

## Energy Market Investigation

### Provisional Findings and Notice of Possible Remedies

#### Response of E.ON

#### 1 INTRODUCTION

1. To date, E.ON has made two substantive submissions to the Competition and Markets Authority (“CMA”), the first of which was in the form of its response (the “**First Issues Response**”) to the Energy Market Investigation Statement of Issues (the “**First Issues Statement**”) published on 24 July 2014. The second was in the form of its response (the “**Updated Issues Response**”) to the updated issues statement (the “**Updated Issues Statement**” or “**UIS**”) published on 18 February 2015.
2. On 7 July 2015, the CMA published its summary of provisional findings (the “**Summary of Provisional Findings**”), along with a notice of possible remedies (the “**Notice of Possible Remedies**”). On 10 July, the CMA published its full report on its provisional findings (the “**Provisional Findings**”), along with associated appendices (the “**Provisional Findings Appendices**”). This document represents the response from E.ON to all of these documents (the “**Response to Provisional Findings and Possible Remedies**”).
3. We comment below on some of the key areas in which the CMA did not provisionally find an Adverse Effect on Competition (“**AEC**”), followed by comments on the profitability analysis conducted by the CMA. Thereafter, we comment specifically and in turn on each of the possible remedies and, where appropriate, the associated provisional findings that led the CMA to consider these possible remedies.
4. We reserve the right to submit further comments on the Provisional Findings and Possible Remedies, including taking account of further comments made by third parties, if E.ON considers it appropriate to do so. We also reserve the right to comment further on the analysis in the CMA data room following closing of that on 31 July 2015.

#### 2 EXECUTIVE SUMMARY

5. **E.ON recognises the comprehensive nature of the CMA’s investigation into the energy market, building upon its UIS and associated working papers (“the Working Papers”) and welcomes the CMA’s finding that numerous aspects of the energy sector are working effectively and efficiently.** In particular, E.ON agrees with the clear conclusion that there are no areas in which vertical integration (“**VI**”) is likely to have a detrimental impact on competition for

independent suppliers and generators, including the levels of liquidity in the wholesale market, and that VI does not give rise to an AEC.

6. **E.ON agrees with the CMA view that there is no tacit coordination through public price announcements by suppliers in the energy market.** E.ON agrees that there is no evidence of suppliers using price announcements as a mechanism to signal their intentions in relation to pricing to rival suppliers, but rather the behaviour observed of suppliers is likely to be consistent with unilateral incentives. As the CMA has indicated in their Provisional Findings, there are many factors which make it difficult for firms to reach and sustain coordination, a view which we presented in our Updated Issues Response.
7. **E.ON does not agree with the CMA that the current exemptions that small suppliers receive on certain social and environmental obligations do not give rise to an AEC due to distortion of competition.** As we made clear in our Updated Issues Response, E.ON believes that there is a distortion as the exemption creates a clear cost disparity between smaller and larger suppliers and allows smaller suppliers to offer some of the lowest fixed price contracts in the market. This distorts competition in this part of the market to the detriment of those customers choosing to be with a larger supplier, including those less active customers of the larger suppliers who end up picking up the Energy Company Obligation (“**ECO**”) and Warm Homes Discount (“**WHD**”) costs for their more active fellow energy customers.
8. **E.ON recognises the potential impact of obligation costs on small suppliers, but strongly believes that altering the rules in the context of ECO to more easily allow for secondary trading or a buy-out mechanism would help ensure obligated parties could meet their obligations in a cost effective way.** This would encourage the most efficient delivery operators to install more measures, whilst providing a low cost way for smaller suppliers to expand. This would allow for the removal of the exemption and hence avoid distorting the retail energy market.
9. **E.ON agrees with the CMA’s findings regarding competition in wholesale electricity markets, including the distortion in the market created by a lack of locational allocation of losses and the concerns raised around the allocation of Contracts for Difference (“**CfDs**”) outside of the competitive process.** E.ON supports the possible remedies that the CMA has proposed in these areas (Remedies 1 and 2) and believes they could be effective in achieving their aim in a proportional way.
10. **E.ON does not agree with the CMA finding of an AEC through an overarching feature of weak customer response.** The evidence presented by the CMA

shows that significant numbers of customers are engaged, have been engaged and switched in the past, or are likely to become engaged and switch again in the future. The CMA presents evidence on potential gains from switching and suggests that there are fundamental features of supplying energy to customers which give greater importance to these gains. E.ON does not agree with the CMA view that energy is a homogenous product as there are many elements associated with the supply and service of this product which are not homogenous, and this influences the decisions customers make in whether to act on potential savings.

11. **It therefore follows that E.ON does not agree with the CMA finding that an overarching feature of weak customer response gives us a position of unilateral market power, or that we have the ability to exploit such a position.** Customers on standard variable tariffs (“SVTs”) are not a homogenous group; E.ON cannot distinguish between these customers and therefore needs to treat every SVT customer as if they are potentially engaged and active, including in terms of competitive pricing and service quality.
12. **E.ON does not believe there is evidence of it “exploiting” any market power through making excessive margins from its customers. E.ON strongly disagrees with the CMA findings in this area given that there are significant flaws in the CMA analyses.** The CMA focus on the Return on Capital Employed (“ROCE”) results in an artificially high and unreliable view of returns. Specifically for the small and medium enterprise (“SME”) market, the CMA has dismissed valid risks when assessing profitability, thereby understating the competitive level for margins in this market. More broadly, in order to support its provisional conclusions on profitability, the CMA has undertaken a range of benchmarking exercises and tried to identify appropriate comparators. E.ON believes there are significant weaknesses in the CMA analyses in these areas, many of them due to a focus on inappropriate subsets of the energy industry. E.ON has provided compelling evidence for alternative margin comparators, which results in a mean EBIT margin of 7.5%. E.ON would assert that its supply earnings before interest and tax (“EBIT”) averaged over 2007-2013 at [%]%, and that of the industry as a whole, at 2.8%, are at the very low end of the range of margins from these comparators and significantly below the average EBIT of 7.5%
13. **Without prejudice to our views on the CMA findings detailed above, E.ON agrees with the CMA principle that whichever remedies it proposes should be based on providing a framework for effective competition and facilitating widespread customer engagement through informational remedies or potentially market-opening remedies.** E.ON therefore welcomes the inclusion of Remedy 3 on the removal of the “simpler choices” component of Retail

Market Review (“**RMR**”), as well as Remedy 4a on measures to reduce barriers to switching and the principle of Remedy 5 which seeks to prioritise the roll-out of smart meters to customers on prepayment meters (“**PPM**”).

14. **E.ON supports the principle behind Remedy 7a which seeks greater transparency in the SME market**, but believes this can be more effectively delivered through supplier quoting services allowing commercial Price Comparison Websites (“**PCWs**”) to enter the market. **E.ON also welcomes Remedy 7b which seeks to improve the transparency and trust in third party intermediaries (“TPIs”)** and believes this works effectively alongside the other possible information remedies.
15. **E.ON believes that Remedy 8 prohibiting the inclusion of terms that permit auto-rollover contracts is an effective remedy**, and reinforces a step that we have already made to seek to improve engagement with SME customers, including easier comparability of products.
16. **E.ON agrees that it is essential that customers have access to complete and accurate information that they are able to understand and we have actively sought to improve communications to all our customers**. We therefore believe that Remedy 9 and Remedy 10 can be effective at building upon this improvement, further increasing engagement of customers, particularly in helping SVT customers understand how easy it can be to engage in the market and the benefits of doing so.
17. **E.ON opposes the introduction of a ‘safeguard regulated tariff’ as proposed by Remedy 11 as it is too complex to implement, too likely to have adverse side effects and is not proportionate**. Setting such a tariff would be extremely difficult, with numerous issues arising, including many negative impacts reducing relevant customer benefits, as well as undermining the other remedies proposed by the CMA. The majority of the other remedies seek to increase levels of customer engagement through various synergistic approaches, whereas it is clear that the introduction of a safeguard tariff is highly likely to increase customer disengagement.
18. **E.ON believes that competition and markets are the most effective and efficient approaches to deliver the best outcome for customers and hence any intervention in these areas needs to be minimised**. This would suggest the remedy of a safeguard tariff, were it to apply, should only apply to a small subset of the market.
19. **E.ON agrees that improvements in settlement of gas can bring benefits to customers and fully supports Project Nexus**. We believe that the timescale for

this is achievable and should not slip any further. E.ON does not believe that Remedy 12b which would require monthly submissions of Annual Quantities (“AQs”) is proportionate, as Project Nexus will deliver the majority of the benefits in this area, making further costly remedies unnecessary.

20. **E.ON believes that tariff innovation should and will be driven by customer demand and that use of half-hourly (“HH”) consumption data in the settlement of domestic electricity meters is likely to facilitate tariff innovation.** However, we believe the focus of Remedy 13 should be on removing the barriers to, and reducing the costs of, half-hourly settlement. We are confident that, once barriers have been removed, the market is capable of delivering this objective more efficiently, driven by demand from customers, alongside the roll-out of smart meters.
21. **E.ON has and continues to support Ofgem in its work to continuously improve and develop the efficacy of financial reporting in the form of the electricity generation and electricity and gas supply licences’ Consolidated Segmental Statements (“CSS”).** In that regard, E.ON believes that, whilst there is scope for improvement, as proposed by Remedy 14, the existing financial reporting frameworks already give a high degree of transparency and assurance around the profitability of the Six Large Energy Firms (“SLEFs”).
22. **E.ON welcomes Remedy 15 which seeks to introduce measures that provide all stakeholders with greater reassurance that the impact assessments carried out to support policy decisions are well grounded** and that everyone has confidence in them, leading to outcomes that all can buy into.
23. **E.ON agrees that Ofgem’s statutory duty to protect the interests of customers by promoting effective competition has been weakened as a result of the amendments made in the Energy Act 2010 and therefore supports Remedy 16.**
24. **E.ON agrees that having a clear separation between Government and Ofgem, as proposed in Remedy 17,** would result in a strong governance process which would enable the regulator to act and take decisions in an independent way. It would also help Ofgem to fulfil its role as economic regulator to be able to comment independently on DECC policies via the consultation process.
25. **E.ON is supportive of Remedy 18 which makes proposals to improve the system of code governance and in particular facilitate the development of changes to codes and how such changes are implemented.** However, we do have some concerns with the lack of detail in some areas of these possible remedies and would welcome further clarification.

### 3 PROFITABILITY

26. The CMA has undertaken analyses on the profitability of suppliers in both the domestic and SME markets in its Provisional Findings and has provisionally concluded that the prices paid by domestic customers have been above the levels it would expect to see in a competitive market and, for SME customers, substantially above those levels.
27. E.ON's average GB Supply business EBIT is [REDACTED]% for the period 2007 – 2013 and the SLEFs combined average supply EBIT is only 2.8% over the same period. E.ON does not believe these margins are indicative of an uncompetitive market nor do they provide evidence that it "exploits" any market power through making excessive margins from its customers.
28. In conducting its analyses of profitability, the CMA collected data for 2007 and 2008 but has only used that where it considers appropriate. E.ON would suggest that it is important for the CMA to expand its analyses to include these years, as there do not appear to be valid reasons for their omission. E.ON believes inclusion of this earlier data is crucial because it represents a period of significant volatility and high prices in the wholesale markets which later years do not. Any conclusions the CMA reaches and subsequent remedies it proposes need to be robust to such market conditions and hence need to be considered.
29. E.ON strongly disagrees with the CMA findings as there are significant flaws in the CMA analyses. The rest of this section provides a high-level account of these flaws, with greater detail provided in **Appendix A**. The CMA assessment based upon ROCE is fundamentally flawed and its analysis on competitive benchmarking shares many of the same shortcomings, including being unjustifiably narrow in nature. E.ON has presented clear evidence and justification for the use of a suitable portfolio of comparator industries for EBIT margins which show that its margins, and those of the industry as an average, are towards the lower end of this range.

#### 3.1. Return on capital employed

30. E.ON continues to believe that ROCE analysis of inherently asset-light energy supply businesses is inappropriate and considers it highly likely that, even if all of our detailed points were fully addressed, it would still lead to a misleading portrayal of the profitability of E.ON and its competitors. It is notable that the CMA has not ultimately applied ROCE methodology to its previous investigations into Audit and Retail banking and that there is a substantial evidence base from

academics and other regulators regarding the unreliability of ROCE for asset light industries<sup>1</sup>.

31. Other similarly asset light firms, in markets for which there is no evidence to suggest are anything other than competitive, show similarly high ROCE figures as retail energy supply. This shows that such high ROCE figures for asset light industries are spurious.
32. Notwithstanding the points above, E.ON does not agree that the CMA has appropriately included all of the assets relevant to retail energy suppliers in its analysis, demonstrated by:
  - Failing appropriately to value existing customers and the costs associated with retaining these customers;
  - Failing adequately to capture various elements of collateral and risk in its estimates of capital employed; and
  - Not applying Modern Equivalent Asset (“**MEA**”) uplifts to any of the book values for property and IT spend/systems.

These flaws result in ROCE analysis that produces results which are artificially high and the difficulty of correcting them shows that ROCE analysis is inherently unreliable in an asset light business.

### **3.2. Analysis of SME risk**

33. E.ON recognises that the margins present in the SME market are higher than those seen in both domestic and industrial and commercial (“**I&C**”) markets but believes there are key underlying reasons for this, primarily due to the significant risks this business carries, as detailed in our Updated Issues Response<sup>2</sup>. E.ON is concerned that the CMA has dismissed these valid reasons in its assessment of risk for SMEs. It is the case that there is less scope for cost pass-through (certainly for E.ON where our fixed price SME contracts do not have cost pass-through elements), a greater degree of shape risk and higher bad debt costs compared to I&C.

### **3.3. Analysis of efficient prices and costs**

34. It is E.ON’s view that the CMA analysis on efficient prices and costs has significant weaknesses. Within this analysis, the CMA recycles many of the same

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<sup>1</sup> See, for example, Dieter Helm, paragraphs 17-18:  
<http://dieterhelm.co.uk/sites/default/files/Penalty%20tariffs,%20open-ended%20regulation%20and%20embedding%20overcharging%2020.07.15.pdf>

<sup>2</sup> Paragraphs 290-295 of E.ON’s Updated Issues Response

assumptions and associated problems highlighted above with regards to ROCE, and hence the results suffer from the same issues, effectively invalidating them.

35. There are further flaws in the approach the CMA takes in determining efficient wholesale costs and indirect costs. E.ON does not agree that the concept of a lower quartile (or similar subset) of efficient costs for wholesale gas and electricity is valid. Different suppliers have different hedging strategies which will yield different outcomes in terms of overall wholesale costs at different times. Using a lower quartile for wholesale costs, particularly given the extremely small sample size, effectively requires all suppliers to “beat the market average” at all times, a clear impossibility with different hedging strategies.
36. In addition, the CMA does not take account of differences in region or customer mix for indirect costs which, when using a lower quartile (or similar subset), could lead to understating what would be comparable indirect costs of the other providers.

#### **3.4. Margin Benchmarking**

37. The CMA has used within-industry comparators to provide benchmarks for margins. E.ON has significant concerns with this narrow focus as it has a number of shortcomings.
38. E.ON does not consider that I&C margins represent a competitive benchmark for domestic and SME supply margins. I&C contracts generally have the greatest degree of cost pass-through (e.g. obligation costs) and many pass-through both wholesale price and volume risk through buy-to-back contracts. Given this degree of risk pass-through from suppliers to customers, margins in the I&C segment are not an appropriate benchmark.
39. The CMA has also used mid-tier gross margin comparators, albeit from a very limited sample of two (First Utility and Ovo Energy). E.ON does not agree with the CMA justifications for using such a narrow group. E.ON believes that, at the very least, this analysis should be expanded to include other mid-tier suppliers such as Co-op Energy and Utility Warehouse as E.ON does not agree these are less relevant comparators than those the CMA has chosen to use.
40. The CMA has also compared margins to a number of regulated energy markets, particularly those in Northern Ireland and Australia. E.ON does not agree that these represent competitive benchmarks for non-regulated energy markets as there are lower risks due to not being exposed to revenue and cost fluctuations relating to economic conditions. E.ON does not agree with the CMA that these risks are similar as it is clear that, for example, Power NI faces less exposure in

these areas, a fact recognised by the advisors to the NI Utility regulator<sup>3</sup>. Notwithstanding the above, it is interesting to note that in Australia under the New South Wales (“NSW”) regulated tariff, regulated margins were 5-6% for the period of 2007-2014<sup>4</sup>. It is therefore clear that, even between regulated tariffs in different countries, there is significant variation in margins and we would again assert that the CMA should use a broad range of comparators in order to obtain a sufficient degree of robustness in their analysis.

#### External Comparators

41. E.ON also has significant concerns with the lack of breadth in the CMA comparators. When conducting a benchmark exercise for price determination in NSW, the analysis produced by SFG Consulting for the Independent Pricing and Regulatory Tribunal (“IPART”)<sup>5</sup> clearly recognised:

*“the importance of using a sufficiently large sample size to ensure the statistical reliability of estimates”,*

And that:

*“The problem with small samples is that it is unclear just what interpretation should be placed on the information”.*

42. Whilst the report recognised the importance of balancing the above requirements with the need to ensure that the set of comparator firms face substantially the same risk and growth prospects as a NSW electricity retailer, the analysis was still able to use a very large sample of nearly 700 listed retailers, across different industries and regions. E.ON would not necessarily advocate that the CMA use such a broad data set in its analysis, but believes it is important to highlight the extreme narrowness of the CMA’s current approach.
43. E.ON has previously submitted evidence to the CMA describing a sample of EBIT margins from other comparable industries and continues to assert that this is the most reliable way to form a view on the energy supply industry’s profitability. We are concerned that the CMA has dismissed this evidence on the basis of differences in risk profile or capital requirements/asset structures.
44. E.ON has conducted further analysis in this area, providing evidence to address the concerns raised by the CMA, and we do not believe there is a justification for

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<sup>3</sup> [http://www.uregni.gov.uk/uploads/publications/Annex\\_7\\_-\\_ECA\\_Margin\\_submission.pdf](http://www.uregni.gov.uk/uploads/publications/Annex_7_-_ECA_Margin_submission.pdf)

<sup>4</sup> <http://www.aemc.gov.au/getattachment/daac13b3-2b7e-4622-881f-a8c32fdec34e/NERA-report.aspx>

<sup>5</sup> [http://www.ipart.nsw.gov.au/files/f2342b47-09d6-429a-8652-a1e00091c310/Consultant\\_Report\\_-\\_SFG\\_Consulting\\_-\\_Estimation\\_of\\_the\\_regulated\\_profit\\_margin\\_for\\_electricity\\_retailers\\_in\\_NSW\\_-\\_June\\_2013.pdf](http://www.ipart.nsw.gov.au/files/f2342b47-09d6-429a-8652-a1e00091c310/Consultant_Report_-_SFG_Consulting_-_Estimation_of_the_regulated_profit_margin_for_electricity_retailers_in_NSW_-_June_2013.pdf)

dismissing this analysis which shows that the mean EBIT margin for a suitable portfolio of comparators is 7.5%. E.ON would contend that its EBIT averaged over 2007-2013, and that of the industry as a whole, are at the very low end of the range of margins from the list of comparable firms and significantly below the average EBIT of 7.5%.

## 4 E.ON'S RESPONSE TO FINDINGS AND REMEDIES

### 4.1. Upstream Efficiency

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

45. E.ON agrees with the CMA's provisional finding that the current system of allocating losses to market participants on a uniform basis creates a cross subsidy and distorts competition in the market. Therefore, we support the proposed remedy to introduce a requirement for variable losses to be priced by location.

46. E.ON has long supported this proposal. Indeed, the introduction of a locational allocation of losses was outlined at privatisation, in the original Pooling and Settlement Agreement, as something which should be considered going forwards. We have been disappointed that previous attempts to introduce this have been frustrated, even though analysis has shown such a scheme would bring a net benefit to customers.

47. E.ON considers that this solution could be introduced relatively easily and quickly. We are mindful that remedies to AECs should be proportionate and that the CMA would be concerned if high transactional costs were associated with this proposal. However, much of the work has already been carried out. The latest code modification proposal P229 provided a solution with a net predicted benefit, which could be implemented relatively easily, particularly as the parameters needed for its introduction are already contained in the Balancing and Settlement Code ("**BSC**").

48. We consider this further in our response to the questions raised against this remedy.

**(a) What would be an appropriate method for ensuring that variable transmission losses are priced on the basis of location?**

49. As we mention above, most of the work to introduce such a scheme has effectively been carried out already. Therefore, it would seem appropriate to

introduce the form of scheme which was developed under the last considered modification P229, based around seasonal loss factors. Although further work would be required to produce the Transmission Loss Factors associated with this solution, these would be produced annually and would cover an entire season at a time, rather than any shorter timescales, which will help to limit the effort necessary to do this. We believe that this solution provides an appropriate combination of cost reflectivity, stability and efficient implementation approach.

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

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

50. E.ON believes that the current split should be retained. Our understanding is that the 45:55 split is effectively a 50:50 split adjusted to reflect where system metering for generation and demand is typically located. As demand response becomes more prevalent in the market and therefore competes with generation directly to provide a number of energy balancing services, it is important that generation and demand are exposed to the same market signals, to the extent that this can be achieved efficiently.

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

51. The distributional impacts associated with this proposal occur between different generating stations or groups of customers located at different parts of the network. There is no redistribution between generators and suppliers unless the relevant proportions in b) above are changed. Clearly, redistribution of costs or revenues between parties will affect the profitability of those parties in different ways. Some will benefit whilst others lose out. However, this generally occurs whenever a significant market rule change is implemented.
52. Recent Connection and Use of System Code (“**CUSC**”) modification CMP213 (Project Transmit) was implemented largely ignoring the distributional impacts on parties even though these are considerable. The parties who lost out under that modification would generally benefit from the introduction of a locational losses scheme. To maintain a consistent and fair approach, we believe that distributional effects should therefore also not have an undue influence on whether or not this remedy should be implemented.

**(d) Should the CMA implement this remedy directly, i.e. via an order, or should it make a recommendation to Ofgem to initiate a BSC modification instead? Are there any particular aspects of Ofgem’s objectives and duties to which the CMA should have regard if implementing this remedy by a licence change?**

53. E.ON does not believe this remedy should be implemented via a recommendation to Ofgem as this could leave room for parties opposed to this proposal to frustrate the assessment process to delay its implementation.

54. Given the amount of work already carried out, we would suggest that this remedy would be more efficiently and effectively introduced through an order requiring that the original solution developed under P229 is implemented, including a suitable deadline for doing so.

#### [Contracts for Difference](#)

55. E.ON welcomes the CMA’s overall support for CfDs and agrees with the CMA that the reduction in risk is likely to lead to lower costs to customers overall.

56. E.ON also agrees that the move to competitive allocation of CfDs was an important step, providing an immediate benefit to customers. Extending the scope of competitive allocation should continue to be a priority for DECC, especially in light of its stated priority to reduce the burden on customers. As we highlighted in our response to the Updated Issues Statement, the allocation of CfDs outside of this competitive process risks unnecessarily expensive deployment of low carbon technologies which customers will have to pay for via higher energy bills.

57. E.ON agreed with the principles behind the Final Investment Decision enabling for Renewables (“**FIDeR**”) scheme. This was necessary to ensure no hiatus in investment whilst CfDs were developed. However, we have been concerned about the magnitude of budget provided under the FIDeR scheme. It is E.ON’s view that too many projects were supported under this scheme. As the CMA highlights, a comparison with strike prices achieved in the first CfD allocation round demonstrates a potential for significant savings in costs.

58. Similarly, we remain concerned about the potential for further projects to be allocated CfDs outside the competitive process. Whilst this may be necessary in very limited circumstances, we agree with the CMA that this potential for non-competitive allocation does give rise to an AEC.

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

59. E.ON supports this possible remedy which is an improvement on the current approach. We believe DECC should use the competitive allocation process wherever possible but do accept there may be some very limited exceptions that could be justified today. However, if Government wishes to support First Of A Kind (“**FOAK**”) technologies, it would in our view be preferable to support these with government grants, as opposed to utilising some of the Levy Control Framework (“**LCF**”) CfD budget which will inevitably displace lower cost projects. It is clear that the LCF is already under very considerable pressure.

**(a) Would the remedy ensure that CfDs that are allocated outside the auction mechanism are awarded only when the benefits of doing so outweigh the costs?**

60. This remedy will ensure DECC is transparent in any decision to award CfDs outside the mechanism and is required to justify these decisions. However, any impact assessment relies on the quality of its assumption and inputs, which are often extremely challenging to predict over the life of a CfD contract. Therefore, it is unrealistic to expect this remedy to ensure CfDs are only allocated outside the auction mechanism when the benefits outweigh the costs

**(b) How much discretion should DECC retain in terms of the weight it places on each factor that it takes into account in coming to a decision on which projects to award CfDs outside the CfD auction mechanism? Should DECC be required to consult on and determine these factors and their relative importance in advance to enhance transparency? Should the weighting of each factor be constant across projects?**

61. CfD allocation decisions should ultimately be about cost to customers; this is how the CfD auctions are structured, with the cheapest project being successful.

62. The UK has already set objectives to reduce greenhouse gas emissions (Carbon Budgets, EU targets) and has set a reliability standard to determine the desired level of security of supply. The benefits of supporting a technology outside competitive auctions should be expressed in terms of the costs of achieving these set objectives. There is no need to weight each factor when coming to a decision on allocation outside the auction, DECC should simply be required to quantify financially the expected benefits in doing so, expressed as savings in costs over time. For example DECC might quantify future reductions in strike prices as a result of supporting a technology today.

**(c) In which exceptional circumstances should DECC be able to allocate CfDs outside the auction process? For example, for reasons of industrial policy, where there are wider market failures, or where there may be insufficient competitors to hold an auction?**

63. The sorts of circumstances in which it may be justified to allocate CfDs outside the auction process, are those in which there is some other overarching reason that outweighs the otherwise accepted benefits of proceeding by competitive auction. There remains a risk around this though, without further benefits arising from the decision. For example, just because there are insufficient competitors to hold an auction, this should not give an automatic right to a higher priced CfD - there should be a countervailing reason why a CfD should be granted in the particular circumstances. There is also a question about whether there should be some element of competitive tension, for example between the costs of different nuclear technologies, which may mean one gets a CfD but another does not. There should not be an automatic right to a CfD just because it is difficult to allocate one according to normal competitive allocation processes.
64. As described above, DECC should justify such decisions based on an analysis of future reductions in bills.

***Remedy 2b – DECC to undertake and consult on a clear and thorough assessment before allocating technologies between pots and the CfD budget to the different pots***

65. Overall E.ON supports this remedy which will lead to more transparent decision making. We believe the CMA should go further by suggesting that DECC set out milestones which lead to technology neutral auctions as soon as possible. This will, in the medium term, negate the need to continue with this remedy.

**(a) Would the remedy ensure that future decisions by DECC on the allocation of technologies and the CfD budget to the different pots are taken in a robust and transparent manner?**

66. The remedy would improve transparency. The robustness of the decisions depends on the quality of the assessments and of the assumptions used in those assessments as well as the principles underlying the assessments.

**(b) Is the remedy likely to result in a positive change in how DECC makes decisions regarding the allocation of the CfD budget to the different pots?**

67. E.ON hopes that DECC already makes decisions regarding the allocation of CfD funds between pots in a robust way and has no evidence to suggest otherwise, based on the first CfD auction.

68. The remedy will ensure decisions are transparent to all stakeholders and it is possible that challenge from other stakeholders will improve decision making.

**(c) How regularly should DECC review the allocation of technologies between pots? What information should DECC publish when deciding to amend the allocation of technologies between pots? Should it also on a regular basis consult and/or publish reasons for not amending the allocation of technologies between pots?**

69. DECC should review the allocation of technologies between pots for each allocation round and publish its associated assessments. This will ensure all technologies can move to the established technology pot as soon as possible, which will result in the lowest costs to customers. However, E.ON also believes there is a need to publish a plan of action now on the transition to technology neutral auctions, so the industry can prepare for this.

70. Decisions on the allocation of technologies should be based on a by exception principle. Therefore, all technologies should compete in the established technologies pot unless there is a justifiable reason for their not doing so. Justification should be based on a belief around future cost reductions for customers.

**(d) Should DECC be limited in the maximum proportion of the CfD budget that it can allocate to each of the different pots?**

71. As described above, technologies should only sit outside the main established technologies pot if there is a justifiable, cost-based reason for them doing so. E.ON does not believe there should be an arbitrary limit to funding in each of the pots but DECC's overall aim should be to move to a single auction with all technologies competing against each other. This is best achieved by moving technologies from the non-established pot 2 auctions to the established pot 1 auctions as soon as possible.

**4.2. Weak Customer Response and UMP in the Domestic retail market**

72. E.ON does not agree with the CMA finding of an AEC through an overarching feature of weak customer response. The CMA customer survey shows that most people are aware they can switch supplier (89% know), are aware they can switch payment method (81% know) and are aware they can switch tariff (76% know). The inferences drawn would seem confused; in paragraph 8.77 of the

Provisional Findings, the CMA asserts that 36% of respondents did not think it was possible to change one (or more) of either supplier, tariff or payment method, whereas that would seem to be a measure of awareness of the ability to change all three (of whom many would be PPM customers, where there is currently restricted choice). The data above shows that this is actually at most only 11% who did not think it was possible. We would suggest that the dominant inference is that the vast majority of SVT customers are fully aware that they can change supplier.

73. The customer survey also looks at levels of switching and the degree to which customers either shop around or consider switching. The data in Table 1 of the Customer Survey appendix shows that 66% of respondents had either switched supplier, shopped around to compare suppliers or considered switching suppliers. This is followed up by the data in Table 6 and paragraph 75, which show that 79% of respondents had either considered switching, or were likely to consider switching in the next 3 years or both.
74. These elements of the customer survey support E.ON's view that most customers are engaged, have been engaged and switched in the past or are likely to become engaged and switch again in the future. Hence, the supply of retail energy to domestic customers is not a market where the majority of customers are disengaged. The customer survey does not support the CMA's statement<sup>6</sup> that "*material numbers of customers appear fundamentally disengaged*" – it does better support the CMA's suggestion in the same paragraph that "*customer engagement should not be regarded as a binary phenomenon: customers can be considered to be relatively engaged or disengaged along various dimensions of choice.*"
75. The CMA also cites analysis on the potential gains from switching available to customers in the period Q1 2012 to Q2 2014 as further evidence of customers being disengaged. However, the CMA acknowledges that gains from switching are likely to be present in most markets, and E.ON would support this view that gains are required for competitive markets to function, as they provide an incentive for customers to engage. Indeed, a market with low potential gains from switching is likely to see limited levels of engagement and switching, which could be considered less competitive. Hence, it is not the case that the presence of gains in a market indicates a lack of competition.
76. The CMA customer survey supports this view in its analysis of the required gains for customers in order for them to consider switching. The results of this

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<sup>6</sup> Paragraph 7.95 of the Provisional Findings

analysis (Table 12 Appendix 8.1) produced a median value of £120, with nearly 40% of customers requiring over £200 of potential savings before they would consider switching. However, the potential gains available from switching do not cover the full set of decision making that a customer goes through – price is not the only consideration in a customer’s decision to switch.

77. The CMA suggests that, due to the homogenous nature of energy, the primary factor in deciding to switch is price. E.ON would agree that price is an important consideration for customers but would suggest that, as in most competitive markets, there are many other factors which a customer would take into account when considering switching. Many more customers trust their own suppliers than other suppliers, and this is likely to influence their decision to switch supplier. This is reinforced by the CMA customer survey analysis (Figure 22 in Appendix 8.1) which shows that around 60% of respondents are either satisfied with their existing tariff or are confident that they are on the best deal with their existing supplier.
78. E.ON has worked hard to build up good relationships with its customers through its Trusted Energy Partner strategy<sup>7</sup> and believes that this is an important driver of retention of customers. We have seen our NPS score improving over the last few years, in line with our customer service and believe this is plays an important part in a customer’s decision making process with regards to switching. Poor customer service does lead to customers leaving a supplier and, we would suggest, makes it less likely that they will return to that supplier, even if it may be cheaper. Having good customer service is an important consideration to customers, as evidenced by the fact that nearly all commercial PCWs have some form of service rating alongside their price quotes.
79. E.ON therefore contends that whilst the physical product is homogenous, it is not necessarily viewed as such by customers. There are many other elements of the service of this product which are heterogeneous and result both in a range of prices available in the market and an influence on the decisions customers make in whether to act on potential savings.
80. It therefore follows that E.ON does not agree with the CMA finding that an overarching feature of weak customer response gives us a position of unilateral market power, or that we have the ability to exploit such a position. As discussed in our response to the Updated Issues Statement<sup>8</sup>, E.ON does not believe that just because a customer is on an SVT, that they are not engaged or

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<sup>7</sup> We shared our “Trusted Energy Partner” strategy with the CMA at our site visit on 22 September 2014, and also in our Opening Statement at the formal Hearing on 4 March 2015.

<sup>8</sup> Paragraphs 160-167 of E.ON’s Updated Issues Response

that they are not active. Customers on an SVT are not a homogenous group<sup>9</sup>, as shown by the CMA customer survey, and E.ON cannot distinguish between customers who are truly inactive and those who may become active again in the future. E.ON therefore needs to treat every SVT customer as if they are potentially engaged and active, including in terms of competitive pricing and service quality.

81. The CMA analysis indicates that there is a propensity for those that have low incomes, have low qualifications, are living in rented accommodation or who are above 65, to be less engaged. However, as stated above, E.ON treats these customers the same as it treats other SVT customers who may be more engaged and who thereby provide protection via competition to the more vulnerable and perhaps less active customers on SVT.
82. E.ON does not believe that there is evidence of it “exploiting” any market power through making excessive margins from its domestic customers. Whilst, on average, 71% of our customers are on our SVT, our profits in the domestic sector remain reasonable. We have clearly highlighted above, in the section on profitability, that the CMA analyses has significant flaws, undermining the validity of the conclusions reached in this area. Given that any remedies which the CMA proposes to introduce need to be proportionate, E.ON does not believe there is evidence to support any high risk or intrusive remedies.
83. As we set out in paragraph 111 of the Updated Issues Response, E.ON has actively sought to engage its customers in a number of different ways and continues to seek improvements in this area, directed by the current competitive drivers in the market. However, when considering the proposed remedies which seek to improve customer engagement, it is important to ensure that they are effective and proportionate.
84. Without prejudice to our views on the CMA findings detailed above, E.ON agrees with the CMA principle that whichever remedies it proposes should be based on providing a framework for effective competition. Therefore, we welcome the inclusion of Remedy 3, to remove from domestic retail energy suppliers’ licences the “simpler choices” component of the RMR rules, which will seek to address some of the issues we have raised in previous responses with regards to RMR.
85. E.ON also supports the CMA principle that remedies should facilitate widespread customer engagement and that the most effective approach for achieving this is through informational remedies or potentially market-opening remedies. Such

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<sup>9</sup> Paragraphs 175-180 of E.ON’s Updated Issues Response

remedies will build upon the currently good level of competition in the market by further encouraging and maintaining customer engagement.

86. E.ON does not agree that there needs to be a transitional safeguard tariff aimed at disengaged customers. A remedy of this type would not be proportionate, with the complexity and risks outweighing the potential small financial benefit for some customers, with adverse impacts on others.
87. E.ON believes that any potential remedies should focus on enhancing competition in the market. E.ON does recognise that there is a more vulnerable segment of customers who have the propensity to be less engaged. Whilst E.ON seeks to treat all its customers fairly, E.ON believes that it is a policy decision as to whether these customers need additional forms of consumer protection, as opposed to “just” the operation of competition in the market. If it is believed that they do need this additional safeguard, we would submit that this could be more simply delivered via Government policy. This is the approach that is already seen with the WHD and a similar approach of defining eligibility and a benefit for these customers would seem to be a simpler and more effective approach than a safeguard tariff, if protection for the vulnerable were deemed necessary.
88. In the rest of this section, we provide more detail on each of the proposed remedies as well as responses to the questions asked.

***Remedies to provide the framework for effective competition between retail energy suppliers***

89. E.ON raised its concerns about the impact of regular changes in Ofgem’s regulatory requirements/approach and the ever-increasing volume/complexity of regulation in the First Issues Response and Updated Issues Response. We therefore welcome the focus of the CMA on RMR. E.ON agrees with the principle behind RMR in terms of a simple, open and transparently fair market, but would suggest that whilst it has been successful in some areas, it has created issues in others.
90. Whilst elements of RMR have led to improvements to comparability, simplicity and fairness, E.ON agrees with the CMA finding that the ‘simpler choices’ component of RMR has resulted in a stifling of innovation through greater uniformity of tariffs, potentially misleading information to customers (see paragraph 182) and an increase in the difficulty of rewarding low volume users. We therefore welcome this remedy and comment more specifically in the paragraphs below.

***Remedy 3 – Remove from domestic retail energy suppliers’ licences the ‘simpler choices’ component of RMR***

**(a) Would this remedy be effective in increasing competition between domestic retail energy suppliers and/or between PCWs? What additional tariffs would energy suppliers be likely to offer that they currently do not due to the RMR restrictions?**

91. E.ON believes that this remedy would be effective in increasing competition between domestic retail energy suppliers and between PCWs. Giving suppliers a greater range of tariffs will allow them to produce more innovative products, seeking not only to attract those customers who are currently less engaged, but also to maintain the engagement of those customers who are more active. As we highlighted in the Updated Issues Response<sup>10</sup>, there are two elements which dictate how many customers can be said to be engaged, namely the number of customers moving from SVT to a non-SVT tariff, which is offset by the number defaulting back to SVT for a period of time. The use of innovative tariffs can seek to increase the number of customers switching from SVT to non-SVT tariffs whilst at the same time either reducing the number defaulting back to SVT or reducing the time they remain on SVT before engaging in the market again.
92. The effectiveness of this remedy would be further increased through the impact of levels of competition on PCWs. Removing the simplification of cash discounts component of ‘simpler choices’ will encourage suppliers, but particularly PCWs, to compete for customers by passing on cashbacks. Combined with a greater tariff range, this will give them the opportunity to secure exclusive tariffs from suppliers, creating greater competitive tension between PCWs and suppliers but also between PCWs themselves.
93. At this stage, we would not speculate on what specific tariffs may exist in a more liberal market but the CMA has historical examples (such as E.ON’s StayWarm tariff) that provided genuine niche solutions to customers. Current tariff developments have been constrained by the RMR rules and there would need to be a period of customer research to identify the most effective new tariffs. E.ON would be excited to develop new tariffs, [✂]. As the market moves through the digital transformation with the introduction of smart meters and digital data centres, it is highly likely that a greater number and variety of tariffs will be brought to market, maximising the effectiveness of this remedy.
94. It might be feared that allowing more or different tariffs, particularly innovative tariffs, has the risk that customers may not be sold the best tariff for them.

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<sup>10</sup> Paragraph 166 and Figures 5 & 6 of E.ON’s Updated Issues Response

However, this risk is mitigated by licence conditions SLC25 and SLC25C, which place strong requirements on suppliers to provide complete and accurate information in a way which the customer can understand. Ofgem should readily be able to enforce these requirements by asking for evidence of effective supplier processes including risk assessment. The same requirements could also be extended to PCWs in order to ensure this risk is mitigated across the market.

**(b) Removing the four-tariff rule is likely to increase the range of tariffs on offer and result in different tariffs being offered on different PCWs. Are there, therefore, any remedies that the CMA should consider alongside this remedy, to encourage domestic customers to use more than one PCW in order to facilitate effective competition between PCWs and domestic energy suppliers?**

95. E.ON does not believe that encouraging domestic customers to use more than one PCW would necessarily be a helpful and effective remedy. It is not necessary in engaging SVT customers to suggest that they should search for the best deal; indeed that could make search seem harder than it is. The key element for customers to engage with PCWs is for them to be able to trust the information that they receive through this route (we cover in our answer below the options for ensuring that customer do trust PCWs) and messages suggesting they need to consult more than one PCW may undermine this trust and reduce the effectiveness of the remedy. E.ON believes that PCWs already have good incentives to compete with one another for customers, for example through cashbacks, and this should be the mechanism to encourage customers to visit more than one PCW. Additionally, if an Ofgem “meta-PCW”, as proposed in Remedy 6, also included comparisons between PCWs, this would facilitate such competition. With appropriate rules governing PCWs to ensure trust, the removal of the ‘simpler choices’ component of RMR will increase this competition.

**(c) We note that if this remedy were to be imposed, Ofgem’s Confidence Code requirement for PCWs to provide coverage of the whole market appears likely to become impractical as the number of tariffs offered increases and PCWs agree different tariff levels and commissions with energy suppliers. Should this element of the Confidence Code be removed, therefore, as part of this remedy? If so, are alternative measures to increase confidence in PCWs required? For example, in order to maintain transparency and trust, should PCWs be required to provide information to customers on the suppliers with which they have agreements and those with which they do not?**

96. E.ON agrees that Ofgem’s Confidence Code requirement for PCWs to provide coverage of the whole market is likely to become less practical as the number of tariffs, potentially with different structures, increases. The current requirement risks pushing PCWs out of the market as the incentives for suppliers to pay commissions are drastically reduced as PCWs have to show all tariffs by default and hence this could reduce the effectiveness of this remedy.
97. E.ON agrees that an alternative approach may be more suitable, requiring PCWs to provide information about which suppliers are not covered (and perhaps some key metrics about them such as their average prices and customer satisfaction ratings). This would help customers to know whether they are getting a good view of the market, and hence increase trust in PCWs, whilst allowing PCWs to continue to remain in the market and compete. The proposed Ofgem “meta-PCW” would presumably cover the whole of the market (subject to this being practicably possible) and if implemented could therefore fill any gap here.
- (d) Rather than removing all limits on tariff numbers and structures, would it be more effective and/or proportionate to increase the number of permitted tariffs/structures? If so, how many should be permitted and which tariff structures should be allowed?**
- (i) For example, would requiring domestic energy suppliers to structure all tariffs as a single unit rate in pence per kWh, rather than as a combination of a standing charge and a unit rate, reduce complexity for customers, while avoiding restricting competition between PCWs? Alternatively, would such a restriction on tariff structures have a detrimental impact on innovation in the domestic retail energy markets?**
98. E.ON believes that it would be more effective to remove all limits on tariff numbers and structures as this will allow the greatest level of innovation in the market by allowing market forces to determine the optimum level and hence maximise the effectiveness of the remedy. It is very difficult to pick an “optimal” number of tariffs which balances simplicity versus competition and it would need to accommodate the most innovative supplier. Whilst removing all limits may increase the level of complexity for customers, using a PCW allows most complexity to be handled on behalf of the customer through the PCW itself, and hence this should not create a negative impact.
99. It is possible that in the absence of regulation, some tariffs might emerge which could not easily be calculated and compared by a PCW itself, for example one might consider a customised fixed bill price based on past half-hourly usage. Technically, such tariffs could still be compared via a PCW (e.g. by automated

querying of the supplier's website by the PCW), though some features (e.g. level of risk) do not easily lead themselves to price based comparisons.

100. Furthermore, we believe that more innovative tariffs, which are perhaps less susceptible to comparison on price alone, may also be the most likely to offer significant added value to customers and thus themselves increase engagement. Whilst recognising this challenge, we do not believe it is a reason of itself to restrict tariff numbers or structures, as we believe that PCWs can innovate effectively to produce solutions in this area.
101. E.ON does not believe that the current tariff structure creates too much complexity and hence does not see the need for imposing a single unit rate structure, which has severe downsides in terms of distributional impacts. Applying a standing charge plus a unit rate is the most cost reflective approach and hence most efficient. Whilst removing the standing charge and recovering the fixed cost elements through the unit rate may benefit certain low consuming customers (some of whom are not at a detriment e.g. second home owners), it would also unfairly punish high consuming customers, many of whom may well be in fuel poverty. In addition, as the market develops with more digital options and smart meter data, greater flexibility in tariff structures is likely to allow greater innovation.
102. In distorting economic incentives, removing the standing charge also raises a risk that at some point some distributed generation technology becomes cheaper than the single unit rate in pence per kWh, but still requires grid connection and common goods (e.g. system balancing, capacity margins). This situation would already have been reached with solar PV in some parts of Europe, though not yet in Great Britain. This creates a perverse situation where a network connection and common goods are subsidised for those who can afford to purchase a new technology, to avoid its costs, by those who cannot afford to.
103. An alternative approach to a single unit rate would be to regulate the standing charge, which could cover a significant proportion of costs (e.g. network costs, obligation costs). This could then leave suppliers to compete on the unit rate based upon their wholesale costs and their efficiency and profit aspirations. We support this approach in principle but it does still have some difficulties, namely in developing the level of regulated standing charge.

***Remedies to facilitate widespread engagement by domestic customers***

104. E.ON believes that such remedies can improve upon the current levels of engagement in the market. E.ON has actively sought to engage its customers in

a number of different ways, and these remedies would allow us to build upon these processes to ensure it is effective as possible.

***Remedy 4a – Measures to address barriers to switching by domestic customers***

**(a) Will the roll-out of smart meters address the feature of uncertified electricity meters? If not, what additional remedies should we consider to address this feature?**

105. Yes, the roll-out of smart meters will accelerate meter replacement and hence address the feature of uncertified electricity meters. Going forward all meters will be compliant with the Measuring Instruments Directive; this removes the certification life of gas and electricity meter assets and introduces service testing to determine if certain meters need to be exchanged on safety or accuracy grounds.

**(b) Will the roll-out of smart meters address the barriers to switching faced by customers with Dynamic Teleswitched (“DTS”) meters? If not, what additional remedies should we consider to address this feature?**

106. Yes, the roll-out of smart meters will help address the barriers to switching faced by customers with DTS meters.

107. There are some additional challenges to consider. For example customers may need to switch to a tariff with Standard Settlement Configurations that are supported by smart meters. Replacement of DTS meters may be more complex than conventional meters, particular if they are linked to a heating system. Many DTS meters are installed in flats which, in common with all smart meters, are likely to require alternative Home Area Network (“HAN”) solutions which will need to be developed. Suppliers have a licence obligation (SLC39.1) to take all reasonable steps to resolve these issues, which should provide sufficiently strong regulation.

**(c) Should PCWs be given access to the ECOES database (meter point reference numbers) in order to allow them to facilitate the switching process for customers?**

108. The Executive Committee of the Master Registration Agreement (“MRA”) is currently exploring this issue via a working group. In principle, we agree that access to data is important for PCWs but there have been instances in the past of inappropriate use of the ECOES database by TPIs.

109. It is not clear that access to the ECOES database would reduce potential errors in switching any more than the Midata programme is already doing. Both ECOES and Midata capture the necessary data to facilitate switching (and Midata has

the additional advantage of facilitating switching by making tariff and usage data available). In any case, it is essential that appropriate safeguards are in place from both a data protection and commercial information security perspective.

110. The sharing of data must only be with a customer's permission; as this has not been designed into ECOES as it has with Midata, it may be more difficult to retrospectively develop customer-led controls over sharing of data in ECOES.

111. E.ON does not believe the CMA should introduce this remedy directly; instead, the MRA working group should be allowed to finish its report and make appropriate recommendations. In addition, the Midata API project will enable this access and more to PCWs. The Midata API project commenced as an industry project last summer to enable automated access to Midata files. This will enable a customer to consent to such access being granted to, for example, a PCW or alternative energy supplier, to directly access that data automatically.

**(i) To what extent would this reduce the rate of failed switches and/or erroneous transfers?**

112. Inaccurate information provided by third parties is a key driver of failed switches and erroneous transfers via TPIs. Access to more accurate data would reduce these and improve the transfer process for customers. However, it is not clear that giving PCWs access to the ECOES database would deliver significant benefits beyond the data available through the Midata program.

**(ii) Are there any data protection issues we should consider in this respect?**

113. Data protection is a key issue that must be addressed. If this remedy is implemented, a robust process for permitting access to ECOES data will need to be put in place. Safeguards can be put in place via the MRA where access is only granted to those companies accredited by Ofgem. In addition, ongoing audits could be introduced to ensure compliance with the appropriate data protection and information security requirements. These issues are being investigated by the MRA working group.

114. As highlighted above, access to this data must only be given with the express permission of customers.

**(iii) Will access to this database still be relevant once smart meters have been introduced?**

115. Yes. This database holds information relating to a customer's supply point (for example their network connection location, capacity, address and so on) which is critical to ensuring that a customer can transfer accurately. This information will still be required once smart meters are installed. With next day switching

this data becomes even more important as the time to rectify issues with the switching process is reduced.

**(d) Should there be penalties for firms that fail to switch customers within the mandated period (currently 17 days, next day from 2019)? How should these penalties be administered? At what level should the penalties be set? Should customers who suffer a delayed or erroneous switch receive the penalty as compensation?**

116. Ofgem already monitors supplier switching performance and would take enforcement action if there was evidence of systemic failure to meet the required targets. This could involve penalties. E.ON would expect Ofgem to compel the failing supplier to redress customers who have suffered loss as a result of a delayed or erroneous switch and that any penalty should be applied to a charity or other organisation operating in an area linked to switching, e.g. previous penalties have gone to support Citizens' Advice Bureau's work on encouraging switching.
117. E.ON is not aware of any evidence that customers are deterred from switching by concern that the time taken may be slightly delayed. If it was a material factor then we would expect some suppliers to offer a financial guarantee as a sign of confidence in their switching performance.
118. Erroneous transfers cover a range of causes, including both an incorrect sale to the right party and a transfer of the wrong party. In the former case there can also be degrees of fault, ranging from gross misspelling, through to late cancellation and a customer change of mind. To make sure suppliers focus on resolution, there is no attempt to ascribe blame and therefore not a direct penalty (other than potential Ofgem enforcement action). However, if resolution is not well handled, customers are compensated through a £20 payment.
119. Energy UK (with engagement from suppliers, Citizens Advice and Ofgem) is leading the development of a switching guarantee and as part of this is considering whether further compensation might be practical. E.ON does not believe the CMA needs to introduce further penalties at this stage.

**(e) When next-day switching is introduced, will a 'cooling-off' period still be required? Could it be avoided by requiring that no exit fees are charged within two weeks of switching?**

120. A cooling off period is required by EU and UK law. Industry, Ofgem and Citizens Advice are considering how to implement this with next day switching.

121. The CMA's proposal to avoid any delay to switching by requiring no exit fees within two weeks of the switch already exists under current regulations. Current Cooling off Regulations already allow for a customer to switch or cancel their contract within the first fourteen days without incurring a penalty.

122. Therefore, E.ON does not believe any further remedy is necessary.

**(f) Are specific measures required to facilitate switching for customers living in rented accommodation (either social or private)?**

123. E.ON does not believe specific measures are required to facilitate switching for customers living in rented accommodation. Arrangements concerning ownership of a property are not directly relevant to a supplier.

124. There is a risk that any remedy in this area, for example by forcing either landlords or tenants to be responsible for the energy supply, would have unintended consequences resulting in poor customer experiences.

125. There are already additional measures related to deemed contracts which are likely to be more relevant to customers who take out short term lets. These are in SLC7.7 and require suppliers to highlight alternatives to deemed contracts, in effect to promote their fixed term products as an alternative to their standard variable tariff. E.ON considers whether more could be made of this prompt in our response to Remedy 10(e).

**(g) Does the 'Midata' programme, as currently envisaged, provide sufficient access to customer data by PCWs to facilitate ongoing engagement in the market? Should PCWs – with customer permission – be able to access consumer data at a later date to provide an updated view on the potential savings available?**

126. The Midata programme does provide sufficient access to data. The information currently in scope includes current tariff, payment method, Meter Point Asset Number ("MPAN"), annual usage and start date of existing contract. E.ON does not believe additional information is needed to facilitate ongoing engagement in the market.

127. Midata is not a marketing tool. It is designed to facilitate customers being able to switch by having access to key information and, if they do decide to switch, to facilitate the process. It is a customer-led process; once a customer gives consent, PCWs can currently access Midata for 30 minutes. There may be a case to allow PCWs direct access to data beyond this quoting journey but this must be something a customer explicitly allows. Controls would need to be put in place to ensure this wider access to a customer's Midata is carefully controlled.

128. It is not currently mandatory for all suppliers (with only the seven or so largest suppliers having originally opted in), or for all PCWs to implement Midata API capability. This means some customers will not be able to benefit from Midata. We would strongly encourage implementation across all suppliers (which principle was agreed with DECC last year) and PCWs to ensure the benefits of the programme can be fully realised.
129. Any updated view provided by a PCW must be an accurate reflection of the market. The current personal projection methodology assumes a customer remains with their existing supplier for twelve months, reverting to a standard tariff if their existing contract ends within that twelve month period. This could lead to misleading views of potential savings. Similarly, when giving a view of savings, PCWs must make it clear that switching suppliers before a contract has finished may incur an exit fee.

**(h) Do customers need more or better information or guidance on how their new smart meters will work?**

130. E.ON does not believe the CMA needs to introduce prescriptive remedies to improve information or guidance.
131. The Smart Metering Installation Code of Practice sets out requirements for information provision on smart meters. This includes the information which is given before installation and a demonstration of the In Home Display. From the installations E.ON has completed to date, we see that customers are comfortable with how their smart meter works. However, some customer groups may need more support with using the In Home Display (“IHDs”) to the extent that this supports behaviour change. Smart Energy GB’s communications activity and a natural increase in awareness of smart metering will, E.ON believes, help to rectify this. However, we also expect to continue to respond to queries about IHDs and to proactively provide advice on how to use them to support energy consumption reduction.

***Remedy 4b – Removal of exemption for Centrica on two-year inspection of gas meter***

132. The Provisional Findings report at para 8.12.8 and Appendix 8.6 refers to Centrica’s derogation in relation to meter inspections for gas meters. However, Centrica were granted 2 derogations by Ofgem for the meter inspection obligations in Standard Licence Condition 12 of both the gas and electricity standard licence conditions. The derogations cover both classic meters and non-compliant smart meters and are due to expire at 31 March 2016.

133. On 23 July, Ofgem published its consultation “Reforming suppliers’ meter inspection obligations”<sup>11</sup>, with a recommendation to repeal the meter inspection licence condition. E.ON believes that the most appropriate route for changes in this area is via this consultation, although we do provide some comments on this remedy below.

**(a) Would this remedy be effective in removing the distortion to competition that currently exists as a result of Centrica’s derogation on the inspection of gas meters?**

134. Removal of the obligation as Ofgem proposes (or of the derogation as the CMA proposes) would reduce the number of meters churning from Centrica to a new supplier, following a change of supplier, which are beyond their inspection dates when compared to those churning from other suppliers without the derogation.

135. E.ON would also agree that Centrica has a lower cost base as a result of the derogations. These cost savings can be significant given the reduction of visits made for inspections and associated back office activities. Removal of the obligation (or derogation) would also reduce this benefit to Centrica.

**(b) Would it be preferable to remove Centrica’s derogation, or extend the derogation to other suppliers?**

136. It would be preferable to remove the obligation completely, as proposed by Ofgem. If the outcome of the consultation is five yearly inspections this would have a similar effect to extending the derogation to all. The current Centrica derogations relax the inspection provisions based upon an alternative inspections regime and are granted subject to further conditions, for example, meeting minimum levels of theft detection. Any additional conditions should still reflect customer protections, including safety.

137. E.ON welcomes Ofgem’s consultation on the meter inspection obligation as we believe change in this area is essential for smart roll-out. The DECC Impact Assessment for smart metering includes a reduction in costs for customer site visits, and assumes a change in the current meter inspection regime. To be able to realise the benefits of smart metering the frequency of meter inspections needs to be reduced.

**(c) If Centrica’s derogation were removed, should it be phased out over a period of time? If so, how long should Centrica be given in this respect?**

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<sup>11</sup>[https://www.ofgem.gov.uk/sites/default/files/docs/2015/07/reforming\\_suppliers\\_meter\\_inspection\\_obligations\\_final\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2015/07/reforming_suppliers_meter_inspection_obligations_final_0.pdf)

138. Whilst E.ON's preference is for the obligation to be removed or the derogation principle to be extended across all suppliers, should Centrica's derogation be removed we believe it should lapse at 31 March 2016 when the derogation was due to expire and no phasing out beyond that date should be required.

***Remedy 5 – Requirement that energy firms prioritise the roll-out of smart meters to domestic customers who currently have a prepayment meter***

139. E.ON agrees with the CMA that the roll-out of smart meters has the potential to address a number of the barriers to switching identified, particularly in relation to prepayment meters. In fact, E.ON has already identified this potential and we are structuring our roll-out programme to prioritise customers with a prepayment meter.
140. E.ON developed a smart Pay As You Go (“PAYG”) offer within the Foundation Period of the Government's smart roll-out programme, which we are currently piloting with our customers. This proposition is available to all of our customers; however we are specifically promoting this new way of paying for energy to those customers currently on prepayment meters, as well as those who pay when they receive their bill.
141. In 2016, E.ON expects PAYG installs to make up [X] % of all our smart installations and in 2017 they will make up [X] %. Our focus in this area has been driven by the market, without any intervention; [X]. E.ON has set the price level for its PAYG product at the level of prices to its direct debit customers. E.ON believes that other suppliers could have built the same business case, however they may have chosen to focus their smart investment in other areas.
142. E.ON would support a remedy which made a focus on customers with prepayment meters a priority in suppliers' roll-out plans; although we believe the market is delivering this anyway, as demonstrated by the focus of our roll-out. We do somewhat regret that this could impact a competitive position that we have taken in the market. E.ON does have concerns with how prescriptive the CMA's proposed remedies are. This is likely to reduce their effectiveness, increase costs and make them less proportionate overall; we outline these concerns in response to the questions below.
- (a) Would this remedy be effective in allowing prepayment customers to engage fully in the market and benefit from a wider range of tariffs? Would it be effective in reducing the costs of supply to prepayment customers?**
143. The PAYG offer that we have already developed opens up all tariffs to PAYG customers and we are able to offer a discount based on the lower cost to serve

of the payment type. This demonstrates that in principle, a smart meter and associated tariff does allow prepayment customers to engage fully and reduce costs.

144. However, the proposed remedy, in particular option b (exclusive focus on prepayment customers) is likely to reduce the efficiency of the roll-out programme and increase costs overall (see response to part b below).

**(b) Which version of this remedy would be more effective and/or proportionate?**

145. Both versions of the remedy, as proposed, present challenges, but these appear significantly greater in option b.
146. Option a (prevent suppliers installing 'dumb' prepayment meters) appears sensible but there may be circumstances where it is not possible to install smart meters, these need to be taken into account by the remedy. For example, we are currently not able to install our PAYG smart meters in flats due to issues with HAN solutions. Until these technology issues are resolved, banning the installation of 'dumb' prepayment meters would not be desirable as it would mean that suppliers would have no mechanism to manage such customers' debt issues, significantly increasing their bad debt risk. Derogation or exceptions would therefore be required.
147. For this reason, any remedy should also require DECC to deliver its solutions (such as alternative HAN) in a timely manner.
148. Option b (exclusive focus on prepayment meters) is unlikely to be proportionate. Prescribing the types of customers that E.ON needs to target is likely to reduce the density of our smart installs. Although there may be some geographical clusters of high density of PPM meters, we would expect that most of our installers' work areas would include a split of PAYG and credit installations. Requiring us to only target PPM replacements would mean that we would lose the efficiency of attempting to install smart meters for all customers in a particular area, which would increase the overall cost of the smart roll-out. We measure installation efficiency in Jobs per Day ("JPD") and our initial view is that the proposed remedy (option b) would reduce the efficiency from [REDACTED]JPD at the peak of the roll-out programme to [REDACTED]JPD. This is likely to increase E.ON's costs by around £[REDACTED]m, a significant cost increase when taking into account we are already prioritising our smart installations towards prepayment customers.
149. It is also important to note the impact on those credit meter customers who are engaged and who want to enjoy the benefits of smart as early as possible. These customers may feel that they are being unfairly penalised as a result of the

proposed prioritisation and there are also significant benefits of installing smart meters for some groups of non-prepayment customers. In a similar manner, any supplier wishing to develop innovative time of use tariffs would be limited in which customers this could be for, until such a time that they had replaced all their prepayment meters and then moved on to replacing non-prepayment meters.

**(c) Would any additional or alternative measures be required to ensure that this remedy comprehensively addressed the overarching feature of weak customer response arising in particular from those with prepayment meters?**

150. As highlighted above, E.ON supports a focus on prepayment meters but does not believe a prescriptive remedy is appropriate, similarly we do not believe the CMA needs to prescribe any additional or alternative remedies.

151. However, national communications activity from organisations such as Smart Energy GB would help ensure any remedy was effective. Similarly, the involvement of local, engaged community groups, such as social housing providers, would increase the effectiveness.

**(d) What issues may arise as a result of prioritising the installation of smart meters in the homes of customers who currently have prepayment meters?**

152. As highlighted in response to (b) above, an exclusive focus on existing prepayment meters is likely to increase the costs of the roll-out across the industry.

153. In addition to the costs identified in (b) above, suppliers would need to shift the focus of their roll-out programme and front load some of the costs. For example, replacing prepayment meters is more complex and costly than replacing credit meters, so these costs would be incurred earlier in the roll-out programme. Similarly, suppliers may need to change their marketing approach as prepayment customers are more likely to respond to more expensive communication channels such as outbound calls and face-to-face appointments, which suppliers may not yet have in place to support the smart roll-out.

**(e) Would it be more effective and/or proportionate to require energy suppliers to accelerate the roll-out of smart meters across the retail markets as a whole, in order to facilitate engagement more broadly, rather than focusing on customers on prepayment meters?**

154. In principle E.ON agrees this would be more effective but in practice there are a number of challenges with the roll-out timescales as they stand. These include delivery of the data and communications network and the Data Communications Company (“DCC”), the availability of Smart Meter Equipment Technical Specifications (“SMETS2”) and alternative HAN solutions, all of which are being delivered by DECC. Therefore we believe it is more proportionate to focus on making sure that all suppliers are active in the short term. Significantly reducing the rollout duration would be extremely difficult, even with significant spend and even a small reduction in time would be expensive. E.ON’s consistent and continuing position has been that we require 5 years from delivery of a successfully operating DCC to effectively achieve a successful rollout at reasonable and proportionate cost for all. We therefore have real concerns, which we are raising with DECC and Ofgem, at the current proposal to reduce the duration of roll-out to four years – even assuming the DCC is now delivered to its revised later target date.

***Remedy 6 – Ofgem to provide an independent price comparison service for domestic customers***

155. E.ON agrees with the CMA that PCWs are an important means by which effective competition can develop in domestic retail markets and has seen the impact of PCWs in terms of increasing transparency in the market to enable switching, with levels increasing from around 16% in 2011 to around 31% in 2014. As such, E.ON believes that PCWs have a vital role to play in the market, and any remedy which impacts PCWs needs to ensure that they can continue to fulfil this role.

**(a) Would this remedy be effective in increasing customers’ trust in PCWs and thereby encourage engagement in the markets and switching?**

156. E.ON would potentially support an Ofgem-run “meta-PCW” in principle, provided that it covered the entire market (see our answer to (d) below) and its purpose was to act as a reference for customers to check prices and quotes, rather than as an alternative switching service. However, we believe that it would be extremely difficult to guarantee a whole of the market price comparison website following the removal of the ‘simpler choices’ component of the RMR rules. Indeed, we are not convinced that it is possible to run a whole of the market price comparison website without weakening Remedy 3 by retaining some restriction on the *form* of tariffs, something we believe would have the overall impact of discouraging engagement in the market (see also our answer to (d) under Remedy 3).
157. If a website were to be introduced, there are a number of considerations that need to be taken into account to ensure that this is as effective as possible and

to remove any negative impacts this might otherwise have. E.ON believes that a “meta-PCW” run independently could provide a trusted information service for many customers, with a resulting increase in engagement and switching. It is interesting to note that some PCWs have carved out for themselves in public perception almost the role of consumer champions, commenting on price changes, criticising suppliers and encouraging switching. It would be instructive to survey customers to see whether they realise that PCWs actually make more money out of more customer switching.

158. Any service would need to be introduced carefully so as to not undermine existing commercial PCWs, either by becoming the default option or by further undermining trust in the existing PCWs if customers see this introduction as an indicator of lack of trust on the part of society/the establishment, resulting in the need to appoint Ofgem as an alternative trusted PCW.
159. As we have made clear earlier in our response (see paragraph 77-79), E.ON does not believe that price is the only factor for customers when assessing tariffs and choosing to act on this assessment. The majority of commercial PCWs include additional information around quality of service (in some form), which is an important aspect and hence this information would need to be included on the independent PCW otherwise it would be less informative than the existing PCWs and could result in customers making choices that are not necessarily right for them.

**(b) Should this service be online-only, or should it also operate over the telephone for those customers without access to the internet?**

160. In principle, should an Ofgem service be created with the purpose of allowing customers to check what they are getting from PCWs, it should match the services offered by PCWs. A telephone option would therefore allow for equivalent access and hence increase the effectiveness of the remedy. This is particularly important for those customers whom the CMA has identified in its customer survey as being both vulnerable and without internet access. However, it is also important to understand the likely cost and funding of such a service. Without better understanding of exactly what form of telephone service would be offered and customer testing around likely uptake, it is hard to form a view on whether or not a telephone option would be proportionate.
161. In addition, as society as a whole moves towards a more digital and online focussed world, it is likely that the requirements for a telephone service will reduce. It would therefore make sense that, if a telephone service were to be included, the effectiveness of this service be monitored and if it no longer delivers sufficient benefit, then the telephone service should be removed.

**(c) Is there a risk that such an independent service could undermine the development of other PCWs in the energy sector? How could this risk be mitigated?**

162. Yes, there is a possibility that a successful Ofgem service could undermine other PCWs, both in terms of reputation/trust and commercially. It is possible that this impact could be mitigated by restricting the scope of the Ofgem PCW, particularly with regards to its ability to transact and a requirement to provide details of the full market. We discuss these further in our responses below.

**(d) Should the Ofgem website quote the energy suppliers' list prices only? Or should it seek to provide full details of all quotes available on the market (including on other PCWs), ie function as a meta-PCW?**

163. E.ON believes that for the Ofgem service to be most effective, it needs to provide full details of all quotes available on the market, including other PCWs. Without such a requirement, we do not see why an Ofgem service would be any more useful or trustworthy than other PCWs.

**(e) How could we ensure that an Ofgem price comparison service was robust in terms of offering all tariffs available on the market? Should there be an obligation on retail energy suppliers and/or PCWs to provide information to Ofgem on their tariffs?**

164. If implemented, the Ofgem PCW should include quotes from across the whole market and hence would need to be able to collect data from suppliers and PCWs. E.ON believes the most effective method for implementing this would be for the Ofgem PCW to interact directly with suppliers' existing quoting tools in a similar manner to how commercial PCWs currently operate in quoting for insurance. Therefore, E.ON does not believe there needs to be an obligation on suppliers to provide all of their tariff information to Ofgem, just to grant access.

165. The more difficult requirement would be for Ofgem to gain the capability to adjust its service rapidly in order to take account of innovations in the form and structure of tariffs. This may be particularly difficult for tariffs that make full use of the data available from the emergence of smart meters.

**(f) Should any price comparison service operated by Ofgem be transactional, ie be able to carry out switches for consumers, or should it provide information only?**

166. E.ON does not believe that an Ofgem service should be transactional as this would likely have a significant impact on the existing commercial PCWs and may result in some of them exiting the market and hence a reduction in competition.

Many customers use PCWs as an information tool, searching for the tariff best for them, before contacting the supplier directly, either through the supplier's website or by telephone. A non-transactional Ofgem PCW would therefore provide a very similar function for those customers.

167. Those customers who currently transact directly through PCWs would have the choice to continue to rely on those PCWs, continuing to trust in the service provided (those who currently use PCWs are confident in their ability to find the right energy deal and make the right switch). Alternatively, should they choose to visit the Ofgem PCW first, they would then have an additional step of going directly to whichever supplier (or PCW) they have chosen.

**(g) What would be the likely costs to Ofgem of offering this type of price comparison service? Would Ofgem need additional funding and/or statutory powers in order to provide this type of service? If so, where should this funding come from?**

168. If the service is restricted to a website and if suppliers are required to provide information in a suitable format then we would expect the operation of such a service to be largely automated, with budget required only for the IT systems and the creation, maintenance and improvement of the service. Should this cost be small in the context of Ofgem's existing budget, it would not be worthwhile creating a new funding stream. If more complex tariffs emerge and the rate of change increases, then the resources required for maintenance and improvement are likely to increase to such an extent that maintaining a market-wide comparison may become prohibitively expensive, significantly reducing the proportionality of this remedy.
169. As discussed in our response to question (b), should the service include telephony, this could result in more significant costs. Without better understanding of exactly what form of telephone service would be offered and customer testing around likely uptake, it is hard to form a view on these costs.
170. E.ON believes that an Ofgem service should be information only and it would not therefore be practical to charge suppliers for acquisitions where the customer had earlier used the Ofgem service. Rather, if this is to be implemented, it should just be charged for as part of Ofgem's overall service costs.
171. Furthermore, the transaction costs of charging individual suppliers separately for their acquisitions would be likely to be high in relation to the cost of operating an online service.

**(h) How should customers be made aware of the existence of this service? Should information be provided by energy suppliers on bills/during telephone calls? Should PCWs be required to provide links to the Ofgem website during the search process to allow customers to cross-check prices?**

172. There needs to be careful consideration of how customers be made aware of the existence of this service. Any mandated advertising of an Ofgem PCW could undermine the ability of commercial PCWs to compete. We would expect the media to make customers aware of the existence of any Ofgem PCW without mandate or expenditure.

173. Mandating commercial PCWs to provide access to (or even recommend) a cross check with an Ofgem PCW would imply that the commercial PCW was not itself trustworthy. It is hard to see how this could increase trust in commercial PCWs.

**(i) Is there any additional information that Ofgem should provide on its website relating to energy suppliers and/or tariffs to facilitate the customer search and switching process?**

174. There is the potential for the site to provide more general information such as how the market works, who are the key participants and what makes up a bill. The site could also provide information on items such as energy efficiency advice, smart meters and their benefits and how to resolve problems with suppliers.

***Remedy 9 – Measures to provide domestic customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information***

175. E.ON agrees that it is essential that customers have access to complete, accurate information that customers are able to understand. A key point of contact with the customer is through their bills and annual statements and hence it is important that these are effective as possible in facilitating their ability to access and assess information.

176. There have been numerous changes to the information provided to customers over the years, some of which have been effective by simplifying the communication and providing clear engagement information such as the “Could You Pay Less?” (“CYPL”) message, but there is still room for improvement in this area. E.ON’s specific views on these are detailed below.

**(a) Does the current format and content of energy bills facilitate engagement by customers? Is there additional information that should be included on bills? Should the quantity of information on bills be reduced to enhance clarity?**

177. E.ON believes that improvements to the current format and content of energy bills and annual statements can be effective at increasing the levels of engagement of customers. Whilst this will inevitably involve some degree of costs to implement, these are likely to be relatively low and hence E.ON views this as a proportionate remedy.

178. Based upon recent market research, E.ON believes that, if the following points are considered when communicating information to customers, then energy bills and other communications can be more effective at engaging them:

- [REDACTED];
- [REDACTED];
- [REDACTED];
- [REDACTED];
- [REDACTED]; and
- [REDACTED].

In general, information should be displayed in a simple format, with not too much detail.

179. Based upon this qualitative market research, customers have advised us that information about payments and energy usage was more important and they felt this should be contained at the front of the bill. Customers skim read the summary to ensure their payments are as they expected, and ignore the detail on their payments and energy usage on subsequent pages unless there is an anomaly. The information that they consider key to switching should be contained all in one place, and, notwithstanding the comments above, their preference was on the last page.

180. Customers also advised that they consider the CYPL message as part of the key information for switching, and, again, therefore their preference was that this is featured on the last page. Following such customer led research to improve communications will ensure that this remedy is effective at reaching as many customers as possible to encourage them to further engage with the market.

181. E.ON would like to see greater clarity around the CYPL messaging, particularly around the ‘narrow and wide’ messages. The narrow message focuses savings to the customer whilst maintaining their current meter type, account management and contract type, whilst the wide message compares to the

cheapest tariff irrespective of these elements. Customers find these two approaches confusing; they don't understand the difference and this is continually raised by customers with our front line advisors. Given that the wide message is likely to provide the stronger signal to customers to engage, we would suggest that the narrow message be removed. In addition, the mandated wording of the CYPL message does not include a clear and strong call to action, and improving this is likely to result in greater effectiveness.

182. The CYPL message is underpinned by the Personal Projections, which are calculated on the assumption that a customer will default on to a variable tariff at the end of their fixed term. This can result in the savings available to a diligent customer being overstated, and risks leading to premature action. However, this is only likely to impact the most engaged customers who seek to switch many months prior to the end of their current fixed term contracts. These customers are likely to actively seek the best price in the market and hence rely less on the CYPL prompt. For those customers towards the end of their contract term, and those currently on SVT, the risk is minimal or non-existent and the CYPL prompt is an effective tool for encouraging engagement. More space is available on the annual statement and an enhanced message could encourage SVT customers to look at potential savings and try out their supplier's web-site (with the hope that this experience would reduce barriers to checking regularly).

183. In addition to the above considerations, the bill needs to meet the requirements of the following regulations:

- Energy UK Code of Practice for Accurate Billing;
- Gas and Electricity supply licence, including RMR and more recent SLC for QR codes ;
- EU Third Directives;
- Industry change (Distribution and Connection Use of System Agreement ("DCUSA")); and
- Gas and Electricity Complaints Handling standards Regulations 2008.

Over the years information has been added to the bill, as part of these new regulations. However, existing information on bills has not been thoroughly reviewed as part of these changes.

184. E.ON had worked hard to simplify our bill, and to keep it to a single sheet of A4 paper, which had been well received by our customers. However, with more and more requirements, both by RMR and other initiatives, such as the requirement to incorporate QR codes, the bill has become increasingly

congested. This has made it more and more difficult for the customer to understand the information and discern what they need from the bill.

185. In light of this, our recommendation would be that an industry review is carried out of the bill to ensure all information is pertinent to the customer and is clear, simple and engaging.

**(b) When customers seek to switch tariffs, are they given enough/too much information on the terms and conditions of their new contract?**

186. Customers are given comprehensive information over the telephone when agreeing to switch tariff or supplier. Some information, for example reading out standing charge and unit rate data whenever a tariff is discussed, is too much information and requires substantial systems investment to help advisors to avoid over lengthy conversations, which struggle to retain a customer's focus. Customers are given either full or subsets (such as key facts) of the full terms and conditions by email or letter (according to their preference) along the switching journey.

187. The Retail Market Review and Standards of Conduct have meant more information is now included in Ts & Cs, resulting in a significant increase of information. Suppliers are required by licence to provide notification of the principal terms to their customers, but the information within this definition is increasing. E.ON would recommend that a full review of this information requirement is conducted to identify if these can be shortened and simplified whilst still retaining essential information.

**(c) Should customers be prompted to read their meters (quarterly or annually), either by information on their bill or by a phone call from their energy supplier? Would this increase engagement by improving the accuracy of billing?**

188. The status of the reading on the bill is currently flagged, e.g. whether the reading is estimated, an actual reading or a customer's own reading. E.ON has a number of mechanisms already in place to prompt a reading which meets our Billing Code obligations. E.ON prompts customers for readings via email, SMS and letters. They can provide these readings to us by a number of channels including online, Interactive Voice Response, the E.ON app or in writing. As such, E.ON does not believe that additional prompts to customers beyond this to read their meters would be effective in increasing engagement or improve accuracy of billing.

**(d) Once customers reach the end of a contract period, should subsequent bills highlight that they have now been moved onto the standard variable tariff and/or other default tariff and encourage them to check whether they are on the most appropriate tariff for them?**

189. Yes; this is already covered by the CYPL messaging, which is included on every bill. This is included on all bills irrespective of whether their existing tariff is coming to an end or has already ended. E.ON does not believe additional messaging on the bill, other than including a call to action within the message, would increase customer engagement (but see also Remedies 10 and 11 for potential communications other than the bill).

***Remedy 10 – Measures to prompt customers on default tariffs to engage in the market***

190. Whilst E.ON is supportive of efforts to engage more customers, and in particular through prompts, E.ON does not believe that a safeguard tariff is necessary, and given that it would be extremely complex to implement (see our response to Remedy 11), we do not believe it would be proportionate. Therefore, any prompts for customers to engage in the market should not result in their moving to a safeguard tariff.

**(a) What information should be included in the prompts to customers on default tariffs in order to maximise the chances that they are acted upon?**

191. Customers already receive CYPL messages on their bills and annual statements and, for customers on default tariffs, this message would highlight any savings that the customer could receive by engaging in the market and switching tariff. E.ON is supportive of efforts to engage more customers, but we are mindful of the risks of irritating customers through too many such messages and hence believe continuing with the CYPL messages (taking into account our comments on Remedy 9) is the most effective approach, although we do highlight some additional options in our response below.

192. Whilst the majority of customers are aware that they can engage with the market by switching supplier, tariff or payment method, those who are less engaged may benefit from additional information in these areas. In addition, some key messages could include:

- Statements about how easy it is for customers to obtain information and look for savings (e.g. via PCWs);
- Statements about the trade-off between engaging and the benefits (e.g. spending 20 minutes could save up to £100);

- Reassurance of what can (and can't) happen in the process (e.g. the customer cannot lose supply); and
- Reassurance to the customer of what different terms mean (e.g. fixed, exit fees and what will happen at the end of the tariff term).

193. This information would provide a balanced prompt to those less engaged customers about the ease and benefits of engaging whilst reassuring customers about potential concerns they may have.

**(i) Should customers who have failed to engage be informed that they are 'no longer under contract for energy', that they have been 'rolled onto a safeguard tariff', or an alternative message, for example, emphasising how many customers in their area have switched in the last year?**

194. E.ON does not believe that informing customers who have not switched and hence default to SVT that they are 'no longer under contract for energy' would be accurate and hence opposes this proposal. All that has ended is the fixed term tariff and such messages could mislead customers into thinking that there is a risk to their energy supply or that they have no obligation to pay.

195. E.ON does not believe that a safeguard tariff is necessary and given that it would be extremely complex to implement (see our response to Remedy 11) we do not believe it would be proportionate. Therefore, any prompts for customers to engage in the market should not result in their moving to a safeguard tariff.

196. However, E.ON does believe that terminology and communications could be improved to provide a clearer call to action for those customers on an SVT. For example, creating an annual renewal date for customers on SVTs (e.g. on the anniversary of their moving to this tariff) could create a pseudo-renewal contact point where suppliers can point out features of their existing SVT tariff (both positive and negative) and other options available. Whilst much of this information is already communicated to customers through their bills and annual statements, a change in style and tone of communication via 'renewal date' could increase engagement.

**(b) How should prompts be communicated to customers? For example, there is some evidence from the financial sector that text prompts are particularly effective at raising awareness in terms of overdrafts etc.**

197. E.ON already uses text prompts for customer service messages, but it is very important that customers expect to receive the message. Unsolicited marketing messages have a very real risk of irritating customers potentially leading to disengagement. In addition, text messaging services have substantial data

requirements in terms of contact details and this would take a long time to build up, require customer consent and come at a cost.

198. Exploring channels other than letters is a sensible approach. For example, to mitigate the risk that disengaged customers do not open the letters they receive from their suppliers and hence miss important informational triggers, a potential option might be to write some key trigger information on the envelopes themselves. This could be simple CYPL message which would then encourage the customer to open the letter and read the greater level of information contained therein.

**(c) What should be the timing and frequency of prompts in order to balance effectiveness in terms of encouraging engagement with the cost and potential irritation that might arise from repeated prompts?**

199. In order to maximise the effectiveness of prompts, the best approach would be to conduct customer research in this area in order to balance the potential benefits and detriments. However, E.ON believes that it is likely that prompts more frequently than quarterly would lead to customer irritation. Options for customers to opt out of prompts could mitigate the risk of customer dissatisfaction but may undermine the effectiveness of the remedy.

**(d) Who should provide the prompts: customers' energy suppliers, Ofgem or another party?**

200. E.ON believes that the most effective approach would be via adjustment to the current communications that suppliers send to customers. However, E.ON notes the success of DECC's advertising campaign in early 2015, which led to a 80% increase in total switching<sup>12</sup>. This suggests that, actually, perhaps all customers need is a nudge from an independent trusted body, here Government.

**(e) Are there particular groups of customers who should receive prompts at specific points? For example, should house-buyers be prompted to engage with the market on completion of their purchase?**

201. Whilst in principle it may be effective to target prompts to specific groups of customers such as house-buyers, this is likely to be impractical. Whilst E.ON does have specific house move channels, not all customers moving house go through these channels, nor are all customers going through the house moves channel actually moving house. Therefore, a specific requirement in this area

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<sup>12</sup> DECC reports that more than £38m was saved by 130,000 households switching energy supplier in just one month of the Power to Switch campaign. <https://www.gov.uk/government/news/millions-saved-in-one-month-as-switching-energy-supplier-rockets>

could be difficult to implement, increasing cost and hence reducing its proportionality.

202. E.ON is making significant efforts to improve customer journeys for home moves, retaining existing relationships with customers and trying to make this less transitory in nature. We are doing this in response to the current competitive pressures in the market, which are likely to increase still further in response to those remedies which the CMA implements. E.ON therefore believes that it will be more effective to allow suppliers to determine how and whom they contact in accordance with our responses to this and other remedies.

**(f) Is there benefit in others in the markets, such as rival energy providers or TPIs, being made aware of which customers remain on default tariffs (or have been rolled on to the safeguard tariff)? In this respect, data protection issues would need to be carefully considered. The ability of other market participants to identify inactive customers, however, has the benefit of potentially encouraging the customer to switch tariffs once out of contract.**

203. No, as E.ON has already indicated, customers on SVT are not an amorphous, homogenous group. Some will have been on SVT only fleetingly, others longer and some a long time; for some it is a positive choice, for others it is, as described here, a default tariff. Whilst sharing this information would allow other market participants to try to engage these customers, E.ON believes that the effectiveness of the remedy would be severely impacted by customers' response to unsolicited calls. Such calls are likely to annoy customers, could undermine trust in what they are being told by their suppliers and would therefore not be effective in increasing the level of engagement. Given the challenges the industry has faced with outbound sales in addition to the data protection difficulties, this option is likely to be difficult to implement well and hence would not be proportionate.

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

204. E.ON opposes the introduction of a 'safeguard regulated tariff' as it is not justified by the evidence (see **Appendix A**) and too complex and with risk of adverse side effects to be proportionate. Setting such a tariff would be extremely difficult with numerous issues, it would have many negative impacts, reducing relevant customer benefits as well as undermining the other remedies proposed by the CMA.

205. The introduction of a safeguard tariff is likely to work in direct opposition to the other remedies which the CMA is proposing. The majority of these seek to address the underlying cause of the AEC described in the CMA findings, namely the CMA's view around disengaged customers. Whilst E.ON does not agree with the CMA findings, it is clear that the introduction of a safeguard tariff is highly likely to increase customer disengagement. The message that customers are to be protected and that they are now 'safe' will discourage those customers who end up on the safeguard tariff from engaging with the market.

206. Further detail of these concerns is given in our responses to the questions below.

**(a) Should the safeguard tariffs be set on a cost-plus basis, or should they be related to other retail prices?**

207. A cost-plus basis is hugely difficult (as detailed in our response to question (b)), but this would seem better suited to an aim to correct for the proposed AEC of SVT prices believed to be being set above a competitive market level for an SVT product. Referencing to non-regulated product prices (if this means non-SVT) would be unworkable due to the frequency of change in these prices.

208. It is unclear what the basis of costs should be. Should the cost basis be calculated as an industry average (we show below that a lower quartile would not be practical), this could lead to suppliers having to supply a domestic customer at a loss given the licence condition (SLC22) which gives suppliers a duty to supply a domestic customer on request. Whilst we accept that this would provide a significant incentive on suppliers to reduce their costs, and the potential headroom in setting the level could mitigate this possibility, this is a potentially significant impact for less efficient suppliers, which could not be immediately remedied.

209. In addition, it is not clear how the different cost basis between suppliers as a result of exemptions to obligations would be addressed. Should the average cost basis include small suppliers who receive this exemption, this would significantly increase the likelihood of the large suppliers who incur this cost having to supply customers at a loss. If small suppliers were not included in the calculation of the cost basis in the area of obligations, then they would continue to receive this cost advantage over the larger suppliers, with the associated distortion in the market.

210. Clearly a whole other raft of questions is raised around what the "plus" element of "costs-plus" should be.

211. It is unclear what the CMA envisages the impact of a safeguard regulated tariff would be on the existence of a “normal” SVT tariff and whether that still exists in this world. The result of this approach would almost certainly distort competition.
- (b) If the safeguard tariffs were set on a cost-plus basis, which approach(es) we should consider to determining the wholesale energy cost element of the tariffs? What are the relative merits of the proposed approach(es) in the context of the purpose of the safeguard price cap?**
212. Determining the approach for a cost-plus basis for the wholesale energy cost element of the tariff would be extremely difficult. It would require a benchmark purchasing strategy to be assumed for both electricity and gas and this would also likely determine the frequency of price changes in the safeguard tariff. In addition this would impact the level of risk that suppliers faced, with the most likely mitigation being suppliers taking all steps to align their hedging approach to that assumed when determining the safeguard tariff.
213. Should a longer hedge be used as a basis for this cost assessment, resulting in greater price stability for customers, this would leave the tariff open to criticism about responding too slowly to price reductions. More significantly, a longer hedge may mean it is difficult for suppliers to mitigate their risk by aligning their hedging profile to the benchmark hedge as they are unlikely to have much certainty as to how many customers they will have on the safeguard tariff over this period, creating a significant volume risk.
214. As the supplier is unable to charge more for the safeguard tariff than the price cap, if they are unable to match the hedge for both cost and volume, they could be forced to sell at a loss, potentially a very large loss if there were volatile wholesale market conditions. During a price spike in the wholesale market, subject to what the safeguard tariff qualifying criteria are, many customers may wish to move on to the safeguard tariff, so suppliers would be in a position of needing to supply a larger volume of customers than they had originally hedged for, at a higher cost base. This impact would be much larger for a supplier with an initial low proportion of customers on the safeguard tariff, due to the larger number of customers likely to move. During a large spike, this behaviour could overwhelm a supplier’s ability to finance its business, resulting in bankruptcy. We would expect this risk to raise the cost of capital and expected return for supply businesses. The magnitude of risks arising from volatility in the wholesale market can be seen in the impact on supplier profitability in 2007 – 2008, but for a full assessment of this risk the CMA should test any proposal against a range of scenarios as well as any review of past patterns.

215. Should a shorter hedge be assumed in the cost base, this could reduce some of the issues highlighted above but would introduce new, equally significant, issues. A shorter hedge may be easier for suppliers to match in the market, but would result in a requirement to change the safeguard tariff price more frequently, resulting in a more volatile price for customers. Should this approach result in quarterly, or even monthly, price changes to the safeguard tariff, this is likely to lead to a poor and confusing customer experience for those customers on this tariff. Most extremely (but we mention it given the focus the CMA has had on this), a “spot” approach to wholesale pricing could result in extreme volatility for customers.
216. It may be difficult to communicate the need for such frequent price changes and would likely result in many more instances where successive price changes were based upon estimates of customer use, with additional complexity if one bill covers more than one price change.
217. Accounting for the cost of ‘shape’ in wholesale energy would also be problematic. Whilst shaped products are available in the market, they tend to have the greatest liquidity closest to delivery, particularly at day-ahead and within-day. As discussed in the CMA’s Provisional Findings, this does not currently cause significant problems for suppliers, who are each comfortable with their own method of managing this risk, but it would prevent the use of real market prices for setting the expected wholesale cost base and a methodology for determining the costs associated with this would need to be developed.
218. In addition, there are a number of costs which are only known after they have been incurred, most notably some obligation costs, Balancing Services Use of System (“**BSUoS**”) and imbalance costs. The difficulties of forecasting imbalance costs are well documented with reference to Ofgem’s former SMI cost index and the criticisms this received<sup>13</sup>. BSUoS and imbalance forecasts are also problematic, particularly given the introduction of the Electricity Balancing Significant Code Review (“**EBSCR**”) which is making changes to the balancing prices over the coming years, as well as the increasing volatility which is in any event expected with the greater incidence of intermittent generation on the system. Suppliers manage these cost inputs to their SVT by forecasting the costs (including networks and obligation costs); in a safeguard tariff Ofgem there would also need to be a process to reconcile for any difference in outturn.

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<sup>13</sup> Ofgem has, of course, now withdrawn the SMI – <https://www.ofgem.gov.uk/electricity/retail-market/monitoring-data-and-statistics/understanding-energy-prices-great-britain/supply-market-indicator>

219. Finally, with the introduction of Electricity Market Reform (“EMR”), there are new obligation costs associated with CfDs and the Capacity Mechanism which will need to be accounted for. The current approach to recovering these costs from suppliers means that this is extremely difficult and could represent a substantial risk to suppliers if this was incorrect.

**(c) Could the imposition of a transitional safeguard price cap result in energy suppliers reducing the quality of service offered to customers on this tariff? Is this risk reduced by customers’ ability to choose alternative, unregulated tariffs?**

220. There is a remote possibility that some suppliers could reduce their quality of service but E.ON believes that this is unlikely. We have seen in the past that customers respond to poor service by leaving a supplier, as expected in a competitive market. We therefore believe that the current drivers for providing good service to remain and those suppliers who did reduce their service level would be punished by customers. In addition, reducing the quality of service may not be compatible with compliance with treating customers fairly, as required under SLC 25C.

**(d) Should all domestic customers on default tariffs be rolled onto the safeguard tariff, or should this remedy only apply to a subset of these customers? If this remedy should not apply to all customers, why? And how should energy suppliers identify those customers who should be covered?**

221. As previously stated, E.ON does not believe that a safeguard regulated tariff is an appropriate remedy as it would be too complex to be proportionate. E.ON believes that competition and markets are the most effective and efficient approaches to deliver the best outcome for customers and hence any intervention in these areas needs to be minimised. This would suggest the remedy, were it to apply, should only apply to a small subset of the market.

222. As previously stated, E.ON believes that it is a policy decision as to whether some customers need further forms of consumer protection, in addition to the protection they receive via competition in the market. If it is believed that they do need this additional protection, we would submit that this could be more simply delivered via Government policy in a similar approach to that already used for WHD.

223. E.ON has made it clear that customers on SVT are not an amorphous, homogenous group, and it would seem counter-intuitive to implement a protection remedy automatically to those customers who are on SVT, as some

will only be on this product for a short period of time before re-engaging and some may well be on this product as a conscious choice. It would also create a massive and difficult to justify intervention and distortion in the market, which could not be proportionate.

224. Applying this remedy to a subset of customers would require suppliers to continue to provide another default SVT. This could then lead to times at which the default SVT could be cheaper than the safeguard price cap (for example, due to differing wholesale purchase timing and so costs), resulting in a very difficult message to explain to customers why they had been moved to the safeguard tariff, when at times this might result in them paying more than the SVT they had been removed from.
225. The treatment of customers on time of use tariffs would also pose a significant problem. There are currently a variety of time of use tariffs (E7, E10, dual-MPAN meters such as Restricted Hours Tariff (“RHT”) and DTS), and there is a lack of robust data on average usage and a high diversity in that usage. These challenges are significant enough that Ofgem has yet to devise a tariff comparison rate (“TCR”) rule for time of use tariffs. This leads to difficulty in determining an appropriate cost base for these customers as well as determining whether they should roll on to the safeguard tariff or stay on their current time of use tariff.

**(e) How should the headroom be calculated to provide the right level of customer protection while not unnecessarily reducing healthy competition?**

226. E.ON does not agree with the CMA analysis which suggests that we are making excessive profits in the supply of energy to domestic customers. We do not agree with the calculation of the prices being around 5% higher than the theoretical “competitive level” and hence do not think the safeguard tariff should be set at a level lower than that currently seen in the market.
227. Without prejudice to the above, should the CMA take the remedy forward, E.ON believes that determining what the headroom should be is extremely difficult. As the CMA has itself noted, there is a fundamental conflict in setting a price cap above the level which it has determined to be competitive. Any reduction in the price of SVT tariffs below that set by competitive forces is likely to result in a reduction in the number of customers who engage and switch and we believe that any such reduction will harm competition. This has led this tariff to be

christened the “Goldilocks tariff” by commentators<sup>14</sup> but the seriousness of the issue should not be underplayed. There have been examples in the past, e.g. the Pool Price cap in 1994-6, where it was suggested that the level at which the cap, in that case on wholesale prices, was set served to deter new entry into the market.

**(f) What regulatory information would be required to set the safeguard tariffs?**

228. Please see our response to (b) for which components of wholesale energy costs are relevant. It is likely that, in order to set this element of the costs, suppliers would need to provide their view on each of these items.

229. For other costs (including forecasts of these), the regulator would need a similar set of information to that which was used by Ofgem in constructing its former SMI, of which the most significant are:

- Network costs: This includes gas network load factors, gas network charges, electricity network charges and BSUoS charges;
- Supplier operating costs: This includes customer service, staffing, IT and calculation of MEA, sales and marketing, billing, metering costs and bad debt costs as well as depreciation and amortisation costs; and
- Environmental and Social Obligation costs: This includes information on Renewable Obligation (“RO”) buy-out and targets, Feed in Tariffs (“FITs”) costs, ECO, WHD, CfDs and Capacity Mechanism costs.

**(g) How long should the safeguard price caps be kept in place? Is it appropriate to include a specific sunset provision, or should there be a commitment to review the need for and level of the safeguard price caps after a certain period of time?**

230. Given our view that a safeguard tariff is not necessary, should one be introduced, E.ON believes that it is extremely important that it is a transitional tariff only. It should therefore have a sunset clause after three years which, given design and implementation, should be around 2020, by which time smart meters should be universal. A full review would need to be carried out, starting at two years.

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<sup>14</sup> Littlechild comments: <http://www.telegraph.co.uk/finance/newsbysector/energy/11724476/Goldilocks-energy-price-limit-doesnt-bear-scrutiny.html> and Bernstein Research

**(h) How frequently – if at all – would the level of the cap need to be reassessed? If the cap is set on the basis of directly passing through wholesale and network costs, then it may not be necessary to revisit the safeguard price level.**

231. Please see our response to (b). Frequency of changing the level of the price cap is largely determined by what assumption around purchasing strategy is made in setting the cost basis for wholesale energy. However, at a minimum, an annual review of other costs would also be required to review the price to reflect expected changes in inflation, network costs and government policy costs. As discussed, there are significant issues with all approaches.
232. Even if the cap is automatically calculated, for example from suppliers' weighted forecast energy costs plus network costs plus other direct cost elements set out in our response to (f) and a gross margin assumption, it still has to be translated into a price. Modifying the SVT to such a structure would be complex for suppliers and confusing for customers. Some rule on frequency of change must be set, which balances avoidance of bill shock (if costs rise), delay to passing on benefits (if costs fall), the costs of administering price changes and the impact to customers from increased frequency of price changes.
233. Frequent changes are also likely to increase PPM charges (only in a pre-smart world) due both to the cost of applying changes and also the consequences of price change messages not being picked up promptly when customers vend.

**(i) Which energy suppliers should be subject to the safeguard cap, and why? Should it be restricted to the Six Large Energy Firms, or should all retail energy suppliers be covered?**

234. E.ON disagrees with the CMA findings that customers are disengaged and that as a result suppliers have unilateral market power resulting in excess profits. However, the underlying concept of the proposed remedy is to protect customers that are disengaged and, in order to be consistent, this logic should therefore apply to all suppliers that have disengaged customers, however this is defined. We also note that the range of SVT prices currently on offer includes higher prices from some smaller suppliers, so existing market conditions would indicate that if any safeguarding is needed, the need for it is not restricted to larger suppliers.

**(j) How should the transition from the current arrangements be managed? We note that an immediate requirement to change the prices for all customers on standard variable tariffs, rollover, evergreen, deemed and out-of-contract tariffs might put pressures on certain suppliers more than others. Should there be, therefore, a period over which the safeguard price cap is phased in? If so, how long should this period be and how should the transition work?**

235. The transition time depends on the design features of the safeguard price cap. Detailed design of the tariff could take significant time, likely requiring substantial further consultation with the industry. Following detailed design, an implementation period would be required to allow suppliers to prepare for the new tariff, followed by a smooth transition which would be a vital component considering the sheer number of customers this could apply to.
236. The time, cost and impact of such a change should not be underestimated. It also should not be forgotten that many customers were very recently migrated under RMR to suppliers' new RMR-compliant tariffs and therefore this is going to signify more upheaval for those customers. This also plays in to the customer communication programme discussed below.
237. If the safeguard tariff is indexed to wholesale energy costs or otherwise can change quarterly or more frequently, systems investment would be required (as well as a major customer communication programme). If the safeguard price cap required changes to payment method differentials, rebalancing of standing charges and unit rates, dual-fuel and on-line discounts, then more time would be required, both to plan and to implement.
238. It is therefore difficult to state with any degree of confidence as to how long the transition should be. Should a final decision to proceed with this remedy take place at the end of 2015, it could take many months to design the tariff and allow an implementation period. It is therefore likely that a transition would not be until 2017 and would then continue through 2017 and 2018.
239. If the design of any safeguard price cap makes assumptions as to the hedging profile used by suppliers, then allowances must also be made for suppliers' existing purchases (as of the date at which the details of any proposal become firm). This would suggest a period of some years for transition. This rather militates against the use of this remedy, given it was apparently itself envisaged as a transitional measure of limited duration, whilst other remedies have their impact. It rather suggests it is not suitable for that task.

**(k) Would energy suppliers have the ability to circumvent the remedy, for example, by encouraging disengaged customers to switch on to less favourable, unregulated tariffs, and how such risks could be mitigated?**

240. This risk is no different to that which exists today – that in a falling market a supplier could inappropriately promote fixed price products – but has an effective deterrent in Ofgem’s enforcement of the Marketing and Standards of Conduct Licence Conditions (SLC25 and SLC25C).
241. If the difficulties associated with customers on time of use tariffs cannot be overcome (see response to question (d)), these would not be subject to the price cap but are protected by the requirement to promote single rate savings on bills and annual statements.
242. It should also be noted that, if one believes the CMA’s own characterisation of these customers as disengaged, it would seem contradictory and counter-intuitive to believe these customers would suddenly become engaged, respond to suppliers and start switching to other tariffs.

**(l) Should the CMA set the level of the safeguard price caps itself, or should it make a recommendation to Ofgem to do so?**

243. Ofgem has the expertise in costs analysis for many of the required components based upon its experience of producing the SMI and it also did a lot of work on price caps in the context of Mr Miliband’s proposal for one to apply, so this is likely to be the most suitable approach. Ofgem would also be best placed to conduct ongoing review of costs and hence of prices. Lastly, there also needs to be potential for the option of appeal to the CMA should the safeguard tariff be set too low.

**(m) Are there any potential unintended consequences of setting safeguard price caps, for example, in terms of their potential impact on the level of other, unregulated tariffs?**

244. In addition to the practical issues that we have highlighted in our response to previous questions in this area, E.ON believes there are numerous and significant unintended consequences associated with the introduction of a safeguard price cap, all of which impact the effectiveness of the proposal.
245. The introduction of a safeguard price cap is likely to work in direct opposition to the other remedies which the CMA is proposing. The majority of these seek to address the underlying cause of the AEC described in the CMA findings, namely that of disengaged customers. Whilst E.ON does not agree with the CMA findings, it is clear that the introduction of a safeguard price cap is highly likely

to increase customer disengagement. The message that customers are to be protected and that they are now 'safe' will discourage those customers who end up on the safeguard tariff from engaging with the market. Further, it is unclear what will happen at the end of the transitional price cap. Will these 'safe' customers then move into the market?

246. Applying a control remedy as intrusive as a regulated tariff is likely to distort competition in the rest of the market, potentially impacting innovation and further working against those remedies seeking to increase competition in these areas.
247. Beyond these high-level fundamental concerns, there are specific elements of the safeguard price cap which could impact customer satisfaction, resulting in further distrust and disengagement. The safeguard price cap will likely result in more frequent price changes for those customers, with a greater reliance on estimated bills, which will be more complex and confusing in their information.
248. A short review period with a short hedge may have adverse effects in the wholesale market, drying up longer term liquidity, potentially undermining the finding that there is no AEC caused by liquidity in the wholesale market. This may in turn add risk to investment in traditional thermal generation assets.
249. Overall, it is clear that the difficulties and downsides to a safeguard price cap make it high risk in achieving its aims of protecting disengaged customers, particularly given that the CMA has significantly overstated the degree of disengagement and associated harm.

#### **4.3. Weak Customer Response and UMP in the Microbusiness retail market**

250. E.ON believes that the supply of energy to SMEs is a market in transition, where increasing competition is demonstrated by the growing level of participants in the market. E.ON has sought to drive greater engagement with SME customers at contract renewal through proactive and clear communications, keeping renewal offers open until the first bill post the end of the contract and through ceasing auto-rollovers. As a result we are not only seeing greater engagement at renewal, but also increased customer satisfaction.
251. E.ON agrees that there is not as much transparency in relation to supplies to SMEs (including microbusinesses) as there is in the residential market. In our Updated Issues Response (para 282-286) we highlighted the greater level of difficulty in comparing offers from suppliers, due to a lack of consistency between suppliers as to their treatment of certain costs. Any remedies need to consider the most effective way of dealing with this issue alongside the difficulty represented by the greater diversity in the SME market.

252. E.ON sees the increasing number and activity of TPIs as a significant improvement in the SME market, helping to engage customers, increase transparency and ultimately increase competition. In our Updated Issues Response, we raised our concerns about the conduct of a small minority of TPIs, potentially undermining trust in TPIs as a whole. Similarly, we stated in the Updated Issues Response our belief that our cessation of auto-rollovers assists customers in comparing different prices. We therefore welcome the opportunity to comment upon the proposed remedies in these areas.
253. E.ON notes the CMA analysis which indicates that a substantial number of microbusinesses appear to be achieving poor outcomes in their energy supply. Whilst it is the case that the profitability of E.ON's SME business is higher than the domestic segment, the SME business carries a number of significant risks which need to be taken into account.
254. We have clearly highlighted above in the section on profitability that the CMA analyses has significant flaws, undermining the validity of the conclusions reached in this area. Given that any remedies that the CMA proposes to introduce need to be proportionate, E.ON does not believe there is evidence to support any substantial or intrusive remedies.
255. The remainder of this section of the response gives more detail on E.ON's view on each of the proposed remedies and associated questions for microbusiness. For the purposes of this response we assume that these remedies are relevant for microbusinesses, defined as a business which has fewer than ten employees and a turnover or balance sheet total of less than €2 million, or consumes less than 100,000 kWh of electricity a year, or consumes less than 293,000 kWh of gas a year.
256. Customers falling into this category are offered electricity and gas contracts on a price book basis, i.e. hedged with prices being updated on a weekly or monthly basis, with costs being calculated on a typical profile class enabling a mass market approach to calculating a price (E.ON does have some microbusinesses in our Corporates business, for which a more bespoke approach is taken).
257. Customers falling outside of this category, (including gas customers consuming >73,200 kWh), are typically priced on a bespoke basis, with each customer having a discrete cost base calculated on their specific demand usage, using half hourly settlement data when appropriate.

***Remedies to facilitate widespread engagement by microbusiness customers******Remedy 6 – Ofgem to provide an independent price comparison service for microbusiness customers***

258. E.ON believes that increasing transparency in the market is an effective way of encouraging those customers who are on default tariffs to engage. Our own customer research has highlighted that microbusinesses prefer to research energy prices on-line and hence we believe that PCWs could play an important role in the market. However, given the current lack of commercial PCWs in this market, E.ON has a view that it is more effective to introduce solutions which enable these to come to the market, thereby creating competitive drivers on both suppliers and TPIs. This would continue the transition that is currently taking place in the market driving through greater levels of competition. [✂].
259. In addition to price, there are a significant number of additional variables that customers use when deciding on supplier and tariff. This makes the use of a traditional PCW approach, focusing on price alone, more difficult and less useful for the customer. It would appear sensible, therefore, to use a slightly different approach which is similar to that used in obtaining insurance quotes. This is a more involved process than a PCW quoting simple energy prices and instead would involve customers applying a more detailed range of search criteria with the PCW using that to link to providers' quoting tools. Commercial PCWs are already experienced in these processes in a range of different markets and hence would be able to bring this to market more effectively than an Ofgem-run "meta-PCW". We discuss this option further in our response below and in our response to Remedy 7a.

**(a) Would this remedy be effective in increasing customers' trust in PCWs and thereby encourage engagement in the markets and switching?**

260. Given the current lack of significant numbers of commercial PCWs in the SME market, E.ON believes that a more effective approach is to use options which encourage these to enter the market and compete. Introducing an Ofgem-run "meta-PCW" would likely create a significant barrier to entry for commercial PCWs as they would have to work very hard to persuade customers to move from such a site to their own.
261. It is extremely important that any such services provide clear and consistent information, reducing the efforts and costs associated with researching prices. E.ON believes that commercial PCWs have more experience in delivering this and greater incentives to innovate in order to produce the most effective outcome for customers. An Ofgem PCW would likely be significantly more

prescriptive and hence hinder innovation in this area to the detriment of customers.

**(b) Should this service be online-only, or should it also operate over the telephone for those customers without access to the internet?**

262. If such a service were to be implemented, E.ON would suggest that it would be more proportional for it only to be an on-line service. As set out above, our research supports the view that microbusiness customers prefer to conduct their research on-line and as a result support for a telephone service will give rise to additional costs that do not necessarily provide any additional benefits for most microbusiness customers. A suitable compromise could be for the site to provide telephone numbers for suppliers to signpost to those customers who wish to discuss their contract.

**(c) Is there a risk that such an independent service could undermine the development of other PCWs in the energy sector? How could this risk be mitigated?**

263. E.ON does have some concerns in this area, particularly given the fact that commercial PCWs are less established in this market than they are in the domestic energy market. Whilst an established PCW may be able to absorb the impact that introducing a new competitor would have, a new entrant to the market would be less well placed to do so.
264. This risk could be mitigated by in effect treating the Ofgem-run “meta-PCW” service purely as a research tool, used as a reference to check prices rather than fulfilling a switch. It would be helpful for consumers if this remedy was implemented together with a confidence code for PCWs, that applied the relevant components of the TPI code for example, which should also provide greater consistency in the information provided to customer and promote better standards and increased trust in PCWs.

**(d) Should the Ofgem website quote the energy suppliers’ list prices only? Or should it seek to provide full details of all quotes available on the market (including on other PCWs), ie function as a meta-PCW?**

265. The publication of full details to allow for more customer specific pricing to be published is more problematic, given the number of variables that are taken into consideration within pricing. Suppliers’ price very differently based upon:
- Consumption;
  - Credit Score;
  - Payment Type and Payment Discounts, Direct Debit, Prompt Payment;

- Pass through of Third party cost elements, e.g. FiTs, RO, EMR, Capacity Charges, Reactive Charges;
- Fully Fixed, Variable, Fixed Energy;
- Contract Length, 1, 2, 3 years, 30 day notice, etc.;
- Rollover contract or default to SVT;
- Other charges / discounts, paperless billing / self-serve, late payment charges, etc.; and
- Time of use, base rate, night rate, evening / weekend rates, summer / winter, etc.

266. In order to provide a trusted reference point, as with insurance PCWs, the independent website will need to ensure that pricing is provided that enables a customer to make a comparison on a like for like basis. For example, there are some products in the market that are described as “fixed”, but contain some variable elements where costs are passed through. The comparison information available needs to clearly highlight these potential differences so that customers when searching can compare on a like for like basis. As a minimum we would support the provision of pricing information by all suppliers for their evergreen tariffs and, for example, a fully fixed one year, single rate tariff, with no pass-through elements. A robust algorithm should be able to achieve this. We anticipate that these prices could represent a ceiling price allowing customers to continue to negotiate.

267. It should also be noted that this service could only be offered to micro-businesses using a profile class for electricity and consuming <73,200 KWh for gas. Customers on half hourly settlement or > 73,200 KWh are priced on a bespoke basis, with costs calculated for each discrete customer on a daily basis. These customers would therefore not be able to access this service. This would include Maximum Demand customers, currently on profile class 5-8, who are about to be migrated to half hourly settlement as part of P272. Should the PCW be able to access the half hourly data, it is possible to use this in quoting services, but this would likely incur considerable additional cost to build access to this data.

**(e) How could we ensure that an Ofgem price comparison service was robust in terms of offering all tariffs available on the market? Should there be an obligation on retail energy suppliers and/or PCWs to provide information to Ofgem on their tariffs?**

268. If the approach taken were similar to how commercial PCWs currently provide service in other markets, by using a search tool that interacts with the existing quoting engines of suppliers (in a similar manner to how we understand the

insurance market works), it would be unnecessary to provide this information to Ofgem. Given E.ON's preference for this approach, we do not believe there needs to be an obligation on suppliers to provide all of their tariff information to Ofgem. The provision of this information would add additional burden to a business and would not in itself improve access to pricing information for customers compared to that which could be delivered via a search tool interacting with quoting engines.

**(f) Should any price comparison service operated by Ofgem be transactional, ie be able to carry out switches for consumers, or should it provide information only?**

269. If such a remedy were to be implemented, it should be non-transactional in order to mitigate the potential impacts on commercial PCWs. This would also have the advantage of preserving the benefits to customers of being able to negotiate discounts with suppliers as it would continue to encourage them to contact suppliers directly for their best prices. Again, our research supports the view that customers research pricing information on-line, but prefer to complete a transaction / undertake negotiation via a conversation rather than continue to transact on-line.

**(g) What would be the likely costs to Ofgem of offering this type of price comparison service? Would Ofgem need additional funding and/or statutory powers in order to provide this type of service? If so, where should this funding come from?**

270. If on-line only, the costs of providing this service should be kept to a minimum, including IT investment to create the website/pricing tables and batch process for suppliers to upload prices on a daily, weekly, monthly basis. Should this cost be small in the context of Ofgem's existing budget, it would not be worthwhile creating a new funding stream. If the cost of the service were significant, this would make the remedy even more onerous, particularly compared to E.ON's preferred approach of a search tool interacting with quoting engines of suppliers.

**(h) How should customers be made aware of the existence of this service? Should information be provided by energy suppliers on bills/during telephone calls? Should PCWs be required to provide links to the Ofgem website during the search process to allow customers to cross-check prices?**

271. If it were to be implemented, there needs to be careful consideration on how customers be made aware of the existence of this service. Any mandated

advertising of an Ofgem-run “meta-PCW” could undermine the incentive for commercial PCWs to enter the market. We would expect the media to make customers aware of the existence of any Ofgem PCW without mandate or expenditure.

272. Mandating commercial PCWs to provide access to (or even recommend) a cross check with an Ofgem-run “meta-PCW” would imply that the commercial PCW was not itself trustworthy. It is hard to see how this could increase trust in commercial PCWs.

**(i) Is there any additional information that Ofgem should provide on its website relating to energy suppliers and/or tariffs to facilitate the customer search and switching process?**

273. There is the potential for the site to provide more general information such as how the market works, who are the key participants and what makes up a bill. The site could also provide information on items such as energy efficiency advice, smart meters and their benefits and how to resolve problems.

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

274. E.ON supports remedies which seek to improve the levels of transparency and information available to customers as this aligns to our own strategy of communicating and engaging with customers, through which we have seen significant improvements in terms of greater levels of negotiation and customer satisfaction.
275. However, given the greater amount of information required by SMEs in order to be able to make the most appropriate decision with regards to tariff and supplier, careful consideration needs to be given to ensure suitable comparison can be made by customers. As such, a more sophisticated approach similar to that used to obtain insurance quotes is likely to deliver a better outcome for customers.

***Remedy 7a – Introduction of a new requirement in the licences of retail energy suppliers to provide price lists for microbusinesses on their own websites and to make this information available to PCWs***

**(a) Would this remedy be effective in increasing price transparency for microbusiness gas and electricity tariffs? Would it serve to make comparisons between different suppliers easier, either directly or by encouraging the development of PCW services for microbusinesses? If not, are there other measures that would encourage this development either as an alternative to this remedy or in conjunction with it?**

276. Simply providing price lists on-line for each supplier would not be particularly helpful or engaging for microbusinesses given the diversity of time of day tariffs, contract lengths and differing pricing approaches adopted by suppliers. This would not necessarily provide any better information than can be obtained through on-line quoting facilities and does not improve a customer's ability to easily compare prices across suppliers.

277. We also have concerns around the competition law implications of providing price lists on-line if these are accessible by our competitors. This would seem a quite unusual step.

278. However, providing price lists to PCWs would encourage the development of their services. It might also improve consistency amongst PCWs' and suppliers' own quoting tools to ensure that quotes are provided in a consistent fashion, for example, by contract length, time of use, payment method, fixed or variable (if pass through), other terms / discounts, etc., to ensure that customers can compare like with like.

**(b) Do microbusinesses have sufficient access to the information they need (for example on their meter types) in order to engage effectively in the search and switching process?**

279. Yes, their current bill / renewal offer letter should provide all the information required to get an accurate quote, including meter details, annual consumption, current tariff and payment method. Should customers move to HH settlement, then it would need to be made clear that they can contact their supplier for their HH data if they wish to use this as the basis for obtaining or negotiating quotes.

**(c) How long should energy suppliers be given to provide the required information?**

280. This information already exists and is provided as per our response above.

**(d) Should energy suppliers be permitted to fulfil this requirement by providing an automated quoting service on their websites (where microbusinesses can put in their details in order to obtain quotes) rather than a list of prices?**

281. E.ON believes that a quoting facility that provides more customer specific pricing information for customers will make pricing comparisons easier. Those quoting tools would then form the information basis for commercial PCWs to use to provide broader market-wide quotes in a similar fashion to the insurance industry. The customer visits the PCW, inputs a set of standardised information which the PCW then uses to access individual supplier (and TPI) quoting services to provide a list of quotes. Indeed, we are already aware of at least one participant in the market seeking to do exactly this.
282. The entry of this type of arrangement with commercial PCWs would likely encourage more and more suppliers to provide their own quoting tools in order to be included within the market-wide search, which would then encourage further commercial PCWs to come to the market. This would increase competition between suppliers and PCWs to the benefit of customers.
283. The experience that existing PCWs have offering this type of service and the incentives they have to continue to innovate and improve their offering mean that they are best placed to provide this rather than an independent Ofgem PCW.
284. However, this information should be provided in a consistent structure with a set of key information required by the customer in order to aid simple comparison between suppliers on a like for like basis.
285. It is also important to note that whilst microbusiness customers use online services for information purposes, many of them prefer to contact suppliers directly over the telephone in order to finalise and transact. E.ON believes this is to their benefit, as the increased information can allow them a greater ability to negotiate in such discussions.

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

**(a) Would this remedy be effective in improving transparency over incentives and trust in TPIs in the energy sector? How could the CMA ensure that this remedy was enforced, ie that TPIs were providing the specified information?**

286. This remedy would be effective, especially when used in conjunction with a TPI Code of Conduct, which we hope Ofgem will expedite. Customers should always be provided, by their TPI, with all key information to allow them to make a like for like comparison, which should also include:

- Which suppliers are being quoted;
- How much is being paid by the customer, via uplift or banded commission; and
- The basis upon which the TPI has made the recommendation, i.e. price, fixed versus pass through, customer service, or other factors.

**(b) What information should be provided by TPIs to microbusinesses in order to enable them to make informed choices?**

287. The following information should be provided:

- The TPI's unique identifier to enable audit of all sales (as controlled via a Code of Practice);
- Consumption, as detailed in the renewal offer letter if available;
- Tariff structure, single, multi rate;
- Payment type;
- Fixed or Pass Through / Variable;
- Rollover contract or default onto a SVT;
- Total suppliers searched;
- Whether they work directly with suppliers or via an aggregator;
- At least three like for like quotes including existing supplier, cheapest, and one alternative;
- Total Commission, including how this is paid, i.e. upfront or over the course of the contract;
- Principal Terms; and
- Total cost / annum.

**(c) Could the provision of certain types of information have unintended consequences (eg customers choosing tariffs based on commission rates rather than total price)? If so, are there any steps that could be taken to mitigate this effect?**

288. Simply providing a quote based upon pence per unit could be misleading if that price excludes elements of the total cost, e.g. RO, FiTs, EMR. The total costs of the contract, including commission, needs to be provided on a like for like basis. In addition, as we move to a potentially more complex half hourly settlement market this may provide the potential for further customer confusion.

**(d) Should the specified information be provided to customers in writing or orally (or both)? At what stage in the sales process should this information be provided?**

289. In writing prior to contract acceptance or verbally (with call recording).

**(e) Should this remedy be introduced in addition to Ofgem's proposed code of conduct? Or should only this remedy (or only Ofgem's code of conduct) be introduced?**

290. This remedy should be introduced in conjunction with Ofgem's Code of Practice which needs to include an audit and self-assessment framework. Customer complaints suggesting a breach of these remedies should be investigated by a Code Manager to ensure compliance of both the TPI and Supplier. E.ON has already adopted safeguards along these lines.

**(f) Are there any additional measures that should be implemented alongside this remedy to enhance its effectiveness?**

291. As above. The E.ON TPI Code of Practice already provides an effective framework for TPIs to operate within, having been implemented in 2012, and hence a similar framework applied to all suppliers would be a sensible approach.

***Remedy 8 – Introduction of a new requirement into the licences of retail energy suppliers that prohibits the inclusion of terms that permit the auto-rollover of microbusiness customers on to new contracts with a narrow window for switching supplier and/or tariff***

**(a) Would this remedy be effective in allowing microbusiness customers greater opportunity to engage (by removing the narrow window in which they can choose not to roll-over automatically)?**

292. This would be an effective remedy. E.ON has expressed to Ofgem previously the view that auto-rollover contracts should be prohibited. Since removing rollover contracts E.ON has witnessed greater engagement amongst SME customers with more than [X]% of customers now actively choosing a contract. However, to be truly effective, this remedy needs to be implemented in respect of existing contracts as well, or otherwise customers will not benefit until 2017 at the earliest and potentially longer if on 2, 3, 4 or even 5 year contracts. In addition, prohibiting auto-rollovers would make comparing contracts on a like for like basis across suppliers easier for customers, thereby enhancing the effectiveness of other remedies which seek to improve the information available to customers.

**(b) Are there any means by which energy suppliers could circumvent this remedy to continue to lock customers into energy tariffs that they have not chosen for extended periods of time?**

293. Suppliers could look to bundling energy with other added value services, e.g. micro-generation, lighting / heating contracts and lock customers into energy contracts for an extended period of time. This approach can sometimes be advantageous to customers, but it needs to be clearly communicated to them if any contract they sign has an associated long-term energy supply agreement. This question also underlines the importance of making the remedy apply to existing contracts, as detailed above.

**(c) What is the minimum or maximum notice period that customers should be required/allowed to give in order to exit a contract that they have been rolled on to?**

294. E.ON would suggest that 30 days, as per current 'notice' periods, would be suitable, subject to assessing the impact of faster switching. This should also apply to 'Deemed' contracts, coupled with extension of suppliers' right to object to transfer where there is an unpaid bill, helping suppliers to mitigate against Change of Tenancy debt and therefore avoid passing on this cost to all Deemed contract customers.

**(d) Should energy suppliers be required to inform customers that they are nearing the end of their contract and prompt them to switch?**

295. Yes, though this could be via renewal offers, as often happens today.

***Remedy 9 – Measures to provide microbusiness customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information***

296. E.ON has sought to drive greater engagement with SME customers through re-design of its SME renewal journey. The majority of business customers are on fixed contracts, and hence a key point of engagement should occur as this contract comes towards its end date. We were the first supplier to put contract end dates on bills in response to customer feedback, which has now been implemented across the market as part of RMR. E.ON has significantly improved its renewal journey, improving the initial offer letter, providing all customers with two reminder letters during their notice period, and following up with an outbound telephone call should customers not respond to this communication. E.ON believes this has been effective at increasing the level of engagement, with an increasing number of customers contacting us at renewal to negotiate their price.

297. It is important to note that the key driver for E.ON with regards to improving customer engagement has been the increasing level of competition in the market. E.ON believes that this trend would continue in the market even without the proposed remedies, but recognises that those remedies which support this transition could have the potential to accelerate this process.

298. In addition, many of the suggestions that we make for improving information for domestic customers apply equally for microbusiness customers, and so we refer back to our responses in this section.

**(a) Does the current format and content of energy bills facilitate engagement by customers? Is there additional information that should be included on bills? Should the quantity of information on bills be reduced to enhance clarity?**

299. For many businesses, bills provide little ability to improve engagement. The critical point for providing transparency and simplicity is at the point of renewal/quote. Removing much of the 'regulatory' information currently contained on bills would reduce the amount of text on bills and may therefore appear to be clearer and simpler to customers.

300. Please see our response to Remedy 9 in the domestic market for further detail.

**(b) When customers seek to switch tariffs, are they given enough/too much information on the terms and conditions of their new contract?**

301. We are currently required to provide customers with too much information at the point of sale. Our experience suggests that this can increase the call time associated with switching for customers with little benefit for them. Whilst it is important that customers are provided with principal terms (as required by licence) in writing prior to agreeing a new contract (as a minimum via email), the information contained with principal terms is increasing. E.ON would recommend that a full review of this information requirement is conducted to identify if these can be shortened and simplified whilst still retaining the essential information.

302. Please see our response to Remedy 9 in the domestic market for further detail.

**(c) Should customers be prompted to read their meters (quarterly or annually), either by information on their bill or by a phone call from their energy supplier? Would this increase engagement by improving the accuracy of billing?**

303. We do not believe that a prompt to read meters would necessarily increase customer engagement but encouraging customers to do so would increase

accuracy of bills which could provide a benefit to them. Perhaps a more important prompt around meters would be an encouragement to install a smart meter, with information on how to do this and the associated benefits.

**(d) Once customers reach the end of a contract period, should subsequent bills highlight that they have now been moved onto the standard variable tariff and/or other default tariff and encourage them to check whether they are on the most appropriate tariff for them?**

304. E.ON agrees that this information should be communicated to customers who have been moved on to an evergreen product and that it would be a useful measure to continue to encourage them to check they are on the most appropriate tariff for them. E.ON actively seeks to engage these customers through outbound calls as well as ongoing prompts via bills.

***Remedy 10 – Measures to prompt customers on default tariffs to engage in the market***

305. E.ON already actively seeks to use prompts to encourage customers to re-engage with the market, both via communications as customers come to the end of their contract, and also once a customer is on a variable tariff. Remedies which support this approach are likely to be effective in engaging customers.

**(a) What information should be included in the prompts to customers on default tariffs in order to maximise the chances that they are acted upon?**

**(i) Should customers who have failed to engage be informed that they are ‘no longer under contract for energy’, that they have been ‘rolled onto a safeguard tariff’, or an alternative message, for example, emphasising how many customers in their area have switched in the last year?**

306. E.ON does not believe that informing customers who have not switched and hence default to an evergreen tariff that they are ‘no longer under contract for energy’ would be accurate and hence opposes this proposal. All that has ended is the fixed term tariff and such messages could mislead customers into thinking that there is a risk to their energy supply or that they have no obligation to pay.

307. For those customers on a Deemed tariff, this message is more appropriate (and required by SLC7.7), but the customer is still in contract, obliged to pay their bills and entitled to the service set out in our Terms and Conditions and ‘Treating Customers Fairly’ statement. E.ON already seeks to contact these customers to switch to a contract that is more suitable for them, and improved messaging may be effective.

308. Similarly, for those customers who have decided to leave a supplier but have yet to switch and hence are on an Out of Contract (“**OOO**”) tariff, this message may be more applicable and may encourage them to finalise their decision and either switch or renew to another contract with their original supplier.

309. E.ON does not believe that a safeguard tariff is necessary and given that it would be extremely complex to implement (see our response to Remedy 11) we do not believe it would be proportional. Therefore, any prompts for customers to engage in the market should not result in them moving to a safeguard tariff if a customer fails to respond to the prompts.

**(b) How should prompts be communicated to customers? For example, there is some evidence from the financial sector that text prompts are particularly effective at raising awareness in terms of overdrafts etc.**

310. E.ON’s preferred method of contact is via bills and renewal/quote communications. Text messaging may work for ‘owner/operators’, but for many small businesses it may not be possible to gain a mobile telephone number for the decision maker, undermining the effectiveness of this approach.

**(c) What should be the timing and frequency of prompts in order to balance effectiveness in terms of encouraging engagement with the cost and potential irritation that might arise from repeated prompts?**

311. E.ON believes that suppliers are likely to put customers defaulting onto SVT / OOC / Deemed rates onto a monthly billing frequency to avoid the likelihood of debt being accrued on the account before the customer takes action. This will also:

- Increase the number of communications to customers; and
- Prompt the customer to give 30 days’ notice;

If a supplier chooses quarterly billing instead, E.ON suggests that the prompts should still be given monthly.

**(d) Who should provide the prompts: customers’ energy suppliers, Ofgem or another party?**

312. E.ON believes the most effective route for communication of such prompts is via energy suppliers. Customers tend to trust their own energy supplier, have established relationships and are more likely to engage with them if the communication is from them. However, as we highlighted in our response to prompts for domestic customers, a Government campaign may also be successful in increasing awareness in the SME market.

**(e) Are there particular groups of customers who should receive prompts at specific points? For example, should house-buyers be prompted to engage with the market on completion of their purchase?**

313. E.ON believes there would be benefits in specifically targeting those customers on either Deemed or OOC products. Whilst this constitutes a small number of customers, the nature of these contracts means that there are greater risks for suppliers in providing them and hence greater costs which can result in higher prices. A clear call to action for these customers would be beneficial both for customers in order to encourage them to seek a tariff which may be more suitable for them, and also for suppliers by reducing the risks associated with these products.

**(f) Is there benefit in others in the markets, such as rival energy providers or TPIs, being made aware of which customers remain on default tariffs (or have been rolled on to the safeguard tariff)? In this respect, data protection issues would need to be carefully considered. The ability of other market participants to identify inactive customers, however, has the benefit of potentially encouraging the customer to switch tariffs once out of contract.**

314. E.ON believes that TPIs are already active in the market, seeking to attract customers, including those on default tariffs. Providing greater levels of transparency in the market and encouraging customers to engage through some of the other suggested remedies, would further increase the likelihood that those customers would switch on to a more suitable tariff for them. Therefore, E.ON does not believe that it is necessary for this information to be directly provided to others in the market. It is also important to note that, without appropriate regulation of TPIs, providing this information would simply be likely to exacerbate the levels of customer complaints from unsolicited approaches.

***Remedy 11 – A transitional ‘safeguard regulated tariff’ for disengaged microbusiness customers***

315. E.ON opposes the introduction of a ‘safeguard regulated tariff’ as it is too complex and risky to be proportionate. Our response to this remedy with regards to the domestic market details these issues, many of which if not all, apply equally to the microbusiness market. Setting such a tariff would be extremely difficult with numerous issues, it would have many negative impacts reducing relevant customer benefits as well as undermining the other remedies proposed by the CMA.

316. E.ON would also highlight that there are significant differences between the types of default tariff that a microbusiness customer may find itself on, namely Evergreen, Deemed or OOC. In practice, the Evergreen tariff is similar in function to the SVT in the domestic market whereas Deemed and OOC have a very specific purpose and are tailored to reflect the risks of those tariffs.
317. Deemed tariffs apply to customers who have not signed up to a contract but consume energy, most typically when such customers move into a new property. Deemed contracts carry a significantly higher level of risk, primarily due to bad debt, as current regulation prevents suppliers from insisting debt is paid before switching. This risk is exacerbated by the associated commodity risks given the limited information on volumes and duration of need of that volume that customer must use. E.ON would advocate that measures to address this bad debt risk to suppliers, and hence cost to customers on Deemed tariffs, would be more effective than seeking even greater levels of protection. Applying a 30 day notice period to such tariffs and allowing suppliers to recover debt when customers leave would mitigate this risk, reduce suppliers' costs and therefore avoid the necessity of passing this cost through to all customers on Deemed tariffs via gross margins.
318. There is a specific licence condition for Deemed tariffs which requires suppliers to ensure that the terms of these tariffs are not unduly onerous (SLC 7) and hence these customers already receive protection from Ofgem's application of this licence condition. E.ON therefore believes additional protection in the form of a safeguard tariff remedy for Deemed tariffs is unnecessary.
319. OOC tariffs apply to customers who have terminated their contracts with their supplier, with the intention of switching to a new supplier, but have yet to do so. E.ON suggests that these customers are not disengaged in that they have made an active decision to leave a supplier, and hence do not need a remedy that provides protection; rather they need a remedy which seeks to encourage them to follow through on their original engagement with the market and decision to switch. This remedy could be a requirement on suppliers to take all reasonable steps to contact such customers (E.ON already proactively seeks to engage these customers as detailed in our Updated Issues Response<sup>15</sup>).
320. OOC tariffs also carry significant bad debt risk as suppliers have no way of knowing when a customer may leave, and they often do so without paying their latest bill (as evidenced by the very high levels of bad-debt write-off – in 2014, E.ON's bad debt write-off was around 26% of revenue in OOC, compared to

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<sup>15</sup> Paragraph 278-279 of E.ON's Updated Issues Response

around 5% for customers on fixed contracts). Similar risks as described for Deemed tariffs around commodity risks also apply. E.ON therefore does not agree with the CMA analysis which suggests that it has market power over these customers and that they are at a detriment as a result.

321. It is unclear how risk is to be managed under the safeguard price cap. Deemed and OOC tariffs are at a higher rate because they price in the risks connected with serving customers who fall within those classes. It would seem unfair to socialise these additional costs across all customers on the safeguard price cap and hence there would need to be a deemed safeguard price cap and an OOC safeguard price cap, as well as an evergreen safeguard price cap.

322. Given these aspects of Deemed and OOC tariffs, E.ON has not considered these tariffs when answering the questions below on the safeguard tariffs for microbusinesses.

**(a) Should the safeguard tariffs be set on a cost-plus basis, or should they be related to other retail prices?**

323. E.ON believes that, should this be implemented, it would need to be on a cost-plus basis.

324. Please see our response to a safeguard tariff in the domestic market for further detail.

**(b) If the safeguard tariffs were set on a cost-plus basis, which approach(es) we should consider to determining the wholesale energy cost element of the tariffs? What are the relative merits of the proposed approach(es) in the context of the purpose of the safeguard price cap?**

325. All the issues that were highlighted in our response to a safeguard tariff for the domestic market apply equally to a safeguard tariff for microbusinesses. However, the process is likely to be even more difficult given the more limited data available to estimate cost of shape, balancing risk etc.

**(c) Could the imposition of a transitional safeguard price cap result in energy suppliers reducing the quality of service offered to customers on this tariff? Is this risk reduced by customers' ability to choose alternative, unregulated tariffs?**

326. It is unlikely that the imposition of a transitional safeguard tariff would result in a reduction of the quality of service as the existing competitive pressures would continue, with customers likely to leave a supplier as the result of poor service. The need to treat microbusinesses fairly would also militate against this. However, it may lead to suppliers reconsidering any wider classifications they

have, for instance E.ON classes all SMEs as microbusinesses. The introduction could lead to this being changed, with the loss of some protections, including ombudsman appeal.

**(d) Should all microbusiness customers on default tariffs be rolled onto the safeguard tariff, or should this remedy only apply to a subset of these customers? If this remedy should not apply to all customers, why? And how should energy suppliers identify those customers who should be covered?**

327. As previously stated, E.ON does not believe that a safeguard regulated tariff is an appropriate remedy as it is neither effective nor proportionate.

328. As we have previously detailed, E.ON does not believe customers on Deemed or OOC contracts should be covered by this remedy. However, it is also not clear that this should be applied to customers on Evergreen products or, indeed, to what sub-set of customers on evergreen products it should be applied. The other proposed remedies which seek to improve some of the features of the market such as transparency, role of TPIs, communication and information and prohibiting auto-rollovers would remove any potential detriment to those customers. E.ON believes that these remedies can be effective and hence remove all need for a safeguard tariff for any group of customers.

**(e) How should the headroom be calculated to provide the right level of customer protection while not unnecessarily reducing healthy competition?**

329. E.ON does not agree with the CMA analysis which suggests that we are making excessive profits in the supply of energy to microbusiness customers. As a result, we do not agree with the calculation of the prices being around 14% higher than the theoretical “competitive level” and hence do not think the safeguard tariff should be set at a level lower than that currently seen in the market.

330. Please see our response to a safeguard tariff in the domestic market for further detail.

**(f) What regulatory information would be required to set the safeguard tariffs?**

331. Please see our response to a safeguard tariff in the domestic market for further detail.

332. However, E.ON believes that producing this information would be much more complex for microbusinesses as few costs are currently allocated robustly in

detail, e.g. to distinguish single rate Profile Class 03 costs from Evening & Weekend Profile Class 03 (or other Profile Classes).

**(g) How long should the safeguard price caps be kept in place? Is it appropriate to include a specific sunset provision, or should there be a commitment to review the need for and level of the safeguard price caps after a certain period of time?**

333. Given our view that a safeguard tariff is not necessary, should one be introduced, E.ON believes that it is extremely important that it is a transitional tariff only. Given the greater diversity in shape of customer demand in microbusinesses, it is likely that a transition towards time of use tariffs is more important and hence the sunset provision should be earlier than in the domestic proposal. This then raises further questions around the proportionality of this remedy.

**(h) How frequently – if at all – would the level of the cap need to be reassessed? If the cap is set on the basis of directly passing through wholesale and network costs, then it may not be necessary to revisit the safeguard price level.**

334. Please see our response to a safeguard tariff in the domestic market for further detail.

**(i) Which energy suppliers should be subject to the safeguard cap, and why? Should it be restricted to the Six Large Energy Firms, or should all retail energy suppliers be covered?**

335. It should very clearly apply to all energy suppliers, if it is to apply at all. Please see our response to a safeguard tariff in the domestic market for further detail.

**(j) How should the transition from the current arrangements be managed? We note that an immediate requirement to change the prices for all customers on standard variable tariffs, rollover, evergreen, deemed and out-of-contract tariffs might put pressures on certain suppliers more than others. Should there be, therefore, a period over which the safeguard price cap is phased in? If so, how long should this period be and how should the transition work?**

336. Please see our response to a safeguard tariff in the domestic market for further detail.

337. Given these timescales, and the requirement for an earlier sunset clause, it does not appear to E.ON that the introduction of a safeguard tariff is feasible or proportionate.

**(k) Would energy suppliers have the ability to circumvent the remedy, for example, by encouraging disengaged customers to switch on to less favourable, unregulated tariffs, and how such risks could be mitigated?**

338. Please see our response to a safeguard tariff in the domestic market for further detail.

**(l) Should the CMA set the level of the safeguard price caps itself, or should make a recommendation to Ofgem to do so?**

339. Please see our response to a safeguard tariff in the domestic market for further detail.

**(m) Are there any potential unintended consequences of setting safeguard price caps, for example, in terms of their potential impact on the level of other, unregulated tariffs?**

340. Please see our response to a safeguard tariff in the domestic market for further detail.

#### **4.4. Settlement**

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

**(a) How long should the parties be given to implement Project Nexus?**

341. E.ON fully supports Project Nexus. The date for full implementation has now moved to 1st October 2016. We understand the reasons for delay but agree with the CMA that implementing Project Nexus is a priority and timescales should not slip any further. For the avoidance of doubt, we would not suggest that the implementation date of Project Nexus should be changed again.

342. We welcome the additional oversight that PWC is bringing to provide assurance that Xoserve is on track to deliver the desired system changes in line with the revised timescales.

**(b) Should the CMA implement this remedy directly (eg via an order and/or a licence modification) or should it make a recommendation to Ofgem to implement the remedy?**

343. The CMA should make a recommendation to Ofgem to implement the remedy. It is important that Ofgem has shared accountability in order for this project to succeed.

344. We agree that a licence obligation is a sensible route to deliver this remedy; however, this obligation needs to be placed on gas transporters rather than

suppliers. This is because Xoserve, which is delivering this project and responsible for the delays, is the agent of transporters.

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

**(a) Is it proportionate to require the mandatory monthly updating of AQs?  
Would it be more proportionate to require less frequent updating of AQs?  
Would less frequent updating still be effective in terms of removing the scope for gaming of the system?**

345. We do not believe that monthly updating of AQs is proportionate. Project Nexus will ensure that AQs are updated whenever a meter read is taken and provided to Xoserve, and AQs can only be updated once meter reads are taken. This remedy therefore requires monthly meter reads which would be expensive, at least until smart meters are installed.
346. Once Project Nexus has been delivered, shippers will pay for the gas consumed by their registered sites (rather than a smeared estimate) together with a proportionate share of unidentified gas. In addition they will receive transportation charges commensurate with that volume (for the bulk of sites this will be proportional to AQ). AQs will still be relevant for transportation costs and as a practical basis, for advising transporters of the volume of gas required in any period; but, overall, AQs will become less relevant once Project Nexus has been delivered. Their accuracy may assist, but does not remove, any shipper's option to input to the system a different volume of gas to that advised by the transporter. Accordingly, post Nexus, we do not believe that monthly refresh of AQs, which may be misaligned with meter readings, is necessarily desirable since the consequences are, at that stage, less significant than under the reconciliation by difference processes currently employed.
347. The key requirement is regular periodic reads ensuring AQs move in line with customer demand levels. We believe the benefits of the proposed remedy could be achieved in a more proportionate way through the introduction of performance assurance to ensure read frequency is appropriate and any delays in read submission are penalised appropriately.

***Remedy 13 - Requirement that domestic and SME electricity suppliers and relevant network firms agree a binding plan for the introduction of a cost-effective option to use half-hourly consumption data in the settlement of domestic electricity meters***

**(a) Would this remedy be effective in stimulating tariff innovation, in particular in terms of time-of-use tariffs?**

348. Tariff innovation should and will be driven by customer demand. Use of half-hourly consumption data in the settlement of domestic electricity meters is likely to facilitate tariff innovation. A plan to move to half-hourly settlement is therefore welcome. However, a binding or mandatory roll-out risks inefficiencies, which could increase costs.

349. We believe the focus of this remedy should be on removing the barriers and reducing the costs of half-hourly settlement (see response below for a discussion of these). We are confident that, once barriers have been removed, the market is capable of delivering this objective more efficiently, driven by demand from customers, alongside the roll-out of smart meters.

**(b) How long should the parties be given to agree this plan?**

350. Although we do not believe a mandatory plan is essential, as industry has been discussing these issues for some time now, we believe a plan could be developed and agreed to within three to six months.

**(c) What are the principal barriers to the introduction of a cost-effective option to use half-hourly consumption data in electricity settlement for profile classes 1 to 4? How could these be reduced?**

351. Principal barriers include capturing, storing and processing the large amounts of data as a result of half-hourly settlement.

352. There are a number of ways these costs could be kept to a minimum. For example, centralised data processing for electricity would deliver economies of scale and keep costs lower, this is the approach used in the gas industry.

**(d) Should the use of half-hourly consumption data in settlement for these profile classes (or certain of them) be optional for energy suppliers, or should it be mandatory? What are the advantages/ disadvantages of each approach?**

353. As highlighted above, we believe the use of half-hourly data in settlement for profile classes 1-4 should be optional. This allows the market to innovate and deliver this solution at a rate determined by customers' demand for new products.

354. We expect half-hourly data to be used in settlement in future for these profile classes but it is possible the market will develop a solution that delivers more innovative tariffs without the need for half-hourly settlement. The market is capable of determining the approach, whereas mandating a solution at this stage risks pre-judging technology developments and could result in forcing industry to incur costs that are unnecessary.

**(e) Are there any distributional considerations that we should take into account in relation to time-of-use tariffs? For example, might vulnerable customers end up paying more if they fail to change their consumption patterns? Or will the decline in the required generation capacity outweigh any increase in peak prices?**

355. There are distributional considerations that need to be taken into account. For example, new technologies such as smart appliances or energy management systems are likely to be needed to allow customers to take full advantage of time of use tariffs. Not all customers will want to install such technology and some customers may not be able to afford it.

356. Therefore we strongly believe that the market should be able to develop these innovative tariffs at its own pace, driven by customer demand. Some customers may prefer not to use time-of-use tariffs and this choice should not be removed by regulations.

357. We would caution against justifying any remedy based on an expected reduction in the cost of generation capacity. These costs are extremely difficult to predict, in any case, the distributional impact would still exist even if the overall costs were lower than they would otherwise have been.

**(f) When should the (optional/mandatory) use of half-hourly consumption data replace settlement based on assumed customer profiles? Is it necessary to wait until 2020 when all domestic customers have smart meters installed? Alternatively, could the use of half-hourly consumption data be phased in for those customers with smart meters prior to 2020?**

358. We believe the use of half-hourly consumption data should be optional and will be developed by the market without the need for dates and targets. Once the smart meter roll-out picks up, before 2020, we would expect half-hourly settlement to be phased in as demand for more innovative tariffs grows.

359. Should the use of half hourly data be mandated, this would be most effective if introduced from 2020 once the smart meter roll-out is complete.

#### **4.5. Quality of Decision Making**

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

360. E.ON has and continues to support Ofgem in its work to continuously improve and develop the efficacy of financial reporting in the form of the electricity generation and electricity and gas supply licences' CSS. In that regard, E.ON believes that, whilst there is scope for improvement, the existing financial

reporting frameworks already give a high degree of transparency and assurance around the profitability of the SLEFs.

**(a) Should the scope of the individual areas reported on align with the scope of the markets as set out for generation and retail supply in our provisional findings? For example, should a requirement to report wholesale energy costs on the basis of standard products traded on the open wholesale markets be imposed?**

361. E.ON believes that the scope of the individual areas reported as set out for generation and retail supply in the Provisional Findings is too limited as it does not include large SME and I&C customers. These customers are included within the scope of the current CSS Financial reporting, and hence E.ON would suggest that this provides a better scope for reporting.
362. However, E.ON believes there are other areas where the scope of the current CSS Financial reporting could be improved. The current scope only covers the supply and generation activities of licensed suppliers and generators. However, small scale generation and generation associated with local supply is authorised by exemption rather than licence, along with some very small scale supply of supply associated with local generation. The generation and supply activities of companies authorised by exemption are not reported. The increasing levels of both generation and supply by companies that are not licensees means that the CSS is only giving a partial picture of a corporate group's total generation and, to a lesser extent, supply activities. E.ON therefore suggests that the current CSS elements of the Generation Licence Condition 16B and the Supply Licence Condition 19A could be improved if it:
- Covered all generation and supply of a corporate group, including non-licensed;
  - Included generation balance sheet information; and
  - Reported the amount of investment in generation over the previous twelve month period.
363. E.ON is concerned that introducing requirements for companies to report wholesale energy costs on the basis of standard products traded on the open wholesale markets risks limiting companies to only trading standard products. This has the potential of distorting competition, liquidity and commercially-driven outcomes. Further, a requirement to report wholesale energy costs based upon a standard product is likely to contain high degrees of estimation in relation to bespoke purchases and thus to mislead. For example, a supply company will have processes and contractual arrangements to manage shape and demand volatility. These will reflect a number of factors such as, but not

limited to, the supplier's own risk appetite in respect of length of hedges and its approach to managing the demand risk linked to the weather. Each of these aspects is significant. To convert them into something they were commercially never intended to be would introduce significant levels of judgement.

**(b) What regulatory reporting principles would be particularly relevant to the preparation of regulatory financial information in this sector?**

364. E.ON would propose several regulatory reporting principles that could be relevant, namely:
- A wider prohibition on cross subsidy between different businesses of the licensee;
  - A prohibition of discrimination in trading of electricity and gas; and
  - All internal procurement from related third parties by supply licensees to be at wholesale market prices.
365. E.ON believes that the three licence conditions (Generation 17A, Electricity Supply 19B and Gas Supply 19B) should be modified so as to provide a wider and more consistent approach to a prohibition on cross subsidy. To achieve this, all licensees should be prohibited from their licenced activity giving any cross-subsidy to, or receiving any cross-subsidy from, any other of their activities or those of their affiliates and related undertakings.
366. E.ON believes that all generation, electricity supply and gas supply licensees should be subject to a prohibition of discrimination in the respective selling and buying of electricity and gas.
367. The Generation Licence Condition 17 "Prohibition of Discrimination in Selling Electricity" already exists, but only a limited number of generation licensees are currently subject to the condition. Further, to help protect small generators in particular; all electricity and gas supply licensees should be subject to a prohibition of discrimination in the buying of electricity and gas.
368. As first raised in our response to Ofgem's June 2013 "Wholesale power market liquidity: final proposals for a 'Secure and Promote' licence condition and Draft Impact Assessment", E.ON advocates a requirement that all internal procurement from related third parties of electricity and gas by supply licensees should be at the price that a corresponding external trade would have taken place.

**(c) Would summary profit and loss account and balance sheet information for each area be sufficient to enable the effective regulation of the sector and the development of appropriate policies? Or should the large domestic and SME energy suppliers be required to collect and submit additional, more granular financial information?**

369. E.ON believes that, whilst there is scope for improvement, the existing set of CSS financial reporting information is largely fit for purpose for regulatory authorities and other interested parties. A minor enhancement to support transparency would be the publication of Supply EBIT net margin percentages within the layout of the CSS profit and loss account (largely to make this more obvious – they can, of course, be calculated currently).

**(d) Should Ofgem require that the summary profit and loss and balance sheet information be audited in accordance with the regulatory reporting framework?**

370. With effect from 2014, existing CSS information is already subject to an audit, through a requirement in the licence that an opinion be obtained that as to the extent to which the Relevant Licensee has properly prepared the Consolidated Segmental Statement in accordance with this licence condition and the Guidelines.

371. The exact wording of the opinion can be found in E.ON's UK Consolidated Segmental Report, for the year ended 31 December 2014<sup>16</sup>. E.ON believes that the scope of this audit already provides adequate assurance over the validity of the CSS financial information. Note that the existing CSS information requirements do not currently include balance sheet information.

**(e) Should this remedy apply to the firms that are currently under an obligation to provide Ofgem with Consolidated Segmental Statements? Or should it apply to a larger or narrower set of firms?**

372. E.ON believes that the existing rules to determine which firms are captured by the CSS reporting requirements are not as appropriate as they could be for securing transparency in the market. We would suggest that all licensed suppliers (electricity and gas) should have to produce and publish a CSS.

373. We recognise that the cost of securing an audit opinion is relatively high for smaller suppliers. We would therefore suggest that the current licence requirement, to include in the CSS a report from an Appropriate Auditor, might

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<sup>16</sup>[https://www.ofgem.gov.uk/sites/default/files/docs/2015/04/links\\_to\\_consolidated\\_segmental\\_statement\\_s.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2015/04/links_to_consolidated_segmental_statement_s.pdf)

be relaxed for suppliers who supply less than 250,000 customers or do not have affiliated generators, perhaps through a simpler audit requirement.

374. Given the transparency already established in the wholesale market, whilst still suggesting the widening of the scope of generators required to produce and publish CSSs, we would suggest that the CSS licence condition only applies to licensed generators that are within corporate groups that include licensed suppliers (electricity or gas).

375. **What would be the costs of imposing such a remedy? We note that some firms' reporting systems are not currently capable of providing information on such a 'market-orientated' basis and that our remedy could require significant additional system requirements.**

376. E.ON's existing Transfer Pricing methodology was reported upon by BDO LLP in their "Ofgem Segmental Statements Review" 16 January 2012<sup>17</sup> and already achieves the criterion of being "market-oriented". E.ON does not believe a more extensive approach, such as looking into and tagging trades entered into by a trading business, is necessary.

**(f) Should the CMA implement this remedy by way of licence modifications or by way of a recommendation to Ofgem?**

377. E.ON has a strong preference for a recommendation to Ofgem. This is so that, as far as possible, full governance is applied to these licence modifications, as should be applied to all licence modifications. Direct licence modifications implemented by the CMA removes the ability of Ofgem to assist in producing a technically robust licence modification and the protection for licensees as to be able to appeal to an independent body, the CMA, if Ofgem's drafting discriminates against particular licensees.

**(g) To what extent should this financial information on performance be published?**

378. E.ON believes that it should be published and that unpublished information inherently would not meet the CMA's stated objective of transparency.

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<sup>17</sup> <https://www.ofgem.gov.uk/ofgem-publications/84249/bdo20report.pdf>

***Remedy 15 – More effective assessment of trade-offs between policy objectives and communication of impact of policies on prices and bills***

**(a) Are such assessments of the impacts of policies on prices, bills and on the trilemma trade-offs carried out to a sufficient extent currently? Are there specific areas where such assessments are not currently carried out, or might be undertaken more comprehensively?**

379. Impact assessments are carried out routinely to justify a particular policy decision. However, it is not clear that the analysis is always sufficiently robust and stands up to independent scrutiny. For example, such assessments typically pick up the direct impacts, normally costs of policy options, but too often fail to take account of the indirect impacts, normally benefits, in a sufficient way. Impact assessments also rely heavily on long term assumptions around counterfactuals that are inherently difficult to predict (e.g. gas prices will go up), a greater focus on policy impacts in different scenarios would be welcome.
380. Policy decision making must take account of the competing factors around affordability, environment and security of supply. E.ON would welcome measures which provide all stakeholders with greater reassurance that the impact assessments carried out are well grounded and that everyone has confidence in them, which leads to outcomes that all can buy into.
381. Impact assessments often focus too heavily on a headline cost or benefit which can often be misleading given the complexities and uncertainties involved. More effective summaries of impact assessments would therefore be welcome.

**(b) Are the assessments sufficiently scrutinised?**

382. It is not clear to E.ON that impact assessments are sufficiently scrutinised. We believe there is not enough independent oversight of the assessments being carried out internally by DECC, and this is an area where there is room for improvement. Better impact assessments will lead to better decision making, and outcomes that work for customers.
383. Therefore it is worth exploring whether there is a role for an independent body or panel of experts to review impact assessments or whether such assessments should be carried out by an independent organisation or panel of experts.

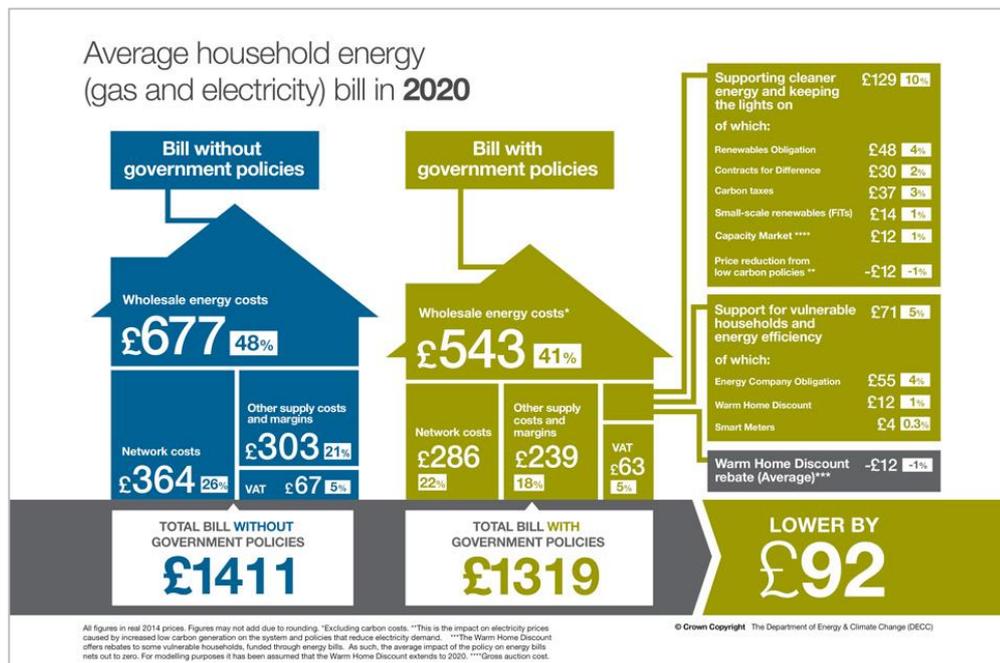
**(c) Are the assessments sufficiently disseminated to interested parties? Which parties need to be informed about these assessments?**

384. DECC publishes detailed impact assessments alongside its policy decisions. Some stakeholders may not be aware of this and may not know where to find

these reports. They follow a standard template which can often be difficult to interpret and understand.

- 385. There is an opportunity to improve the communication of the messages from these impact assessments. For example, it may be worth providing in policy decision documents an executive summary of the impact assessment which can then provide prompts to stakeholders on where to access the main report. Furthermore, clearer referencing of the cost and benefits of policy options should be better reflected in decision documents, thereby helping to justify why a particular choice has been made.
- 386. We would suggest that such impact assessments are not accessible to most consumers. For example, the suggestion that bills will be lower in the future thanks to particular policies suggests that bills will go *down* to most people whereas what it really means is that bills will go up but, with the impact of certain policies, will be lower than they would otherwise have been if those policies did not exist. In other words they are based on a particular counterfactual which is unlikely to be clear to many consumers and is not simply communicated – see example below.

**Figure 1:** Illustration of Policy Impact Assessments



Source: <https://www.gov.uk/government/news/warmer-homes-secure-supplies-and-lower-bills>

**(d) Is there an additional role for either Ofgem and/or DECC in carrying out assessments of the impacts of policies and trilemma trade-offs, or communicating the results of them?**

387. There is certainly a role for DECC and/or Ofgem to carry out impact assessments, this already exists today. E.ON does not believe there is a need for an additional role but we do believe impact assessments could be improved and communicated more effectively, as outlined above.

**(e) Should further, authoritative analysis be published to assist the public discussion? What form might this take? Which existing bodies are best positioned to undertake this role?**

388. As outlined above it is important that stakeholders have confidence in the way that policy decisions are made. Robust impact assessments are an essential tool to help make this happen. E.ON believes there is merit in having an independent body or panel of experts carrying out, or at least reviewing the analysis within an impact assessment. For example, key decisions under the Electricity Market Reform (EMR) policies are reviewed by an independent panel of technical experts. Similar panels could be set up to review impact assessments.

**(f) Is there a sufficient case to justify creating a new, independent body tasked with scrutinising the impact assessments of policymaking bodies and/or providing authoritative analysis to inform the public debate?**

389. E.ON agrees that there is value in having independent, external scrutiny of the impact assessments of policy making bodies. It is important to ensure any remedy in this area is proportionate; it may be that using panels of experts to review or challenge impact assessments would be cheaper than setting up a new body and would achieve the same benefits. A similar approach has been used effectively when making decisions under EMR policies using the EMR Panel of Technical Experts.

***Remedy 16 — Revision of Ofgem’s statutory objectives and duties in order to increase its ability to promote effective competition***

**(a) What specific changes should be made to Ofgem’s statutory objectives and duties in order to ensure that it is able to promote effective competition in the energy sector?**

**(i) For example, would it be possible to revert to the role of competition that existed before the introduction of the Energy Act 2010?**

390. E.ON would suggest that Ofgem’s statutory duty (section 3A(1), Electricity Act 1989) of:

*“protecting the interests of existing and future customers, wherever appropriate by promoting effective competition”*

was sufficient emphasis for them to promote competition.

391. However, this was weakened by the inclusion, by the Energy Act 2010, of a new Section 3A(1C) which provides that, before deciding to carry out their functions in a particular manner with a view to promoting competition as mentioned in subsection (1B), the Secretary of State or the Authority shall consider whether there is any other manner (whether or not it would promote competition as mentioned in subsection (1B)) in which the Secretary of State or the Authority (as the case may be) could carry out those functions which would better protect those interests. This is a clear dilution of the previously stronger competition duty, as was argued to Government at the time.
392. The issue would seem to be in having too much regard to political pressures (for example, in the creation of the RMR reforms or in the case of locational transmission charging). This would be best resolved by clear separation between Government and Ofgem, as proposed in Remedy 17, and also by greater confidence by Government that Ofgem would be effective (and hence that legislation was not appropriate).
393. Subject to the comments made above around the safeguard tariff, E.ON would also expect the findings of the CMA Investigation to have helped clarify that promoting effective competition is most likely to be the best means of protecting consumer interests.
394. In paragraph 198 of the Summary of Provisional Findings, the CMA highlights “simpler choices” as an example of interpreting statutory duties leading to a proposal which was not the most effective at promoting effective competition. We would suggest rather that this was a judgement, with which one may or may not agree, as to how to promote effective competition. “Simpler choices” aimed to reduce barriers to customer engagement; the CMA assesses that it was ineffective in doing this and weakened innovation but that (mis-)judgement would not be affected by the potential remedy.

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

**(a) In which circumstance should Ofgem have the right or duty to express views on DECC’s policies and DECC/Ofgem strategy for their implementation? What format should such views take? Should DECC have a duty to formally respond?**

395. It is important that there is a strong governance process in place that enables the regulator to act and take decisions in an independent way, without fear of repercussions from the government of the day. This will help to ensure that it is able to perform its statutory duty to protect the interests of customers in the most robust way.
396. To ensure that DECC is able to design effective policies to deliver desired government objectives, there may be a role for Ofgem to play in advising how this could best be implemented. However the government will have a democratic mandate from the public, and if they have voted in favour of particular manifesto commitments, it should not be for an independent regulator to challenge the broad aspects of policy. Instead, views should be narrowly focussed on how this can be delivered to best serve the interest of customers.
397. Where Ofgem has expressed a view, as with any other input from stakeholders, it is important that DECC responds with a clear rationale as to why it has decided to take a particular course of action. This of course should be backed up by a robust impact assessment to justify that decision.

**(b) In what circumstances should Ofgem have the right to seek a formal direction from DECC to implement a certain policy?**

398. We do not believe there is a need to change the current arrangements.
399. It is important to retain the independence of the regulator from government in order to effectively perform its statutory duties. The circumstances in which DECC should have the powers to direct Ofgem to implement a specific change should in our view remain narrowly focussed. Strengthening the primary duty of Ofgem to promote competition will help to address some of the concerns set out in the preliminary finding, particularly around the risk of putting undue pressure on the regulator. The principles for DECC to direct Ofgem to take a particular course of action should be based on having democratic legitimacy, and limited to DECC initiating new primary or secondary legislation. In doing so

it will have to justify why it wishes to direct Ofgem to pursue a particular path and Ofgem can only receive and implement that within its statutory duties.

**(c) Would DECC's formal direction undermine (or appear to undermine) Ofgem's independence?**

400. Yes, if DECC were to give direction on a matter which went beyond policy and potentially inhibited Ofgem's action as an economic regulator. However, as set out in our response to Remedy 16, we believe Ofgem's statutory duties do not now give sufficient emphasis to promoting effective competition. A strong regulator will continue to exercise its statutory duties, and even when a government wishes to pursue a particular policy, should resist such pressure if it is not in the interests of customers.

**(d) Would other measures be effective in promoting the independence of regulation?**

401. No. Clarifying the role of the economic regulator to emphasise Ofgem's responsibility to promote competition as a primary objective provides it with a strong statutory foundation for taking policy decisions, and will help promote its independence.

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

402. E.ON is supportive of this remedy. We believe that it would help promote greater consistency of code administration, to allow Ofgem to monitor performance of the code administrators and take enforcement action if necessary. Whilst we do not have a significant issue with how code administrators currently carry out their roles, we recognise that there is still some scope for greater sharing of best practice and that some parties have raised this as an area of concern.
403. We are mindful that different code administrators are appointed in different ways. For example, National Grid is appointed for the CUSC by virtue of its licence. For the Master Registration Agreement (“MRA”), DCUSA, Supply Point Administration Agreement (“SPAA”), Smart Energy Code (“SEC”) and some other codes, a company has been set up which subcontracts the Code Administrator role to another party under tender. Elexon is a subsidiary of National Grid, funded by BSC parties. Therefore, any licensing approach will have to cater for these different circumstances to provide a consistent regulatory framework.
404. Our responses to the specific questions raised on this issue are as follows:

**(a) Is this recommendation likely to result in a positive change in the initiation, development and/or implementation of code changes that pursue consumers' interests?**

405. Although we do not perceive a major issue with code administration per se, E.ON does support this remedy as an appropriate solution to foster greater confidence in the code arrangements. To the extent that these are preventing parties from becoming more engaged in the code change mechanisms then this should be helpful to promote further participation and in turn more innovation in the market arrangements. It is likely to provide specific benefits in terms of improved cross code coordination and more consistency between code change processes.

**(b) Would this remedy be more effective if certain functions currently carried out by code panels and/or network owners (eg setting up working groups) were transferred to code administrators?**

406. The Panels presently set the timetable and Terms of Reference for assessing modification proposals, as well as providing recommendations to Ofgem on whether they should be implemented. The value they bring to the process is an understanding of how complex a change is likely to be and its likely impact on the industry and customers, which in turn influences how it should be assessed. A code administrator may not be able to provide the depth of knowledge that a panel can provide. Therefore, we foresee an enduring role for Panels going forwards.

**(c) Would this remedy be more effective if Ofgem or DECC were to impose stricter requirements relating to the selection (eg competitive tender), financing and/or independence of code administrators (and/or delivery bodies)?**

407. This provision already exists for some codes. Where it does not, such as the administration of the CUSC, it would seem to introduce a layer of cost and complexity for limited potential benefits.

***Remedy 18b – Granting Ofgem more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes***

408. E.ON would be supportive of this remedy provided that sufficient safeguards are in place to ensure that assessment and implementation timescales are developed with full due regard of the impact on customers, market participants and other affected stakeholders. We can foresee circumstances when it would be helpful for Ofgem to take a role in steering a change through the process.

409. This proposal would seem to have a limited effect for some codes where timescales can only be extended with Ofgem's permission, but may be a significant change for other codes.

**(a) Is this recommendation likely to result in a positive change in the development and/or implementation of code changes that pursue consumers' interests?**

410. It will if used in the correct circumstances. To be successful, it is essential that Ofgem fully resources its attendance at code panels and work groups so that it is able to gain a full understanding of the implications of its decisions on the market and ultimately customers. This is a bit patchy at present.

**(b) Would this undermine the principle (and effectiveness) of industry-led code changes?**

411. We do not think this would be a significant issue as long as this power is used sparingly for important modifications only.

**(c) Should this power be limited to the completion of certain elements of the development or implementation phase (eg consultation, setting up working groups)?**

412. It would seem appropriate to apply this power to all of the process. However, Ofgem should be required to consult with Panels and perhaps in some instances with industry parties, where it intends to set challenging timescales for consultation or assessment. The views that it receives should be recorded, for instance in the relevant Panel's minutes.

**(d) Should Ofgem's ability to use this power be limited to defined circumstances (eg modification proposals which are relevant to Ofgem's principal objectives) or should it be left to Ofgem's discretion?**

413. As mentioned above, we believe that this should be used sparingly, not least to ensure that Ofgem has the appropriate resource available to undertake this role. One possible approach would be for this to be limited to modifications which have been raised as a result of the Significant Code Review ("SCR") process.

***Remedy 18c – Appointment of an independent code adjudicator to determine which code changes should be adopted in the case of dispute***

414. It is not very clear what is exactly intended with this particular remedy. Our assumption is that the independent code adjudicator would be introduced to deal with disputes which arise as a result of Ofgem's role being extended in the code process under remedy 18b. If this is the case then we agree that some

form of dispute mechanism should be available to deal with disputes between parties over whether a modification is being progressed or implemented in an appropriate manner.

415. We do not believe that a specific body needs to be set up to undertake such a role as we would expect such instances to occur on an infrequent basis. One approach might be for an independent expert to be appointed to assess the situation under dispute and to make a recommendation as to the appropriate way forward. A similar approach was adopted recently for Project Nexus where an independent consultant was appointed to assess appropriate timescales for its implementation. The CMA could be given the power to appoint such an expert if requested by Ofgem or a code participant.

**(a) Are there benefits in terms of independence, impartiality and/or industry know-how of an independent code adjudicator that are not available with Ofgem, given its other responsibilities, when undertaking the adjudicator role?**

416. Without knowing exactly how it is envisaged this role would operate in the arrangements, it is difficult to comment on this aspect. If the independent adjudicator is intended to also resolve disputes over implementation of modifications under code self-governance arrangements, then there may be a benefit associated with an independent party who can devote resource and knowledge to this task. However, it is not clear that there would be the workload to justify a specific organisation to undertake this role, or that there would be a significant benefit of transferring this responsibility away from Ofgem who should already be impartial and knowledgeable when undertaking this role.

**(b) Would there be unintended consequences, arising for instance from an increased lack of coordination between code modification governance, licence modifications and legislation?**

417. Again, without the greater detail provided on what this role would entail, it is difficult to ascertain whether any particular issues would arise. On a general point, the more fragmented the process becomes in terms of responsibilities, then the greater the risk that unintended consequences and inefficiencies may enter into the arrangements. The key issue will be to ensure that roles and responsibilities are clearly defined and that the appropriate checks and balances are put in place to ensure that decisions are made which deliver real benefits to customers and the efficient operation of the market.

#### 4.6. Remedies not taken forward by CMA

418. E.ON welcomes the CMA's conclusion that remedies a-f are not appropriate and should not be pursued further. The inclusion of these remedies in the document for the purposes of completeness serves to highlight the distortive effect which control based interventions have on a competitive market.

419. E.ON's favoured approach to any remedies implemented would be to focus on encouraging competition to function effectively to the benefit of all customers, regardless of their chosen level of engagement. However, Remedies a-f inhibit effective competition by undermining incentives to engage, and restricting the long term development and innovation required for the Smart future.

420. As defined by the CMA's own guidelines, each of the remedies a-f is not proportionate due to one or several of the following features:

- The remedy is not effective in achieving its legitimate aim;
- The remedy is more onerous than needed to achieve its aim;
- The remedy is not the least onerous if there is a choice between several effective measures; and
- The remedy produces disadvantages which are disproportionate to its aim.

421. As these remedies are disproportionate to CMA's provisional findings, we believe it is unlikely that these remedies would ever represent viable options for the GB energy market.

422. The remainder of this section of the response gives more detail on E.ON's view on each of the remedies a-f and why they are not appropriate for further consideration.

#### ***Remedy a - Price control regulation of all domestic and microbusiness retail energy tariffs***

423. As the CMA have stated, price regulation is generally imposed where the supply structure of a market does not enable competition. This is not the case for the GB market, as confirmed by the CMA in their Provisional Findings.

424. Introducing price control across all of the domestic and microbusiness markets is tantamount to concluding that any form of competition is not the best route for customers and that no other remedies would be effective. It would remove all the existing benefits of competition and restrict any incentives for innovation. Clearly this approach is not at all proportionate to the CMA's findings.

425. Aside from the fundamental proportionality conflict with the CMA's findings, this remedy is also extremely problematic in terms of implementation. Prior to agreeing on the regulated tariff level, the regulator will be required to assess a myriad of different cost components, across a diverse group of suppliers in the market, all with different operating models. Achieving this will be a challenge, let alone getting the level right in the market. Setting the tariff too low would undermine any incentives for innovation. Setting the tariff too high, whereby suppliers are able to offer a lower price than the regulator's reference, would undermine the credibility of the regulatory protection. Regardless of the outcome, it is unlikely that such an exercise will be cost effective or efficient, and this onerous cost will ultimately be borne by the very customers it seeks to protect.

***Remedy b – Requiring energy firms to inform customers about the cheapest tariff on the market (across all suppliers)***

426. It is highly implausible that mandating suppliers to advertise competitor products should even be considered as a possibility in any other competitive market. E.ON agrees with the CMA's conclusion that requiring suppliers to advertise competitors' tariffs would not provide customers with the correct incentives to engage effectively in the market, as they rely on their supplier to engage on their behalf. Therefore this remedy, in addition to the competitive and potential legal issues it creates, would be ineffective in achieving its aim of increasing customer engagement. Other remedies within the CMA's proposals aimed at facilitating widespread engagement are more proportionate to the findings and are therefore more viable options for consideration. We understand that Ofgem plan to publish the market cheapest tariff in their market monitoring report, which should lead to greater media, and hence customer, awareness of the cheapest tariff (albeit only for the average customer).

***Remedy c – Opt-out collective switching of disengaged customers***

427. This remedy fundamentally conflicts with the principle that customers should be able to freely able to choose their suppliers. By attempting to focus on disengagement, customers who choose not to engage and vulnerable customers who are less able to engage would all be captured under the same process.
428. This pseudo-market approach is ineffective in its aim of addressing perceived inactivity, as customers have a process inflicted on them rather than actively engaging in the market. These customers would get a temporary price benefit, but at the cost of an increased risk of poor outcome in the form of confusion,

disruption, transfer errors and poor service arising from a complex, centrally mandated process.

429. Implementing mandatory collective switching would require suppliers to adhere to a specified type and quality of service, undermining incentives for innovation and differentiation of service offering. It is unclear what the perceived financial benefit would be to customers, and as such it is unlikely that the costs of implementing such a remedy would be justified.
430. E.ON therefore agrees with the CMA's assessment that the risk of material detriment to customers and limiting of innovation make this remedy disproportionate to its aim. Other remedies within the CMA's proposals aimed at facilitating widespread engagement are more proportionate to the findings and are therefore more viable options for consideration.

***Remedy d – Introduction of a single price for gas and electricity customers***

431. As discussed earlier in this submission, E.ON agrees with the CMA's provisional finding that the "simpler choices" component of the RMR has given rise to an AEC through reducing retail suppliers' ability to innovate in designing tariff structures to meet customer demand and by softening competition between PCWs. We welcome remedy 3, which addresses this and aims to facilitate more effective competition to the benefit of all customers.
432. Conversely, remedy d would apply greater restrictions on competition and innovation than currently in place by limiting suppliers to just one tariff structure, with no scope for any innovation and differentiation of service offering. E.ON therefore agrees with the CMA's assessment that this remedy would not facilitate the longer term development of competition in the market, nor would it provide any benefits to customers. In summary, this remedy is ineffective, disproportionate to the AEC and produces many disadvantages.

***Remedy e – Introduction of price non-discrimination provisions***

433. Non-discrimination provisions, in the form of SLC25a, have been imposed on supply market in the recent past (2009-2012). Experience and hindsight have shown that this intervention distorted competition, without making any difference to the major issue of BG's relative electricity and gas pricing. In their Provisional Findings, the CMA has commented on the damaging impact SLC25A had:

*"150. Overall, we think it is likely, on the basis of the evidence that we have seen, that SLC 25A contributed to a softening of competition on the SVT, although other factors may also have had an impact. However, since Ofgem*

*has confirmed that this licence condition is no longer in place, we do not consider that it currently leads to an AEC.”*

434. E.ON therefore agrees with the CMA’s view that remedy e would not be effective in its aim of providing a benefit to customers and create a distortion to competition which is not proportionate to the findings. A more proportionate approach is that proposed in remedy 3 which removes such distortive restrictions on competition.

***Remedy f – A transitional safeguard regulated price structure***

435. E.ON agrees with the CMA assessment that this remedy would not achieve its aim of protecting disengaged customers as it would actually require an increased level of engagement to be effective. In addition, mandating the standardisation of tariffs and their structures produces distortions to competition and is more onerous than required. This remedy is therefore not proportionate or effective.

**4.7. Additional remedies proposed by E.ON**

436. Whilst the approach to the remedies has been generally comprehensive, E.ON believes that the CMA has overlooked an opportunity to address distortions arising from the exemptions that small suppliers, with less than 250,000 customers, receive on certain social and environmental obligations. We note that some of the responses from the smaller suppliers appear to confirm our view of this distortion, stating that the exemption impacts them by either slowing down their rate of customer acquisitions to delay surpassing the obligation thresholds, or by being able to offer a lower price compared with other suppliers. We do not agree with the CMA’s provisional conclusion that these exemptions do not give rise to an AEC.
437. As we have previously made clear in our Updated Issues Response, E.ON believes that there is a distortion as the exemption directly reduces a small supplier’s costs and allows smaller suppliers to offer some of the lowest fixed price contracts in the market. This means those customers choosing to be with a larger supplier, including less active customers, end up picking up these costs on behalf of their more active fellow electricity consumers. The CMA’s own analysis draws on DECC’s assessment of a £36/annum impact on the household bill arising from the ECO scheme alone, which would not be applied to tariffs offered by exempt suppliers. This, combined with the impact of exemptions from other schemes, is not an insignificant amount in comparison to the range of potential gains available from switching.

438. We do accept that for some smaller suppliers, the cost of delivering the obligations once they reach the current 250,000 customer account threshold may be high. However, rather than continue with exemptions that distort the market, the CMA should propose a remedy that creates a level playing field for all suppliers and avoids thresholds that create an artificial barrier to growth. This could be done by developing and introducing a buy-out regime to the successor to the current ECO regime from 1 April 2017. Under this reform, all suppliers below 250,000 customer accounts would automatically be able to pay a buy-out price instead of meeting the obligation. Suppliers with greater than 250,000 customer accounts would have the option of whether or not they wish to pay the buy-out on some or all of their obligation.
439. Any buy-out payments made by suppliers would be transferred into a central fund; delivery agents could then tender competitively for these funds and install the associated measures. This market mechanism would encourage the most efficient delivery agents to install more measures and be rewarded for this, whilst providing a low cost but fair way for smaller suppliers to expand. There would consequently be no incentive on smaller suppliers to slow down their growth of acquisition, and once they reach a critical size, would have a process whereby they can continue to keep the cost of compliance with the obligation to an absolute minimum. Furthermore by creating a market via a central fund, it will help to ensure that the obligation targets are met in the most cost effective way.

## Appendix A - Profitability

### A.1 Introduction and executive summary

A.1. In its Provisional Findings, the CMA provisionally concluded that:

*“there is a range of evidence that suggests that average prices paid by domestic customers have been above the levels [it] would expect to see in a well-functioning competitive market.”*

and;

*“[for] SMEs, the evidence suggests that average prices have been substantially above the levels we would expect to see in a well-functioning competitive market.”<sup>18</sup>*

A.2. This is despite E.ON’s average EBIT being only [X] % and the SLEFs combined average supply EBIT being only 2.8%, over the period from 2007 to 2013. These margins are clearly low compared to a range of other companies in comparable sectors, demonstrating that the margins in energy supply are competitive.

A.3. The CMA has not conducted a full analysis benchmarking energy supply profits to other comparable industries, but instead has conducted a number of pieces of analysis focussing only on the energy supply industry, which it relies on to support its provisional conclusions. Whilst making comparisons to other industries does require the evaluation of appropriate adjustments to ensure that the figures are comparable, E.ON believes that completely ignoring these comparisons severely undermines the validity of the work carried out by the CMA around the GB energy supply industry profitability and associated metrics. The much narrower set of analysis relied upon by the CMA comprises:

- An analysis of the ROCE for the SLEFs, which the CMA compares to its estimates of the weighted average cost of capital (“**WACC**”);
- An analysis of “efficient prices and costs”, based on an assessment of reasonably efficient levels of cost and an assessment of a fair ROCE (or “capital charge”);
- A “margin benchmarking analysis” where the CMA compares EBIT and gross margins for energy suppliers to other benchmarks from within the GB energy supply industry; and
- An analysis of average prices, which the CMA notes is still being developed.<sup>19</sup>

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<sup>18</sup> Paragraph 189 of the Provisional Findings summary

- A.4. The CMA's analyses are significantly flawed, for a number of reasons, which together show that these analyses cannot be used to justify the CMA's provisional conclusions.
- A.5. The CMA's ROCE analysis is inappropriate given the asset light nature and other characteristics of the industry. This is demonstrated clearly by the counterintuitive results in the CMA's analysis. The CMA's estimates of an efficient capital base within its analysis of efficient prices and costs is based on some of the same underlying assumptions as the CMA's ROCE analysis. For this reason, the CMA's analysis of efficient prices and costs is similarly unreliable.
- A.6. E.ON also notes that the CMA positions its ROCE and efficient price and cost analysis as two separate analyses, and notes that it gains assurance from the fact that these produce broadly consistent results. However, given that these two analyses contain some of the same underlying assumptions, the CMA is incorrect to view them as separate analyses.
- A.7. Both the CMA's ROCE analysis and its analysis of efficient costs and prices contain further, incorrect or unrealistic assumptions:
- The ROCE analysis for E.ON contains material errors/oversights in relation to the treatment of customer lists, collateral and fixed assets (Property Plant and Equipment ("**PPE**") and Software and billing systems);
  - The CMA's analysis of efficient costs uses unrealistic assumptions and arrives at an unrealistically low figure for the efficient level of costs incurred by GB energy suppliers; and
  - In both of these analyses, these flaws will overstate the degree to which actual profits earned by the SLEFs appear to be above the competitive benchmark which the CMA is using.
- A.8. Finally, in relation to the CMA's margin benchmarking, the CMA has focussed on a narrow range of within industry comparators. In E.ON's view, these provide no reliable evidence that the margins earned by GB energy suppliers are above what would be expected in a well-functioning market. Further analysis that E.ON has conducted shows that margins earned by GB energy suppliers are lower than those earned by a range of comparable firms from other industries.
- A.9. In this Appendix, E.ON presents its high level views on the CMA's analysis, based on the information that can be disclosed to E.ON. However, E.ON's advisors, KPMG LLP ("**KPMG**"), have commented in more detail on the CMA's analysis in

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<sup>19</sup> Paragraph 183 of the Provisional Findings summary

their confidential submission from the CMA's disclosure room between 13 and 31 July 2015 ("the disclosure room"). This response should be read in conjunction with KPMG's confidential submission from the disclosure room. E.ON would also like to reserve the right to make further submissions once it has been able to digest the redacted version of KPMG's confidential submission and the summary report of the work carried out in the recent disclosure room by KPMG.

A.10. The rest of this section proceeds as follows:

- First, E.ON sets out the flaws in the analysis that the CMA has put forward to justify its provisional conclusion that prices in the GB energy supply industry are above what would be expected in a competitive market. Specifically, we discuss:
  - The CMA's ROCE analysis, setting out our concerns and our view that the CMA cannot place any weight on its results;
  - The CMA's assessment of the risk associated with the SME segment, and our concerns that the CMA has not adequately taken into account the higher risk associated with the SME segment;
  - The CMA's analysis of efficient prices and costs, and explain why this analysis is not reliable; and
  - The CMA's analysis of margin benchmarks, explaining why the within-industry benchmarking that the CMA relies on provides absolute minimum margin benchmarks, rather than a fair margin for the GB energy supply industry.
- Second, we set out what in our view is a more reliable basis for analysing profitability in GB energy supply, and provide empirical evidence for suitable margin comparators.

## **A.2 The CMA's analysis cannot be used to support its conclusions on profitability in GB energy supply**

### **A.2.1. The CMA's analysis of ROCE is unreliable**

A.11. The CMA has provisionally concluded that:

*"Out-turn profits for the supply business as a whole were significantly above the cost of capital: the average ROCE was 28% against a weighted average cost of capital of 10%"<sup>20</sup>*

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<sup>20</sup> Paragraph 10.124, Chapter 10 of the Provisional Findings

A.12. In this section, E.ON sets out its views on the CMA's analysis of ROCE, explaining why this analysis cannot be used by the CMA to support its provisional conclusions. Specifically, this section is split into the following parts:

- First, we explain again why a ROCE analysis is inappropriate for examining the GB energy supply industry.<sup>21</sup> We note that the CMA dismissed this view in its Provisional Findings, and so we provide further evidence to show that the CMA was incorrect to do so;
- Second, setting aside E.ON's overall concerns about the inappropriateness of ROCE analysis, we show that the CMA's ROCE analysis is likely to produce unreliable results; and
- Third, we describe some specific issues with the CMA's calculation of E.ON's ROCE.

#### [ROCE analysis is inappropriate for a GB energy supply business](#)

A.13. As explained previously to the CMA, E.ON considers that a ROCE analysis for energy supply is entirely inappropriate, given the asset light nature of the business and other industry characteristics.<sup>22</sup> In this section E.ON shows that:

- This view is supported by academics and other regulators; and
- That the CMA's own results show the inherent unreliability of attempting to use a ROCE analysis for an asset light industry.

A.14. This is in contrast to the energy generation market, where the significant fixed asset base can be valued relatively simply, making it well-suited to a ROCE analysis, as performed by the CMA in Appendix 4.2 of the Provisional Findings.

A.15. E.ON notes the following comments from academics and other regulators, regarding the unreliability of ROCE for asset light industries:

- The Northern Ireland Utility Regulator: *"While network price controls have tended to provide a WACC-based return on assets/historical investment, this conventional approach is more difficult to apply to price controls for businesses with relatively small physical asset bases. As a consequence, regulators setting price controls for retail businesses have placed greater reliance on historical precedent and benchmarking to the margins earned by comparable businesses."*<sup>23</sup>

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<sup>21</sup> E.ON has previously made this point in writing to the CMA. See for example Paragraph 1.2 of E.ON's response to "Assessment of profit margin comparators for the competitive benchmark in GB energy supply working paper" dated 11 May 2015, for the most recent submission on this issue.

<sup>22</sup> Paragraph 1.3 of the ROCE response of E.ON, dated 1 May 2015.

<sup>23</sup> Paragraph 6.2 of the Utility Regulator's Proposals for the 2014 Power NI Supply Price Control, Consultation paper, dated 23 July 2013.

- Lonie et al for Oxera: *“Measuring an appropriate level of profit margins is a difficult process—but where a regulator or competition authority is reviewing an asset-light industry, the alternative route of applying the WACC to the tangible asset base appears likely to underestimate the return required by investors.”*<sup>24</sup>
- Office of Fair Trading commissioned research: *“Where there is poor MEA data in industries with high intangibles and low fixed assets (e.g. trading companies and knowledge-based sectors); or where it is not possible to allocate capital between lines of business, the suggested profitability measure is return on sales or margins, with the benchmark being comparator companies.”*<sup>25</sup>

A.16. E.ON also notes that in other market investigations the CMA (or the Competition Commission (“CC”)) has decided not to conduct a ROCE analysis where the characteristics of the industry imply that its results will be unreliable. In relation to both the CMA’s retail banking market investigation (ongoing) and the CC’s statutory audit market investigation, the CMA decided not to undertake a market-wide profitability assessment. In both cases, the CMA’s decision was based on concerns about the reliability of such an analysis, given the nature of the assumptions that would have to be made.<sup>26</sup> In the case of the statutory audit market investigation, the CMA in particular concluded that a ROCE analysis would be unlikely to be robust enough to be used to draw conclusions, given the importance of the capital base to the ROCE assessment, together with the number of assumptions that would need to be made in undertaking a ROCE analysis for the audit industry.<sup>27</sup> E.ON urges the CMA to take a similar decision in this investigation, and not place weight on the results of its ROCE analysis, given its unreliable results.

A.17. In previous submissions E.ON highlighted three broad reasons why ROCE analysis is unreliable in asset light industries, which the CMA has dismissed in the Provisional Findings. In the next paragraphs E.ON sets out why the CMA was wrong to dismiss these points, showing that E.ON’s views are further supported by the results of the CMA’s analysis set out in the Provisional Findings.

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<sup>24</sup> Last paragraph <http://www.oxera.com/Latest-Thinking/Agenda/2014/Something-for-nothing>Returns-in-low-asset-industr.aspx>.

<sup>25</sup> Figure 1.2 page 10 of Assessing profitability in competition policy analysis, A report prepared for the Office of Fair Trading by Oxera, dated July 2003.

<sup>26</sup> Paragraphs 25 and 26 of the Updated Issues statement, for the Retail banking market investigation, dated 21 May 2015; Competition Commission Audit Market Investigation – see for example paragraph 69 of Profitability working paper– part one, dated 3 October 2012.

<sup>27</sup> Paragraph 69 of Audit inquiry Profitability working paper– part one, dated 3 October 2012.

*ROCE is unreliable for industries with a low physical asset base compared to their operational costs*

- A.18. In response to the CMA's ROCE working paper, E.ON explained that GB energy supply businesses have a low physical asset base compared to their operational costs. As such, most expenditure is not capitalised on to the accounting balance sheet and the capital employed element of the ROCE appears low.<sup>28</sup> This low asset base in the reported balance sheet does not fully capture the level of capital investment that the firm has made in intangible assets.<sup>29</sup>
- A.19. In the Provisional Findings, the CMA recognises the need to ensure that all the capital employed by firms is identified and included in its analysis. It concludes that it has included the relevant assets in its analysis.<sup>30</sup>
- A.20. E.ON disagrees with the CMA's conclusion that it has appropriately included all of the assets relevant to GB energy suppliers in its analysis, and this is demonstrated by the results of the CMA's ROCE analysis:
- The output EBIT margin implied by the CMA's capital estimation is 1.3%<sup>31</sup>. This is below several benchmark margins that the CMA itself acknowledges are competitive and/or lower risk than SME/domestic supply, such as the margin in the I&C segment of energy supply of 2.0%<sup>32</sup>. The CMA therefore proves, through its own analysis, that the amount of capital that it has estimated in its ROCE analysis is too low;
  - There has been no attempt by the CMA to MEA uplifts to any of the book values for E.ON's fixed assets. For example, the PPE and Billing systems are all held at book value; and
  - The variability in the capital employed in E.ON's ROCEs across the period is implausible, as set out further below.

*Difficulties in valuing a largely intangible asset base leads to unreliable results*

- A.21. Calculating a firm's ROCE requires estimation of the MEA value of the firm's assets. As E.ON has previously submitted to the CMA, when this asset base is largely intangible, the ability to do this in a robust manner becomes limited, resulting in statistically questionable results. For example, volatile and nonsensical outputs such as negative return on capital employed figures.<sup>33</sup>

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<sup>28</sup> Paragraph 2.1 of the ROCE response of E.ON, dated 1 May 2015

<sup>29</sup> Paragraph 2.4 of the ROCE response of E.ON, dated 1 May 2015

<sup>30</sup> Paragraph 20 of Appendix 10.3 to the Provisional Findings

<sup>31</sup> Paragraph 10.39, Chapter 10 of the Provisional Findings

<sup>32</sup> See for example para 10.96 of chapter 10 to the Provisional Findings

<sup>33</sup> Paragraphs 5.1 and 7.2 of the ROCE response of E.ON, dated 1 May 2015

- A.22. The CMA considers that a low asset base does not, in itself, make ROCE analysis less meaningful.
- A.23. E.ON considers that low asset base industries are more likely to have a high level of intangible assets, which are more difficult to quantify in a robust manner. Further, the impacts of any assumptions and inaccuracies in the capital base estimation have a larger impact on the out-turn ROCE, simply as a product of the low value of the denominator in the ROCE calculation, as acknowledged by the CMA:

*“...for an asset-light business, the required margin is sensitive to small absolute changes in capital employed.”<sup>34</sup>*

- A.24. This is demonstrated by the volatility in the ROCE outputs for E.ON over time. For example, the range of [X] percentage points presented in the CMA’s ROCE working paper<sup>35</sup> arises as small changes in capital employed have large implications for the output ROCE. This demonstrates the inherent unreliability of ROCE analysis in asset light industries.
- A.25. Further, the CMA’s average figures disguise an enormous amount of variability in the underlying data: for E.ON, the CMA calculated ROCEs that varied by [X] percentage points across the years. The standard deviation of the CMA’s sample average was [X]%.<sup>36</sup> This significant volatility casts significant doubt on the reliability of the CMA’s analysis, undermining its ability to place weight on its results.

*Analysis of other firms demonstrates that ROCE is inappropriate for asset light industries*

- A.26. In previous responses to the CMA, E.ON performed a desktop ROCE analysis for a sample of asset light firms, operating in sectors for which there is no evidence to suggest are anything other than competitive. Similarly high ROCEs are found for these sample firms as those calculated by the CMA for the GB energy supply industry. As E.ON has explained previously, this highlights that ROCE is not an appropriate method for estimating the profitability of asset light industries.<sup>37</sup>
- A.27. Obviously E.ON was using purely publicly-available information, not being privy to the type of additional data that the CMA has been able to request as part of this Energy Market investigation. The CMA dismissed the ROCE analysis on

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<sup>34</sup> Paragraph 10.97, Chapter 10 of the Provisional Findings

<sup>35</sup> Paragraph 5.2 of E.ON’s response to the retail supply profitability ROCE response, dated 1 May 2015

<sup>36</sup> *Ibid*

<sup>37</sup> Table 1 and 2 of the ROCE response of E.ON, dated 1 May 2015

other firms submitted by E.ON, arguing that E.ON did not seek to adjust for the intangible assets in these other firms, which the CMA had done in its ROCE analysis of the GB energy supply industry.<sup>38</sup>

- A.28. E.ON disagrees with the CMA that this is a valid reason to dismiss the relevance of comparisons to firms in other industries. In its analysis, the CMA has reduced E.ON's own reported balance sheet by approximately 50%. In other words, the CMA's adjustment to E.ON's capital base has been to reduce the overall capital employed, compared to the reported accounting values, rather than uplift the value. If a similar adjustment was made to the balance sheets of the comparator firms E.ON previously used, the ROCE estimates for these comparator firms would only increase. Therefore, using the CMA's assumptions, the ROCE results previously presented by E.ON for these comparator firms could be viewed as, if anything, conservative. As a result, E.ON reiterates that the fact that such high ROCEs can be estimated for these comparator firms (for which there is no evidence to suggest operate in anything but competitive industries) continues to provide a good illustration that ROCE analysis is simply inappropriate for asset light businesses.

*Conclusion on the use of ROCE analysis in asset light industries*

- A.29. Overall, E.ON concludes that there is considerable evidence demonstrating the inappropriateness of ROCE analysis for GB energy supply businesses, from academics, other regulators, other CMA investigations and the CMA's own ROCE results. As a result, the CMA should not continue to pursue and rely upon this flawed analysis, nor place any weight on its results in its Final Report.

The CMA's ROCE analysis is based on assumptions that are likely to produce unreliable results

- A.30. Setting aside our concerns about the inappropriateness of ROCE for analysing the energy supply business in GB, in this section we set out some further flaws in the CMA's methodology that mean it is likely to produce unreliable results. This undermines the CMA's ability to put weight on the results of its ROCE analysis for its analysis of the profitability of the GB energy supply industry.
- A.31. The CMA provisionally concludes that out-turn profits for the supply business as a whole were significantly above the cost of capital. This conclusion is based on the CMA's analysis of an average ROCE, compared to the WACC, across the SLEFs.<sup>39</sup>

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<sup>38</sup> *Ibid.*

<sup>39</sup> Paragraph 10.124, Chapter 10 of the Provisional Findings.

- A.32. E.ON notes that the CMA performed sensitivity analysis for its average ROCE figure where it removes the two least profitable of the SLEFs.<sup>40</sup> The CMA does not provide a strong justification for removing these firms. Furthermore, the CMA does not consider the impact on its average figures of other outliers in the data – Centrica and Scottish Power. According to the CMA, Centrica generates 57% of the profits in excess of the cost of capital, and E.ON considers that removing Centrica from the average ROCE calculation is likely to reduce the average ROCE over the period.<sup>41</sup> A finding of average excess industry profits cannot be supported if this is largely driven by just one firm.
- A.33. A further issue relates to the time period of the CMA’s analysis. The CMA has data for 2007 and 2008, yet it focuses on the 2009 – 2013 time period. E.ON considers that the longer time period (2007 – 2013) would afford the CMA the opportunity to capture more of the full economic cycle than the shorter 2009 – 2013 time period. The CMA states that “competitive conditions changed significantly around 2009”<sup>42</sup>, but E.ON considers that it is appropriate to nevertheless consider a time period that captures more of a full economic cycle”.

*Conclusion on the reliability of the CMA’s results*

- A.34. E.ON considers that the CMA’s ROCE analysis is likely to be statistically unreliable for at least two reasons. First, the CMA’s analysis fails to consider the impact of two outliers in the data, one of which even the publically available information suggests is driving the CMA’s results. Second, the CMA does not consider a sufficiently long time period, to capture the full economic cycle. Overall, these concerns cast significant doubt on the reliability of the CMA’s ROCE analysis and the ability of the CMA to place weight on its results.

*The CMA has made errors in measuring E.ON’s ROCE*

- A.35. In this section, even setting aside the concerns that E.ON has set out so far in relation to the appropriateness and reliability of the CMA’s ROCE analysis, E.ON sets out some material errors in the CMA’s analysis of E.ON’s ROCE.<sup>43</sup>

*The CMA has significantly underestimated the replacement cost of customer relationships*

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<sup>40</sup> Paragraph 10.126, Chapter 10 of the Provisional Findings

<sup>41</sup> Table 10.2 of Chapter 10 of the Provisional Findings

<sup>42</sup> Paragraph 10.6, Chapter 10 of the Provisional Findings

<sup>43</sup> Note, this is not a complete list but rather picks up the most significant errors. E.ON has previously commented on specific errors by the CMA in its ROCE analysis in the Appendix to E.ON’s ROCE paper, dated 1 May 2015.

- A.36. First, the CMA has significantly underestimated the replacement cost of customer relationships. The CMA's estimate previously valued the overall replacement cost of one of E.ON's existing customers at £[REDACTED] per product account.<sup>44</sup> E.ON considers that this is a substantial understatement of the true replacement cost.
- A.37. The CMA has adopted a bottom-up cost methodology which is intended to estimate the replacement cost of the customer base. In assessing the relevant costs, the CMA has only included the marginal, direct costs of acquiring customers, such as broker fees and face-to-face sales channels. However, as well as the direct cost of the sales channels, there are also costs of managing those specific sales channel activities, costs of onboarding, costs of administering "early" losses (say within 6 months) and also ongoing retention costs, none of which have been captured by the CMA's analysis. The result is a significant understatement of the replacement cost of customer relationships.
- A.38. E.ON suggests that the CMA could sense check the value that it has assigned to each existing customer by:
- Comparing the cost per customer from recent customer acquisitions in the market, to the £[REDACTED] per product account estimate. For example, Utility Warehouse recently paid approximately £270 per customer for 800,000 customer accounts from NPower;<sup>45</sup> and
  - Performing a calculation of the net present value ("NPV") of the average customer, which would provide a good indication of the cost required to acquire a new set of customers. This would involve; taking an assumed energy bill price, calculating an annual profit by applying a pre-determined "fair" margin to this price, discounting this value over this remaining period using an appropriate discount rate and then applying an appropriate amortization period.
- A.39. E.ON considers that both of these sense checks do/would demonstrate the size of the CMA's understatement of the replacement costs of customers.
- The CMA has underestimated the Value to the Business ("VTB") of E.ON's PPE and Software/Billing systems*
- A.40. The CMA has underestimated the VTB of E.ON's PPE and Software/Billing systems. This is demonstrated by:

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<sup>44</sup> Paragraph 4.4 of E.ON's response to the CMA's ROCE paper, dated 1 May 2015

<sup>45</sup> *Ibid*

- PPE: E.ON's freehold property is held in a separate legal entity. Consequently, the value to the business of E.ON's PPE was not reflected in the balance sheets submitted to the CMA. The market value of this property is approximately £[REDACTED]m.<sup>46</sup> Further, E.ON asserts that the property costs in the P&L would need to remain therein as a proxy for the depreciation charge on the freehold property; and
- Software/billing systems: The accounts of British Gas Trading Limited at 31 December 2013 (the entity in which it runs its Residential and Business energy businesses) contains software with an original cost of just over £1bn and a net book value of just over £0.5bn. Whilst the scale of E.ON's systems would be smaller (by virtue of number of customers), these figures are significantly larger than the intangible software figures used by the CMA in E.ON's capital employed.

*The CMA's analysis of collateral is not based on reliable evidence*

- A.41. The CMA has devised an approach for evaluating the cost of collateral, basing all of its conclusions, prima facie, on a single example being the nature of the arrangements between First Utility and Shell.
- A.42. Given that Shell is reported to hold warrants which would give it up to an 8% stake in First Utility<sup>47</sup> if specific value thresholds are met, E.ON is uncertain if the trading and collateral arrangements referred to by the CMA would necessarily represent an entirely arms-length deal. Further, E.ON considers that the trading fee charged would be dependent on the prices, risks and terms of the specific contract. E.ON has not been provided with the details of these terms and cannot therefore assess how this fee might differ for a stand-alone provider with individual requirements, similar to those of E.ON's GB energy supply business.
- A.43. Given that E.ON has already previously submitted extensive information to the CMA regarding its own collateral costs,<sup>48</sup> it would encourage the CMA to utilise this information in arriving at an assessment of collateral costs and capital employed. During the course of consulting about the methodology for collateral information, the CMA made enquiries concerning a number of different types of collateral (contingent collateral, risk capital, notional capital and regulatory collateral) all of which appear to have been dismissed in favour of the single First Utility / Shell example.

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<sup>46</sup> This compares to a range of £[REDACTED]m to £[REDACTED]m in E.ON's submitted balance sheet.

<sup>47</sup> <http://news.sky.com/story/1518672/first-utility-targeted-by-500m-cvc-bid>

<sup>48</sup> See for example, E.ON's collateral submission on 30 January 2015 - "S58 Follow-Up"

- A.44. E.ON would encourage the CMA to continue to explore the various elements of collateral and risk, to complete these elements of capital employed with figures that represent what E.ON actually incurred, rather than using a single benchmark arrangement relevant to another company's circumstances and aims. It is likely that the figures actually incurred by E.ON would represent a floor value, with the strength of E.ON's parent company's credit rating decreasing the need to put up collateral, and increasing opportunities to trade bilaterally.
- A.45. E.ON would expect that the economic return of a business to be assessed on the basis of all costs incurred and therefore include, as a point of principle, the costs of exceptional items. The only correct exclusion would be for the mark-to-market valuation adjustments relating to derivatives, which have been separately identified within the profit and loss information submitted to the CMA.

#### *Conclusions on the errors in measuring E.ON's ROCE*

- A.46. The CMA's analysis of E.ON's ROCE will overstate its ROCE, as the CMA has not appropriately valued E.ON's capital employed. Specifically, the CMA has materially understated the replacement cost of customers and the VTB of E.ON's PPE and Software/Billing systems. In addition, it is not clear that the CMA's valuation of collateral costs is reliable, given the evidence on which it appears to be based.

#### **A.2.2. The CMA's analysis of SME risk**

- A.47. E.ON is concerned that the CMA understates the risks of supplying SME businesses. Differences in risks that are not accounted for in the CMA's analysis mean that comparisons across different segments of the energy supply industry are unreliable.
- A.48. The CMA appears to provisionally conclude that the SME segment may to some extent involve greater risks than the domestic segment, but also states that the SME segment is no more risky than the I&C segment, noting that:

*"we were not convinced that bad debt risk was intrinsically higher for SME customers"*

[and that]

*"we agreed that in theory the SME and I&C business was likely to be more exposed to the economic cycle than domestic customers and we took this into*

*account in estimating the required WACC for the GB energy business as a whole.”<sup>49</sup>*

A.49. In E.ON’s view, the risk associated with the SME segment is greater than both the domestic and I&C segments, and this has not been taken into account in the CMA’s analysis. This view was set out in the summary of E.ON’s hearing on 4 March 2015 as follows: *“The SME business was higher-risk market than domestic, for example bad debt was currently around [X]% in SME while between [X] to [X]% in domestic. Bad debt in the SME business had been higher in the past, up to approximately [X]% following the recession in 2009. As fixed-price tariffs were the norm in the SME market, E.ON had greater exposure on costs such as FiT or Network charges than it did in the domestic market. There were other risks: information provided by SMEs about their energy use was not always accurate as well as the micro and macro-economic risks linked to the performance of the customer’s business and the overall economy that could also mean that the actual consumption of the customer is less. Finally, SME customers often used less energy than domestic ones but had similar costs in terms of payment type, indebtedness and debt collection to a quarterly billed domestic customer. These risks needed to be factored in when E.ON considered the costs and returns of SME customers on a NPV basis.”*

A.50. In the rest of this section, E.ON sets out:

- Evidence from both E.ON’s financial information and stock market data, to demonstrate that the SME segment of GB energy supply is likely to be higher risk, in particular in comparison with the I&C segment; and
- How the failure to take account of these risks impacts the CMA’s analysis.

[E.ON’s financial information illustrates that the SME segment is more risky than the I&C segment](#)

A.51. As explained in the hearing (and above), bad debt costs and therefore the revenue risk is much greater for the SME segment than the I&C segment. In fact, when a longer period is considered i.e. going back to 2007, a period which captures more of the full economic cycle, the difference in bad debts is more pronounced. Taking bad debts as a proportion of revenue, the average bad debt from 2007 to 2013 was [X]% for the SME segment, which compares to just

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<sup>49</sup> Paragraph 10.17, Chapter 10 of the Provisional Findings

[REDACTED]% in the I&C segment.<sup>50</sup> This clearly demonstrates that there are substantially higher risks associated with the SME segment.

- A.52. E.ON also notes that the amount of working capital required to run the SME business is greater than the working capital required to run the I&C business. This is due to the different payment terms offered to SME customers, compared with I&C customers. In fact, E.ON's own data for working capital, by business segment, shows that the working capital requirements for the SME business is almost three times those of I&C.<sup>51</sup> E.ON therefore has to put more capital at risk to run the SME business, compared to the I&C business. More capital at risk requires a higher EBIT margin, in order to adequately compensate the business.<sup>52</sup>

[Market returns data demonstrates that the SME segment is more risky than the I&C segment](#)

- A.53. In this section, E.ON provides further evidence to demonstrate that the risks associated with SLEFs' SME businesses are likely to be substantially greater than those associated with I&C customers. In order to provide evidence of the risks associated with the SME segment compared to the I&C segment, we have analysed the difference in risk associated with SME firms (i.e. the SME customers of energy suppliers) as compared to larger firms (i.e. the I&C customers of energy suppliers).
- A.54. The analysis conducted is based on the theory that if stock markets are efficient<sup>53</sup> a group of firms earning persistently high returns must be associated with higher risk. At a high level, our analysis compared the stock market returns in "small firms" with the stock market returns on the rest of the market. If these small firms show persistently higher returns, on average, then this is evidence that these small firms have persistently higher risks.
- A.55. Our analysis, set out in more detail below, shows that the small firms we have analysed earn persistently higher returns than the market average. This implies that SME firms are likely to be far more risky than larger businesses on average.
- A.56. This in turn implies that having such SME firms as customers confers *systematic* risks on the SME segment of energy supply businesses, which do not apply to the same degree to the I&C segment.

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<sup>50</sup> [REDACTED]% in domestic.

<sup>51</sup> On a percentage of turnover basis i.e. compare working capital ÷ turnover for SME and I&C

<sup>52</sup> For example if £200m capital is at risk and WACC is 10% then £20m EBIT is required. But if £70m capital is at risk then only £7m EBIT is required.

<sup>53</sup> Which the CMA implicitly assumes when they use the CAPM for cost of capital estimation.

- A.57. In the rest of this section the analysis is explained in more detail.
- A.58. E.ON’s analysis looks at the returns of microcap firms, as a proxy for the SME customers of a retail supply business. This analysis proceeds by analysing the returns on a value-weighted portfolio of the smallest decile of firms (“**SF portfolio**”) of listed companies.<sup>54</sup> We then also construct a market-wide portfolio, and calculate the returns to that portfolio (“**RM portfolio**”). The difference in the average returns across these two portfolios can then be calculated (“**SF-RM**”).
- A.59. Although our analysis describes the stocks in the SF portfolio as the “smallest”, we note that these firms are relatively large by SME standards. For example, in 2010, firms with a market cap of up to £21.96m were included in the SF portfolio - so these firms are relatively large by SME standards. Were we to construct a portfolio of even smaller firms, to even better proxy for SME businesses, it is likely the returns to that portfolio would be even more volatile than the SF portfolio we have used. Therefore as a result, our analysis based on the SF portfolio almost certainly understates the returns required by investors on smaller SMEs, and therefore, if anything, understates the risks associated with smaller SME firms.
- A.60. All the data used from this analysis were obtained from the University of Exeter Xfi website and cover the period October 1980 to September 2014. This is the longest period of data available. The results of this analysis, showing the difference in the returns to the market portfolio compared to the smallest firms are reported in Table 1.

**Table 1:** SME/Microcap return analysis

Monthly data:	SF	RM	SF-RM
Mean	1.56%	1.04%	0.51%
Standard Error	0.26%	0.22%	0.23%
t-statistic	5.92	4.65	2.23
Annualised difference x 12			6.16%
Compounded annualised difference			6.34%

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<sup>54</sup> Where returns are calculated as the change in share price plus dividends compared to the starting price.

Where;

- SF: returns from the smallest decile of firms;
- RM: returns of a market portfolio; and
- SF-RM: returns from the smallest decile of firms less returns from the market portfolio.

- A.61. Table 1 provides a range of summary statistics regarding the SME/Microcap return analysis. For the purposes of this analysis, the key variable of interest is SF-RM, which is the difference between the returns from the smallest decile of firms and the returns from the market portfolio. The relevant mean and standard errors are also presented. Additionally, we undertake hypothesis testing (t-tests) to determine whether the difference in the returns to the small firms compared to the rest of the market are statistically significant. We see that both SF-RM and RM-RF are statistically significant with means of 0.51% and 0.53% (monthly).
- A.62. The analysis reveals that the difference between the returns to the SF portfolio and the RM portfolio (SF-RM) is large and statistically significant – over 0.5% per month. In other words, the returns to small businesses are significantly higher than those in the rest of the market. Annualising this derives a premium associated with our SF portfolio of around 6.3%. To put this in context, this is actually similar to the Market Risk Premium (“MRP”) over that period, implying that microcaps must be twice as risky as “the market” if markets are efficient, as the MRP is a measure of the risk in the overall market and the SME/”microcap” premium would be additional risk on top of this..
- A.63. To conclude, E.ON finds that the stock market returns to smaller firms are persistently higher, on average, than the returns to a market-wide portfolio. Assuming that markets are efficient (which the CMA itself assumes elsewhere in its analysis),<sup>55</sup> the only rational explanation for persistently higher returns to the stocks of smaller firms is as compensation for a greater level of risk being associated with smaller firms.
- A.64. This implies that the customers served by the SME businesses of energy suppliers are inherently riskier than those served by the I&C businesses. In other words, there is evidence to show that there is greater systematic risk for energy suppliers’ SME businesses, compared to their I&C businesses. In the next section we discuss the implications of this for the CMA’s analysis.

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<sup>55</sup> In using the Capital Asset Pricing Model, the CMA is assuming that markets are efficient.

### Implications for the CMA's analysis

- A.65. In the previous section E.ON has provided analysis to demonstrate that greater risk is associated with energy suppliers' SME businesses, as compared to their I&C businesses. While the magnitude of the risk associated with energy suppliers' SME businesses is difficult to quantify, the CMA must nevertheless recognise the higher risk associated with the SME segment in interpreting its findings in relation to the SME segment.
- A.66. In a ROCE analysis, a greater risk for a particular segment should be associated with a higher WACC. While the CMA has constructed a WACC for the supply business as a whole, it should be aware, when interpreting the ROCE for the SME segment that the WACC for this segment of energy suppliers' businesses is in fact higher than the one calculated for the supply business as a whole.
- A.67. In interpreting margins, the CMA should rationally expect energy suppliers to earn higher EBIT margins on SME customers, as compensation for the greater risk associated with the SME business segment. This is evidenced by the higher levels of bad debt, larger amount of capital at risk (see paragraphs A.51 to A.52 above) and the higher risk nature of the end customer more generally, all of which would rationally require higher margins, in order to adequately compensate the business. As a result, comparing EBIT margins of the SME segment with other segments of the energy suppliers' business is not straightforward. In particular, it would be incorrect to infer anything about competitive conditions in the SME segment based on a simple observation that EBIT margins in that segment are higher than the other parts of energy suppliers' businesses.
- A.68. Overall, therefore, E.ON concludes that there is evidence to show that energy suppliers' SME businesses are riskier than energy suppliers' I&C businesses. The CMA should take this into account in making any comparisons between the SME segment and other parts of energy suppliers' businesses. In particular, one would rationally expect higher EBIT margins in the SME segment, compared to other parts of energy suppliers' businesses.

### **A.2.3. The CMA's analysis of efficient prices and costs is flawed**

- A.69. The CMA observed differences in profitability across the suppliers, which it considered were due to differences in; average prices per MWh, differences in

wholesale energy costs, differences in indirect costs per customer and differences in capital employed.<sup>56</sup>

A.70. In an attempt to control for the differences described above, the CMA conducted an analysis of “efficient prices and costs”. At a high level, the CMA compares what it calculates as an efficient benchmark level of revenue with the actual revenues earned by the SLEFs, in order to assess whether they are earning more than what the CMA has concluded represents an amount that would be earned in a well-functioning market.

A.71. In E.ON’s view this analysis contains significant flaws, which invalidate its results. We begin by summarising the CMA’s analysis of the competitive benchmark level of revenue, before setting out the flaws in more detail.

#### Summary of the CMA’s analysis of a competitive benchmark level of revenue

A.72. The CMA begins by calculating what it argues is an efficient level of costs for energy suppliers. In order to do this, the CMA:

- Calculated an efficient wholesale cost per customer, based on the lower quartile of the SLEF wholesale costs and the average of two specific firms’ realised wholesale costs;<sup>57</sup>
- Calculated an efficient indirect cost per customer, based on the lower quartile of the SLEF indirect costs;<sup>58</sup>
- Retained the firms’ own network and obligation costs per customer;<sup>59</sup> and
- Estimated an efficient capital base, with fixed assets modelled on Centrica, the lower quartile of the SLEF debtors, the upper quartile of the SLEF creditors and the remaining balance sheet passed through on the same basis as the ROCE analysis.<sup>60</sup>

A.73. The CMA then added a capital charge to its estimated efficient capital base, to arrive at an overall competitive benchmark level of revenue.<sup>61</sup> The CMA attempts to perform the analysis above at the segment level, i.e. with separate calculations for domestic, SME and I&C.

A.74. We set out in the next sections the significant flaws in this analysis.

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<sup>56</sup> Paragraph 10.41, Chapter 10 of the Provisional Findings

<sup>57</sup> Paragraph 35 of Appendix 10.5 of the Provisional Findings. We note that sensitivities using average wholesale costs and the spot price were also performed.

<sup>58</sup> Paragraph 48 of Appendix 10.5 of the Provisional Findings

<sup>59</sup> Paragraph 37 of Appendix 10.5 of the Provisional Findings

<sup>60</sup> Table 3 of Appendix 10.5 of the Provisional Findings

<sup>61</sup> Specifically, Revenue = efficient direct costs + efficient indirect costs + (WACC\*efficient capital employed).

### The CMA's analysis of an efficient level of revenue is flawed

#### *The CMA's analysis suffers from the same flaws as the CMA's ROCE analysis*

- A.75. First, the methodological flaws set out above in relation to the ROCE analysis, also apply to this analysis. Specifically, the CMA's estimate of an energy supplier's efficient capital base is based on many of the same assumptions that the CMA used to construct its capital employed measure as part of its ROCE analysis.
- A.76. As a result, the analysis suffers from many of the same issue as the CMA's ROCE analysis, set out in section A.2.1.
- A.77. In addition, E.ON notes that the CMA presented this analysis of efficient price and cost benchmarking as a separate analysis from the ROCE, noting that it gains "*assurance that different sources of evidence on profitability give broadly consistent results.*"<sup>62</sup> However, given that this analysis of competitive benchmark revenues is based on some of the same assumptions as the ROCE analysis, in E.ON's view the CMA should not view these as "different sources of evidence."
- A.78. In addition, there are further flaws affecting specifically the CMA's analysis of competitive benchmark revenue and cost analysis, which we explain in the next section.

#### *The CMA's analysis is based on further unrealistic assumptions*

- A.79. In this section E.ON sets out flaws in the CMA's analysis of direct, indirect costs and of an appropriate capital charge.

#### *Wholesale costs*

- A.80. As set out in paragraph A.72, the CMA calculated an efficient wholesale cost per customer, based on the lower quartile of the SLEF wholesale costs and the average of two firms (whose costs the CMA considered more closely reflected those on the wholesale markets).<sup>63</sup> E.ON disagrees with the CMA making any adjustments to firms' actual wholesale costs in order to calculate an "efficient" level.
- A.81. Each firm's actual level of wholesale costs will depend on the hedging strategy that a firm deploys. Different firms will have different hedging strategies, all of which may be reasonable *ex ante*. The hedging strategy chosen by each firm will

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<sup>62</sup> Paragraph 10.138 of the Provisional Findings summary

<sup>63</sup> Table 1 of Appendix 10.5 to the Provisional Findings s

depend on the profile of their customer base, their strategy in relation to the tariffs they have on offer, the firm's risk appetite, and will also be chosen to try to gain a competitive advantage. However, different hedging strategies will yield different outcomes in terms of the level of wholesale cost a firm actually incurs at different points in time. It is inappropriate to select the lowest quartile of these actual costs each year and label this an "efficient" level of direct costs – thereby assuming that firms whose hedging strategies resulted in different costs in that year somehow behaved "inefficiently".

- A.82. Further, at a market level, it would be logically impossible for the combined SLEF to recover its wholesale costs over the period, if all firms were only 'permitted' the lower quartile level of wholesale costs.
- A.83. The CMA also conducts another version of this analysis, using spot market prices instead of its measure of efficient wholesale cost. As stated in a previous response<sup>64</sup>, in E.ON's view this analysis cannot be used to inform any assessment of profits of GB energy businesses. As the CMA notes, there are benefits to consumers in moderating risk through hedging (and that independent suppliers also hedge their energy needs in advance).<sup>65</sup>
- A.84. Overall, therefore, the CMA's calculation of 'efficient direct costs' is based on unreasonable assumptions about what should constitute an efficient level. These assumptions bias downwards the CMA's estimate of an efficient level of revenue.

#### *Indirect costs*

- A.85. As set out above, the CMA calculated an efficient indirect cost per customer, based on the lower quartile of the SLEFs' indirect costs. The CMA makes reference to the indirect cost ratios of the mid-tier suppliers, to support its use of the lower quartile ratio for the SLEFs,<sup>66</sup> noting that Ovo Energy and Co-op Energy ranked better than the average for the SLEF.<sup>67</sup>
- A.86. The concepts of a lower quartile in a sample of six firms and a read-across to only two mid-tier suppliers are not statistically robust.
- A.87. In addition, the CMA appears not to have taken account of differences in region or customer mix. The level of indirect costs per customer varies by business segment, tariff type and geography (amongst others). Consequently,

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<sup>64</sup> Paragraph 10-12 of E.ON's response to "Electricity Spot Price Scenario (Invitation to comment)" 25 March 2015.

<sup>65</sup> Paragraph 10.74 of chapter 10 to the Provisional Findings

<sup>66</sup> Paragraph 48 of Appendix 10.5 to the Provisional Findings

<sup>67</sup> Paragraph 47 of Appendix 10.5 to the Provisional Findings

benchmarking to the lowest quartile firm for each segment independently could understate the indirect costs for the other providers. This unrealistic assumption could lead to the CMA's estimate of 'efficient' revenue being unreasonably low.

#### *Capital charge*

- A.88. Notwithstanding our comments above about this analysis being based on many of the same flaws as the CMA's ROCE analysis, E.ON describes some additional methodological flaws in the CMA's calculation of the capital charge in its competitive benchmark price and costs analysis below.
- A.89. The CMA has assumed that an efficient level of working capital is the lowest quartile for debtors, and highest quartile for creditors. It is E.ON's view that this assumption is inappropriate because:
- Different energy firms are likely to have different credit terms with their suppliers, so the efficient level of creditor days will vary by firm. Taking the upper quartile could therefore result in some energy firms' 'efficient' creditor days actually being in breach of their contracts i.e., after the date at which they are legally obliged to pay their supplier; and
  - The ability of a company to collect debts after a fixed time lapse is limited by the average credit term offered. If debts turn bad and the credit term is breached then, it is efficient to follow legal procedure and recover these debts even though the credit term period has lapsed. Different firms are likely to offer different credit terms to their customers and have different customer mixes, which will drive different levels of bad debt. The efficient level of debtor days will therefore vary by firm.
- A.90. This unrealistic assumption has the effect of driving down the allowed capital base in the CMA's calculation of an efficient level of revenue, and therefore lowering the allowed margin/capital charge. This therefore biases downwards the CMA's estimated efficient level of revenue.
- A.91. E.ON also highlights that there may be differing accounting policies in place across suppliers as to whether certain credit balances are shown within creditors or as a deduction against overall debtors. Unless adjustments are made for such differences, this would necessarily affect and potentially obfuscate the above working capital benchmarking process.

#### Conclusions on the CMA's analysis of efficient prices and costs

- A.92. The CMA's analysis of an efficient level of revenue suffers from the same flaws as the CMA's ROCE analysis. As a result it cannot provide a reliable benchmark

for energy suppliers' revenues, as part of the CMA's analysis of energy supply firms' profitability.

- A.93. In addition, the CMA's analysis of an efficient level of revenue is based on further unrealistic assumptions, which together imply that the CMA's estimate of an efficient level of revenue is too low. As a result, benchmarking the actual revenues earned by the SLEFs to this unrealistically low level of 'efficient revenue' cannot be used to draw any conclusions about whether out-turn profits for the energy supply industry exceed those that would be expected in a well-functioning market.

#### **A.2.4. The CMA's margin benchmarking analysis**

- A.94. As set out in section A.2.1, E.ON considers that ROCE analysis is inappropriate for asset light industries. Instead, E.ON has submitted to the CMA that margin benchmarking, to firms from a range of other comparable industries, is the most appropriate method for analysing profitability in GB energy supply.<sup>68</sup>
- A.95. The CMA has conducted a margin benchmarking analysis, but has focussed this solely on within-industry comparisons. The CMA dismissed comparators from other industries, citing concerns that they face different risks and have different capital requirements.
- A.96. E.ON notes that Ofgem based its margin analysis on energy supply on comparators from other retail industries in its 2011 RMR. In addition, a report prepared by CEPA on behalf of Power NI also used comparators from a range of other industries to assess the profitability of energy supply. E.ON would also like to highlight that CEPA analysed 31 firms, across six different sectors, in their margin benchmarking analysis, which is substantially greater than the number of firms considered by the CMA.<sup>69</sup>
- A.97. E.ON sets out a further analysis in section A.3 below, comparing margins in the GB energy sector with firms in other, comparable industries, and also presents evidence to support E.ON's view that these are appropriate comparators.

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<sup>68</sup> Paragraph 1.2 of E.ON's response to the Assessment of profit margin comparators for the competitive benchmark in GB energy supply working paper, dated 11 May 2015.

<sup>69</sup> Table F.2, Annex F from CEPA Power NI 2014 Price Review: Financeability and its implications for a required profit margin. It is unclear what the sample size was in the RMR study, although we note that comparators across three different sectors were reviewed.

A.98. In this section, E.ON discusses in turn the suitability of the within-industry comparators relied upon by the CMA in its analysis as benchmark margins, namely the I&C segment, mid-tier firms, regulated firms and non-SVT tariffs.<sup>70</sup>

[I&C margins represent a floor rather than an accurate competitive benchmark for the domestic and SME energy supply segments](#)

A.99. The CMA refers to the 2% EBIT margin in I&C as being a competitive benchmark margin, particularly for the SME segment. E.ON disagrees that the I&C margin can be used in this way, as SMEs are more risky customers than larger corporates, as E.ON has provided evidence for in section A.2.2.

[The CMA's mid-tier margin comparators are not reliable](#)

A.100. The CMA compares the gross margins of the mid-tier suppliers, with those achieved by the SLEFs. The CMA concludes that a 'competitive' benchmark for the SLEFs is 12% (although the range of gross margins for mid-tier suppliers is 11 – 23%).<sup>71</sup>

A.101. In this analysis of the mid-tier firms, the CMA made two key assumptions:

- First, the CMA performed the analysis at the gross margin, rather than EBIT, level, to allow for differences in customer acquisition costs and investments in staff costs and facilities;<sup>72</sup> and
- Second, the CMA places more weight on the comparisons of the SLEFs to First Utility and Ovo Energy because they were not vertically integrated and did not therefore benefit from the cost savings that may arise, as a result.<sup>73</sup>

A.102. In relation to the first assumption, E.ON agrees that it is more appropriate to do the analysis at the gross margin level, rather than the EBIT level, given the start-up phase that the majority of the mid-tier suppliers are in and therefore their level of indirect costs. However, E.ON still has reservations regarding the accounting policies used for cost allocations to direct and indirect costs (such as TPI/brokerage fees), which may limit the reliability of this analysis.<sup>74</sup> Even when focussing solely on gross margin, differing suppliers will have a variety of

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<sup>70</sup> With the non-SVT vs SVT comparisons being done at the gross margin level, rather than EBIT.

<sup>71</sup> Paragraph 17c of Appendix 10.6 to the Provisional Findings and Para 84 of chapter 10 of the Provisional Findings

<sup>72</sup> Paragraph 61 of Appendix 10.5 of the Provisional Findings

<sup>73</sup> Paragraph 57 of Appendix 10.6 of the Provisional Findings

<sup>74</sup> Paragraph 5.8 of E.ON's response to the Assessment of profit margin comparators for the competitive benchmark in GB energy supply working paper, dated 11 May 2015

approaches to their pricing and gross margin levels by virtue of their individual circumstances and strategic aims through a cycle of business growth.

- A.103. In relation to the second assumption, E.ON does not consider that Co-op Energy and Utility Warehouse are less relevant than First Utility and Ovo Energy as comparators to the SLEFs. As set out above, the CMA has justified its reliance on First Utility and Ovo Energy by reference to them not being “vertically integrated”.<sup>75</sup> However, if SLEFs are labelled as “vertically integrated” (by virtue of common ownership of Supply and Generation and parent company support) then the supply businesses of the SLEFs could be deemed to benefit from similarly derived cost savings as Co-op Energy and Utility Warehouse, to the extent that these exist for so called “vertically integrated” firms.
- A.104. The period average of the SLEF gross margins was 17% and 18% in electricity and gas, respectively.<sup>76</sup> E.ON notes that, based on its own desktop research, the gross margins of the mid-tier suppliers are highly volatile. Given this volatility and the fact that the average gross margins are broadly comparable to the SLEFs, E.ON finds it difficult to see that the CMA can conclude that gross margins of mid-tier firms are significantly lower than those of the SLEFs<sup>77</sup>.

[Regulated firms’ margins do not represent a competitive benchmark](#)

- A.105. The CMA also refers to regulated firms in Northern Ireland and Australia as being potential benchmarks for a competitive margin for the GB energy supply industry. In its discussion of these regulatory precedents, the CMA dismisses E.ON’s view that price cap EBIT margins from these regulated industries would be lower than those reasonably expected in a competitive market, since suppliers operating in a competitive market would be exposed to greater levels of risk. The CMA’s rationale for this is that a) it is not automatic that a supplier in a competitive market is more exposed to revenue and cost fluctuations relating to economic conditions than a regulated firm; and b) that the retail supply industry in GB can pass through costs to a similar degree as the degree of cost pass through that is allowed to the regulated firms.<sup>78</sup>
- A.106. E.ON considers that Power NI clearly faces less exposure to revenue and cost fluctuations relating to economic conditions: 70% of Power NI’s revenue is guaranteed irrespective of volume changes. Indeed, Economic Consulting

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<sup>75</sup> Paragraph 57 of Appendix 10.6 to the Provisional Findings

<sup>76</sup> Paragraph 63 of Appendix 10.6 of the Provisional Findings

<sup>77</sup> We would also note that, in order to be comparable with the SLEFs, such margin assumptions should be adjusted to account for business growth, and differing levels of regulatory obligations.

<sup>78</sup> Paragraph 55 of Appendix 10.6 of the response to the Provisional Findings

Associates<sup>79</sup> specifically draw attention to this when commenting on the difference between Australia and Northern Ireland, stating:

*“Power NI is subject to a price control which offers a cost pass-through for energy costs. The form of Power NI's price control, being based on customer numbers rather than volumes, also protects it from volume aspects of demand risk, which SFG identified as the primary source of systematic risk in its analysis.”<sup>80</sup>*

- A.107. As a consequence, the margins for the SLEFs should be higher than those in Northern Ireland to account for different levels of risk. The EBIT margin is set at 2.2% for Power NI, and so this represents a minimum level of margin that would be expected for a GB energy supplier, operating in a competitive market rather than an absolute competitive benchmark.

#### [Conclusions on the CMA's analysis of within-industry margin benchmarks](#)

- A.108. As set out above, the CMA refers to a number of comparators from within the energy supply industry, as a benchmark for the margin earned by GB energy suppliers in the domestic and SME segment. Overall, E.ON has shown that there is no reliable evidence that these margin comparators show that margins across the SLEFs have been above competitive levels.

### **A.3 Comparison of energy supply margins with other industries**

- A.109. As set out above, the CMA has dismissed E.ON's view that margins of firms in other industries are relevant comparators for the GB energy industry. In this section, E.ON sets out empirical analysis to i) identify a reliable set of comparator firms from outside of the energy industry; and ii) demonstrate that energy suppliers' margins are significantly lower than these comparator firms.

#### **A.3.1. The CMA is incorrect to dismiss comparators to other industries**

- A.110. E.ON has previously submitted to the CMA that a sample of EBIT margins from other comparable industries is the most reliable way to form a view on the energy supply industry's profitability. E.ON has previously proposed a range of potential benchmark firms<sup>81</sup> but the CMA dismissed these benchmarks on the basis that:

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<sup>79</sup> Advised the NI Utility regulator

<sup>80</sup> [http://www.uregni.gov.uk/uploads/publications/Annex\\_7\\_-\\_ECA\\_Margin\\_submission.pdf](http://www.uregni.gov.uk/uploads/publications/Annex_7_-_ECA_Margin_submission.pdf)

<sup>81</sup> Paragraph 31 of Appendix 10.6 of the Provisional Findings

*“...we considered that sectors outside GB energy retail, would face different risks and have different capital requirements.”<sup>82</sup>*

A.111. E.ON notes, however, that the CMA used similar comparison firms to those proposed by E.ON in its calculation of the asset beta in its analysis of WACC as part of its ROCE analysis.<sup>83</sup> This undermines the CMA’s view that differences in risk profiles might make these firms inappropriate for the purposes of margin benchmarking.

A.112. In this section, we present analysis that shows there is no evidence to dismiss in principle comparisons to other industries. Indeed, in this section we show that it is possible to identify comparator firms to energy suppliers with similar risk profiles and capital requirements/ asset structures. These firms can therefore be used as part of a reliable margin benchmarking analysis for energy suppliers.

A.113. We identified this set of appropriate comparator firms by:

- Generating a sample of comparator firms, using the firms used by the CMA in its cost of capital analysis and the sample that we suggested previously;
- Evaluating the systematic risk in each of these firms using data on asset betas;
- Evaluating the capital structure of the firms by using both the market to book value ratios and asset turnovers;
- Using the empirical data on systematic risk and capital structure we select a sample of the most comparable firms to GB energy supply; and
- Calculating the mean EBIT of this comparable sample and comparing it to E.ON’s and SLEF’s EBIT.

A.114. In the rest of this section we set out in more detail the steps in our analysis which calculated the margins of an appropriate set of comparator firms for the GB energy supply industry. We then compare the margins of these comparator firms with those of the SLEFs, before concluding.

### **A.3.2. Construction of an appropriate set of out of industry comparator margins**

#### [Our starting sample](#)

A.115. We started with a list combining the retail firms used as part of the CMA’s cost of capital analysis in Appendix 10.4<sup>84</sup> with some of the sample asset light firms

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<sup>82</sup> Paragraph 35, Appendix 10.6 of the Provisional Findings

<sup>83</sup> See for example, paragraph 67 of Appendix 10.4 of the Provisional Findings

<sup>84</sup> Paragraphs 67-69 of Appendix 10.4 of the Provisional Findings

provided by E.ON in its response to the CMA's ROCE working paper (namely ASOS, N. Brown, TalkTalk and UK Mail). These are shown in Table 2 at the end of this section (our "starting sample of comparator firms").<sup>85</sup>

#### Analysis of systematic risk

- A.116. We then sought to assess the systematic risk associated with each of the firms in our starting sample of comparator firms, in order to determine whether it was similar to that faced by the GB energy supply industry. In order to do this, E.ON has used each firm's asset betas as a measure of systematic risk. If there were limited differences in the asset beta of a comparator firm and the asset beta associated with the energy supply industry, this would suggest that their risk profiles are not likely to be substantially different.
- A.117. In Table 2 at the end of this section, we show a comprehensive analysis of asset betas for our starting sample of comparator firms.<sup>86,87</sup>
- A.118. The CMA concluded that the appropriate asset beta for GB energy supply is around 0.7 to 0.8, and that the appropriate equity beta is around 1. Allowing for the inevitable standard error of beta estimates, we might reasonably assume that comparator firms with asset betas in the range of 0.6 to 0.9 have broadly the same systematic risk characteristics as GB energy supply. The four firms listed below in paragraph A.122 all fall within this asset beta range.

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<sup>85</sup> NB. It was unclear to E.ON how an analysis that is based upon the period 2009-2013 can include Dixons Carphone, a firm that only came into existence in August 2014, and so we interpret references to this merged entity as intending a reference to Dixons Retail plc.

<sup>86</sup> We show asset betas calculated using both the CMA's un gearing formula that it used in its analysis in the PFs, (which assumes a Modigliani and Miller Passive Debt Management Policy, or ("PDMP")) and the un gearing formula that the Competition Commission has used in some previous market inquiries (which assumes an active debt management policy with instantaneous re-balancing of the gearing ratio ("ADMP")). The differences in the results based on the two approaches for calculating asset betas are minor. Our source for equity betas referred to by the CMA as "levered betas" is the December 2013 London Business School Risk Measurement Service Quarterly Report ("LBSRMS"). Like the CMA, we use monthly data. As these betas are based on 60 monthly observations they will cover the entire period analysed (i.e. 2009-2013) and so we use average gearing levels over the period 2009-2013 in estimating the asset betas. We assume that debt betas are zero in making these calculations.

<sup>87</sup> The CMA's own analysis stated that supermarkets are not a suitable analogue for energy retail. Nonetheless, we show data on these firms for full comparative purposes. We initially include Just Energy, but as this is a non-UK listed firm we are not able to obtain an LBSRMS equity beta estimate, nor are we able to observe the average corporation tax used in the CMA analysis. So instead we take the CMA's reported equity beta and calculate the ungeared beta assuming, in line with the CMA's UK analysis, that the average corporation tax rate is 27%. Note that this tax rate only matters in the case of a PDMP calculation. For an ADMP with instantaneous rebalancing, the tax rate is irrelevant.

### Analysis of asset structure

- A.119. For the starting sample of comparator firms we also sought to assess their asset structure in order to determine whether it was likely to be similar to that for GB energy suppliers.
- A.120. We propose two objective measures of the asset structure of our comparator firms:
- First, we take market to book ratio (defined as market value of equity/book value of equity). Asset light firms, and hence firms which are more likely to be comparable to energy suppliers, should be characterised by having higher ratios; and
  - Second, we look at the asset turnover ratio (Sales/Capital Employed). Again, asset light firms, and hence firms which are more likely to be comparable to energy suppliers, would be expected to be characterised by high ratios.
- A.121. In Table 2 at the end of this Appendix, we set out these two ratios for each firm in our starting sample of comparator firms. In addition, for each of these firms, we also calculate both its ROCE (which can be decomposed into asset turnover and sales margin) and its EBIT/sales (sales margin) ratios. These are also presented in Table 2 at the end of this Appendix.<sup>88</sup>
- A.122. We accept that there are no absolute cut-offs for defining asset light, but looking down the list of firms we view four firms as fulfilling the criteria of having an asset beta in the appropriate range, a high market to book ratio and a high asset turnover ratio (our “final sample of comparator firms”). These are:
- Next plc;
  - ASOS;
  - Dixons Retail; and
  - UK Mail.

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<sup>88</sup> In Table 2 we note that we have excluded Just Energy. This is because in some years (2009-11 inclusive) its equity book value is negative, and indeed in 2009 the capital employed is actually negative. This renders any attempt to calculate average ROCE, market to book and asset turnover ratios meaningless.

### **A.3.3. Using our final sample of comparator firms as a benchmark for the margins of energy suppliers**

A.123. We calculate the mean EBIT margin for our final sample of comparator firms as 7.5%. The ROCE has a mean of 32.6%.<sup>89</sup>

A.124. E.ON's EBIT averaged [~~2.8~~] % from 2007 to 2013 and the SLEF EBIT average was 2.8%.<sup>90</sup> These margins are at the very low end of the range of margins from the list of comparable firms and significantly below the average EBIT of 7.5%, presented.

### **A.3.4. Conclusions on margin benchmarking to other industries**

A.125. In this section E.ON has presented a sample of firms that it believes can be used as reasonable comparators for the GB energy supply industry, as part of a margin benchmarking analysis.

A.126. The analysis shows that the EBIT margins earned by GB energy suppliers are substantially lower than the average EBIT margins made by these comparator firms. This provides good evidence that energy suppliers are not making out-turn profits substantially in excess of a competitive level.

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<sup>89</sup> In addition to this analysis, we calculate three further sets of averages. The first takes just the CMA's chosen analogues, with no adjustment for "asset lightness" and calculates the mean EBIT margin. That mean is 7.1%, although this sample includes many firms that cannot be thought of as asset light (including airlines and retailers with either high PPE levels or high stock levels). We note that this group has an asset beta at the lower end of the CMA's stated range. We also calculate mean margins for the list of our analogues and the CMA analogues, which produces a mean margin of 7.5%. The asset beta for this group of firms falls slightly below the CMA's range of asset betas, suggesting, as a group, they have less systematic risk than energy retailers. Finally, we calculate a simple average across the entire group of analogues that has been considered in the asset beta estimation process, by E.ON and by the CMA. The result here is a margin of 6.3%, although as is to be expected, the inclusion of supermarkets pushes the asset beta well below the CMA's specified range.

<sup>90</sup> Figure 4 of Appendix 10.2 to the Provisional Findings

**Table 2:** Potential analogue firms for beta and average margin calculation

Firm	CMA Comparator? <sup>93</sup>	2009-2013 Accounting Data							Equity Beta <sup>94</sup>	ADMP <sup>91</sup> Asset beta	MM PDMP <sup>92</sup> Asset beta	Comparator Validity	
		Av. market capitalisation	Av. equity	Av. debt	Av. market to book ratio	Av. ROCE	Av. asset turnover ratio	Av. EBIT margin				Valid?	Reason (see key)
Next Plc	Yes	5,463	235	724	23.61	55.30%	3.32	16.70%	0.74	0.65	0.67	Yes	R1
EasyJet plc	Yes	2,733	1,963	1,230	1.33	8.80%	1.15	7.30%	0.89	0.61	0.67	No	R2
International Consolidated Airlines Group, S.A.	Yes	4,863	4,293	4,934	1.19	3.30%	1.43	2.50%	1.44	0.71	0.83	No	R2
TalkTalk Telecom Group PLC	No	1,850	491	516	3.73	14.70%	2	7.30%	0.71	0.56	0.59	No	R3
ASOS Plc	No	1,724	96	0	16.13	40.60%	5.25	7.70%	0.9	0.9	0.9	Yes	R1
N Brown Group plc	No	970	419	284	2.29	16.20%	1.18	13.80%	0.79	0.61	0.65	No	R2
UK Mail Group plc	No	211	69	6	3.05	25.20%	6.21	4.10%	0.66	0.64	0.65	Yes	R4
Kingfisher plc	Yes	7,126	6,272	1,326	1.12	9.50%	1.56	6.10%	0.93	0.78	0.82	No	R2
Marks & Spencer Group plc	Yes	6,799	2,816	2,943	2.44	15.90%	1.86	8.50%	0.79	0.55	0.6	No	R2
Travis Perkins plc	Yes	2,611	2,450	789	1.03	9.80%	1.48	6.80%	1.64	1.26	1.34	No	R2
Dixons Retail plc	Yes	1,053	619	589	2.99	9.30%	5.44	1.70%	1.18	0.76	0.84	Yes	R4
Tesco PLC	No	34,986	18,124	14,647	1.97	11.00%	1.99	5.60%	0.75	0.53	0.57	No	R2
J Sainsbury plc	No	7,369	5,982	2,971	1.25	9.40%	2.5	3.80%	0.61	0.43	0.47	No	R2
Wm. Morrison Supermarkets plc	No	8,252	5,907	1,735	1.4	12.20%	2.31	5.30%	0.42	0.35	0.36	No	R2
<b>Average of asset light</b>						<b>32.60%</b>	<b>5.06</b>	<b>7.55%</b>	<b>0.87</b>	<b>0.74</b>	<b>0.77</b>		
<b>Average of CMA Comparators</b>						<b>16.0%</b>	<b>2.32</b>	<b>7.1%</b>	<b>1.09</b>	<b>0.76</b>	<b>0.82</b>		
<b>Overall Average</b>						<b>17.20%</b>	<b>2.69</b>	<b>6.90%</b>	<b>0.89</b>	<b>0.67</b>	<b>0.71</b>		

<sup>91</sup> Source of asset beta: assumes an Active Debt Management Policy (ADMP), used by the CC in some previous market inquiries

<sup>92</sup> Source of asset beta: assumes a Modigliani and Miller, Passive Debt Management Policy (PDMP), used in the CMA's analysis in the Provisional Findings

<sup>93</sup> CMA comparator is a firm used as part of the CMA's cost of capital analysis in Appendix 10.4 to the Provisional Findings

<sup>94</sup> Source of equity beta: December 2013 London Business School Risk Measurement Service Quarterly Report

**Table 3:** Key to Table 2

<b>Reason code</b>	<b>Explanation</b>
R1	Firm is asset light defined by both market to book (M/B) and asset turnover (T/O) ratios
R2	Firm is not an asset light comparator on either M/B or T/O basis
R3	Firm is not an asset light comparator on T/O basis
R4	Firm is asset light on T/O basis though not M/B basis

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