ecotricity

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12th December 2014
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The Renewable Energy Company Ltd (Ecotricity) Response To Statutory Consultation on proposed licence modifications to improve the transparency of energy company profits

Dear Robyn Daniel,

Ecotricity is a renewable energy generator and supplier with over 145,000 customers and 71MW of renewable generation across the UK. As a small independent participant in the energy market, the impact of the lack of transparency employed by the Big Six energy companies has long concerned us. We have expressed these concerns in various consultation responses including May 2012, July 2012, December 2013 and November 2014.

We support the overarching objectives to increase scrutiny and transparency and believe these are long overdue. Ofgem should continue to focus on policy that directly and indirectly enables increased renewable power capacity, improves competition and prevents abuse of market power. Increasing scrutiny and transparency are measures that will undoubtedly improve these problematic areas of the energy industry.

Relevant Licensee Definition

We note that the definition of relevant licensee is to be modified to indicate it only refers to suppliers that are part of a vertically integrated group of companies.

We would like to caution that Ofgem should not treat all vertically integrated energy companies in the same manner. As previously noted, vertical integration, where large baseload generation capacity is linked to a supply arm, can harm the competitive position of non-integrated firms. We strongly question, however, whether the same is true for small-scale intermittent vertically integrated companies, such as Ecotricity.

We are pleased to see that Ofgem will consider the scope of the obligation to produce Consolidated Segmental Statements outside of the Big Six after the findings of the CMA investigation have been published. It should also ensure independent suppliers are given sufficient time to prepare for the change.

If they are included, Ofgem must make a distinction in its approach between those vertically integrated suppliers with market power and those without. The level of scrutiny and reporting obligations should be proportionate to this level of power. The greater the size of the company, the more likely it is that its vertical integration will have an adverse effect on competition. It is for these reasons that independent vertically integrated companies should not be subject to the same scrutiny and reporting burden as the Big Six.

International Transfer Pricing

Regarding transfer pricing, we must reiterate our previous concern that has not been addressed in the statutory consultation. Scrutiny to transfer pricing for large energy companies must apply to both UK and international arms. Multinational transfer pricing enables companies to mask their profits for taxation purposes and move money between various arms and jurisdictions. Intra-group transfer pricing activities between UK and foreign arms of the same group of companies can influence wholesale, and in particular, retail pricing. Thus international transfer pricing itself is undoubtedly as significant a threat to competition in the energy market as vertical integration. As an independent British company, Ecotricity do not have the option of moving funds to arms in foreign jurisdictions as some of our competitors do; and this gives them an unfair competitive advantage.

Draft Condition 19.A.7 states the following:

The Relevant Licensee must, for the purposes of ensuring the transfer pricing methodology is appropriate and up to date:

a) *Keep transfer pricing policies under review;*
b) *Ensure that the supporting information that supports the transfer pricing policies remains appropriate and up to date; and*
c) *Include transfer pricing policies and procedures in any appropriate annual audit.*

We recommend amending the sub clauses a-c to state that all relevant licensees have an obligation to include transfer pricing policies for both their UK and international arms.

Misleading Profits

Transfer pricing is an integral tool for the Big Six. Currently they are able to sell power from their generation arm to their relative trading arm. Subsequently a degree of revenue can be placed into the generation business; often in a foreign country. Generation stations in the UK are therefore able to sell power to the trading business, and keep their profits in another country. This is because the generation business is a separate subsidiary company located outside of the UK.
Consider the following hypothetical scenario: an energy company, with its retail base in the UK, operates its trading arm elsewhere. The trading arm's cost base is defined by what the generation arm has sold them, (the generation arm can also be held abroad) whilst their profit comes from selling power to their retail business. The retail business' cost base is determined by trading and generation; it can therefore set tariffs to sell to end customers based on payments made to its own trading arm in a different country. The trading arm's

profits will be subject to different tax legislation and will not be evident in the UK, despite the fact that they belong to the same company. If the tax rules in the country in which the trading arm sits are more favourable than that of the arm, then there is an incentive for the trading arm to artificially inflate prices.

Secondly, there is the on-going concern regarding the lack of transparency over fossil fuelled generation marginal costs, of which set the benchmark of the overall wholesale electricity price. Further scrutiny is required to ensure these aren't being over inflated or skewed in a manner which is detrimental to the industry, and in turn end consumers.

Audits

We support the requirement for Consolidated Segmental Statements to be evaluated by an appropriate auditor. However, we once again strongly advocate this applies to transfers between jurisdictions. Without this, an incomplete picture of the companies' finances is inevitable. Declared profit of just the UK arm may be an inaccurate reflection of actual margin achieved as profits can be obscured.

Conclusion

Overall, we are pleased that Ofgem intends to increase the level of detail and scrutiny and require audits.

We support Ofgem's approach of waiting for the CMA to publish its findings before deciding on whether to expand the scope of obligated licensees. Should the scope be expanded, Ofgem must account for the differences between independents and the Big 6; when determining the reporting burden of each.

We are also pleased that Ofgem is now focussing on transfer pricing; however, we do not believe that it is sufficient to only look at the UK. The potential tension between transparency and competition can only be fairly evaluated once the impact of international transfer pricing is determined.

Ecotricity welcomes the opportunity to respond and hope you take our comments on board. We also welcome any further contact in response to this submission. Please contact Emma Cook on 01453 769301 or emma.cook@ecotricity.co.uk.

Yours sincerely

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