Executive Summary

The impact of COVID-19 stretches well beyond the energy industry and E.ON does not believe that using the default tariff cap in isolation is the right method to recover COVID-19 related costs. Instead, we believe that it should form part of a wider package of measures that may also include Government support for customers struggling to pay their energy bills. That said, we have taken the time to assess Ofgem's proposals in this consultation and have presented our assessment below.

E.ON will be responding to the voluntary Request For Information (RFI) on Reviewing the impact of COVID-19 on debt-related costs in the default tariff cap, which provides the data Ofgem has requested. Therefore, for the purposes of this Consultation response, E.ON has excluded the financial impact of COVID-19 on debt-related costs and would refer Ofgem to our RFI response. Furthermore, as Ofgem has acknowledged in this Consultation, E.ON will not understand the true extent of COVID-19 on our business until more time has passed, and we therefore believe further review(s) will need to be initiated over the next 12 months as a minimum in order to obtain a true evaluation. However, we have provided some non-debt related figures in Table 1 which captures other additional expenditure that E.ON has incurred to date due to COVID-19, which we do not believe is covered within this consultation. The mechanism for recovering these costs is limited, and we believe it is not a fair approach to deny the industry the opportunity to pass these on; the industry simply cannot afford for this to happen. We believe a consistent approach should be taken across all industries to ensure fairness in recovering the costs of COVID-19. For example, we are aware that many service industries have the ability to directly pass on the cost of PPE to their consumers.

Whilst we discuss in depth some elements of the costs we have incurred as a result of COVID-19 in our response, we would like to take this opportunity to further illustrate how increasing industry costs have materially impacted the market. Since 2017 when the benchmark was set for the price cap, the industry has seen the introduction of the Retail Energy Code (REC), the Faster and More Reliable Switching Programme (FMRS), and Market-wide Half Hourly Settlement (MWHHS), all of which come at a cost. In fact, according to our analysis, industry costs are now 74% higher than they were when the benchmark was set. Therefore, we do not believe the industry cost element of the cap accurately reflects the associated uplift in costs that suppliers are experiencing. E.ON intend to write to Ofgem in more detail on this in the near future.

We would like to make Ofgem aware that the commentary on financial figures provided in this response is reflective of E.ON's position only, and does not contain figures related to npower. However, the customer accounts already migrated from npower's portfolio to E.ON have been included in our analysis.

We hope Ofgem takes our analysis into account in revising the price cap methodology for the next price cap period.

Proposals Evaluated

Recovery of Costs

E.ON is supportive of the 'float and true-up' method Ofgem has proposed, due to the time lag that the industry is going to face in knowing the true impact of the pandemic. We believe this method minimises the deadweight cost of risk and minimises distortion of competition in the market.

Another aspect to consider is that deferring costs to future price cap periods may mean that when the cap comes to an end, suppliers are "left short". We would instead suggest that the current method of cost recovery based on forecasted costs continues, but where these forecasts are found to be inaccurate (for example, due to unseasonal weather on Contracts for Difference (CfD), Feed in Tariff (FiT) policy costs or COVID-19) that the costs should be recovered via adjustments similar to the British Gas Judicial Review recovery that is applied to the future period.

Benchmarking

We believe that the benchmarking should be reset. The industry has significantly changed since the benchmark was originally set in 2017, not to mention the introduction of REC, FMRS and MWHHS. This has resulted in the industry, more specifically suppliers, bearing the costs to pave the way for the industry changes on top of the ongoing costs.

Since the benchmark was set, suppliers have incurred further significant costs relating to supplier failure. In December 2019, Citizens Advice estimated that the cost of unpaid bills left behind by failed suppliers since 2018 amounted to £255m[1], since then there have been several additional suppliers that have exited the market, and we expect further mutualisation will be required to cover a shortfall in the 2019/2020 Renewables Obligation (RO) scheme. It is therefore essential that the cap is adjusted to reflect these costs, as they cannot be covered by the current wholly inadequate level of the Headroom Allowance.

Bad Debt

Although we include some commentary on our analysis of our bad debt situation in this response, we refer Ofgem to our response to the voluntary RFI for a more in-depth analysis.

The impact of COVID-19 on the level of bad debt will take a prolonged period to become clear, and it is not easy to predict what this is likely to be going into 2021. As Ofgem has correctly stated, E.ON has seen an immediate impact to cashflow due to affordability issues of customers paying by both Direct Debit and on demand. We have seen an increased number of our customers struggling to pay arrears and for their ongoing consumption, which has led to an increase in the amount of aged bad debt outstanding. Whilst we should recover some of this increase, delays in processes such as field visits, means that the remaining debt will become unrecoverable with a higher balance, and there are likely to be some affordability issues within this, given the impacts on incomes already witnessed.

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[1] https://www.citizensadvice.org.uk/about-us/how-citizens-advice-works/media/press-releases/failed-energy-suppliers-cost-consumers-255m-since-2018-says-citizens-advice/

As a way to offer some support to our customers during the crisis, E.ON has shown some leniency by offering longer repayment arrangements to cater for the issues being faced by many of our customers.

E.ON has also taken on the social responsibility by temporarily putting a halt on our debt collections processes, by not issuing letters, not arranging field visits and not instructing debt collection agencies during the lockdown period.

We take this opportunity to stress that there are still several uncertainties which need to be considered in relation to the current furlough scheme ceasing at the end of October, and its replacement(s). Events are moving quickly and for this reason, we do not know how this will impact our customers in terms of affordability. This is what makes it difficult to predict, given the unprecedented situation.

We are mindful however, of the impact of using the price cap as the method of recovering these costs. We recognise that there is an increase in debt across the board and it could have a disproportionate effect on those customers who are less engaged in the market. We therefore believe that the wider impacts of COVID-19 that do not directly impact the price cap, including debt for non-price cap customers should be considered.

Financial Costs

Industry Costs

Since COVID-19 struck, the industry has seen a material increase in third party costs (TPC), and whilst the price cap allows for the recovery of these costs after the observation window, there are flaws in this recovery process. If there is an increase in TPC that is sustained in the subsequent observation window (as has been the case due to the impact of COVID-19), then there is no opportunity to recover that initial impact of the cost increase, as the cap allowance for the cost will be matched by the future cost. Also, we believe that the existing methodology does not allow for 100% of the costs to be recovered. According to our calculations, we anticipate we would only be able to recover approximately 85% of the costs, losing out on the remaining 15%. This is reflected in Table 1 under Price Effects (Industry Cost).

Prepayment and Smart

Whilst Ofgem has not included the impact on Prepayment Meter customers, we would like to highlight that we have incurred additional costs of approximately [redacted] in servicing our prepayment meter customers during the lockdown period, as shown in Table 1 under PPMIP costs.

Specifically, we have seen an increased requirement for [redacted] replacement prepayment keys and cards for the duration of the COVID-19 impacted period. As a result, we took the provisions we deemed necessary to ensure we had sufficient supplies to meet the demand we were experiencing, which we expect to remain in place for the foreseeable future.

In addition, due to the lack of field visits that we were able to make during the lockdown period, there were minimal smart meters being installed. Consequently, this will result in the total smart programme costs also increasing, particularly due to the underutilised resources during this year. It also means that we have an extra [redacted] of our prepayment meter customers still with a prepayment meter installed rather than a smart meter operating in pay as you go mode. Therefore, E.ON is still bearing the higher cost of servicing these customers, which would not be the case under normal circumstances.

E.ON has also seen an increase in the demand for emergency credits for our prepayment meter customers. This results in additional costs beyond the potential to increase bad debt, primarily through the sending or reversing of special action messages to the meter; E.ON staffing costs to increase or reverse emergency credit; and IT staffing costs to facilitate the special action messages.

Therefore, we believe that prepayment meter customers should be included for the purposes of this consultation, as well as the additional smart meter rollout costs suppliers will inevitably see.

Operational and Resourcing Costs

E.ON attaches great importance to the safety of its employees and it is one of our top priorities. This is evidenced by the measures we enforced to ensure our working sites are safe for our employees in line with government guidelines, as well as providing extra PPE for our field agents when visiting customer's properties. Whilst our engineers usually wear PPE for site visits, we have had to take further precautions due to COVID-19 in ensuring we have sufficient supplies to keep them safe. This has resulted in additional costs of approximately [redacted] which is referenced in Table 1. We expect these costs to remain in place for the foreseeable future, until it is safe to revert back to 'normal' ways of working, although it is yet to be seen exactly what this may look like, hence we cannot predict if there will be costs associated with it. We believe for these reasons, that these costs should be taken into account in the price cap methodology, albeit revisited in a future review so as to allow time for a new 'normal' to evolve.

E.ON has incurred further operational costs of approximately [redacted] by way of 'Special Leave' that was granted to our employees (separate to the government funded furlough scheme), as referenced in Table 1. This included time lost due to colleagues self-isolating, or being symptomatic and shielding. We have lost a total of [redacted] working days so far and until the pandemic is over, we will continue to see this number increase. Whilst we have a social obligation towards our staff by offering a degree of flexibility during the unprecedented time we are in, it comes at a cost to our business. We therefore believe this should be considered as part of the price cap methodology for the next price cap period as a minimum, to allow us to recover some of this cost.

Operational Costs relating to making sites safe, PPE and special leave are driven by servicing the whole Residential portfolio, but as [redacted] of our customer base have capped tariffs, the values in Table 1 below reflects [redacted] of the total cost.

Table 1

	Actuals Aug YTD £m	FC3 2020 Sep-Dec £m	FC3 2020 TOTAL £m	2021 TOTAL £m
Price Effects (Industry cost)	[redacted]	[redacted]	[redacted]	[redacted]
Operational Costs	[redacted]	[redacted]	[redacted]	[redacted]
Making sites safe	[redacted]	[redacted]	[redacted]	[redacted]
PPE for Field Staff	[redacted]	[redacted]	[redacted]	[redacted]
PPMIP	[redacted]	[redacted]	[redacted]	[redacted]
Special Leave	[redacted]	[redacted]	[redacted]	[redacted]
TOTAL	[redacted]	[redacted]	[redacted]	[redacted]

* The industry costs captured here reflect the Third Party Cost (TPC) impacts for E.ON across 2020-2021, and reflect only the TPCs that relate to the capped tariffs.

* The industry costs captured here reflect the TPC impacts for E.ON customers, including the migrated npower accounts. They do not include the npower accounts yet to migrate to E.ON's systems.

* Operational costs that impact on our whole portfolio have been pro-rated to reflect the % of our portfolio on capped tariffs [redacted]. Those which impact purely on capped tariffs have been shown at full impact.

Policy Costs

E.ON agrees with the following proposals made by Ofgem.

Renewable Obligations

We agree with this proposal for this year, however we believe this will need to be reviewed for upcoming price cap periods. We do however, remain concerned that some suppliers may not properly account for their RO obligations in their financial planning, leaving further shortfalls to be mutualised across the industry.

Feed in Tariff

We agree with the proposal and are supportive of any separate consultation on this. All suppliers have incurred higher costs than could be reasonably predicted because of the unprecedented amount of solar radiation and the COVID-driven trigger of generators to begin claiming or to claim for earlier periods. The separate FiT consultation should seek ways of protecting suppliers from unpredictable large movements in rates like we have recently seen, perhaps through use of a k-factor.

Energy Company Obligation

We agree with the proposal on this and have no further comments, on the basis that there is not another lockdown, and therefore no amendment is needed to the methodology.

Warm Home Discount

We agree with the proposal on this and have no further comments, on the basis that there is not another lockdown, and therefore no amendment is needed to the methodology.

E.ON disagrees with the following proposals made by Ofgem.

Contracts for Difference

We disagree that the variances in CfD for 2020/21 are comparable with history, as the use of % change to argue for this is misleading due to the significant increase in the CfD rate in these years. Previous years large variances were also mostly driven by delays in State Aid approval, so are not comparable variations. Even with the BEIS loan, the absolute difference between the cap period 4 and cap period 5 allowance was very significant; at c£0.9/MWh, it is at the very top of the historic differences between the Summer and Winter price cap periods in the same charging year.

A portion of the c£0.9/MWh will have been driven by the fluctuations in wholesale costs which can be partially mitigated through hedging. However, the large changes driven by COVID-19 resulting in decreases in national demand could not be hedged.

Whilst most of the impact of COVID-19 has so far been in Q2 2020, the effects are still being felt, and are expected to continue throughout the winter period. The Low Carbon Credits Company (LCCC) have specified how much they decreased national demand due to COVID-19 in their June 2020 Interim Levy Rate (ILR) forecasts, so this could be used as the basis to determine the effect on the price cap allowance.

In addition, CfD has appreciated in value because it is a loan, which means that suppliers are still subject to paying any associated costs, which we believe is a shortfall that should be taken into account.

Assistance for Areas with High Electricity Distribution Costs Scheme (AAHEDC)

We disagree with the proposals because we do not believe that they take into account any pick-up in consumption. Due to the lack of meter readings that were taken during the lockdown period, we believe that there will be a lag in any accurate figures. There is a significant risk on residential supplies in that the Annualised Advance (AA) and Estimated Annual Consumption (EAC) positions will be out of date. This is likely to impact settlement processes and lead to volatility through the 14 months settlement period. There is also a higher likelihood of settlement closing on an inaccurate position due to reads not being put into the process.

AAHEDC costs were also increased by £0.05/customer and backdated in July 2020 to reflect falling demand, although they were set before lockdown. We believe price cap methodology changes should be made to enable suppliers to recover this in a future period. In addition, we would like to draw Ofgem's attention to the Shetland subsidy beginning in April 2021 (£1/customer) which the current price cap methodology will not reflect. We believe the methodology should be changed to explicitly incorporate this Shetland Subsidy.

Wholesale Costs

Despite wholesale costs being lower during the lockdown period, there were spikes in costs as the system has struggled with lower demand levels. In particular, balancing costs from the Grid are significantly higher and are likely to be reflected in charges passed through to ourselves. Whilst forecasting helps prevent adverse impacts for this by minimising the imbalance charges we receive, we cannot prevent wholesale costs impacting our costs, as we do have to buy the energy at some point before delivery.

In addition, whilst the domestic element of these costs has been taken into account in the price cap methodology, we believe that this will not show an accurate picture of the impact of wholesale costs due to the fact I&C costs have not been taken into account. We believe that the analysis needs to be cost reflective of the costs suppliers have hedged for, which are inclusive of I&C costs.

We also believe that there are other factors which need to be considered, for example, the level of customer engagement and the fact that not many meters were read during the lockdown period due to the lack of site visits, meant that there was an increased reliance on estimated meter readings. A higher use of estimated reads has a subsequent knock-on effect to our operational cost to serve, primarily through the replacement of estimated bills once actual meter readings have been obtained.

Capacity Market (CM) Costs

The assertion that the CM allowance for cap period 4 was unaffected by COVID-19 is incorrect. The methodology works on a fiscal year basis and takes the Apr-Sep20 share of costs from the Oct19-Sep20 CM Year and the Oct20-Mar21 share of costs from the Oct20-Sep21 CM delivery year. Therefore, any COVID-19 impacts in the Nov20-Feb21 period will affect both cap periods 4 and 5. The LCCC forecast of peak demand for the Nov20-Feb21 period decreased by 6% from cap periods 4 to 5 due to expected COVID-19 related impacts. We argue that the effect of this decrease in national peak demand forecast should be at a minimum and should therefore be considered in any adjustment factor.

We agree the effect on peak consumption this winter is uncertain, however the decrease in non-domestic consumption is likely to be more pronounced than the increase in domestic consumption, which is likely to increase the Domestic market share of national peak demand greater than the general increase in domestic consumption. This is likely to offset any theoretical increase in recovery of CM costs over the price cap period 4. We support the proposal to monitor actual demand outturn to assess the final affect.

Network Charges

In paragraph 7.27 of its Consultation document, Ofgem has made the assumption that all suppliers have benefited from the network charge deferral scheme, however, as emphasised in our letter to Ofgem of 3 June 2020, E.ON has not benefitted from this. The opportunity was applied differentially across suppliers and was only offered to those who do not have an investment grade credit rating, a point which we have already raised to Ofgem. The industry does not have visibility of the suppliers who have taken advantage of this opportunity to defer payments. This gives us cause for concern because we do not know what approach Ofgem will take in ensuring the deferred payments are made, especially in the event of a supplier failure. If the costs are mutualised across the industry, we are not in a position to approximate the shortfall without this visibility. Alternatively, network operators could see a shortfall this year and inevitably recover this in future years from suppliers.

That said, regardless of the network charge deferral, we are broadly comfortable with the approach to the methodology Ofgem has outlined, due to charges being set a year in advance, allowing this to be made recoverable in the price cap. We would like to point out however, that the rate of switching has been significantly lower since the start of price cap period 4 during the lockdown, which we believe should be taken into account.

Balancing Costs

E.ON's understanding is that Balancing Use of System (BSUoS) costs have been higher due to the Grid needing to keep the system balanced. However, we believe that Ofgem has not taken into account the increased domestic consumption the lockdown period has seen, and instead has made the assumption that there has been no difference in consumption. The lockdown period saw an increased reliance on estimated meter readings due to the lack of site visits made. We believe the industry will see a lagged impact on the costs it faces as a result of the increased domestic demand and as actual meter readings are obtained going forwards. All suppliers of Default Tariff Customers faced a cost from BSUoS across Summer 2020 as historical levels were lower than those incurred. However suppliers will be recompensed through higher balancing rates charged in Summer 2021. It is therefore essential that the methodology is not changed at this point.