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Derek W Louden

Dear Roger,

04 Aug 2015

Response to provisional findings and the notice of possible remedies

I write to you in regard to the CMA's energy market investigation and in response to the provisional findings and notice of possible remedies which you've issued.

During the course of your Investigation I wrote to you in regard to the profitability from generation of the "Big Six" energy firms. The evidence I provided was based on the firms' submissions to OFGEM over a number of years. It showed that some firms had earned, and were earning, supernormal profits from their generation activities. These EBITDA returns exceeded 60% for a period for one of the "Big Six". This means that of each £1 they collected from generation, 60p was gross profit. I awaited your provisional findings with anticipation, fully expecting that you would find this excessive.

Your provisional findings concluded that the returns earned from generation were not excessive. Consequently, there were no remedies suggested for the generation side of the "Big Six's" operations. I was, and remain, astonished.

I'm struck that there are three possible reasons for the conclusion you have drawn:

1) The evidence the "Big Six" provided you with did not tally with the evidence they gave on their annual returns to OFGEM (you were told their returns were lower than the 50-60% maximum) – you were misled.

2) You consider that EBITDA returns over 50% and sometimes as high as 60% are not excessive.

3) You knew the returns made were excessive but chose to prevent this being disclosed.

Which is it?

Your report doesn't show the EBITDA returns from generation. Some of the "Big Six" were unwilling and/or unable to provide you with a breakdown of their profits by generation type. This suggests they don't know which of their plants make a profit nor how much. You didn't require them to produce this evidence, suggesting you felt profitability in generation didn't matter. You seem to be sensible people who've had successful careers in the professions and in industry. How could you accept a suggestion that "Big Six" firms don't know which plants make money –that's daft.

EBITDA returns were available to you from the data supplied by the "Big Six" to OFGEM and by the submission I sent you. These are both in the public domain. There could be no detriment to any of the "Big Six" from you placing this EBITDA information in plain view - in total - if not by generation type, in the body of your report. You *chose* not to do so. All the information by generation type in your report is redacted. I can see some justification for not showing EBITDA by type of generation but not for missing out the overall total EBITDA return which is already in the public domain.

Having spent over 20 years responding to MMC and OFT investigations into Motor Fuel prices in the Highlands and Islands I shouldn't be surprised to find that we now have the highest electricity prices in the UK due to a unique set of circumstances. SSE's generation arm takes the benefit of the ultra-low cost of generation from hydro power stations. They have refused to disclose the profitability of hydro generation and you have supported their refusal, failing to require them to do so. We're billed the going rate for gas-fired plant, the running cost of which has increased in recent years when the running cost of hydro was unchanged. At the same time SSE's supply arm is allowed to levy a surcharge on Highlands and Islands consumers for the extra cost of maintaining the grid.

From our pre-privatisation position of the lowest price we've travelled to the current position of the highest price. This is great for shareholders, terrible for those on benefits, pensioners, those with disabilities and customers in general in the Highlands and Islands. In light of the supernormal profits earned by SSE's generation arm in the Highlands & Islands the surcharge levied by SSE on Highland customers by their supply arm is unjustified and must end now. You must end it.

The above comments relate primarily to the omissions in your report. The remainder of my comments will be addressed at your findings and your suggested remedies.

Page 7 – Point 21
"Reported wholesale costs remained flat while profit (EBIT) margins fluctuated over the period."

The measure you have chosen in this instance (EBIT) is influenced by asset write-downs on what are known as "stranded assets" these are of two types:

1. Combined Cycle Gas Turbines (CCGT) were built during the "Dash for Gas" but the gas turned out to be neither plentiful nor cheap so they're written off reducing Earnings Before Interest and Taxation (EBIT). My measure Earnings Before Interest Taxation Depreciation and Amortisation (EBITDA) takes account of this and gives a "profit before pockling" figure.

2. Coal-fired plant being phased out due to CO_2 emissions which have to close for the UK to meet its Climate Change obligations.

In both cases the cost is being passed on to consumers. The charges being taken by each company help to reduce their net profit and hence their tax bill. It also allows manipulation of raw material prices (coal and gas) by foreign-owned companies who can base their fuel purchasing operation in a low tax location and then charge a higher price to their UK subsidiary. I've seen nothing to suggest this has been properly looked and addressed. It must be. Raw material costs should not exceed market prices. Charges for Capital should not exceed market rates to reduce taxable profits in the UK. Sort this now!

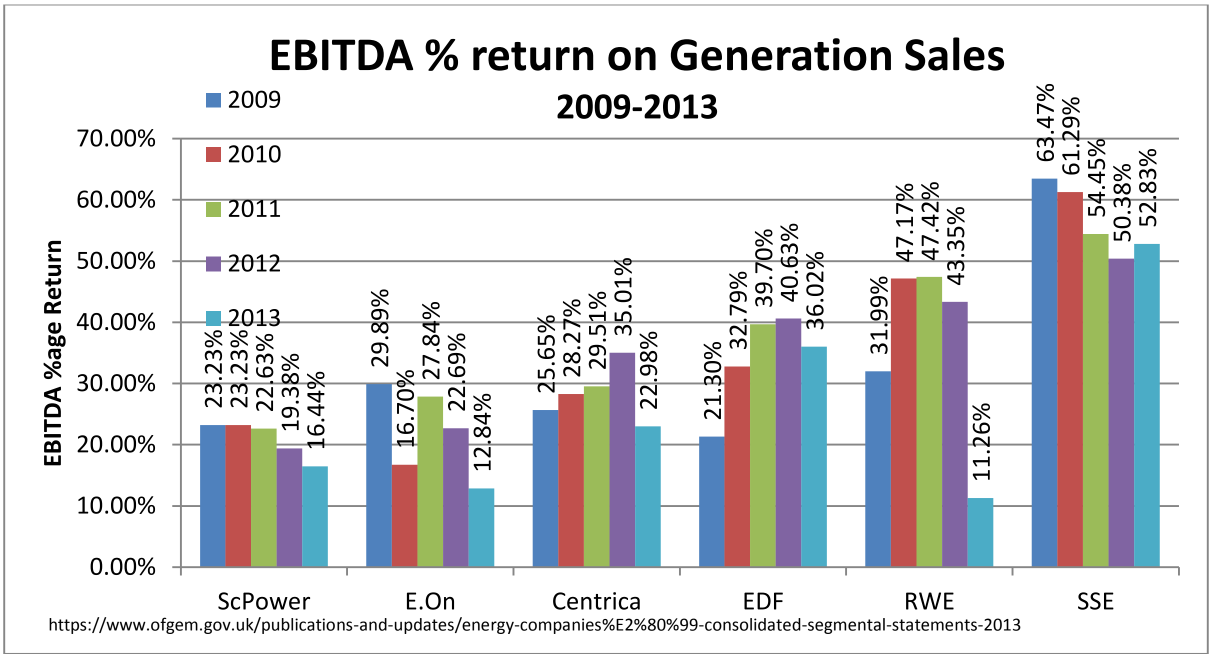
Competition in wholesale electricity markets

Page 10 – Point 38
"...our analysis of the profitability of the generation operations of the Six Large Energy Firms between 2009 and 2013 indicates returns that were generally in line with or below the cost of capital. Our provisional view is that the profitability analysis does not provide evidence that

overall, the Six Large Energy Firms earned excessive profits from their generation business over the period or that wholesale market prices were above competitive levels."

This time you even abandoned EBIT in favour of Return on Capital Employed (ROCE) as your measure of profitability. You concluded that the returns earned from Generation were not excessive. I've got no idea what numbers CMA used for Capital Employed as they aren't shown in your report. What is in the public domain are the figures for EBITDA provided by the "Big Six" to OFGEM each year.

Working out the EBITDA shows very high returns being earned:



http://www.slideshare.net/LoudenDW/dl-analysis-of-wholesale-margins-150315

Foreign-owned firms might well be able to shave bits off their profit by charging their UK subsidiary an inflated price for coal or gas supplied from the holding company to the subsidiary. Any such manipulation via "Transfer Pricing" is illegal. This needs to be checked by you and if found to be the case corrected now.

Page 40 – Section 180
"There were several factors behind the observed differences in profitability between the Six Large Energy Firms, such as differences in average price levels and differences in costs (including wholesale energy costs and indirect costs).
....some firms may not have operated efficiently."

In addition to raw material Transfer Pricing referred to above, this element introduces a second factor which won't affect EBITDA or EBIT calculations but does affect ROCE. What is the Cost of Capital being used? The interest rate should be the Market Rate but your investigation allowed the businesses to set their own Internal Rate of Return (IRR). In other words, a Foreign-owned firm may choose to set up a subsidiary in a tax haven and charge a high Interest Rate on its intra-company loans to the UK (and possibly other) subsidiaries. Profits would be lower in the UK than they would be if a market rate was charged and the UK tax bill would be reduced accordingly. This is a more sophisticated form of "Transfer Pricing" which you've overlooked. Check and sort this now!

Vertical Integration

Page 19 – Section 79

"Overall, we have not identified any areas in which VI is likely to have a detrimental impact on competition for independent suppliers and generators."

Page 20 – Section 84

"Retail energy suppliers do not own or operate any of the physical assets required for the delivery of gas or electricity to their customers' homes."

I'll take these two statements with regard to Vertical Integration (VI) together. The first claims that VI isn't detrimental to competition for new entrants vis-a-vis incumbents. The grid needs strengthened to deal with the huge amount of renewables being connected. This cost can either be spread across all existing grid users or it can be borne by individual new entrants. Incumbents want the second option as the grid strengthening is being paid for by new entrants. Were the cost spread over all grid users then a barrier to entry would be lowered encouraging new competitors to enter the market. This would also encourage businesses controlling the grid to be more cost effective in their solutions since they will share in the cost. If your competitors pay to get connected then you will be encouraged to produce a cost-maximizing solution to grid expansion.

The second statement is correct in England and Wales where the National Grid controls the infrastructure. It isn't the case in Scotland where the grid in the Highlands and Islands is controlled by Scottish Hydro Electric Transmission plc (usually referred to as SHETL) a subsidiary of SSE. The grid in the south of Scotland is run by Scottish Power Energy Networks Holdings Limited.

Technically the Supply arm of SSE and Scottish Power would be separated by "Chinese Walls" from the Transmission and Distribution arms of the business but to say they don't own or operate them is either going a bit far or displaying a lack of understanding of how things work in Scotland.

The incumbents don't appear in any hurry to hook up competitors. The position in the Highlands and even more so the Islands where cabling has been delayed by getting on for 10 years shows this to be a considerable barrier to entry. Many potential users have simply given up. The cost cannot be borne by individual developers, it must be spread amongst all existing users of the grid. One Western Isle will however succeed in hooking up. Ireland won't face the same charges for use of system once it hits the UK mainland. The Irish Interconnector will be built before the Western and Northern Isles are hooked up. This is a problem which the CMA's Inquiry has *chosen* not to address fully. Location pricing intends to rebate distant producers somewhat. It will still leave them paying more than French Nuclear producers pay. You cannot leave this charging regime in place.

Prepayment Meters

Page 22 – Section 94

"Premiums paid by current dual-fuel SVT prepayment customers are currently about the same as those for standard credit – about £75-£80 per year (compared with paying by direct debit)."

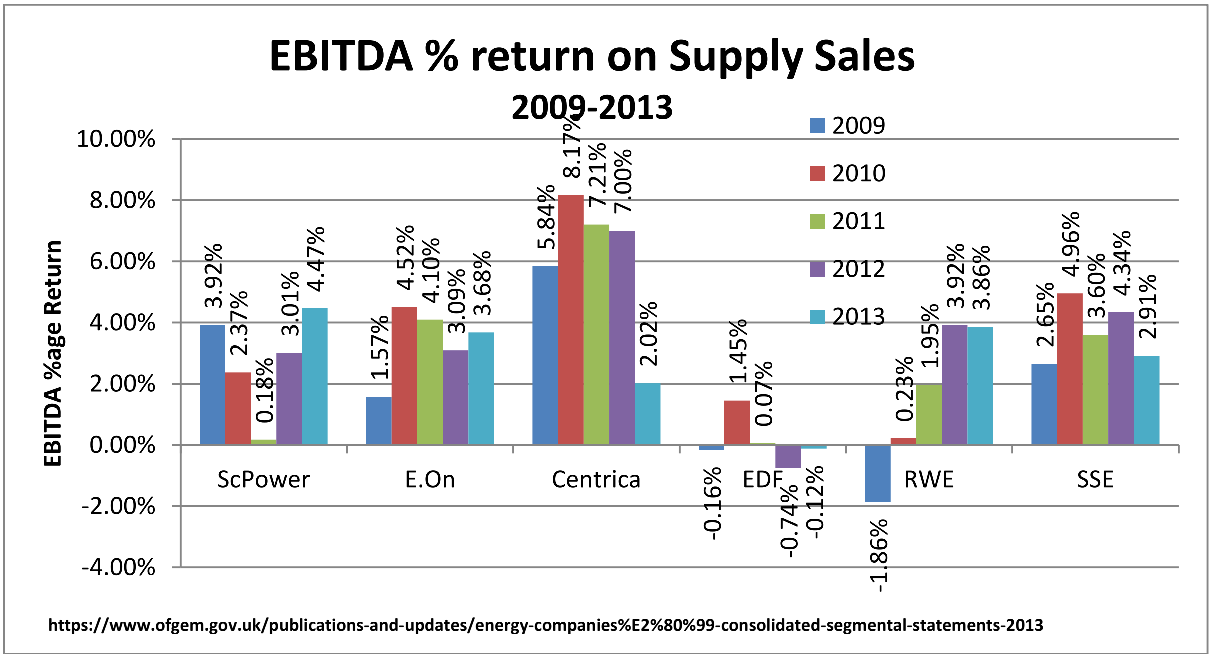
If you pay by direct debit you pay monthly in arrears. If you pay by prepayment meter you pay in advance. The Inquiry has ignored this manifestly unfair charging regime and propose no change. People paying by prepayment meter should be on the lowest tariff the supply business offers. This should happen immediately. There should be no excuses or wait for smart meters. Order the price down to the lowest rate the supplier bills at. Do it now.

Supply Business Conclusions

Page 39 – Section 178

"The results of our analysis are that on a combined basis the supply business of the Six Large Energy Firms earned a return on capital of 28% on average across the five year period from 2009-2013."

This is daft. There is very little capital in the Supply business, the capital is found in the Generation and the Transmission and Distribution elements of SSE and Scottish Power's business. To work out a Return on Capital Employed (ROCE) for Supply will give you a very large percentage. When I looked at the EBITDA return for the "Big Six" the results were as shown below:



http://www.slideshare.net/LoudenDW/dl-analysis-of-wholesale-margins-150315

These firms are losing market share to the next tier of suppliers:
First Utility, Ovo Energy, Utility Warehouse and Co-operative Energy. This would not be the case unless this sector of the market was competitive.

ROCE is a daft measure to use in this market segment. It diverts attention away from Generation which is where the real problem lies. It allowed the CMA to apportion blame to those least deserving of it – the long suffering customers. Prepayment customers are overcharged, reduce their tariffs.

Weak Customer Response and Lack of Engagement

Page 26 – Section 111

"Our customer survey suggests that there are substantial numbers of customers who are disengaged from retail energy markets."

Page 26 – Section 112

"We estimate that there were significant gains from switching that went un-exploited by domestic energy customers over the period Q1 2012 to Q2 2014."

The conclusion reached by the CMA, in large part, is that customers are disengaged from the requirement to monitor the market and to change supplier when required. It also found that the market regulator Office of Gas and Electricity Markets (OFGEM) doesn't think securing a fair price for customers is their job. You rightly found this worrying. You concluded there might be a case for price regulation if your own remedies don't secure the kind of change you are looking for.

OFGEM's Duties and Objectives and Independence

Page 43 – Section 199
"In relation to its duties, OFGEM stated that the competition duty had been progressively downrated in relation to other duties over the last ten years."

Page 44 – Section 200
"We regard it as a significant cause for concern the OFGEM considers that these duties impose a constraint in practice on its ability to pursue competition based policies."

The CMA team want to strengthen OFGEM's role in ensuring effective competition exists in the market. That seems fair. An independent price regulator would, in my opinion, be better.

Absence of Locational Prices for Transmission Losses and Constraints

Page 12 – Section 44
"We have found that the current system of uniform charging for transmission losses creates a system of cross –subsidisation that distorts competition between generators"

Page 12 – Section 46
"Introducing locational pricing for losses would also have a distributional effect, leading to transfers:

a) ...of just under £40 million a year from consumers in the South of England to those in Scotland and the North of England"

I'd support these findings. We're in the ridiculous position where EDF doesn't pay TNUoS charges or Balancing Charges for electricity produced in France but generators in Scotland's Highlands and Islands pay or will pay (if they ever get connected) a fortune. As stated above the changes the CMA makes should leave a Highland or a Northern or Western Isles generator in no worse a position than an Irish or French power producer. If it does leave them worse off, the CMA has failed. It MUST go further to level the playing field for Highland, Northern and Western Isles power producers.

<u>Summary of CMA Findings</u>

- **Wholesale Profits were tested via EBIT and ROCE and found to be normal**
- **EBITDA wasn't used and gives a very different result showing clear excess profits from Generation**
- **Differences in Costs between Suppliers were noted but not explored for evidence of Transfer Pricing manipulation for raw material or finance costs. They must be.**
- **Supply Profits for the "Big Six" were tested by the CMA & found to be excessive. I agree in relation to prepayment meter customers. They should be on the lowest tariff.**

- **EBITDA on Supply is pretty low. ROCE is high because there's no Capital employed in this part of the business. Its a daft measure to use.**
- **The CMA thinks high prices are caused by lazy consumers failing to bother to switch.**
- **I disagree. High prices are caused by very high EBITDA in Generation based on the numbers the "Big Six" report annually to OFGEM. These prices need regulated.**
- **OFGEM are too busy pleasing DECC and don't ensure the market is priced competitively.**
- **A Regulator must be appointed to ensure all prices are fair.**
- **Highland Western and Northern isles generators must access the grid for no more than Irish or French generators are charged. This must happen now!**
- **Grid upgrade costs must be paid by the grid and shared by *all* system users.**

<u>Stuff the CMA didn't do but must</u>

- **Prepayment Meter users should be on the lowest tariff. They pay in advance.**
- **Transmission Network Use of System charges (TNUoS) not fully revised to correct huge difference in charges in different parts of the UK. English & French firms gain at the expense of Scottish & especially Highland, Northern & Western Isles generators.**
- **CMA finds Generators to be in the clear despite EBITDA evidence supplied to OFGEM telling a different tale. The CMA MUST consider generation profitability again.**
- **Transfer Pricing for Raw Materials and Financing Charges must be tackled now!**
- **CMA must cap electricity prices for SVT customers today.**
- **SSE's 2p per unit Distribution surcharge is unjustifiable. Remove it today!**
- **No Highlands and Islands rebate for the low cost & high profitability of hydro power was considered or proposed. It should be.**
- **CMA didn't appear to know SSE & Scottish Power own & run the grid in Scotland. They do and have been slow to hook up competitors. Connection costs are very high acting as an effective barrier to entry especially for the Northern & Western Isles. The remedy should be to spread the cost of necessary upgrades to all existing users of the grid.**

I hope this submission will be acted upon, I'm happy for the submission to be published in the normal way on your website. As before, I'm available to discuss this with you or your team at any time.

Kind Regards

Yours sincerely

Derek

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