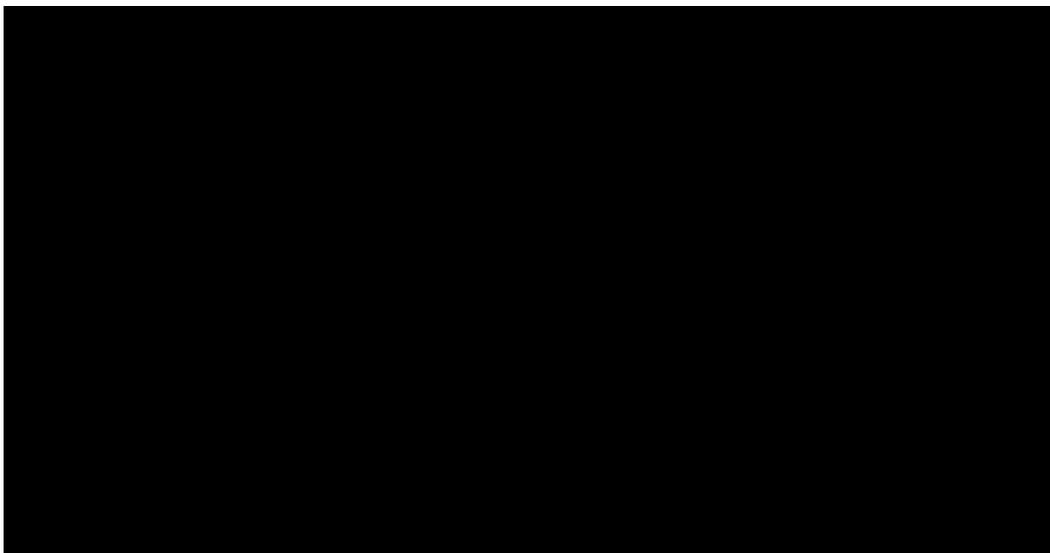
<sup>14</sup> RU UK does have some generation as part of its Community Energy and Combined Heat and Power ("**CHP**") businesses (although it is not all technically CHP). The Community Energy generation is dedicated to its customers; most of the CHP business was originally dedicated to specific customers (and some still is). Any non-dedicated generation is sold through EGC..

<sup>15</sup> May 2014 figures, E.ON internal database.

<sup>16</sup> 2013 Ellexon settlement data.

generate. As **Table 1** below shows, our total supply volume is significantly greater than our total generation volume.

**Table 1:** EGC Buy and Sell trades



*Source: E.ON own data*

\* The Export generation and Supply Volumes are the trades by EGC with E.ON's Generation and Supply Businesses through transfer pricing. These values can be different to those reported in the Consolidated Segmental Statement, which reports the generation and supply volumes of E.ON's Generation and Supply Licensees. Also, the supply volumes in the CSS are the volumes as recorded at the meter point (i.e. net of losses).

44. The majority of our traded volumes go through three public/market channels; auction/exchanges (APX, N2EX, ICE), bilateral OTC screen based trading and transactions with the transmission system operator (the balancing market). We also do a small amount of bilateral OTC off screen direct trading.
45. The SMA is clear on the extent to which E.ON in GB, through EGC, both sells its generation externally and purchases power for its supply business externally. This appears from **Table 2** reproduced below, which appeared at page 97 of the SMA. It shows that E.ON trades proportionately more than the other major suppliers did in 2012 and was proportionately the biggest trader on "purchased" volumes and second biggest trader on "sold" volumes in 2013. It is unfortunate that, as is often the case, the table only reflects the positions of the six major players and not the extent to which other large generators trade externally or only with their own supply businesses, such as Drax, for example, which has an I&C business, Haven Power. We would suggest that this is something that it is worth exploring further in order to understand fully the extent of market capacity and liquidity.

**Table 2:** Ofgem Figure 43: External trading positions of the six largest energy companies

	<b>Externally purchased volumes/Generation output (ratio)</b>	<b>Externally sold volumes/Generation output (ratio)</b>
	<i>Median</i>	<i>Median</i>
<b>2012</b>		
Centrica	3.9	1.2
EdF	0.8	1.0
E.ON	5.1	4.2
ScottishPower	2.5	2.2
SSE	3.9	3.4
Npower	3.8	3.7
Average weighted by big 6 Generation market share	2.8	2.5
<b>2013</b>		
Centrica	3.8	1.5
EdF	0.6	0.9
E.ON	4.6	3.4
ScottishPower	1.8	1.6
SSE	4.2	3.9
Npower	3.4	3.2
Average weighted by big 6 Generation market share	2.5	2.2

Source: Ofgem, SMA (page 97)<sup>17</sup>

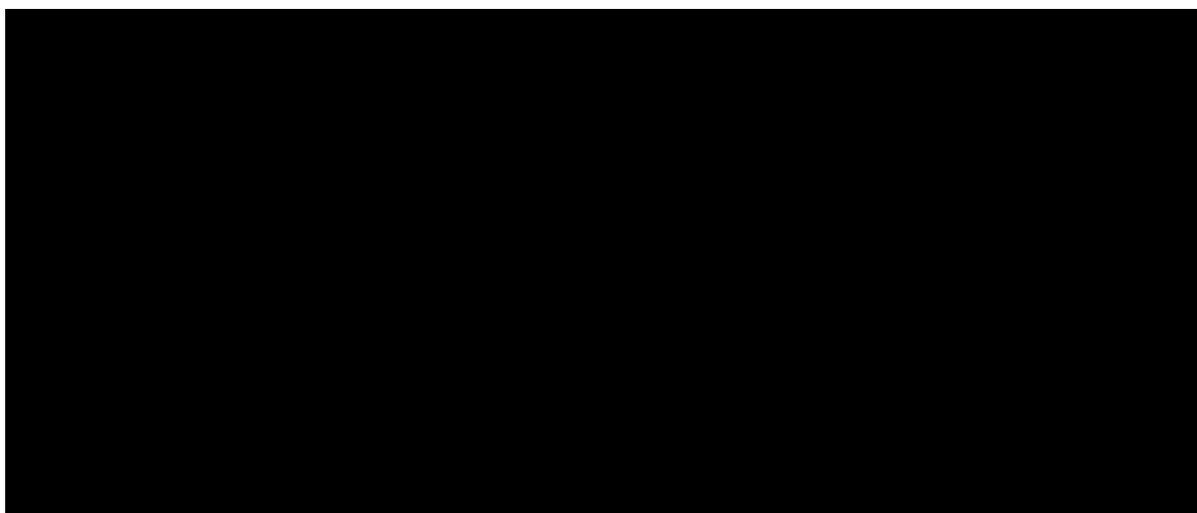
46. Therefore, although E.ON's GB generation and supply businesses are in common ownership they are not vertically integrated operations. Each of E.ON's GB supply and generation businesses is under management pressure to maximise its financial performance. The lower collateral costs of such a larger business would allow a greater

<sup>17</sup> Ofgem noted: Data was provided by each company on electricity supplied, generation output, volumes of energy transferred internally and volume of energy purchased and sold by from external trading counterparties for each half hour trading period in the year. They calculated each of the metrics presented in Figure 43 for each half hour period and presented the median values. They noted that the figures were not entirely comparable as SSE included the output from generation they do not own, but have responsibility for trading through a long term power purchase agreements in generation. This will increase the generation output and slightly reduce their ratios compared to the other companies. EDF provided the energy they have traded in each half hour (some for delivery in that half hour but most for later delivery) rather than the energy that delivered in that half hour. Centrica excluded generation under tolling agreements and the generation output from nuclear generation assets Centrica co-owns were added to the generation figures provided according to Centrica's ownership share in these plants.

volume of trading to be economic and thus aid market liquidity. Whilst it is possible for our trading business to use the output of our generation plant to meet some of the demand of our supply business, the trading business is not incentivised to do so. In particular, the trading business would not maximise its profit, which it is incentivised to do, by taking this course unless such trades would also have been sensible even if the counterparties had been external (minus a small adjustment for transaction costs). Mere co-ownership of supply and generation does not materially reduce the functioning of the wholesale market.

47. In support of greater levels of trading, E.ON has been at the forefront of the development of wholesale market trading systems. In particular it was a founder member of the N2 Exchange in GB ("**N2EX**"), the development of which was industry-led and promoted. On 23 November 2011, E.ON became the first company to sign a gross bidding agreement<sup>18</sup> with N2EX. We are currently putting just over █████ of our estimate of our day ahead planned generation into the N2EX day-ahead auction. As shown in **Figure 2**, through E.ON's actions and those of other players, the N2EX auction has grown significantly since it was launched.

**Figure 2:** N2EX volume development since 2010



*Source: E.ON for the daily absolute E.ON Global Commodities volumes and N2EX for the daily absolute market volumes numbers*

<sup>18</sup> Gross bidding involves participating on both the buy and sell sides of an auction. A firm may enter into a gross bidding agreement with a platform in return for reduced trading fees.

### 3.2.4 E.ON's comments on selected effects that, according to the CMA, may create harm

#### Transaction costs for independent retailers and generators

48. Transaction costs are an inherent part of trading commodities for all companies and not a unique feature of electricity in the Great Britain. Specifically to the trading of electricity in Great Britain, we are not aware of any evidence that Great Britain has a cost base that is generally higher than other equivalent markets in Europe.
49. We agree with the statement "that the current electricity trading rules were designed with strong incentives on generators and retailers to balance their own supply and demand portfolios, by making energy imbalances particularly expensive". We would also agree that this was intended to reflect the need to balance generation and demand in real time and that, in order to avoid the risk of imbalance, all retailers and generators need actively to be engaged in some form of bilateral contracting up to one hour before delivery. This is costly for all, but a necessary factor in the production and supply of electricity due to the difficulty and high cost of storing electricity.

#### Hedging costs for independent retailers and generators

50. Most power markets parties trade predominantly physical forwards (OTC broker based trading) or financial futures, but not both. The growth of volume through day-ahead auctions like N2EX shown in **Figure 2** above are helping to provide robust reference prices against which electricity futures in Great Britain can be settled and so it might be expected that we will see growth in this area. In addition, as discussed below, the proposal that day ahead prices will be the Market Reference Price under Renewable Contracts for Differences is likely to attract still more volume through the day ahead exchanges.

#### Observable prices as poor guides to action

51. The premise that an investor would invest in generation plant just on the basis of forward prices is not correct, in our view. Most large-scale generation plant takes more than three years to construct and has an economic life measured in decades whilst few end customers have shown any interest in contracting for electricity for a duration over two years. This implies that forwards prices and liquidity are unlikely ever to be present far enough in advance to justify new

build. The investor would consider their own price tracks but these would be an extrapolation and based on their own assessment – a potential market view – not actual prices.

52. The introduction by the Electricity Market Reform ("**EMR**") of the Capacity Mechanism (with potential 15 year contracts on offer for new plant with the first auction December 2014) will help generators partially address the issue of having to develop projects over greater timeframes than their customers (retailers and ultimately their customers) are prepared to contract.
53. On the retail side, we do not believe that the role of forward prices is to "act as a guide to the future level of spot prices"; rather, we believe that forward prices exist to allow retailers and generators to reduce their risk via hedging. Furthermore, forward prices should be an indication of the risk-weighted price at which retailers are willing to purchase and generators are willing to sell, rather than a simple guide to outturn price. If the risks involved are large and asymmetric, then it is unlikely that the link between forward prices and spot prices will be straightforward. Some key elements driving electricity price are both large and asymmetric, particularly fuel prices (which can spike due to geopolitical events and are strongly influenced by weather) and electricity demand (which is also strongly influenced by the weather).
54. Taking the example of demand, if weather is cold it is very likely that electricity prices will rise, because demand for electricity and gas will rise; this will result in electricity prices rising, as more expensive sources of gas are required and less efficient plant must be used to burn the more expensive gas.

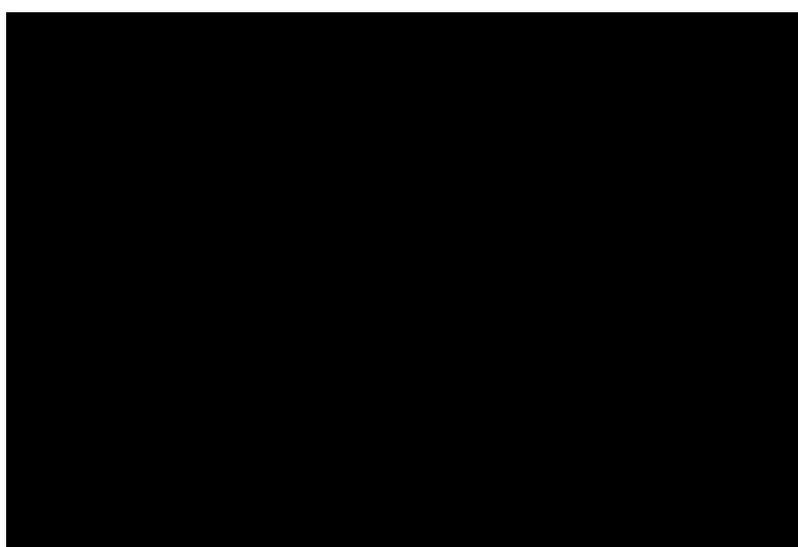
#### [Manipulability of prices in thinly traded or opaque markets](#)

55. In E.ON's view, the Great Britain electricity market is not opaque, even for the less robustly traded products. Information is available on planned and actual generation, on wholesale market prices and forecast and historic customer demands.
56. In relation to the specific point raised around Contract for Differences ("**CfDs**") which are being introduced under the EMR, we would comment as follows. CfD generators are provided with a top-up payment which is dictated by the difference between the strike price that the generator has obtained and a Market Reference Price ("**MRP**"). There will therefore be an incentive on CfD generators to try to sell their power at a price above the MRP, which will allow

them to receive an overall income greater than their strike price. Commercially, this could be an appropriate course for such a generator, if the risks are outweighed by the benefit.

57. There are two different MRPs, one for intermittent CfD generation which will be based on a day-ahead index price determined by an appropriate exchange, and the other for base-load CfD generation which will be based upon season-ahead (eventually moving to a year-ahead) index price. In practice, volumes traded on day-ahead exchanges are generally very healthy as illustrated previously in **Figure 2**, and it is therefore unlikely that this price could be manipulated. This is likely to encourage new intermittent CfD generation to sell most, if not all of its power through the exchange as the lowest risk approach in order to ensure it obtains its full strike price and hence volumes are likely to increase further still.
58. Base-load CfD generation will initially use a season-ahead MRP and hence this index requires suitable volumes to be traded in order to be robust and reduce the possibility of price manipulation. Compared to the day-ahead index price there is less liquidity. This is for two reasons. First, a more limited number of biomass and nuclear generators will be able to secure access to a base-load CfD, meaning liquidity must be generated elsewhere. Secondly, the changing generation mix over time will mean that much more intermittent renewables capacity and comparatively less of the fossil generation which otherwise might trade on these timescales will remain on the system, as illustrated in **Figure 3** below.

**Figure 3:** E.ON view of future capacity mix



Source: Internal E.ON view

[Lack of market and wholesale price transparency as a reason for public mistrust](#)

59. We would accept that suppliers could have done more on the past to explain the link between wholesale and retail prices to their customers. We have taken steps towards this in explaining what makes up a typical customer bill<sup>19</sup> and Energy UK has started to produce a report on wholesale prices<sup>20</sup>. However, it has to be said that the market and the relationship between wholesale and retail prices is difficult to present in a simple and accessible way.
60. The CMA considering this potential harm and publishing its findings should help general perception move towards recognising that wholesale prices are not opaque.
61. In conclusion, as discussed above we consider that liquidity in wholesale electricity markets is sufficient. However, we would support measures to further increase liquidity, particularly away from the day-ahead market, provided they do not give rise to other distortions or adverse effects. On the issue of vertical integration, we do not consider that market liquidity is reduced simply because an entity owns both generation and supply businesses. For example, E.ON is proportionately one of the most active traders on the GB market, even though it owns both supply and generation businesses. If all other entities that combine supply and generation businesses followed E.ON's approach, and made their generation externally available to third parties, that would improve yet further liquidity and price transparency.

### 3.2 CMA theory of harm 2: Vertical foreclosure

62. The CMA has raised as a theory of harm the possibility that vertically integrated electricity companies might harm the competitive position of non-integrated firms to the detriment of customers, either by increasing the costs of non-integrated energy suppliers or the sales of non-integrated generating companies.
63. As has already been discussed under theory of harm 1, E.ON's trading business trades substantial amounts externally – see **Tables 1** and **2** above. This is both in terms of “buy” trades and of “sell”

---

<sup>19</sup> See: <https://www.eonenergy.com/for-your-home/help-and-support/Understanding-your-bill/where-does-customers-money-go>.

<sup>20</sup> See e.g. Wholesale Market report for July 2014: <http://www.energy-uk.org.uk/component/jdownloads/finish/5/1152.html>.

trades, i.e. whether E.ON's trading business is trading with non-E.ON suppliers or non-E.ON generators.

64. In respect of the relationship between EGC and each of E.ON's supply and generation businesses in GB, as our Consolidated Segmental Statements make clear<sup>21</sup>, they trade with EGC under transfer pricing arrangements which are on an arm's length basis at market prices. EGC will similarly trade with third party companies at market prices. As previously discussed, EGC is separately incentivised from either E.ON's supply or generation businesses in GB. Therefore the mischief envisaged by the theory of harm does not arise.
65. We would observe that some players in the market who own existing nuclear generation might use the benefits this brings to cross-subsidise their supply business under a vertically integrated model, to the detriment of other supply players who cannot access these benefits. Existing nuclear generation receives an enormous subsidy from the CPF. It is not, of course, a form of generation that can be quickly developed and brought to market by a new entrant<sup>22</sup>.
66. On this latter point, we did some work prior to the announcement last year in the Autumn Statement of future changes to the CPF around the value that the CPF brought for nuclear generation in the UK. To illustrate the impact of the CPF, we estimated the total cost and the likely additional income for incumbent nuclear operators<sup>23</sup>. This showed that existing UK nuclear assets benefited by between around £245m (in a world where the EU took more action) and around £400m<sup>24</sup> per year out to 2020. Our calculations showed that this benefit could rise to greater than £0.5bn between 2017/18 and 2019/20.

---

<sup>21</sup> <https://www.eonenergy.com/About-eon/our-company/at-a-glance/company-reporting>.

<sup>22</sup> The CPF, according to the Government, was designed to help create more incentives for investment in low-carbon electricity generation through providing support and giving certainty to the price of carbon in the UK electricity generating sector. In fact, the CPS does not incentivise investment in low carbon generation as that function is fulfilled through CfDs, which were designed expressly for that purpose and stand independently from the CPS. In any event, for existing nuclear plant, it is no more than an enormous benefit.

<sup>23</sup> The estimation is based on plant running 80% of the time and closing on announced closure dates. We have assumed that a low efficiency combined cycle gas plant is always at the margin in order to determine the impact of the carbon price on the power price; given that coal will be at the margin at some times, this is a conservative assumption.

<sup>24</sup> To represent the market view of carbon we took the spot price on 1 February 2013 of £3.64/t (£4.19/t). However, to represent a world in which the EU took some action to strengthen the EU ETS, we also considered a case with a smooth transition from this price in 2013 to the European carbon cost in 2020 from the IEA's Current and New Policies scenario within their World Energy Outlook; this has a price of £20/t (\$30/t) in 2020.

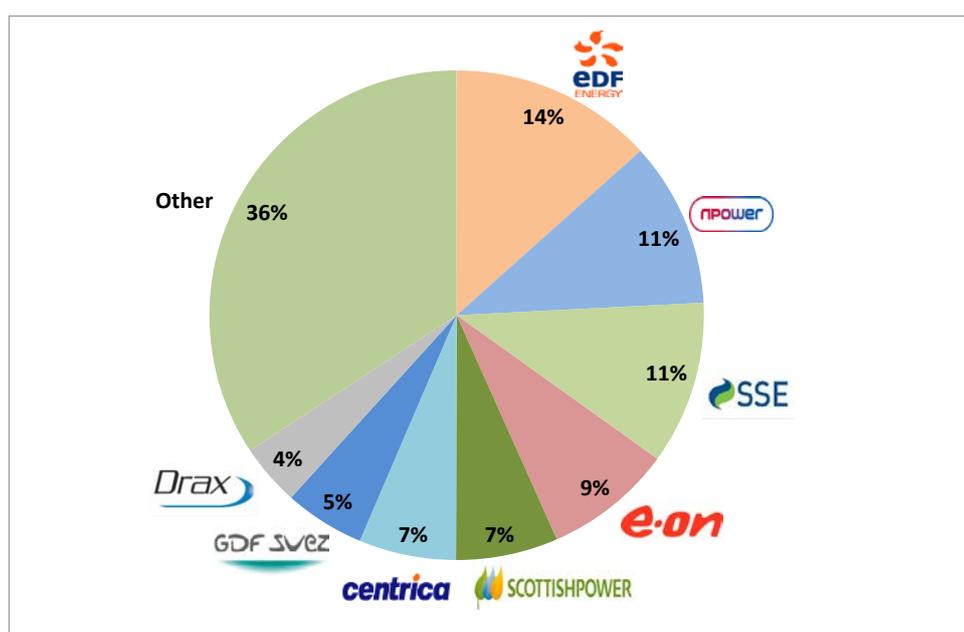
### 3.3 CMA theory of harm 3: Market power in generation leads to higher prices

67. The CMA suggests that market power, unilateral or coordinated, in generation leads to higher prices.
68. In E.ON's view, market power does not exist in generation markets in any form which would allow a generator or group of generators to manipulate wholesale market prices to the detriment of the customer. A generator may hold a transient market position in individual half hours and on short timescales which gives that generator a fleeting advantage, but it would not be possible for any generator systematically to profit from this in the current market circumstances. Should a generator attempt to do so, prices would rise and more plant would be made available in future half hours.

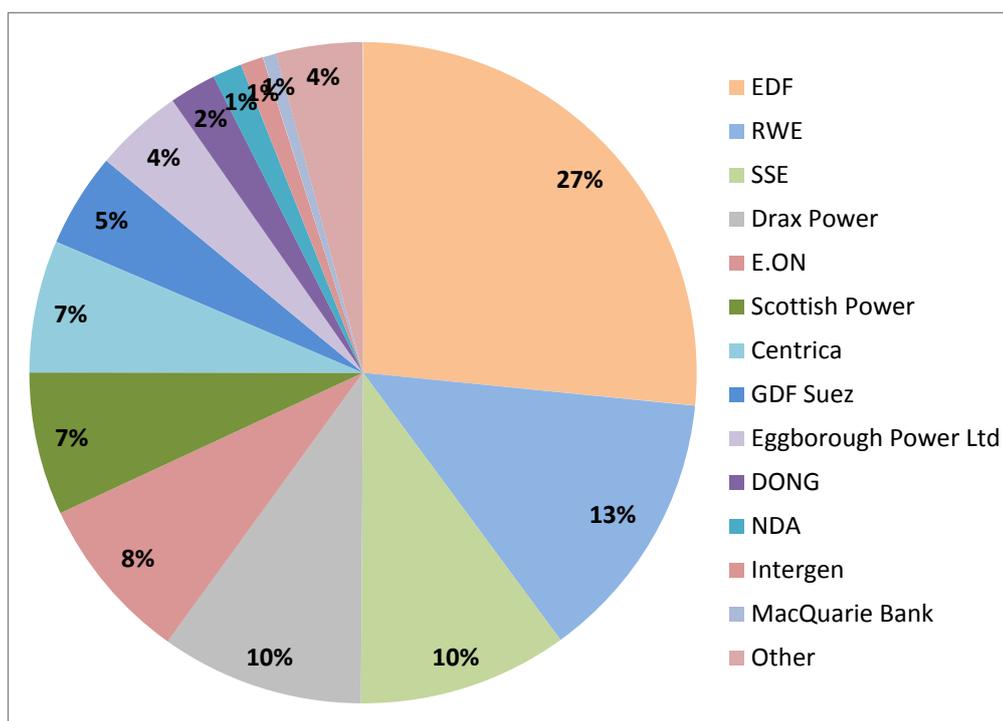
#### 3.4.1 Overall Generation Market

69. We do not see evidence of either unilateral or coordinated market power in the energy market. Market shares in the wholesale market are low, with EdF having the largest capacity market share at around 14% and many other smaller generators operating in the market as can be seen in **Figure 4**. Whilst EdF does have a larger share of electricity generated, there are still many other competitors, as illustrated in **Figure 5**.

**Figure 4:** Capacity split by competitor (as of May 2014)



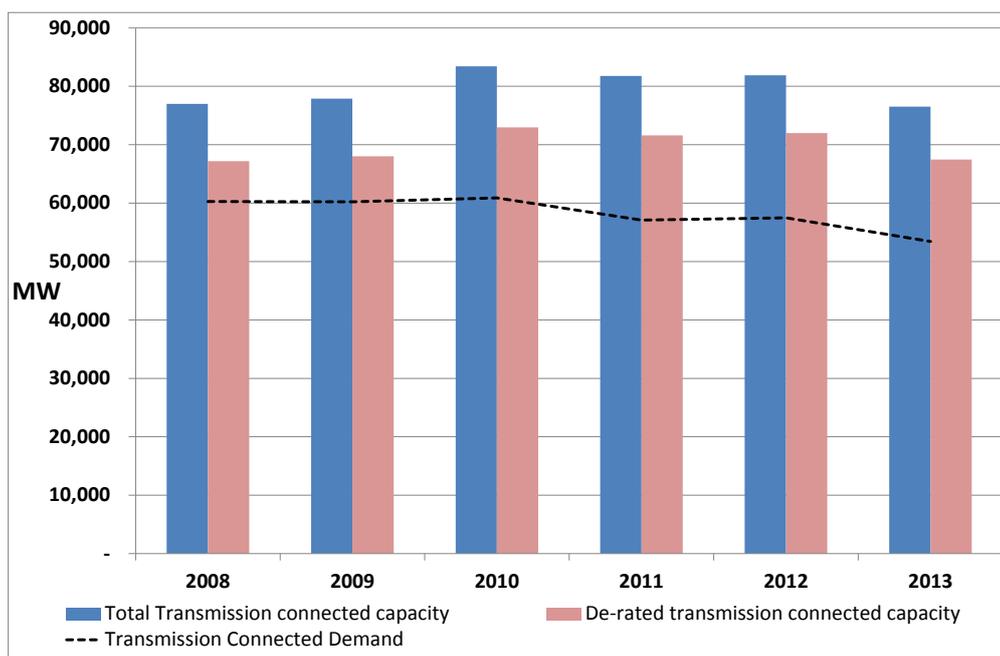
Source: Internal E.ON Database based upon publicly available information

**Figure 5:** Generation (2013) split by competitor

Source: Elexon settlement data

70. In recent years the market has been oversupplied with capacity (even on a de-rated basis<sup>25</sup>) as illustrated in **Figure 6** below and as such competition has been effective in delivering the lowest price. Consequently, even if a generator withdrew large amounts of capacity without good cause (e.g. by blaming a type fault at similar plant where none existed), there remains sufficient spare generating capacity to meet the gap. In that scenario, withdrawal of capacity would not shift the market price and would simply be to the generator's detriment. We do not see such behaviour occurring in the market and do not believe that, in practice, it would in any event be feasible.

<sup>25</sup> By de-rated, we mean taking into account its likelihood of being available to generate. Different technologies are de-rated to different degrees, e.g. a gas plant is more likely to be available to generate than a wind-farm, reflecting the probable proportion of a source of electricity which is likely to be technically available to generate (even though a company may choose not to utilise this capacity for commercial reasons).

**Figure 6:** Historic Supply vs. Demand

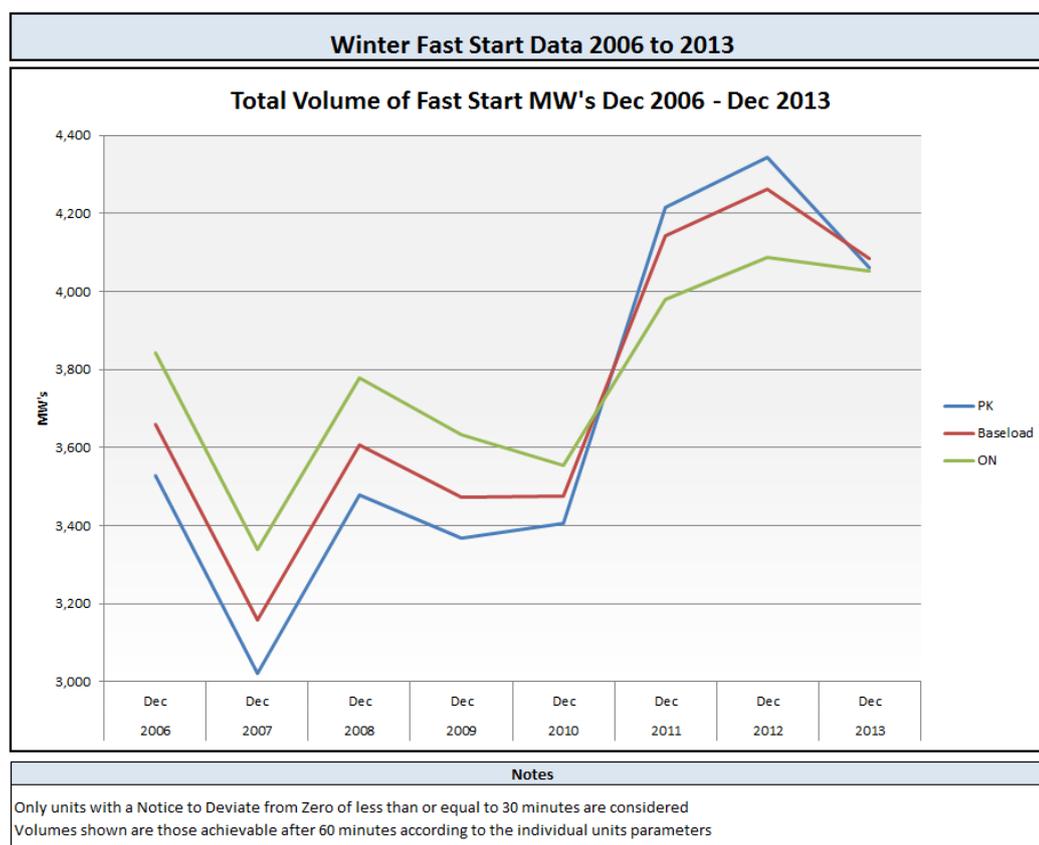
Source: DUKES Ch. 5

### 3.4.2 Comments on CMA's Hypothesis of Time Bound Market Power

71. The price at which generation can deliver energy is dependent upon many different variables; most notably commodity prices (e.g. fuel and carbon etc.) and the plant characteristics (e.g. efficiency, start-up times and costs etc.) and the combination of these determine the merit order for generation. At times of high demand, this can require generation at the top of the merit order to be brought on, sometimes resulting in discontinuities given the high short run marginal costs ("**SRMC**") of these plant. In addition to the high fundamental SRMC of these plant, the lack of ability to earn infra-marginal rents at other times of the year and the risks associated with operating infrequently need to be priced in to make a commercial decision to operate.
72. When National Grid, as system operator, selects a plant in the Balancing Mechanism, they do so to balance the system, to maintain pre-defined reserves, or to solve a physical constraint; this can be a surplus or shortfall. Frequently any shortfall would be for a relatively short period of time and so they have an option whether to instruct a generation unit that has a high price but can run for a short period of time or a generation unit with a lower price that has to run for a longer period.

73. We are told that the system operator makes its decision on a “cash flow” basis – i.e. volume under the curve multiplied by price. On this basis it is often said to be more economical to select a generation unit with a higher price but faster start-up rates than a unit with a lower headline price but longer start-up rates. Therefore, there is no scope for generators to have market power at particular times, even for short periods of time, because of the availability of alternative generation options.
74. **Figure 7** below shows the increase in plant with fast start capability over the last few years and shows competition is actually increasing in this area. Much of this increase is due to the move of many older combined cycled gas fired power stations up the merit order so that they normally only operate during hours of peak demand, primarily operating in open cycle (“OCGT”) mode to allow faster response.

**Figure 7:** Development of Fast Start Capability



Source: Elexon BM data

75. In recent years, the amount of flexible generation has increased, as older mid-merit plant seek to maximise their potential income through a peaking role. Those plants capable of doing so often operate in OCGT mode but many others, whilst not capable of fast

start, are still flexible and can respond quickly to operate in the balancing market. In addition, demand side response has been brought to the market and the combination of these activities has ensured that competition is robust and any benefit to high flexibility is short-lived and rewarded appropriately. We therefore see no scope for time bound market power to exist in this area.

### 3.4.3 Comments on CMA's hypothesis of Local Market Power at particular times

76. The practicable limitations of electricity transmission and distribution systems mean that at particular times there will be constraints on the flow of power across certain points on the network; i.e. transmission constraints, which may result in certain generators in certain locations, having to increase or decrease generation and making a charge for this<sup>26</sup>.
77. The Generation Transmission Constraint Licence Condition ("**TCLC**") in 2012 prohibited the securing of excess amounts when increasing/reducing generation for transmission. E.ON considers that TCLC has more than achieved this goal. In fact, E.ON considers that the TCLC applied more stringent conditions than was necessary and in doing so has introduced unnecessary risks for licensed generators.
78. The main risk is that, in normal trading, the generator can *unknowingly* influence a transmission constraint and thus be at risk of contravening the licence condition. Trying to avoid contravening the licence condition could be restricting competition in generation to the detriment of customers, given the effects on competition in generation, and the effect on prices to customers, that introducing this unnecessary risks for licensed generators has had. To E.ON's knowledge, no formal enforcement action has been brought by Ofgem under the TCLC since it was introduced.
79. The EMR is also introducing a Capacity Mechanism in order to ensure resource adequacy in a world with increasing levels of intermittent generation. DECC has put in place mechanisms to regulate the

---

<sup>26</sup> See, e.g. paragraph 1.2 of the Guidance to the Transmission Constraint Licence Condition, published by Ofgem, where it refers to the fact that, in April 2008 Ofgem launched an investigation under the Competition Act 1998 (CA98) into Scottish Power (SP) and Scottish & Southern Energy (SSE), following concerns raised by industry participants about possible market manipulation and exploitation of market conditions arising from constraints between England/Wales and Scotland.

Capacity Mechanism's operation, to ensure that no market power will arise.

### 3.5 CMA theory of harm 4: Energy suppliers face weak incentives to compete

#### 3.5.1 Summary of E.ON's view

80. The CMA suggests that energy suppliers face weak incentives to compete on price and non-price factors in retail markets, due in particular to inactive customers, supplier behaviour and/or regulatory interventions.
  - a. Hypothesis 4a: Inactive customers reduce the incentives of energy suppliers to compete.
  - b. Hypothesis 4b: Tacit coordination between energy suppliers reduces their incentives to compete.
  - c. Hypothesis 4c: Regulatory interventions reduce the incentives for energy suppliers to compete.
81. E.ON believes in a free and competitive market for energy, allowing for competition on a price and non-price basis, whilst also having some consumer protection for those who do not fully participate in the free market. The combination of these three features should lead to the best outcome for customers.
82. On the specific hypotheses:
  - a. The impact within the market of less active customers is complex; we examine this below.
  - b. We do not coordinate, tacitly or otherwise with our competitors, rather it is the case that strong competitive market forces push us to take account of competitors' behaviour, as well as that of customers. We examine the impact of market forces on our own actions and on those of our competitors in the section below.
  - c. We do believe that some regulatory interventions reduce the incentives for energy suppliers to compete; some of these interventions are nevertheless in the customers' interest, but some are not. We examine regulatory interventions in two sections below, under the first hypothesis regarding inactive customers and under the third hypothesis, regarding other regulation.

### 3.5.2 CMA Hypothesis 4a: Inactive customers reduce incentives to compete

83. E.ON does not believe that inactive customers reduce incentives to compete, as a supplier cannot rely on a customer who might currently not be active in the market continuing to be so.
84. We acknowledge that there are some customers in the market today who are less active than others; however, the fact that these customers are not active today does not mean that they will never be active. We believe that most customers who are not active would become so given a sufficiently large gap in price and/or service between suppliers.
85. Furthermore, the fact that some customers are currently not active does not indicate that they have never been active and, even if they have not been active, they will only be with their former incumbent supplier if no former customer in the same property switched suppliers. For a customer's property never to have been active, they would need to be with the ex-incumbent supplier for electricity and with British Gas for gas (if they take gas) and on a standard product.
86. In **Table 3** below we considered these requirements and found, for customers within our ex-incumbent regions, this number is no higher than 11%. Within this 11% it is likely that there still are customers who have previously switched tariffs or suppliers; we will conduct further and more sophisticated analysis on this point at a later date.

**Table 3:** Analysis of customers in E.ON's ex-incumbent regions

Customer Category	Number	Percentage
Total number of electricity accounts in E.ON's ex-incumbent PES areas of Eastern, East Midlands and Norweb	7,975,000	100%
Total number of E.ON electricity accounts in these regions	2,364,000	30%
Total number of E.ON single electricity standard accounts in these regions	1,060,000	13%
Total number of E.ON single electricity standard accounts which weren't auto-migrated under RMR	890,000	11%

Source: E.ON internal data

87. It is important to realise that the energy market is not necessarily one where customers wish to engage, but rather where they may feel they need to. It is not like the new iPhone, there is no pull to

keep up with one's friends or neighbours. Additionally, there is no loss of product as a result of not engaging (as in most retail markets); if customers do not engage then (so long as they continue to pay, and subject to safeguards) the wires and pipes will still distribute the power and gas to their homes.

88. Energy suppliers are currently in the process of rolling out smart meters to all domestic and small business customers. We believe that smart meters, their associated infrastructure and integration with wider digital capability will overcome many of what might otherwise be seen as the potential barriers to greater customer engagement with and innovation in the market, in a number of ways:
- a. Automatic reading of meters will mean that bills are almost always accurate, overcoming the need to concentrate a large proportion of customer service activity on metering problems and customers are more likely to know what they use and what they pay;
  - b. Improved industry processes, not directly linked to smart metering but delivered via the Data and Communications Company, should resolve many of the problems which result in suppliers offering a poor service to customers, particularly during the switching process; and
  - c. Improved data around customers' usage will allow for provision of more diverse and innovative service to customers – though by the nature of innovation, we cannot be sure which potential products will succeed.
89. We believe that these developments will enable a real transformation in the market, driving enhanced competition in delivery of service and products.

#### [Domestic customer switching rates](#)

90. The Issues Statement focuses on the level of customers switching between suppliers. Focusing on this particular metric ignores two important considerations.
- a. First, the extent to which a customer does not feel the need to switch – either to other suppliers or between the packages of its existing supplier – because they consider themselves to already be receiving a competitive price and product, in terms of the quality of service etc.;

- b. Secondly, because a focus purely on the level of external switching, i.e. switching between suppliers, ignores customers' ability (which they readily exercise) to switch between different packages offered by their existing supplier – “internal switching”.
91. Consequently, low levels of customer switching may well be entirely consistent with, and indicative of, the existence of an intensely competitive market. In fact, in a perfectly competitive market, switching would fall to zero. As Professor Morten Hviid et al. said in the Consultation Response to the SMA from the ESRC Centre for Competition Policy at UEA<sup>27</sup>:

*“inactivity by consumers is not in itself evidence that a market is not functioning. Indeed it could be evidence that it is functioning well.”*

*“in a competitive market equilibrium with identical prices for identical goods, you would obviously see no switching but equally we would not classify such a market as a problem market.”*

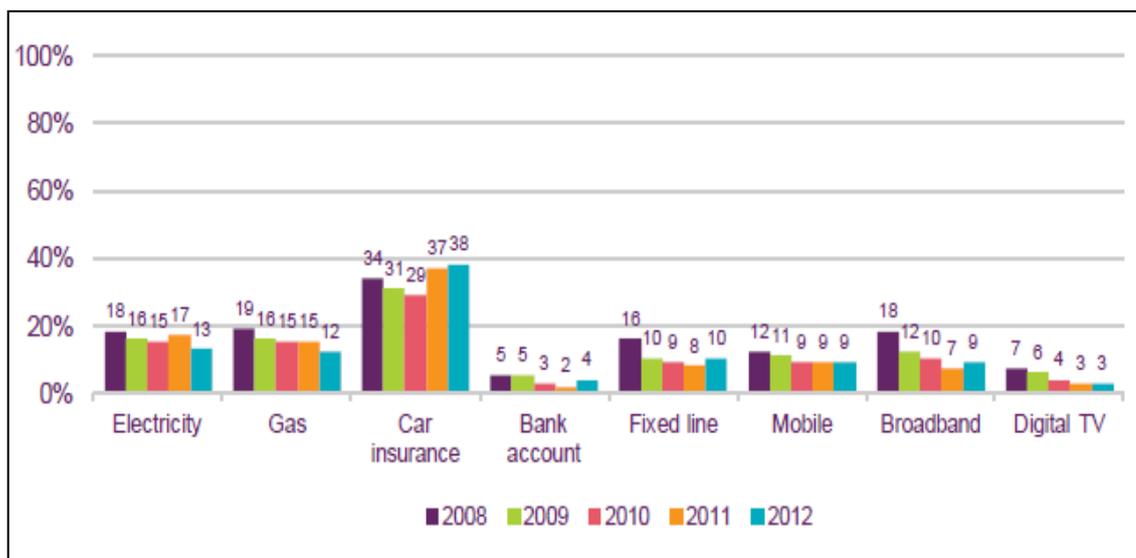
92. As context, it is also worth acknowledging that external switching has dropped, but that there are rational reasons for this. This drop has been largely driven by the exit from various face-to-face sales channels by various suppliers, including E.ON. Selling face-to-face has the inherent problem that customers are unlikely to have their bill history with them and, as a consequence, customers are unlikely to be able to given an accurate view of their consumption and their current tariff. Because face-to-face channels work well for some customers, we tried to find a workable way of using them to sell which ensured fairness for customers and compliance with regulation but struggled to find one. Across the market, doorstep selling began to be withdrawn from 2011 onwards and, amongst the larger energy suppliers, completed by 2012. E.ON has also withdrawn entirely from all residential face-to-face selling.
93. Despite the practice of doorstep selling having ceased, there is still a significant amount of external switching in the industry, which is continuing to drive pressure on energy companies to be competitive.

---

<sup>27</sup> Consultation Response to the SMA from the ESRC Centre for Competition Policy, 27 May 2014, page 3.

94. Whilst external switching is lower than in industries where consumers must make a decision as to their purchase every time they shop (e.g. groceries, airlines, etc.), it compares well when set against other goods or services which are provided on an ongoing basis, but where sales occur on an annual or subscription basis. The following extract, **Figure 8**, from an Ofcom paper on consumer switching provides comparisons across such industries.

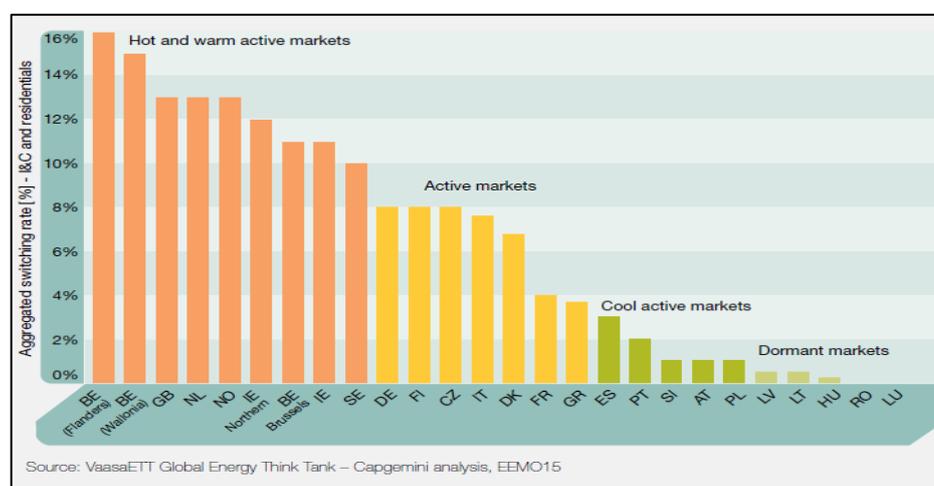
**Figure 8:** Switching in other industries



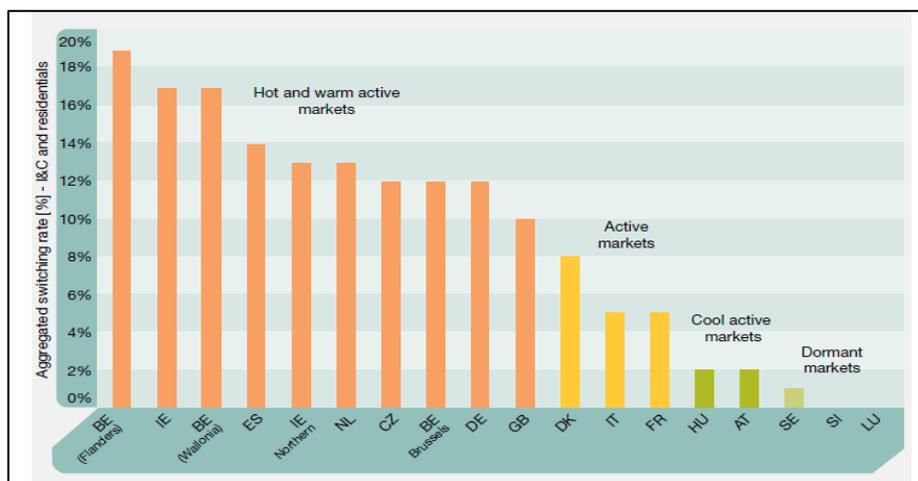
Source: Ofcom Research Report: the Consumer Experience of 2013, January 2014

95. The GB gas and, most particularly, electricity markets also compare favourably with many other European markets, as shown in **Figures 9 and 10** below:

**Figure 9:** European electricity switching rates



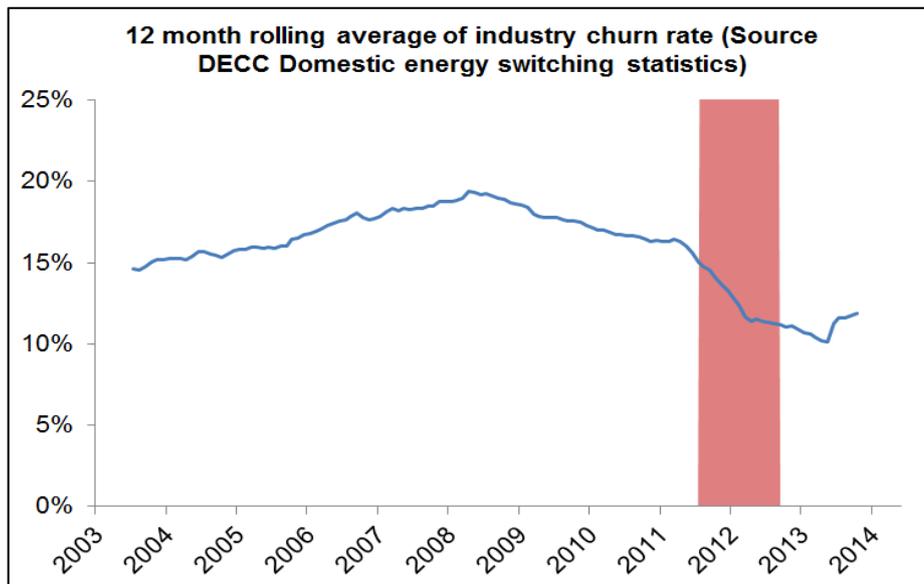
Source: CapGemini - European Energy Markets Observatory October 2013

**Figure 10:** European gas switching rates

Source: CapGemini - European Energy Markets Observatory October 2013

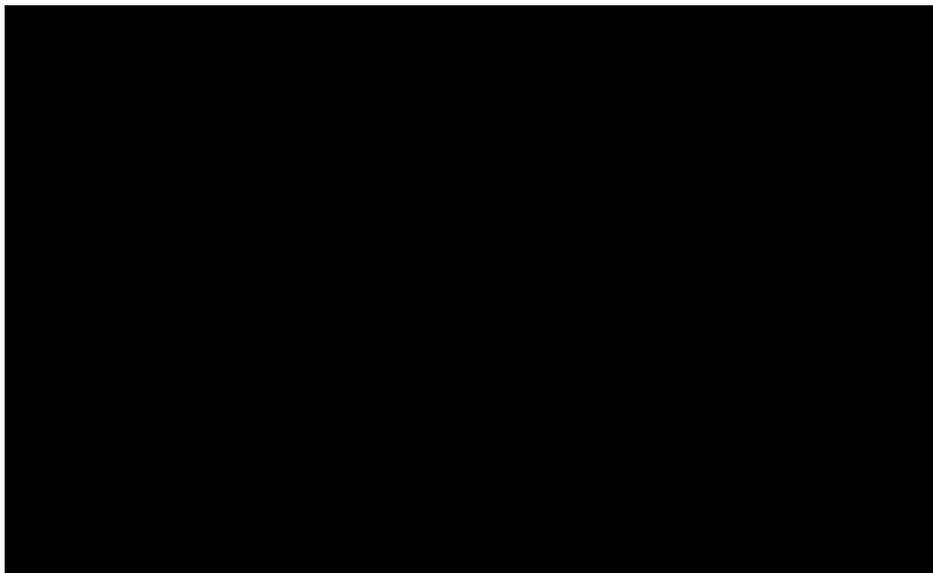
96. As well as external switching there is internal switching. This can be driven by customers proactively choosing to stay with their current supplier, but choosing a different tariff, or by energy companies engaging with their customers to ensure that they are on the best deal for them. This has been an increased focus for E.ON over the last few years. External and internal switching is shown in **Figures 11 and 12** below.
97. Because customers can move between different packages offered by their energy supplier, they may well consider that there is no need to switch to another supplier. Internal switching is therefore potentially an indication of customers shopping around for the best deal, or proactively being offered better terms/prices by their existing supplier to try and discourage the customer from engaging in external switching. As such, evaluating the intensity of competition by reference only to external switching levels underestimates the competitive intensity of the energy market.
98. Further, as noted above, measuring competitive intensity only by reference to switching levels ignores the extent to which customers do not need to engage in any switching because the market is already sufficiently (and highly) competitive.

**Figure 11:** Industry external switching



Source: DECC Domestic energy switching statistics

**Figure 12:** E.ON internal switching



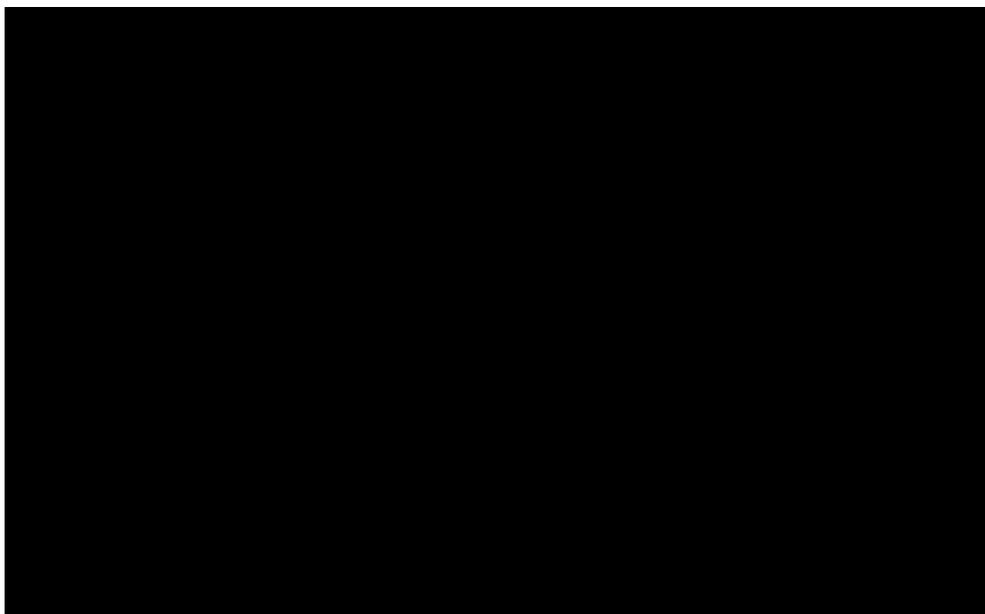
Source: E.ON internal data

99. E.ON believes that customer satisfaction is also a relevant measure of the success of the market. We measure measuring customer satisfaction, using our Net Promoter Score ("**NPS**"), across the GB energy industry, which we have done for the past five years. This is shown in **Figure 13** below.





**Figure 13:** Industry weighted average and E.ON NPS



*Source: E.ON internal data*

100. Finally, we note that market outcomes are driven by both how well the market is working and how well consumer protection is being delivered, so measuring both of these features is necessary. Consumer protections should be measured by specific measures relating to that protection; for example, vulnerable customer protections should be assessed as to whether they are being adhered to, adopted by customers and valued by customers who adopt them.

[E.ON's fresh approach to customers](#)

101. The traditional energy supply commercial model actually uses inactive customers to support the incentive to compete. This approach seeks to offer very attractive prices to new customers, which are partly funded through higher prices for existing customers, who may be inactive. This pricing model has been often seen in other industries such as insurance and banking. This model increases the differential between prices paid by inactive and active customers, arguably increasing the incentive for customers to become active, engage in the market and switch. Whilst the model does not lessen competition, it does mean that less active customers may pay higher prices.

- 102.



[Redacted text block]

103.

[Redacted text block]

104.

[Redacted text block]

105.

[Redacted text block]

106.

[Redacted text block]

107. 

108. For other suppliers, various regulations have been introduced which make the traditional commercial model more challenging, although we do not believe they have prevented the market as a whole from continuing to adopt it. These regulations have included:

- a. Supplier Licence Condition 25A, which was a consumer protection measure introduced for inactive customers that electricity suppliers had in their host regions; it was introduced with a “sunset” clause and has now lapsed. It aimed to reduce price differentials between active and inactive customers and appeared to successfully do so as in-area and out-of-area price differentials fell from £30 to £13<sup>28</sup>.
- b. RMR, which includes a requirement for all suppliers to inform their customers of the cheapest product they could offer that customer and not to have any products that were not available both to existing and to new customers. It is too early to see the full impacts of this measure, but forcing suppliers to offer and to directly inform existing customers of the best deals they offer new customers is likely, over time, to reduce the commercial rationale for making deep discounting offers.

109. We are clear that energy suppliers do not have less *incentive* to compete as a result of such regulation. However, it may be that, because of these measures, the *ability* to compete using one particular tool, price differentials between new and existing customers, may be beginning to be traded off against fairness. So, is it possible to have a model in which there are both very low priced offers for the most active customers and fairness for those who may struggle to engage? Or, is there a trade-off whereby the greater the regulatory protection for existing, less active customers, the lower the price based incentive to switch?

---

<sup>28</sup> Retail Market Review – Findings and initial proposals, Ofgem, 21 March 2011, page 24.

### 3.5.3 CMA Hypothesis 4b: Tacit coordination between six largest suppliers reduces incentives to compete

110. E.ON is conscious that there have been a number of general allegations concerning coordination in GB energy markets. E.ON agrees that, if there were to be any analysis of potential coordination at all, it should be on tacit coordination. None of the reports leading to the MIR<sup>29</sup> presented evidence of actual coordination<sup>30</sup>.
111. However, E.ON believes that the GB energy markets lack a number of the fundamental characteristics of market(s) which may be conducive to coordination and that the conduct of suppliers in the market is not consistent with coordination.
112. There is a degree of transparency over pricing in GB energy retail markets (driven in large part by regulation), as well as elements of supplier costs (due to the impact of regulation and the commonality of certain costs). The GB energy markets are also highly competitive. One would *expect* in this context a supplier to take account of likely pricing initiatives of other suppliers and its own competitive positioning compared with other suppliers when determining its own prices.
113. E.ON uses competitor intelligence such as publicly available information to assess the likely pricing strategies of other suppliers, in particular as regards price increases/decreases, and uses that information as a factor in determining its own pricing strategy.
114. This natural supplier behaviour of taking account of its competitors' actions and positions should not be conflated with the behaviour of suppliers in a market which is susceptible to tacit coordination. This behaviour is consistent with those of suppliers active in competitive markets. As a matter of principle, convergence in pricing movements can be evidence of very strong competition.
115. Before commenting on the hypothesis in more detail, it is also worth exploring why it may appear on occasions that there are 'pricing

---

<sup>29</sup> Ofgem Decision to make a MIR, State of the Market Assessment by Ofgem, OFT and the CMA; and Ofgem's Retail Market Review.

<sup>30</sup> For example, in its State of the Market Assessment, Ofgem noted (at para. 4.45): "*We have examined tacit coordination, rather than any explicit forms of coordination... We have not received any information or evidence during the course of this assessment which might have led us to consider further whether there are any agreements or concerted practices between the parties which may prevent, restrict or distort competition*".

rounds'<sup>31</sup> amongst energy suppliers. The impact of making a price increase in the domestic energy market should not be underplayed or underestimated. A supplier who is the first supplier to announce a price increase will be punished for it for by its customers, by the media, by consumer advocates and social commentators, by Members of Parliament and by Ministers<sup>32</sup>. That supplier will be pilloried and will see enormous erosion of its customer base. By contrast, a supplier who is later to raise their prices is likely to suffer less financial and reputational damage.

116. In addition, E.ON and the other suppliers pre-announce price rises because they have to for regulatory reasons. Pursuant to Standard Licence Condition 23, an energy provider that wishes to proceed with a Unilateral Contract Variation ("**UCV**") is required to give customers a minimum of 30 days' notice in advance of the changes taking effect.

#### Test for tacit coordination

117. To assess whether tacit coordination may arise, a Competition Authority is required to assess, using a proper and correct legal framework, whether certain market behaviours and outcomes are consistent with firms acting *unilaterally* or with *tacit coordination*.
118. The CMA itself, in its Market Investigation Guidelines ("**CMA MIR Guidelines**"), has set out the three cumulative conditions which need to be established in order for coordination effects to be feasible<sup>33</sup>. These criteria are essentially the same as those set out in the *Airtours* case and in the European Commission's Article 102 enforcement priority guidelines, as well as in subsequent cases<sup>34</sup>.

---

<sup>31</sup> The SMA (para. 4.67.) claims that "*from about 2006 onwards, price announcements start to take place in identifiable rounds*".

<sup>32</sup> See, for example, the events of June 2011, when Scottish Power announced an increase in prices and were called before the Energy and Climate Change Parliamentary Select Committee where both their Director of Regulation and CEO, Amparo Moraleda were very aggressively questioned by members of the Select Committee.

<sup>33</sup> CC3 (Revised) – Guidelines for Market Investigations: Their Role, Procedures, Assessment and Remedies (April 2013), para. 237ff.

<sup>34</sup> Case T-342/99, *Airtours v Commission*, [2002] ECR II-2585, paragraph 62; cf. Case C-413/06P *Bertelsmann v Impala* ECR 2008 Page I-04951; Case T-193/02, *Laurent Piau*, paragraph 110 et seq; Case T-374/00 *Verband der freien Rohrwerke and Others v Commission* [2003] ECR II-2275, paragraph 121; Joined Cases C-395/96 P and C-396/96P *Compagnie Maritime Belge Transports and Others v Commission* [2000] ECR 1365, paragraph 36 and 44; Case T-191/98 and 212-214/98 *TACA*, ECR 2003 p. II-3275, paragraph 625 et seq.

- a. Firms need to be able to **reach an understanding** and **monitor** the terms of coordination;
- b. Coordination needs to be **internally sustainable** among the coordinating group; and
- c. Coordination needs to be **externally sustainable**, in that there is little likelihood of coordination being undermined by competition from outside the coordinating group or by the reaction of customers.

119. This submission does not seek to address every aspect of the test for tacit coordination. Rather, it highlights the fundamental characteristics of the GB energy markets which are inconsistent with coordination. These characteristics mean that the GB energy markets are not susceptible to tacit coordination.

120. There is *one* fundamental characteristic of the GB energy markets which means that the first two of these criteria cannot be satisfied in this instance: The fact that there are simply too many suppliers either for the larger suppliers to reach an understanding and monitor the terms of any coordination or for the coordination to be internally sustainable. The legal test for tacit coordination is therefore not met.

121. The fact that there are at least six major energy suppliers operating in the GB energy markets means that tacit coordination would be highly unlikely, either from the point of view of reaching a common understanding on coordination or a mechanism for disciplining any supplier deviating from the common understanding.

122. This assessment is confirmed by EU merger control practice. There is no precedent in which tacit coordination concerns have been established on the basis of so many large suppliers active in a sector.

123. An analysis of EU merger decisions, including more recent merger decisions, where coordinated effects have been given serious consideration shows that intervention (prohibition or remedies to address coordinated effects concerns) has never been imposed in markets involving six (or more) main suppliers post-merger. Indeed, as suggested by the research, the vast majority of cases involving intervention have involved three or two larger suppliers (post-merger)<sup>35</sup>.

---

<sup>35</sup> The one exception to this is the ExxonMobil decision (Case No IV/M.1383) – This decision refers to 7 companies having oligopolistic dominance in Luxembourg – but three of those would have

124. A paper on tacit collusion and numbers/symmetry requirements by Davies & Olczak<sup>36</sup> sets out the results of empirical research of EU Merger Regulation decisions involving 'non-trivial' consideration of coordinated effects. They conclude that "*EC coordinated effect merger decisions and our review of the experimental evidence suggests that tacit collusion is rare with more than two firms, and without symmetry*".

125. A significant degree of symmetry in incentives is also required. Market shares can provide a first approximation of whether firms are symmetric. Such symmetry is absent, in this market. Similarly, there is considerable differentiation between the suppliers in the extent to which they are vertically integrated. We will explore this further in the Initial Submission.

126. Suppliers' ability and incentives to coordinate around a common focal point is further undermined by the degree of regulatory, political and costs volatility. This makes it difficult for a supplier to predict competitor reactions to the uncertain trading environment and increases the scope for deviations from any supposed common understanding.

127. Coordination requires suppliers to be deterred from deviating from a common policy through the expectation of punishment by other suppliers for such deviation. In addition to any punishment mechanism being absent because of the number of major suppliers, the market conditions in this case mean there is no credible deterrence mechanism.

128. E.ON's approach [REDACTED]

---

links post-merger, which would effectively join Exxon, BP/Mobil and Aral and, as a result, limit the number of main suppliers to no more than 5.

<sup>36</sup> "Tacit versus Overt Collusion Firm Asymmetries and Numbers: What's the Evidence?" by Stephen Davies and Matthew Olczak, 2008.

129. As regards external sustainability, coordination would require actual/potential competitors and customers not to have the ability to undermine the common policy being pursued by the 'coordinating group'. The fact that there are a significant number of alternative suppliers with increasing penetration into the sector, and that customers can exercise significant buying power, would further limit any prospects for coordination.
130. Smaller suppliers have the potential to undermine coordination through the fact that:
- a. they are very 'disruptive' to any hope of tacit coordination, encouraged by the fact that they are subject to different regulatory requirements which means they are very competitive;
  - b. the number of smaller suppliers, reinforced by the poorer public image of the six larger suppliers, compared to that of their smaller competitors, means that in aggregate they exercise a strong influence which precludes tacit coordination amongst the larger suppliers;
  - c. the competitive/disruptive impact of smaller competitors is increasingly being felt, as demonstrated by increased switching to smaller suppliers in recent months<sup>37</sup>; and
  - d. barriers to expansion (and, indeed, new entry) are low.
131. E.ON's competitive strategy is driven predominantly by its customers. They can exercise significant power through switching. There are also various developments which enhance the buying power of customers, including customer buying groups and an increasing role for third party intermediaries.
132. The dynamics of the market are such that the ability and incentives of the larger suppliers to coordinate are currently being weakened further. This is likely to continue, in particular as a result of:
- a. Regulatory change, leading to the increased potential for the exercise of buying power by customers (in particular, as a

---

<sup>37</sup> See, e.g. <http://www.energy-uk.org.uk/publication/finish/5-research-and-reports/1165-electricity-switching-figures-july-2014.html>, which notes that over two million customers are buying their electricity from small suppliers, and that small supplier gains vs total gains in the market have remained at above 40% for the first seven months of this year, going above 50% in May 2014.

result of the introduction of smart meters) and further volatility; and

- b. Further entry and expansion by smaller suppliers, including those taking advantage of regulatory changes designed to lower barriers to entry further (such as Ofgem's introduction of the "Secure and Promote" licence condition).

133. For the reasons noted above, certain key features required to be found before a market can be said to be susceptible to tacit coordination are absent. To the extent that there are any conditions in the market which lead to increased transparency and reduced scope for product differentiation, then these tend to be caused by regulation. These include, in particular:

- a. The level of transparency created, for example, by advance notification requirements and segmental reporting requirements; and
- b. The lessening of possibilities for product differentiation as a result of RMR.

134. The Issues Response has noted above the need for a balance between promoting competition and a degree of regulation designed to protect customers. This is also recognised in the Issues Statement<sup>38</sup>.

#### **3.5.4 CMA Hypothesis 4c: Regulatory interventions reduce incentives to compete**

##### Effects of Standard Licence Conditions

135. As discussed under hypothesis 4a above, we do believe that regulation around price discrimination can have a detrimental impact competition for new customers based on price alone; however, we also believe that it can be in the interest of using competitive forces to benefit the average customer through more effective overall competition.

---

<sup>38</sup> The CMA notes that, as part of its analysis of what is a well-functioning market, it will consider a market which is subject to a degree of necessary regulation.

[Effects of Retail Market Reform \("RMR"\) tariff restrictions](#)

136. E.ON opposed RMR when it was first proposed (in its first incarnation and guise, as this did change, but the general thrust was the same) due to a fear that it would stifle innovation and dampen competition. However, as part of its Reset review of all aspects of its relationship with its customers in 2012, E.ON changed its position in the spirit of its own radical review of its relationship with customers and as we believed that it would help restore customer trust in the energy industry. Ofgem's line at the time was along the lines of: if you are serious, industry, about restoring trust, you will get behind RMR. We did.
137. In theory RMR should resolve any customer confusion and inaction/lack of engagement which arose out of the surfeit of tariffs in the market suggested by Ofgem and which, Ofgem said, made it too difficult for customers to compare products. As such, the benefit it should bring is an increase in customers engaged in the market. However, by discouraging supplier innovation, certain aspects of RMR may have (or have had) the unintended consequence of inhibiting the development of new products and services that might otherwise have led to customer benefits or improved engagement. Given the need for disengaged customers to consider engaging, see greater clarity and then actually engage in order for RMR to succeed, we consider that at this stage it is still too early to judge its success.
138. The prescriptive nature and complexity of the RMR rules are likely to stifle and restrict innovation, both from existing suppliers and new entrants. Ofgem allow that a supplier can request derogation for innovation, but the potential risk of the costs of product development and detailed customer research being stranded, together with the extension to timescales makes this unattractive. True innovation will happen when technology (smart, digital and energy efficiency) advances are unconstrained by regulation designed for different circumstances. The availability of more innovative products may also prompt many currently inactive customers to re-engage with the market through providing greater differentiation, particularly in service.
139. E.ON supports the removal of RMR at a point in the future. By 2017 many smart meters will have been rolled out. When smart capability is fully integrated with digital capability and energy efficiency, the industry will be able to make an innovative leap forwards which has not been possible with traditional technology. This should enable a real transformation in customer choice, savings on bills and

satisfaction with energy suppliers. Hence, in E.ON's view, by 2016/17 the RMR rules should be unwound and our view is that, at that point, far more innovation should again be would likely be seen in the market.

#### Effects of social and environmental obligations

140. Over recent years the government has placed more obligations on suppliers to help them deliver broader objectives around social and environmental policies. Whilst we support many of these intentions, we believe the right approach is for the government to finance these schemes, even if they are ultimately delivered on behalf of the government by energy companies.
141. Smaller suppliers are exempt from delivering several environmental obligations, most significantly from the ECO and the WHD, both of which have more than an administrative cost to deliver<sup>39</sup>. These exemptions are facilitating a change in competition in the marketplace, but not one we believe is competitively positive or even neutral. The lowest prices in the market are being offered by small suppliers. They are assisted in this by being exempt from or facing disproportionately lower liabilities under many environmental obligations.
142. For us, customers acquired at some prices offered by small suppliers would be loss making, with the marginal cost of each new customer unlikely to be covered, largely or entirely as a result of environmental obligation costs. It could be argued the exemption will increase long-term competition as it is further accelerating the speed and scale of new entry and expansion by the smaller suppliers. However, as the environmental obligations must still be paid for, this is unsustainable.
143. It was interesting to note the recent criticism of the Secretary of State for Energy and Climate Change, reported in the Press, for leaving a larger supplier (actually Sainsbury's Energy – a white label with British Gas) for a smaller one, whereby he avoided the charges

---

<sup>39</sup> These obligations only begin to apply when suppliers have 250,000 accounts (one dual fuel customer has two accounts). ECO in particular only fully applies when suppliers reach 500,000 accounts. Furthermore, because liabilities under ECO are based on historic customer account numbers and consumption, there is a systematic advantage for growing suppliers, whereby a supplier's cost base is partly linked to its size some time ago. Whilst Government has provided a customer rebate covering the cost of the Warm Homes Discount, this is also available to customers of suppliers who do not actually deliver this policy.

for his own social and environmental obligations<sup>40</sup>. However, the point is real. Even though increasing price differentials due to obligation exemptions would prompt more customers to switch, if larger suppliers reach a point where they cannot compete for new custom, this could result in those customers of current larger suppliers who had yet to switch bearing a larger and larger charge for the obligations – until they also, perhaps, switched.

144. Eventually we would expect this to become unsustainable and for the relevant legislation to have to change; however, reaching this point would still result in significant damage to confidence in UK energy markets and in willingness to invest into them. There would also be the inevitable damage to shareholder value in the interim – including to the shareholders of any recent new entrant suppliers unlucky enough to have grown larger too early to be beneficiaries.
145. A solution would be to alter the ECO rules to more easily allow for secondary trading. This would help ensure obligated parties could meet their obligations in a cost effective way by having access to a pool of measures delivered by other market participants. An alternative mechanism which we have supported would be to set a buy-out price for smaller energy suppliers. This market mechanism would encourage the most efficient delivery operators to install more measures and be rewarded for this, whilst providing a low cost way for smaller suppliers to expand. Both of these mechanisms would allow for the removal of the exemption and hence avoid distorting the energy market.

#### **4 PROPOSED EXCLUSIONS FROM THE CMA'S INVESTIGATION**

146. We note that the CMA is not intending to investigate either the regulated transmission or distribution businesses or many aspects of wholesale gas markets.
147. We agree that it makes little sense for the CMA to investigate regulated businesses as part of this market investigation. As businesses regulated by Ofgem, any such investigation would be more of Ofgem and the returns it allowed than of the market and should be done separately. We have not called for such an investigation. We do agree that the CMA should consider the charging mechanisms for these businesses, however, to the extent

---

<sup>40</sup> For example, the Daily Telegraph <http://www.telegraph.co.uk/earth/energy/11009020/Ed-Davey-accused-of-green-tax-avoidance-after-switching-to-small-energy-supplier.html>.

that they are having an impact on prices in the market and on competition in electricity and gas supply.

148. We would also agree that certain aspects of the wholesale gas market mean that it is easier to see that it generally is well functioning. However, we believe the wholesale gas and electricity markets are linked and that some scrutiny of the wholesale gas market will be necessary in order to fully understand the wholesale electricity market. Generally we believe it is important that the CMA should be able to consider what impact adjacent or ancillary markets to the reference market are having on the reference market.

149. We believe the CMA should consider the evidence it will have received as part of the 'off-the-shelf' requests made to major companies before making a determination of whether vertical integration in gas could be the source of any harm.

<b>INDEX OF FIGURES</b>	
Figure 1	Ranking of political risk
Figure 2	N2EX volume development since 2010
Figure 3	E.ON view of future capacity mix
Figure 4	Capacity split by competitor (as of May 2014)
Figure 5	Generation (2013) split by competitor
Figure 6	Historic Supply vs. Demand
Figure 7	Development of Fast Start Capability
Figure 8	Switching in other industries
Figure 9	European electricity switching rates
Figure 10	European gas switching rates
Figure 11	Industry external switching
Figure 12	E.ON internal switching
Figure 13	Industry weighted average and E.ON NPS

<b>INDEX OF TABLES</b>	
Table 1	EGC Buy and Sell trades
Table 2	Ofgem Figure 43: External trading positions of the six largest energy companies
Table 3	Analysis of customers in E.ON's ex-incumbent regions