# Sustainability Committee
# SC(3)-24-08 (p.3 Annex)

## Note by E.ON UK - Price Changes Explained

Earlier this year Ofgem said:

*"Company decisions on whether to increase prices are based on their own reading of the market. In Britain's competitive market, if they increase bills they have to weigh up how much of that increase will lead to a loss of customers."*

In fact, suppliers need to read the market at all times, whether costs are rising or falling (they are never static). There is no simple answer of when to change prices.

This factsheet seeks to explain how we purchase energy and the impact of the recent falls in wholesale prices on the potential for lower retail prices.

### How does E.ON purchase energy for domestic electricity and gas customers?

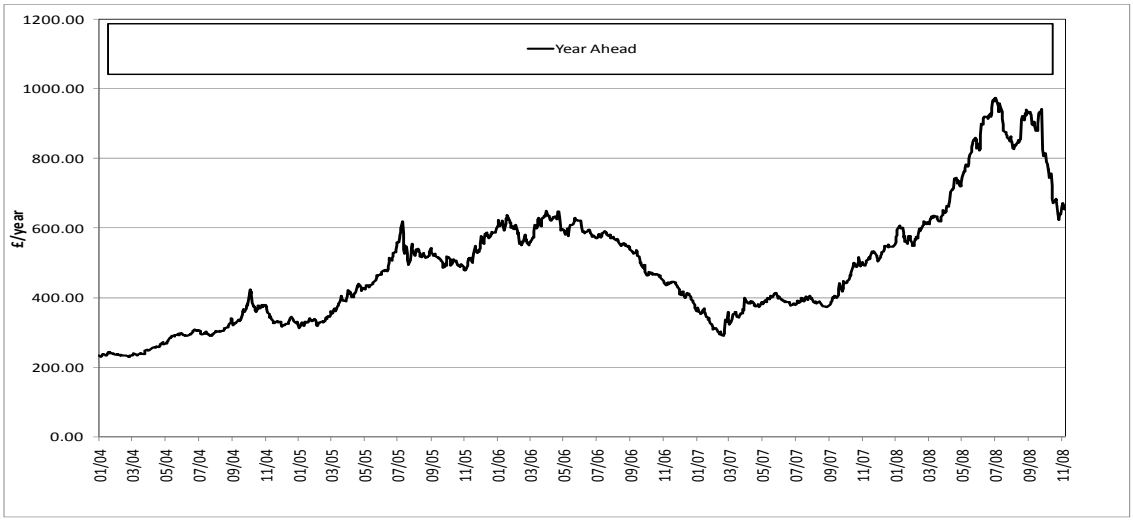
As electricity cannot be stored and gas only in limited quantities, wholesale energy costs are highly volatile, varying in the short term to factors such as weather and plant availability and in the medium term to expectations of movements in oil and other prices and of the margin of supply over demand.

Energy suppliers manage this volatility on customers' behalf. To do this we buy energy ahead of need and over a period of time. These forward purchases can be for some years ahead.

The market price for these forward contracts varies over time. The graph below shows how the year ahead[1] energy costs for an average customer[2] have changed from January 2004 to the present:

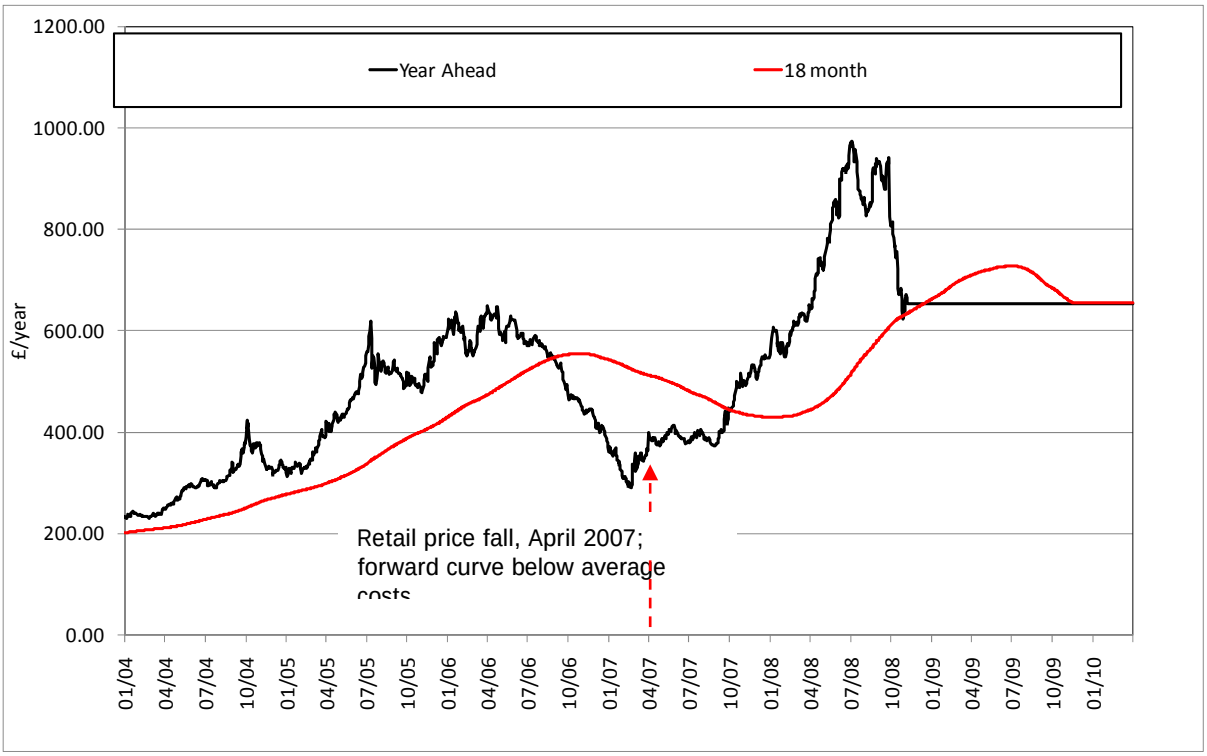
[1] Looking at a whole year removes the effect of seasonal price changes. Short term, "spot" prices vary much more, but do not directly affect retail prices.

[2] Electricity 3,300 kWh; gas 20,500 kWh. The energy cost shown is for a flat demand shape, as traded on the forward markets; the cost for a customer's actual demand profile is higher, but follows the same shape.




By buying forward over different periods, we smooth this volatility for our residential customers. The reasons for this are practical, to reduce estimations in billing, and to reduce uncertainty for customers. Customers can also choose to further reduce volatility, at a small premium, through a fixed or capped price product.

The periods over which suppliers buy energy forwards will vary, but Ofgem's assumption of an average of eighteen months gives the picture. Our energy costs now are therefore the average of the prices we have paid for our forward contracts over the last eighteen months for the current period, as shown by the red line in the graph below. The red line also projects how our energy costs into 2009 would evolve, assuming no change in the forward prices, as shown by the black line (which of course won't happen, but there is no better forecast than the current market price).



Despite the recent fall shown on the graph, forward wholesale prices now are still higher than our current energy costs. This is because our energy costs still include some purchases in the period of low forward prices in Summer 2007 and we are having to replace these with higher priced contracts.

## When will domestic customers' prices fall?

No-one can answer this with any degree of certainty. It will depend on how market conditions develop.

For retail prices to fall, forward wholesale prices will have to fall significantly below our current energy costs, which would require a more sustained and larger drop in forward prices than has occurred so far. This is what happened, for example, at the last fall in retail prices, in Spring 2007. E.ON, like other suppliers, will therefore be keeping the market under review.

Note that there is no rule that there is a six month lag between wholesale and retail prices. This is an observation of what has happened in the past (with the lag no greater when prices are falling than when they are rising), but as Ofgem observed, suppliers need to read the market. We have not previously seen prices rise sharply and then reduce in a relatively short period, so that although average costs have increased substantially they never approached the peak.

It should also be noted, that although customer prices are primarily influenced by energy costs, other elements are also included that currently place upward pressure on tariffs. These include the costs of system operation, environmental obligations and bad debt.

E.ON
13 November 2008