Citizens Advice

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Dear Sir / Madam

Re: Consultation on "Approach to financial and probability analysis"

Citizens Advice holds statutory responsibilities to represent energy consumers in accordance with the Consumers, Estate Agents and Redress Act 2007.

This submission provides our response to the consultation on your approach to financial and profitability analysis published on 8 December. It is entirely non-confidential and may be published on your website.

We are broadly comfortable with the proposed approach set out by the CMA, and wish to make only a limited number of observations on it. We group these thematically in the following pages.

Supply

Given that energy is an essential service, it is crucial that the market serves all consumers well and not simply those in more attractive demographics.

As we have noted in previous submissions and in our meeting with the inquiry team on 30 October, we consider that energy supply is not a single homogenous market but multiple markets, each with quite different characteristics. Segmentation is most apparent in the areas of payment method and in the disparity between acquisition and standard tariffs. Consumers with non-standard metering systems, and those who lack access to the internet or basic banking services will also find themselves constrained to a sub-segment of the market. Switching rates vary by region and the vertically integrated suppliers retain much higher market shares than their national averages in those regions where they were the former monopoly.

We support your proposal to break down analysis of profitability by type of tariff, by type of customer and by region. We would be happy to speak with you further to help you identify appropriate subsets of the market.

Separate analysis of supply and generation

We support your intention to consider the profitability of generation and retail businesses separately. This is necessary as vertical integration is a choice, not a compulsion. The Big 6 firms are in competition with a range of independent generators and suppliers who are not, generally, vertically integrated. This means that their upstream and downstream businesses must be considered separately in order to allow for a like-for-like comparison of profitability and efficiency. Noting that generation is considerably more capital intensive than retail supply, any structural factors that make participation in the latter difficult without presence in the former are likely to create barriers to entry and reduce efficiency incentives.

If both generation and retail markets were individually competitive we would expect cross-subsidy to be unsustainable, as the presence of competition in the segment that had been inflated to subsidise the other would be eroded away by that competition. In practice, there appears to be some evidence that this is not happening. For example, the Consolidated Segmental Statements (CSS) show a roughly billion pound swing in the location of [Big 6] profit from generation to domestic supply activities between 2009 and 2013[i]. The recent woes of the generation sector are well known (and captured well in paragraph 50), but an ability to self-compensate by inflating prices in the supply sector to compensate for those lost profits may suggest soft or inadequate competition in energy supply.

The type and scale of collateral required to participate in the market is raised in your consultation document principally in relation to generation activities but it is also pertinent to the consideration of energy supply.

Generation

In the area of generation profitability, your analysis may be complicated by significant ongoing turbulence in the economic signals faced within that sector that mean that profitability today is not a good proxy for likely future profitability. For example (and this is not intended to be an exhaustive list):

- The introduction of the capacity mechanism from 2018.
- The introduction of a strategic reserve (“Supplemental Balancing Reserve”) with effect from winter 2014/15.
- Changes to the transmission charging regime resulting from Project Transmit, the implementation of which are currently subject to judicial review.
- Ofgem’s intention to move to single-price fully marginal cash-out, which is expected to be implemented in November 2015.
- The introduction of a GB-only “top-up” carbon tax (the Carbon Price Floor) on fossil fuel generation. While its influence on new investment decisions may be limited, the CPF will have the effect of creating windfall winners and losers amongst pre-existing generation as it has a differential effect on the input costs of different technologies.
- The phase-out of the Renewable Obligation and introduction of CfDs from 2018, including a progressive phasing in of competitive price setting and steady expansion in the Levy Control Framework from £2bn in 2011/12 to £7.6bn (in 2011/12 prices) by 2020/21.

- While the current global coal glut has meant gas generation spark spreads have been depressed, this may not persist as a considerable amount of coal-fired generation has either recently closed or will need to close shortly to meet environmental obligations.

In many areas, these changes – once the dust has settled – should improve the future profitability of the generation sector. A move to fully marginal cashout should improve the profitability of flexible generation, while the capacity mechanism is likely to improve the profitability of all thermal generation – resulting in material transfers of wealth from consumers to generators. The introduction of CfDs will also de-risk generation activities for those generators receiving them – pushing commodity fluctuation risks (and costs) onto consumers. As coal comes off the system due to environmental regulation, the viability of pre-existing gas plant should also improve. Given this substantial flux in the generation sector, caution should be exercised in drawing strong conclusions on its likely profitability in the short to medium term based on a snapshot of where it is now.

We agree with your proposal that profits arising from portfolio optimisation should be considered within the scope of generation activities. Your characterisation of the toll generator model in Appendix 1 matches our understanding, and highlights that significant parts of the value associated with generation assets is transferred to their trading arm of those businesses that adopt this model.

Nuclear assumptions

We think the statement in paragraph 62 that "a new entrant wishing to provide base load electricity over the Relevant Period would have chosen between constructing a new nuclear power station… or building a CCGT" is false. We are not aware of any fully merchant (i.e. subsidy free) nuclear power station having been developed anywhere in the world during that period. That nuclear projects cannot be brought forward without subsidy is further evidenced by the Government's decision to offer considerable subsidy to the new project at Hinkley Point C ('HPC'); the agreed strike price is roughly twice the current wholesale power price. While the incoming CfD regime allows for subsidies to be offered to nuclear projects, the outgoing RO regime – which was the one in place during the Relevant Period – does not. We would suggest you narrow your assumption in this area to CCGT only.

Notwithstanding this, if you wish to use newbuild costs for HPC in your analysis as suggested by paragraph 63, a further information source to those suggested is the analysis conducted by the European Commission as part of its consideration of the State Aid case. The Commission's full decision has not yet been published, however discussions with its officials suggest that it included a distributional analysis of possible build costs. It should be borne in mind that the National Audit Office has been highly critical of the process adopted in awarding early CfDs on an administered basis and without competition to renewables[ii], questioning whether the process adopted offers consumers value for money – and the approach adopted by DECC for the HPC deal shared much in common with those deals.

Tax

The consultation is largely silent on the question of tax, bar a passing reference in Appendix 3 on assumptions on marginal tax rate. We think there is a gap in your considerations here in relation to understanding whether the company structures adopted by the overseas owned vertically integrated players have the effect in some instances of artificially suppressing their reported UK profits.

It has been alleged that two of the Big 6 use intra-company financing arrangements to effectively transfer profits from UK activities to overseas jurisdictions where they will be subject to a lower effective tax rate[iii]. There is no suggestion that this is illegal and the companies involved have strongly refuted any suggestion of wrongdoing. But we consider that any ability to move the reported location of profits resulting from UK activities to the reported results of a different subsidiary in a different country could impede an understanding of the true level of profitability of their activities in this country.

We encourage you to seek to identify any areas where financial engineering is used to effectively transfer the reported location of profits overseas and to include those profits in your assessment of UK activities.

Cost of equity and choice of betas

We are comfortable with your use of the CAPM methodology for estimating the cost of capital, and agree that it is a widely understood technique with strong theoretical foundations. You indicate that your consideration of the equity risk premium will include both historical and forward looking approaches, again we think this seems sensible.

For the historical analysis, we wish to caution against over-reliance on long term averages as these may not be representative of the Reference Period. The long-run real rate of return on UK equities is in the region of 5-6% but this has declined to 1.2% thus far this century[iv]. This was heavily influenced by the global financial crisis and may not be sustainable in the longer term. But short-run averages may provide a better reflection of the choices that were available to investors during the reference period – of the investment alternatives they actually had.

We recognise the difficulties in finding an appropriate beta value or range of beta values for the sector. We suggest that, where possible, you give greater weight to those who are either solely or mostly active in the UK to try to reduce the risk that the result is polluted by non-UK activities. For example, it is widely recognised that the German Government's decision to bring forward the forced closure of nuclear power stations following the Fukushima disaster has weighed heavily on the performance of E.on and RWE at group level – but is not really relevant to a consideration of the profitability of their UK activities.

Comparator returns

We agree with the range of competitive benchmarks suggested in paragraph 85. In analysis for its 2008 Energy Supply Probe, Ofgem provided useful comparators that we think are still relevant[v]. We note that for the forthcoming 2015-20 price control the water regulator Ofwat has just set a 1% margin on retail bills and a 2.5% margin for non-domestic customers who will be subject to competition from 2017.

Networks

Transmission and distribution networks are left outside the scope of the analysis. This is consistent with the proposal to exclude these activities from the scope of the investigation in your Issues Statement. In our response to the consultation on that document, and in our meeting with your inquiry team, we asked you to re-consider that exclusion. Their exclusion from the profitability analysis suggests the CMA is not minded to change its view. When you publish the annotated Issues Statement in early 2015 we expect to see a clear explanation of why you have rejected requests to consider network profitability.

We would be happy to discuss any aspect of this submission in further detail if you would find that helpful.

Yours sincerely

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[i] Earnings before interest and tax (EBIT) in the Big 6's generation activities declined by £1.07bn from 2009 to 2013 while EBIT for their domestic supply activities increased by £0.92bn over the same period.

[ii] "Early contracts for renewable electricity," National Audit Office, 27 June 2014. The NAO is conducting a separate inquiry into the HPC deal but is yet to report its findings.

[iii] These allegations featured in a Channel 4 documentary in November 2013. http://tinyurl.com/otoyc9h

[iv] The annualized real return on UK equities from 1900-2013 was 5.3%; from 1964-2013 was 6%; and from 2000-2013 was 1.2% (source Credit Suisse Global Investment Returns Yearbook 2014).

[v] Please see paragraphs 8.19 to 8.22 of its October 2008 Initial Findings. http://tinyurl.com/q89oemv