

6 November 2014

Dear Mr Villalobos

Rebuilding confidence: actions to improve the transparency of energy company profits

This submission was prepared by the Consumer Futures team within Citizens Advice. It has statutory responsibilities to represent the interests of energy consumers in Great Britain and we welcome the opportunity to respond to this consultation. This response is not confidential and can be published on your website.

Concerns about the relationship between costs and profits have contributed to incredibly low levels of consumer trust in energy suppliers.¹ Suppliers routinely attribute price movements to some combination of wholesale cost, network cost and/or social and environmental cost changes but the publicly available data often does not support their statements. As we have stated in earlier responses to consultations on the transparency issue, we find the Supply Market Indicators (SMI) a very useful contribution to the energy debate because they provide a more contemporaneous view of profitability and costs than the Consolidated Segmental Statements (CSS). The CSS are significantly aged by the time of their release; the absence of data on trading activity means they give only a partial picture; and the absence of a full independent audit and difficulties reconciling them to statutory accounts means it is hard for a third party to have confidence in their validity.

We therefore broadly welcome the initiatives outlined in this consultation document to address some of these issues. Requiring for example, the policy-by-policy disclosure of the costs of environmental and social policy obligations is a welcome development. We also support Ofgem's minded-to position not to extend the obligation to produce these statements to companies outside the Big Six.

¹ YouGov polling in September 2013 found that 56% of people agreed that "energy companies treat people with contempt" while only 7% disagreed. 83% felt suppliers maximise profits at the expense of customers <http://tinyurl.com/qbjq>. A subsequent YouGov poll in June 2014 found that 84% of people agree that companies are quick to raise prices when their costs go up, but slower in offering discounts when they fall <http://tinyurl.com/qdn7rz8>.

We do however firmly believe that Ofgem should reconsider some other aspects of the proposed changes, in particular not to require that the CSS audit be undertaken by an independent firm and not to introduce changes to increase the visibility of companies' trading activities. We also think that Ofgem could further reduce the publication deadline for the CSS. By publishing its 2013 CSS alongside its financial results, Centrica has put paid to the idea that 'months' are needed to prepare these documents. A more detailed explanation of our position on these and other issues is set out in the attachment to this letter.

Ultimately though, while reforms to improve the CSS are important, they are nevertheless incremental and nothing short of an in-depth review of transfer pricing that we expect the Competitions and Markets Authority (CMA) to undertake as part of its investigation into the energy market will provide consumers with a clear and trusted view on the basis for their energy bills.

Please do not hesitate to contact me should you require any further information.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Chris Alexander', followed by a small dot.

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Attachment

1. Do you agree with the proposal to tighten the scrutiny of companies' transfer pricing policies?

Yes, but these proposals could go further. In our response to the December 2013 consultation we called for Ofgem to do two things to provide assurance on transfer pricing. The first was to incorporate the results of trading functions in the CSS. The second was to commission a full financial audit of the CSS; one which also had regard to the appropriateness of the companies' transfer pricing policies.² Ofgem proposes to respond to the second (which we welcome) but not the first of these asks. We remain of the view that both should be taken forward.

In our view, Ofgem's inclination to reject the first ask is based on a misinterpretation of the nature of the BDO Report. According to Ofgem, the key finding of the BDO Report is definitive; that "the large energy companies price internal transactions between generation, trading and supply arms at arm's length". But the BDO Report was not a comprehensive audit of both policy and practice of the sort HMRC conducts so our interpretation is a more qualified one. What it actually provides is not this clear *positive* level of assurance but a weaker *negative* one i.e. that nothing was identified that was inconsistent with the arm's length standard that would materially impact the CSS.³ This is not to say that we discount the BDO Report, it is merely to point out that some caution needs to be exercised in interpreting its findings.

Our concern here is that the information that Ofgem seeks to combine with the BDO Report to provide a positive level of assurance – data on the trading results of the Big Six – is itself incomplete. The data submitted by Centrica and Scottish Power about their trading activities, and the partial data provided by SEE, cannot be considered to provide a representative view of trading profits across the Big Six given it excludes the Europe-based E.ON, EDF and RWE Npower. We do not believe that a line can be drawn under the transfer pricing issue until we also have a clear view of the actual trading activities of the remaining three Big Six companies.

We do not find at all convincing the arguments these companies make that it is 'difficult, unduly costly, or even impossible' to isolate the trading data relevant to their GB business and believe that Ofgem should use its powers to compel the full disclosure of this information. Although we do not understand the basis for Ofgem's view that there may be legal barriers to it doing so, this appears to be a situation where it could consider using its powers under Article 40 (electricity) and Article 44 (gas) of the EU 3rd package to force suppliers to disclose their actual trading strategies and costs.⁴

We remain of the view that if the CSS are intended to provide confidence in the true level of profits in the UK then any artificial expatriation of profits, even if entirely legal, needs to be taken into account.

² Consumer Futures, Response to consultation, "Rebuilding consumer confidence: improving the transparency of energy company profits" 6 December 2013, <http://tinyurl.com/kand4e6>.

³ Review of Big Six Transfer Pricing Policies, October 2014, BDO, <http://tinyurl.com/prryvbw>.

⁴ Consumer Futures response to Ofgem consultation, 'Rebuilding consumer confidence: improving the transparency of energy company profits'. December 2013

2. Do you agree with the proposed audit requirement? Do you have any views of the detail of the requirement?

While Ofgem's proposal allows the audit to be conducted by the same firm that performs a company's statutory audit, BDO's recommendation in its 2012 report was for it to be undertaken by an *independent* auditor to ensure that the opinion was not clouded by existing relationships. This was a recommendation that we supported then and continue to support now. We accept that there are arguments both for and against requiring an independent audit – potential additional cost being one of them – but given the parlous state of trust in energy companies means that the presumption should be for more impartiality not less and we are disappointed that these issues have not at the very least been explored in the consultation document.

3. Do you agree [with] the proposed change to the reconciliation requirement?

Yes. The difficulty we have relating the CSS back to the statutory accounts of firms has been such that we have found them to be of very limited practical value. Obligating companies to reconcile their CCS to their UK statutory accounts is in this context a common sense change. The fact that some Big Six companies do not publish UK statutory accounts poses an obvious problem for this reconciliation issue, and requiring that they be reconciled back to audited figures in group accounts seems a sensible albeit second-best solution. Given however that concerns about profit shifting between jurisdictions is a central to the question of transfer pricing, the onus really is on Ofgem to consider other ways it might address this issue – at the very least it contributes to the case for the CSS audit to be undertaken by an independent firm to provide a further level of assurance.

4. Do you think the obligation to produce Consolidated Segmental Statements should continue to be targeted to large vertically integrated companies? If not, who do you think the obligation should apply to and why?

Yes, we do not believe there are grounds for extending the scheme. The CSS was originally a recommendation of Ofgem's 2008 Energy Supply Probe to address concerns that the Big Six were using incumbency and vertical integration to exploit the relationship between wholesale and retail energy prices, and importantly for this question, in a way that made it difficult for smaller, non-vertically integrated firms to compete on fair terms. Despite various interventions by Ofgem in the time that has elapsed since 2009, this concern remains essentially the same in character and will be a central line of enquiry for the CMA in its market investigation. Given the production of audited CSS statements comes at a cost, costs that might prove material for a small player looking to break into the energy market, it should not be extended without a solid justification – one that we do not believe exists at this point in time.

5. Do you agree with the proposed cost categories, and the detailed allocation of cost between these categories? Do you agree with the additional financial and non-financial information to be disclosed?

The refinements to the way the information is presented in the CSS appear sensible and we support them. As we have stated in earlier responses, our main problem with the CSS has been around timing. The lag between the publication of the companies' annual financial

results and the CSS, and has meant that it does not provide a contemporary view of competitiveness and profits in the energy sector.

The proposal to reduce the publication deadline for the CSS from the current six to four months is a good step forward. But given Centrica was able to publish its 2013 report alongside its year-end financial results on 20 February 2014, we think there is a good case for a tighter deadline. In our view the deadline should be set by reference to the firm that responded best to Ofgem's challenge to accelerate CSS publication, therefore stretching lagging firms to catch-up and mirroring what we see in competitive markets, not the other way around, which might be seen as rewarding tardiness.

6. Do you agree with our proposal to require further breakdown of environmental and social obligations costs from the 2015 statement onwards?

Yes. We support and welcome the proposal to require the companies to provide a disaggregated view of social and environmental policy costs as a component of suppliers' overall costs. As we noted in the covering letter to this response, companies often point to the costs of specific environmental or social policy as driving pricing trends⁵ and a more granular view of their actual contribution will help third parties better scrutinise these statements.

7. There is a potential tension between transparency and competition. Do the benefits in improved transparency this package aims to deliver outweigh the risks of an adverse impact on competition?

We do not believe the information that will be disclosed under the amended CSS Ofgem proposes in this paper will adversely impact competition. Moreover even if one believed that information in the CSS might have some detrimental impact on competition (which we do not), the risks appear minor compared to the benefits in terms of renewed trust that improved levels of transparency can deliver in a market – a market whose very fundamentals are in the process of being investigated by the Competitions and Markets Authority (CMA).

⁵ See for example, reference to ECO costs in Npower's media statement for its half-year 2014 performance <http://tinyurl.com/mdkvley>