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Guy Johnson
Company Secretary
General Counsel
Director of Regulation

Mr Alistair Buchanan CBE
Chief Executive
Ofgem
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18th August 2009

Dear Alistair

Thank you for your letter of 4th August 2009, subsequently published on the Ofgem web site, on the topic of the impact of wholesale prices on retail prices and associated customer communication. Andy Duff is away this week and so I am replying on his behalf.

Our concerns about your public suggestion of price reductions fall into five areas;

- it fails to recognise the current position on net margins,
- does not reflect the increase in non-commodity costs that we are suffering,
- the model is not yet sufficiently developed to accurately represent the complexities of wholesale costs,
- fails adequately to reflect forward projections and the volatility of the wholesale market,
- the analysis of itself in any event does not suggest that there is scope for price cuts.

Looking first at the trend of commodity costs, I believe that I have shared the attached graph with you before. What this shows is that between January 2007 and September 2008 wholesale gas costs increased by 200% whilst during the same period npower's gas prices increased by 27%. This demonstrates that over recent years we have protected customers by attenuating price increases during a period of rocketing commodity costs. This "smoothing" of retail prices on behalf of customers can and should continue as long as it is also associated with a sustainable position on net margins.

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The prospect of a wholesale cost reduction triggering a retail price fall depends of course on the level of net margin being earned in the first place. The gross margin calculated in Ofgem's latest (May 09) quarterly analysis implies a net loss in our domestic supply business, a conclusion consistent with our actual recent experience. At these retail price levels we are not covering our costs and overheads. Nevertheless we have begun a major investment programme, our largest in retail's history, designed to improve customer service and reduce costs.

Our first half results were published on Thursday of last week. RWE npower's Operating Result for January to June 2009 (retail and generation) was €135m, a decline from €334m (60%) for the same period in 2008. Operating result for the RWE Group as a whole increased by 4%. Our UK residential retail business made a loss in the first half. There can perhaps be no better evidence of the disadvantage to which our operations in this country are subject in comparison to other countries in Europe and of the difficulties in the UK market at this time. It does seem a little incongruous to us that you should issue a press release calling on the chief executives to explain their positions on pricing against this backcloth.

In response to these economic and market conditions we are carrying out a £100m cost reduction programme in 2009. Amongst other things we have implemented a wage freeze, a recruitment freeze and carried out redundancy programmes in our retail business.

A retail price commentary cannot be based only on a narrow view of wholesale costs and in any event wholesale costs need to be weighed against increases in other costs. The industry is currently experiencing strong upward pressure on a range of costs including transportation charges, CERT, CESP, social obligations and regulatory compliance. Indeed Ofgem's fact sheets on the breakdown of bills emphasise the upward pressure on these costs. For example, as shown in Fact sheet 81 of 06.08.09, CERT costs are now £45 per year for a customer using gas and electricity, an 18% increase over 2008. The new CESP costs will be £3 per customer per year. RO costs have increased by 20% to £12 per electricity customer. In addition the actions that we are taking on debt and disconnection, and the current recession, creates a huge exposure to customer credit risk.

We have held constructive discussions with your colleagues within Ofgem regarding your wholesale cost model. Our initial assessment is that their work is carefully thought through and a potentially valuable contribution to improved understanding of the cost structure and pressures relating to energy retailing. In discussions with your colleagues we identified a number of factors which would lead to a systematic downward bias if the model were used to estimate net margins in its current form. Your colleagues accepted these points and expressed a willingness to work with us to develop the model to improve its accuracy. For example, the Ofgem quarterly review focuses on standard tariffs (across the payment types of direct debit, cash cheque and pre-payment) but ignores the impact of social tariffs and other non-standard tariffs (e.g. online). This would further reduce the gross margin and we have initially assessed the impact as being of some £10 per fuel per year. The analysis does not include costs associated with adjusting commodity positions in the short term (e.g. imbalance, gas swing); in addition during discussions with Ofgem we shared our base load/peak weighting assumptions for power and it is possible that you may review your assumptions. The effect of these changes would be to reduce gross margins by circa £20 per customer per year in each of gas and power.

As you can see from the attached chart, one year ahead wholesale gas prices are still 25% higher than they were at the beginning of 2007. You will also be aware of the steep contango we currently see in forward commodity curves. The Ofgem quarterly analysis projects wholesale costs forward only to January 2010 and does not project forward any other costs.

Recognising the complexity of the factors which influence retail prices raises the issue of what we can usefully say to our customers without potentially opening ourselves up to accusations of signalling. We are aware that there are a number of precedents where suspected signalling of price changes has been a factor in anti-competitive cases and allegations. However we recognise the need to explain the linkage between costs and prices. We would be happy to explore with Ofgem how more information could be given to customers without incurring competition risks. Consistent with our commitment to this end, we intend to provide an indication of the movement in environmental and social obligation costs from 2008 to 2010.

Already there are a number of actual and potential sources of customer information on the outlook for prices. A number of companies provide wholesale market tracker products; changes in the prices of these may indicate the direction of movement of standard products. Similarly, price changes in fixed price products are likely to reflect companies' views about net changes in underlying costs. In addition, fixed price deals give customers concerned about budgeting greater certainty about their energy costs.

Our Retail CEO has held a series of one to one briefings with key journalists. We have published information on our web site and started 'The Brighter Energy Debate' on line to allow real dialogue on a whole range of issues including price.

Of course there is always more that we can do. We are reformatting our bills based on consumer feed back to make them simpler. As an industry we have recruited a new External Affairs Director who will be a spokesperson for the whole industry and help us to improve our communication in all media channels.

Your own comments on the recent Consumer Focus analysis highlighted the dangers of creating expectations on incomplete analysis. We share your desire to ensure that customers do not have false expectancy, making it even more important that your work is soundly based, and believe that the press comment resulting from your release of 6th August was unfortunate. It is also important for the UK market that it is, and is seen to be, based on a competitive structure without inappropriate intervention, particularly at a time when there is a crucial requirement for substantial investment. The recent performance of the UK market in comparison with other markets overseas, caused by government and regulatory intervention as well as the economic downturn, jeopardises that investment programme. This recent process further enhances a perception of the weakening of the competitive market in the UK.

I hope I have managed to convey that it would I believe be improper to further take forward this impetus towards price reductions based on unsound analysis. I hope that the August quarterly report will more accurately reflect the total position as summarised in this letter. Andy is away this week but I know that he believes, as do I, this to be a matter of great importance. Kevin Miles, our CEO Retail, and I would be pleased to meet at your convenience, prior to the publication of your next quarterly analysis and our technical team would also make themselves available to

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meet again with your analysts whenever required. Please ask your office to let us know any times when this could be possible.

Yours sincerely

Guy

Guy Johnson
Director of Regulation

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2007 to 2009 Indexed Commodity Cost Movements vs Retail Prices for Gas
(Index = 100 at 01/01/2007)