The Retail Market Review – the Standardised Element of Standard Tariffs
Response by E.ON

Executive summary

We support the RMR core proposals as an important step towards restoring customer trust, through reducing the perception of complexity and increasing the transparency of price changes. The RMR core proposals will also reduce the barriers to customers' search of product options tariff and hence allow less engaged customers a wider choice.

The structure of the Standard tariff must be consistent with these objectives. Option 2 with a wide standing charge is a good choice. It is much simpler than Option 1 for customers and by being cost-reflective, the wide standing charge avoids distorting choice between the Standard tariff and fixed price and other products.

An Option 3, with regional standing charges, could deliver further benefits through allowing unit prices to be national, without the complexity of Option 1. With Option 3 we would expect suppliers to develop fixed price products are simply comparable to the Standard tariff, so that all customers have a simple choice of fixed or variable and are not inhibited by the potential range of tariff options in a competitive market.

CHAPTER: Two

Question 1: *Do stakeholders agree with our proposed approach to those costs that should be recovered through a standing charge and those costs that should be recovered through a unit rate?*

We agree with the key elements of the proposals, that Ofgem should set a standing charge and suppliers their unit rate, and support the overarching objective of simplifying the Standard tariff and hence reducing the barriers consumer engagement.

The structure of the Standard tariff is vital to the success of the RMR core proposals. The most cost-reflective proposal (Option 2, regional unit rates, with a wide standing charge) will be effective, but could be improved upon with a simple proposal which realises a national unit rate. Conversely, the complexity of regional adjusters could undermine much of the benefit of simplicity for consumers, whilst a narrow standing charge could reduce competitive pressures and be unfair to many customers.

In our response to the main consultation[1] we asked that Ofgem paint a vision of what RMR core will mean for customers. The structure of the Standard tariff should be consistent with this vision. We suggest that the objectives and criteria to assess each option might be:

[1] E.ON. The Retail Market Review: Domestic Proposals, page 4

Objective	Criteria
Facilitate competition	Simple structure Encourages fixed price products to match Enables collective switching Easy for media to use Encourages separate gas and electricity products
Easy for customers	Prices are what is seen on the bill Bill is simple
Fair to customers	Equal preference between Standard and other products No undue differences in margin (by usage, region or payment method) Consistent with parliament's decision on ECO costs allocation
Practical & low risk	Robust to changes in networks price structures Suppliers able to forecast charges (as new network data published) Suppliers have flexibility to respond to risks

These criteria would be best met by an Option 3 - a wide, regional standing charge, which allows a national unit rate

A wide standing charge would make the Standard electricity and gas tariffs cost-reflective. Cost-reflectivity is appropriate in itself to increase fairness between customers, but other advantages would follow:

A. Fair preference between Standard and fixed price products, whatever a customer's usage. If Standard tariffs were not cost reflective (but fixed price, unregulated, products were), higher users would be under pressure to adopt fixed products and lower users might be excluded from product innovation.

B. Development of fixed price and more tailored products with the same standing charge as the Standard tariff, making them directly comparable. Customer access would be improved, by the media publishing unit rate tables of "best 3 fixed 1 year", "best 3 Standard" etc. Customers might choose between products just on the unit rate, although suppliers would always include an annual £ forecast in any Key Facts comparison. Separate electricity and gas tables might lead to customers choosing "best gas" separately from "best electricity."

The benefits in B. above[2] would be enhanced by a national unit price, enabled by standing charge covering regional variation. The national unit price would also make it more likely that collective switching would succeed.

<u>Option 3 - Proposal</u>
Ofgem would set a standing charge for each fuel, payment method and region. These would cover all customer related costs (fixed networks costs, MRA and other 3rd party charges, metering, fixed obligation costs[3], supplier operating costs including a share of overheads, bad debt and profit[4]) and the regional difference in variable networks costs[5] from the national average.

[2] Some change may also be required to current rules on tariff naming. Customers are most likely to only consider switching at renewal, when the details of their current product are irrelevant. A naming convention which allows the unit rate to be incorporated into the tariff name (e.g. Fix 1y 3.4) could be sufficient to allow search if market prices have fallen.

[3] We expect Warm Home Discount to be the only fixed obligation cost. However, suppliers' ECO obligation might be determined by customer numbers, or if allocation is a hybrid there would be a fixed credit.

Illustratively standing charges might be:

	Electricity
Average, MDD	£50
Lowest	£33 (Eastern)
Highest	£74 (Manweb) £89 (Hydro)
QCC	+£10
PPM	+£25

	Gas
Average, MDD	£55
Lowest	£38 (Scotland)
Highest	£75(Southern) £76 (South west)
QCC	+£10
PPM	+£30

There are a number of points to note:

- Suppliers would quite likely charge the same unit rates for direct debit and PPM. The PPM premium would be within Ofgem's control, and might be reduced rapidly as smart meters are installed.
- Suppliers might charge a slightly[6] higher unit rate for payment on demand (QCC), reflecting the higher bad debt costs and delayed cash flow.
- We recommend regional charges for gas are based on Local Distribution zones. This is more cost-reflective than forcing charges to be based on electricity networks regions and better supports the objective of separate gas products. Nor, aside from the Hydro region in electricity, is there a marked difference between fuels in the cost spread between regions and hence any reason to give electricity primacy.
- To help those consumers who wish to do their own calculation we would expect each supplier, Ofgem and Consumer Focus' successor to have a postcode look-up facility on their web-site.

The benefits of securing a national price outweigh the small loss of cost reflectivity, which is in any case hardly greater than Ofgem have already contemplated (in the draft proposals for a wide standing charge and in proposing that standing charges are national). In the most extreme case, the margin on a 50% above average user in the Hydro region would be depressed by only £16[7] (in a bill of around £850)[8].

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[4] The bad debt element would just reflect the standing charge proportion of the bill. The profit element might be notional as most risk is associated with wholesale costs, and bad debt.

[5] Including the impact of line losses

[6] The difference would be smallest if a supplier had a late pay charge and hence the Standard QCC price was for prompt pay

[7] The impact arises from the variable element which is included in the standing charge - £32 in the Hydro region (the remaining £7 variance from average in the standing charge is from high fixed networks costs)

[8] Note that differences between suppliers' cost base will also affect cost-reflectivity, but the effect will be small. It would be spurious to think that the effect could be avoided by excluding competitive fixed costs from the standing charge.

Our assessment of the benefits of the different options against the criteria is:

	Option 3 wide	Option 1 wide	Option 2 wide	Option 2 narrow
Facilitate competition	✓	?	✗	✗
Easy for customers	✓	✗	✓	✓
Fair to customers	✓	✓	✓	✗
Practical & low risk	✓	?	✓	?

The critical difference between the two options which deliver a national price (Options 1 & 3) is in how easy product search would be for customers.

In Option 3 we would expect:

- Adverts to simply promote p/kWh;

- Caveats to adverts, and to best buy tables, to be simple, e.g. "your bill will also include a standing charge, as currently set by Ofgem for the Standard tariff";

- Consumers to compare the unit rate with that in the Tariff Information Leaflet[9];

- Consumers who wish to estimate their annual spend to find this easy if their bill or a Tariff Information Leaflet is to hand. The required information is only annual usage and the Standard tariff standing charge, together with the unit rate in the proposed offer.

In contrast, in Option 1:

- The advertised unit rate would not actually be the unit rate (assuming that suppliers leave the regional adjuster as an additional item);

- The caveat would refer to two additional charges and, until consumers were familiar with the concept of a regional adjuster, need an explanation of what it was;

- Alternatively, if the unit rates were combined (removing the complexity of explanation), there would be no easy comparison with Standard tariffs;

- Consumers might find it as complex to compare various unit rates as Primary and Secondary unit rates are now (in a Key Facts comparison for a dual fuel purchase there would be eight unit rates[10]);

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[9] Or on the bill if they had a VAT inclusive price

[10] Six different unit rates, given that the regional adjusters would be the same for each product for each of electricity and gas

- Consumers wishing to calculate their own bill would need to add the unit rate to the regional adjuster before doing the calculation (but know not do this if the supplier had a single unit rate without regional adjuster in the Fixed Price product).

In addition, Option 1 would require major bill redesign.

In our view the unfairness of the narrow standing charge rules it out as an option. Higher users would be under pressure to adopt fixed products. Lower users might be excluded from product innovation. Higher users on the Standard tariff would make a disproportionate contribution to overheads and to supplier profit, with the greatest unfairness being to PPM customers and those with electric heating (both of whom may also have the least choice of fixed products). The forced differences between payment methods may be incompatible with the Electricity and Gas Directives.

Regard should also be given to parliament's decision on the allocation of ECO costs. Hopefully this will be to allocation by units (or a hybrid), which would reduce the level of a wide standing charge. However, if the decision is for allocation by customer accounts, or even to reject a hybrid, this will likely have been to limit the impact on severely fuel poor customers who are higher users. It would be unreasonable for Ofgem to overrule such a decision.

Question 2: *Do stakeholders have any comments on the proposed broad assessment of the possible elements of the standing charge (set out in Appendix 1)?*

We propose that the standing charge should include the regional variation in variable charges (calculated at average usage). An element will therefore be the (regional variation in) variable networks charges[11] and in losses. Although some of these charges are revised at other times of year than April we believe that only revising the standing charge once a year (in June, reflecting April's charges) would not lead to any risk premium.

The standing charge should also include MRA and other 3rd party charges which are based on supply point numbers.

Our comments on Appendix 1 are:

Networks charges

We agree that gas capacity charges and electricity transmission charges should be treated as variable costs, as the underlying driver is usage.

If Option 2 Wide was adopted it would seem reasonable to have a national standing charge as the regional variation in fixed DUOS costs could be incorporated in the regional unit rate, albeit at some loss of cost-reflectivity.

Environmental Obligations

We expect there to be much more public information over the costs of ECO than has been the case for CERT and CESP. For the carbon target the brokerage will provide a transparent price, whilst for the affordable warmth element we expect suppliers will be required to report costs in some detail.

[11] Including additional costs of pre-2004 IGT networks

The formula in Para 1.26 should therefore only be used at the start of implementing RMR (Ofgem should provide indicative standing charges in December 2012 and firm standing charges in June 2013).

We believe Ofgem's analysis of the situation of small suppliers is correct, but also note that we doubt it would be government's intention to allow small suppliers to target the competitive advantage given by exemption on particular customer groups.   It would seem reasonable for any cost-saving to be in the standing charge and hence equal for all customers.

Incidentally, we would not describe the expected variability in ECO costs as low (Table 2.4). ECO is a completely new scheme and for the closest comparator, CESP, costs have more than doubled from those in the Impact Assessment.

Metering

We agree that Ofgem could reasonably use published metering charges as the basis of calculating the standing charges, separating credit and prepayment. However, we recommend Ofgem also periodically gather information confidentially from suppliers, as a sense check and as a basis for factoring the implications of a rising proportion of smart meters in reducing the differential between credit and prepayment[12].

Supplier operating costs

The standing charge should seek to cover all customer related operating costs, including a share of overheads, bad debt and profit (although the latter two items would be small, as most of the bill and risk is in the variable element). An allowance for the costs of customer churn should be included, but not the cost of customer acquisition.

We agree that Ofgem need only do an approximate calculation of operating costs. The analysis could be based on the data underpinning the weekly report, or through further data from suppliers. It would not be robust to guess from current pricing as aside from the potential error in assumptions over networks and environmental costs, current product structures are quite different from those which will apply under RMR (in our own case, for instance, we have sought to reward customers who pay promptly or by direct debit with a discount off our standard prices and it would have been unduly complex to have different discounts for primary and secondary unit rates).

Very roughly we would expect the operating cost element of the standing charge to be £20-30 for direct debit and £30-40 for payment on demand and for prepayment.

The average standing charge would therefore be around £50 for direct debit (assuming ECO is allocated by units) or 14p/day. We believe this should be acceptable to customers (although if it is not, the solution would seem to be to retain a primary unit rate structure rather than override cost-reflectivity).

[12] Notionally Ofgem will estimate a higher cost of credit metering, but we assume will also presume a lower operating cost.

Question 3: *Do stakeholders have any comments on the treatment of regional cost differences? Do they favour Option 1 or Option 2?*

Please see our answer to Question 1.

We recommend an Option 3 which incorporates regional cost differences into the standing charge. If there are obstacles we have not envisaged we would recommend Option 2.

For Time of Use tariffs we recommend Option 2[13].

Ofgem should seek to explore two changes to further improve the structure of the Standardised element:

- The hybrid method of apportioning the ECO obligation. This would give a credit for each account (paid for by a higher unit cost) and hence allow a lower standing charge. This would be DECC's decision, and unlikely to be implemented until the second ECO period, starting in April 2015, but we believe Ofgem could encourage this process through a discussion document and customer research.

- The potential for offsetting differences in DUOS charges between regions, through a payments system administered by Ofgem. The equalisation payments would be based on supply point numbers by region. Such a structure might allow a national standing charge (although the benefits of this would also need to be established) without requiring distributors to change their charging structures, which would risk inhibiting the development of demand response mechanisms.

Question 4: *Do stakeholders have any comments on the assessment of the individual elements of the possible regional adjuster (set out in Appendix 2)?*

Regional adjusters would put at risk the simplicity of RMR for consumers and we strongly recommend they are not adopted.

For completeness, our comments on the methodology outlined in Appendix 2 are:

A. Differences in losses need to be accounted for. These can amount to around ±£4/customer.

B. The argument for forcing gas regional differences to fit electricity regions is weak. The case for regional adjusters is based on an assumption that consumers do not have to think about them (comparison is just on suppliers' unit rates) and can just accept whatever appears on their bill (a customer who wanted to check the figures would enter their postcode into a supplier or 3rd party's calculator and be given the relevant standing charges and regional adjusters). There is therefore no additional complexity if standing charges vary by fuel. It is also flawed to suggest that only using electricity regions is a benefit for dual-fuel comparisons. Such comparison cannot reliably be made anyway using 'standard equivalent' rates for gas and electricity, as the balance between electricity and gas consumption is an essential input.

[13] E.ON. The Retail Market Review: Domestic Proposals, page 9-11

C. NTS exit capacity charges change in October, as can DUOS charges. A regional adjuster would need to reflect this or have some correction mechanism in the following June's charge[14].

D. For the reasons outlined in B. there is no strong argument for differences in gas costs not to be accurately reflected in any regional adjuster and hence for any gas regional adjuster to be specific to a legacy IGT network. It would also be somewhat unfair that customers in newer properties with modern heating systems gained, even if the cost to other customers was quite small.

Question 5: *Do stakeholders agree with our proposed treatment of the standing charge (based on a broad assessment) and possible regional adjuster (using a formulaic approach) in the licence conditions?*

No. There will be too many variations in individual elements for there to be a formula. For instance:

- networks charges could change during the year or change to a more cost reflective structure (such as a time of day charge);
- average metering charges will change as the proportion of smart meters increases;
- MRA and other 3rd party charges might also change with the smart metering programme;
- Warm Home Discount could be restructured from April 2015;
- If ECO is in the standing charge, its forecast costs will likely change from year to year.

Nor is there any need for a formula – if one could work, then Ofgem could use the formula internally and then publish the standing charge.

We agree that Ofgem's assessment of the standing charge should be based on a broad assessment; it does not need to be to the nearest pound (or two – it may be simpler for customers to round the standing charge to the nearest whole pence/day).

The standing charge should not be amended during the year, except under the most exceptional circumstances. An increase in the standing charge should not require advance notification[15] but even so a second change during the year would impose additional costs for Standard tariff customers and inhibit the development of simple alternative fixed price products.

Question 6: *Do stakeholders agree with the proposed timing of any potential changes to the standing charge and possible regional adjuster?*

Yes. Although a change to the standing charge should not require 30 days advance notification it is very likely to be easier for customers if suppliers make any changes to unit rates at the same time. Ofgem should publish the standing charge by the end of February.

E.ON
2 April 2012

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[14] In theory this could also apply to the regional differentials in Option 3, but it would only be an issue if there were changes in differentials (not the general level, as may happen with NTS exit charges) and in any case Option 3 is not set up to be as exact as Option 1 and can therefore accommodate a bit more volatility.

[15] E.ON The Retail Market Review: Domestic Proposals, February 2013. Q9, page 19.