

**Which?**

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## Consultation Response

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### Rebuilding consumer confidence: Improving the transparency of energy company profits

Which? is the largest consumer organisation in Europe. It is an independent, not-for-profit consumer organisation with almost 800,000 members. Which? is independent of Government and industry, and is funded through the sale of Which? consumer magazines, services and books. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

#### Summary

Transparency has an important role to play in the functioning of the energy markets. It should enable more effective consumer engagement and help improve consumer confidence. It is also a tool to enable Ofgem to fulfil its duties. For this to be realised, transparency must be considered more broadly than solely the costs and revenues of supply and generation businesses in vertically integrated energy companies. There must be meaningful transparency across the energy sector - from energy tariffs to transfer pricing to wholesale market data. Furthermore, Ofgem must also consider what data it needs in order for it to effectively monitor the market, not just what information can be made publicly available.

#### Introduction - The need for and value of transparency

The cost of energy is consumers' top financial concern.<sup>1</sup> Contributing to this concern is the low level of confidence that consumers have that the price they pay is fair. The majority of consumers believe that energy companies put profits before customers, with more consumers believing that profits drive price increases than believe increases in wholesale costs are the

<sup>1</sup> In the August 2013 Which? Consumer Insight Tracker, 79% were worried about energy prices, the joint number one worry for consumers, along with fuel prices. Interviews are conducted online with around 2000 UK adults each month. Which? has found similar results since monitoring started in 2009 with energy prices consistently the number one or two financial worry.

#### **Which? is a consumer champion**

We work to make things better for consumers. Our advice helps them make informed decisions. **Our campaigns make people's lives fairer, simpler and safer.** Our services and products put consumers' needs first to bring them better value.

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reason.<sup>2</sup> Many consumers see little point to engaging in the energy market. They find the structure of tariffs complex and confusing, and they think suppliers are all the same. In the end they feel there is little to gain from the time and effort it takes to find the right tariff and switch because, in the end, suppliers will put their prices up anyway. This sentiment of distrust and disengagement is well reflected in consumers telling us they would more likely attempt to reduce their energy consumption, go out less and use the car less often, than switch suppliers to help them manage their next month's budget.<sup>3</sup>

The on-going and very public blame game between suppliers and government arguing over the reasons behind price rises is likely to further contribute to consumers concern. We know that consumers have little confidence in the government to keep the cost of policies under control.

The end result is that consumers have little confidence that the system and the markets work for them. But meaningful transparency across the energy sector can lead to significant steps to address this crisis of consumer confidence. Addressing their low confidence level is critical to improving consumer wellbeing and to gaining consumer buy-in for the move to a low carbon energy system.

#### The breadth of transparency

The focus of this consultation and work-stream is improving the transparency of the reporting of costs and margins in the large suppliers. We support this and our responses to the specific questions are set out below. But transparency should be considered more broadly:

- Transparency should begin with energy tariffs - clear tariffs that enable consumers to understand the offers available and identify the cheapest offers, and drive effective price based competition.
- There should also be transparency of the relative costs and margins along the energy supply chain. These are important indicators of the level and effectiveness of competition at each point.
- And wholesale energy trading should produce transparent and robust prices data, enabling interested parties to assess the level of competition and the value of offers.

#### Transparency - robust and useful

As Ofgem has set out in this consultation document, transparency must be robust and useful. Robustness should come from data, the accuracy of which can be verified. Without this, confidence in the data will be undermined. However Ofgem's interpretation of 'useful' as *'The information should be relevant, meaningful and timely for stakeholders and commentators, without revealing commercially-sensitive information that could harm competition'* is too narrow. Transparency is not just an end in itself - it should be a tool for Ofgem so it can regulate effectively.

<sup>2</sup> Populus conducted telephone interviews with 2009 GB adults and 201 adults in Northern Ireland between 24 November and 2 December 2012. Data were weighted to be demographically representative of all UK adults. Populus is a member of the British Polling Council and abides by its rules.

<sup>3</sup> Figure 8, *The Imbalance of Power: The Challenge of Energy Efficiency*, Which?, November 2013. Data from Which? survey of 2,055 UK adults online, June 2013

We recognise that energy companies are private organisations and that inevitably some information they hold is commercially sensitive and should remain private and should not be made publicly available. However where necessary commercially sensitive information should be available to the regulator, in order to enable Ofgem to effectively regulate the market and fulfil its duties - by monitoring, scrutinizing and taking action where necessary. Where information is commercially sensitive and Ofgem are keen to publish or there is public interest, part of Ofgem's role should be to provide a digested analyses.

## Consultation Response

### 1. Improving robustness

*Question 1: Would a full financial audit provide greater reassurance about the robustness of the Statements? How much would these audits cost?*

Information needs to be accurate and robust. Unless the information provided, regardless of its purpose, is able to stand up to scrutiny it will undermine any confidence in the information. With regard to the Consolidated Segmental Statements (CSS), Which? supports the introduction of a full financial audit. This would provide the otherwise missing verification of the CSS data that will give consumers and commentators confidence in the integrity of the data and ensure that Ofgem has the best available data to monitor and scrutinize the market.

*Question 2: Do you have further information on the appropriateness of the companies' transfer pricing policies beyond BDO's detailed findings? Is there more that could be done to provide reassurance in this area?*

Transfer pricing methodology is used to determine the prices for self-supply within the vertically integrated companies. Whilst there is no clear picture of what volumes of energy are self-supplied, given the size and influence of the six large vertically integrated companies on end retail prices and wholesale prices it is important that consumers are confident that transfer pricing arrangements deliver a fair outcome for them. Unfortunately as our report *The Imbalance of Power: Wholesale Costs and Retail Prices* set out,<sup>4</sup> it is currently impossible to have confidence that the transfer pricing arrangements are delivering a fair deal for consumers.

BDO's analysis found that transfer prices were often, but not always, based on wholesale energy market price information.<sup>5</sup> If the company considered the particular wholesale market to be illiquid and not a reliable source of efficient wholesale energy prices, or it felt there was insufficient wholesale energy price data available, the company would adjust the price information to be 'appropriate'. BDO also found that transfer prices may also be determined

<sup>4</sup> *The Imbalance of Power: Wholesale Costs and Retail Prices*, Which?, July 2013

<sup>5</sup> BDO LLP, Ofgem Segmental Statements Review, BDO LLP - Final Report, January 2012; Ofgem, Improving Reporting Transparency, January 2012.

by the companies' internal modelling, not wholesale energy market price information. As such it is impossible to determine the fairness, or even the level, of the price offered to the supply businesses within these vertically-integrated companies. BDO found the six large vertically-integrated companies tended to self-supply electricity volumes for delivery in three or more years in the future. The wholesale electricity market this far out is particularly illiquid,<sup>6</sup> which reduces confidence that the prices offered are fair or efficient. As a result Ofgem questioned whether the transfer prices charged to the supplier for self-supplying in this time period were fair or competitive.

This poor scrutiny of transfer pricing and the impact for consumers must be addressed. At the very least Ofgem should have access to the transfer pricing agreements in order to understand to what degree the processes set internally are fair and serve consumers, and to better understand the relative role of the self-supply market and understand the wider implications.

Ofgem must also consider the scope of 'transfer pricing' and what else must be captured within its monitoring and scrutiny. For example, charging regimes between business functions for balancing and settlement and access to trading functions, as well as the charging regimes for 'tolling' businesses which are found in two of the six major suppliers. Charging for such functions may or may not fall within transfer pricing, but should clearly still be captured. Access to this information will allow Ofgem to develop a better understanding of the way these companies operate and the arrangements function. Where the information be commercially sensitive, Ofgem must also provide digested analyses to give consumers, government, media, consumer representatives and commentators confidence in the arrangements.

## 2. Improving usefulness

*Question 3: What information could the companies usefully provide on their trading functions that would improve the transparency of the profits in their generation and supply businesses? What are the costs and benefits of including the trading function in companies' Statements? How possible is it to distinguish between trading for hedging and speculative purposes?*

We believe that the information made available should be relevant to understanding the dynamics and influence of the large vertically integrated companies. We do not believe it should be limited solely to profits in supply and generation. Whilst these are key business functions they do not in themselves provide the full picture. Ofgem should take steps to incorporate trading into the existing reporting. In addition, Ofgem should review which other functions in these firms should also be included in the reporting to enable Ofgem to thoroughly scrutinise the arrangements. Where companies have pan-European functions, Ofgem should work with other European regulators and ACER to put in place appropriate

<sup>6</sup> Chapter 4, *The Imbalance of Power: Wholesale Costs and Retail Prices*, Which?, July 2013



systems. Again, where this information was clearly commercially sensitive, Ofgem could provide a digested analysis to stakeholders and commentators.

*Question 4: Do you agree with the proposal of reducing the deadline for companies to compile and publish their Statements from six to four months? What are the costs and benefits of doing so?*

We support Ofgem's proposal to reduce the deadline from six to four months. This would improve the timeliness of the information for stakeholders and commentators, as well as the information for the regulator and so enable Ofgem to take action more promptly where needed.

*Question 5: Do you consider that there is merit in calculating a ROCE for the generation businesses of the six large energy companies, but not for their supply businesses? Are there any specific issues with how ROCE should be calculated for generation?*

We support Ofgem's proposals to investigate whether the ROCE could add value. This investigation should consider if and how it will be possible to make meaningful comparisons between both the different business functions which do and do not have ROCE and comparisons with analysis from previous years.

### 3. Improving accessibility

*Question 7: How else could Ofgem or the energy companies themselves improve confidence in the energy markets?*

Improving the quality of information regarding the relative profitability of supply and generation in the large vertically integrated energy companies is a positive first step but it must be seen as a first step. As we have set out above, the scope of transparency should be broadened and presented together with a clear articulation from Ofgem of whether this resulting information suggests that the markets are or aren't delivering for consumers. An example of where this currently does not happen is the recently published '*The revenues, costs and profits of the large energy companies in 2012*'.<sup>7</sup> According to Ofgem's analysis of the CSS, in 2012 the average EBIT margin in Generation was 19.9% but Ofgem did not state whether this level of EBIT margin was appropriate or not. When presented alone, without any indication of, for example, how this compares internationally or whether or not this generous profit could be deemed to be super-profits, it raises concerns of whether or not companies are benefiting at consumers expense. We hope that the Market Assessment will address this.

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<sup>7</sup> *The revenues, costs and profits of the large energy companies in 2012*, Ofgem, November 2013