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RWE response to Ofgem consultation on price cap

RWE Generation is a leading European generator and provider of reliable and flexible generation capacity. RWE's core markets are Germany, UK, Netherlands and Belgium. RWE's UK fleet comprises over 8.5GW of capacity, supplying over 10% of all UK electricity demand in 2017, making it the second largest generator in the country. The UK fleet is primarily made up of modern and highly efficient gas-fired combined cycle gas turbines (CCGTs), supplying flexible and dispatchable energy to the grid and providing a significant contribution to the UK's energy security and resilience.

RWE Supply & Trading (RWEST) is a leading European energy trading house and the interface between the RWE Group's operating companies and global wholesale markets for energy and energy-related raw materials in both their physical and/or derivative forms. This includes power, gas, coal, freight, oil, weather derivatives, biomass, emissions certificates and renewable energies. RWEST is responsible for the economic optimisation of power generation and the entire non-regulated gas business of the RWE Group, including all procurement, storage and LNG-related activities.

Please see below the response on behalf of RWE Generation and RWEST.

Chapter 2 in main consultation – 'setting the cap'

Question 1: Which approach for setting a benchmark for efficient costs do you think would be most appropriate?

1 RWE has no clear preference on the methodology used to set the cap. We would note, however, that in setting the cap, Ofgem should take a precautionary approach to ensure that the cap does not undermine the competitive market and the primary protections that it provides to consumers.

2 Ofgem should consider the impact on the wholesale market as well as the retail market. A cap which is set too low or which aims to mitigate suppliers' risks too closely will undermine wholesale market liquidity as well as closing out retail competition. Instead of seeking to manage costs and risks by efficient engagement in the wholesale market, suppliers will merely track the cap. This will reduce retail competition and switching as suppliers have little incentive or ability to compete outside the cap. Tightly tailored caps will also undermine suppliers' creditworthiness, in turn reducing competitors in the market, and remove significant liquidity from the wholesale market. This will increase risk and prices to other market segments and further undermine effective competition.

3 Ofgem's proposed approach to Option 3 (an updated competitive price reference) is the most likely to undermine retail competition and wholesale market liquidity and should not be adopted. An average of the cheapest suppliers is certain to set the cap at too low a level. The decision to exclude suppliers with a large proportion of customers on standard variable tariffs further compounds this problem. An updated competitive price reference based on a different methodology, e.g. an average which excluded a few outliers and niche providers might, however, work and the CMA was presumably thinking along similar lines in selecting the average of two "mid-tier" suppliers for the safeguard tariff.

4 A "bottom up" approach to setting the cap (Option 4) is workable, but Ofgem should not attempt to track actual costs too closely. A cap which aims to track costs closely risks becoming a substitute for competition rather than a complementary and temporary backstop and is likely to be unduly complex and costly to administer. An assessment of each cost component 'bottom up'

could lead to an ‘accurate’ cap level, but there is a significant risk that an “eclectic” approach to individual cost components presents an unrealistically low benchmark resulting from differences in cost allocation rather than any underlying difference suppliers’ efficiency on each cost element. In this instance, the risks of ‘getting it wrong’ are considerable. If this approach is adopted, Ofgem should therefore largely trust suppliers’ cost estimates and not aim to cherry pick the data to identify the most “efficient” supplier.

5 In respect of Option 2 (adjusted safeguard tariff), we would note that the CMA chose two mid-tier suppliers during a period of significant growth in their business which may have the effect of understating the costs of a “representative” supplier today. At the very least, Ofgem would therefore need to adjust the safeguard tariff to ensure that it is sufficient to cover the costs of a representative mid-tier supplier today. As noted above, this assessment should not be based on a selection of only the cheapest suppliers. Ofgem should also include the highest level of headroom to account for the uncertainty about the true level of costs.

6 Whichever methodology Ofgem ultimately choose, the cap should ensure that suppliers are able to finance their activity and make a reasonable return. Undermining the credit worthiness of suppliers by forcing them to sell to customers at a loss will seriously damage the wholesale market, reduce market liquidity and undermine competition in other retail sectors.

Question 2: What are you views on the issues we should consider when setting the overall level of the cap, including the level of headroom?

7 Ofgem should take a precautionary approach to setting the overall level of the cap and should set the headroom at the top of the range. The proposed cap is intended to provide temporary backstop for consumers who are not engaged in the competitive market. The costs of setting the cap too low, or tracking costs too closely, significantly outweigh the consequences of a cap which is marginally too generous. While lower headroom inevitably results in lower bills for those customers who remain on default tariffs, this should not be at the expense of suppliers and customers who are actively engaged in the competitive market nor distort the wholesale market to the detriment of all customers. This balance is particularly acute given that the cap is intended to be temporary. The reputational impact of a regulatory intervention which deters retail entry and undermines wholesale market liquidity will extend well beyond the period of the cap.

Question 4. Do you agree with our proposals on how we will update the cap?

8 RWE agrees with the proposed approach to updating the cap. Specifically Option C, by using cost drivers outside of suppliers’ control, should provide the minimum distortion to the market risks faced by suppliers. In turn, this option is the least likely to distort suppliers’ engagement in the wholesale market to manage their risks. We offer some specific comments on the approach to indexing in our response to appendix 6 below.

9 Ofgem should also provide a mechanism to adjust the cap for events which significantly affect suppliers’ cost bases during the tenor of the cap (e.g., a significant change in Carbon Price Support).

Question 6: Do you have any views on what information we should use to assess the conditions for competition?

10 We share Ofgem's view that looking at market outcomes while the cap is in force is unlikely to provide a good guide to what would happen to competition if the cap is removed. We therefore welcome the focus on demand-side measures which may discourage customers from switching. On the supply side, however, we would note that incentives to invest in innovative business models and technological developments will also suffer under the cap. While we recognise that Ofgem will look at signs of innovation in assessing the effectiveness of competition, the absence of these factors should not be used as part of the assessment of whether the cap should be removed.

11 RWE would also support reversing the burden of proof on assessing the conditions for competition. The presumption should therefore be that the cap harms competition and that it will be removed unless there is concrete evidence to suggest otherwise.

Responses to Questions in Appendix 6.

Question A6.1: Do you agree with our approach to setting the wholesale allowance? In particular, using 2015 for the base period of the adjusted existing safeguard tariff approach.

12 As Ofgem notes, an adjusted version of the existing safeguard tariff avoids the issue of considering wholesale costs independently as these are reflected in the price benchmark established in 2015. Ofgem should, however, adjust this benchmark to ensure that it remains representative of a typical supplier today. Appropriate indexation and sufficient headroom should then ensure that the cap is sufficient for suppliers to finance their business while not distorting suppliers' risk management decisions and engagement in the wholesale market. We would also prefer the wholesale element of the cap to be fixed for a 12-month rather than a 6-month period.

Question A6.2: Do you agree with our approach to updating the wholesale allowance?

13 RWE would prefer to see the wholesale element of the cap updated on an annual basis according to a 6-2-12 annual model rather than Ofgem's semi-annual approach. Fixing the wholesale cap for a year will result in less distortion to the wholesale market and provides valuable price certainty for consumers. Our reasoning is explained further in Q6.3.

Question A6.3: Do you agree with our proposed approach to use a semi-annual cap period, compared with a 6-2-12 annual model, or shorter observation period? Please explain how the alternatives would affect you, if we were to choose those options instead.

14 No, we would recommend using the 6-2-12 annual model. Any intervention in the retail market will affect wholesale market liquidity. As noted in the consultation, suppliers will have strong incentives to follow a hedging strategy that matches the chosen index, rather than pursue a strategy that they believe is most competitive.

15 The crucial issue therefore is not necessarily the frequency of updates and the period for forward contracts, but whether the cap is set with sufficient 'headroom' as noted in QA6.1. With this in mind, we would advocate the 6-2-12 annual model, as a preferred alternative. With a 6-month or shorter period caps, the risk is that suppliers are more likely to treat the cap as a price target. Given that the cap should only be a 'back stop' rather than something trying to precisely follow (or drive) costs, an annual cap would be preferable, provided it is set with sufficient head-

room. Moreover, suppliers tend to only change their prices once a year, so an annual cap would not necessarily lead to greater changes between updates than today.

16 We do not agree with the concern from some stakeholders that introducing a longer period would increase the risk that demand departs from existing forecasts. Suppliers already forecast energy demand within this timeframe.

17 Any approach must, however, provide for adjustment for significant unforeseen changes to the cost base, e.g., a sudden change in the Carbon Price Support rate.

Question A6.4: Do you agree with our approach to modelling forward contracts? In particular: that initial shaping should be based on a 70-30 spilt between baseload and peak load, and the cap will be semi-annual. If not, please provide evidence to support alternative approaches.

18 The split between baseload and peak products should reflect the anticipated value weighted ratio of the products to ensure that suppliers can manage their shape risk within the constraints of the cap. We propose that the way to calculate this is to multiply out-turn prices, for example N2EX half-hourly prices, by the profiled demand for the relevant segment and divide by total annual demand for that segment to determine the relative values of peak vs. baseload products.

19 It should be noted that changes to cash-out prices arising from the change to PAR1 and an increased value of VOLL may increase the value of peak periods and this would increase the proportion of peak product that would need to be incorporated in the calculation of the cap. Ofgem should reflect this uncertainty by setting any headroom at the top end of the range considered.

Question A6.5: What are your views on the necessity and size of an additional allowance for shaping and imbalance costs? Please provide evidence to support this.

20 Sufficient allowance for all costs, including shaping and imbalance costs, is required. The existing version of the safeguard tariff should be adjusted to ensure that it is sufficient to cover all costs, including shaping and imbalance costs, for a typical mid-tier supplier today. Ofgem should also adjust the benchmark to cover future increases in imbalance costs stemming from the change from PAR50 to PAR1. This could lead to higher imbalance costs which would need to be adequately reflected in a bottom-up approach or in calculating the required headroom from a price reference.

Question A6.6: What are your views on the necessity and size of an additional allowance for transaction costs relating to brokers and collateral?

21 Allowance for these costs must be made as these costs exist. As noted above, the existing version of the safeguard tariff should be adjusted to ensure that these costs can still be covered.

Question A6.7: Do you agree that our approach to updating the benchmark for the first cap period is appropriate?

22 The first cap period is likely to start in December 2018 and will be ‘shorter’ compared to a normal cap period (Apr-Sept and Oct-Mar if set every 6 months). As noted above, we would recommend setting the cap on an annual basis.