Response to Ofgem's proposals for the 'Big 6' to report on their Generation and Supply Businesses

Ofgem proposals relate to the publishing of information on the 'Big 6' supply and generation activities to improve transparency and make it easier for potential entrants to assess market opportunities at each point along the value chain. As we have said previously, E.ON is willing to support this in principle and would only caveat with the need to be proportionate in the regulatory burden that this imposes. This will depend on the degree of prescription that is mandated around the level of segmental information provided.

In considering Ofgem's four options for financial information reporting, we agree with Ofgem that there needs to be a balance between the following three factors:

- reliability of the information;
- consistency across companies and over time; and
- proportionality – in terms of the value of the information to the market, the cost to companies of providing it and the extent to which information may be commercially sensitive.

It is with this need for there to be a balance between the three factors that we consider the four options presented by Ofgem.

We also note that Ofgem has significantly increased transparency through the publication of the Quarterly Wholesale/Retail pricing report, which, as a forward looking report, is likely to be more helpful to stakeholders than any of the retrospective analysis proposed here.

Option One

Here the 'Big 6' would be required to publish separate financial information on their gas supply, electricity supply and electricity generation businesses. This would be at the same time as their statutory annual reports are published. They would also provide a broad description of the transfer pricing policy employed. Of the four options presented by Ofgem, this option most closely aligns with E.ON's existing reporting procedures including preparation of statutory accounts for our retail business, and therefore presents the lowest regulatory burden.

E.ON UK should be able to provide data that provides an accurate description of its generation and supply businesses. However, the supply market, and our business, operates on a customer rather than product line basis. Consequently, the supply business only has fully separate information relating to electricity and gas direct costs (for revenue, allocation of dual-fuel discounts would be arbitrary). Arbitrary allocations would be required of our supply business operating costs if these were to be reported as if there were separate electricity and gas supply businesses.

If the information presented for the generation business and the supply business can be the E.ON UK Generation Business and the E.ON UK Supply Business respectively, then the data presented in Option 1 should be clearly reconcilable to the E.ON UK plc Group

EBIT. Also, the accounting policies used would be consistent with and reconcilable to the policies adopted in the production of the E.ON UK plc statutory accounts. However, it must be recognised that in reporting on the E.ON UK Generation Business and the E.ON UK Supply Business, rather than the generation and supply activities of the E.ON Group in Great Britain, not all of E.ON's generation and supply activities in Great Britain will necessarily be covered. For example, wind powered generation by E.ON Climate and Renewables does not form part of the E.ON UK Generation Business. Equally, some licensed exempt supply, such as to a customer of a combined heat and power plant, does take place within the E.ON UK Generation Business. This supply would be incorporated in the generation business figures.

The level of detail required for Option 1 means that E.ON is comfortable with the data being published on a supplier specific basis.

We are not sure what is meant by weighted average cost of electricity and gas for the supply business. If it is simply total cost divided by total volume then we are comfortable with what is being proposed, as we would see this as the most informative and least cost average matrix. If it is any other matrix then greater reporting resources of the 'Big 6' will be required to produce what would be less transparent data.

If a description in the notes to the accounts of the transfer pricing scheme employed is required, then having a broad description is the right approach. Requiring the publishing of a detailed description of the transfer pricing schemes employed risks adversely affecting competition through creating benchmarks, against which competitors start to align their schemes. As a broad description of the transfer pricing employed, E.ON would have to state that it does not have any transfer pricing arrangements between the E.ON UK Generation Business and the E.ON UK Supply Businesses. The E.ON UK Generation Business does have a transfer pricing arrangement with E.ON Energy Trading for its capacity and production. The E.ON UK Supply Business does have a transfer pricing arrangement with E.ON Energy Trading for securing its demand. The arrangements for both transfer pricing arrangements reflect market rates at the time of agreement and are sufficiently arms length so as to meet the tax requirements for trades between companies and between countries. E.ON Energy Trading trades with the wholesale market the power it procures from the E.ON UK Generation Business as part of its normal trading activities. It also, as part of its normal trading activities, procures power and gas to meet its obligations to the E.ON UK Supply Business. As part of these trading activities E.ON Energy Trading does not discriminate between or refuse to deal with customers (without objective justification).

As discussed in Option 3 below, consideration should be given to developing Option 1 for the supply businesses only, so as to reduce the regulatory burden on the 'Big 6' including an additional burden compared to independent generators.

E.ON estimates that to deliver the requirements of Option 1, for the E.ON UK Generation Business and the E.ON UK Supply Business, it will annually incur costs in the order of four man days for arbitrary splitting of electricity and gas in the supply business and four man days for preparing and publishing the information.

<u>Option Two</u>

Option 2 carries the requirements for large amounts of detailed information on the generation business and supply business. As with Option 1, E.ON would be reporting on

the E.ON UK Generation Business and the E.ON UK Supply Business, which would not necessarily cover all of E.ON's generation and supply activities in Great Britain. Also, any separate reporting in the supply business would be subject to arbitrary allocations. The broad description of the transfer pricing arrangements would also be as in Option 1.

It is difficult to see how the extra detail listed in Option 2, for both the generation and supply businesses, is the minimum to provide information of value to existing and potential new entrants to the market. When compared to Option 1, it will impose a greater regulatory burden on companies having to provide such information. This burden would not be proportional to any benefit secured by others.

We fail to see how including fuel used for generation (inputs by station prime fuel type) provides consumers and firms with confidence that the market is competitive and fair. Ofgem suggests that this information "*would provide a sense check of the more aggregated figures and improve the monitoring information available to us. In addition, this data could be used to inform Ofgem's quarterly wholesale retail price report, and broader monitoring of revenues and costs in the electricity markets*". This is broadening the scope of the reporting requirement. Under the principles of good regulation Ofgem's requirements should be targeted; they need to be focused on the problem, and minimize side effects. To ensure proportionality, the data requested must be the minimum to improve transparency and make it easier for potential entrants to assess market opportunities at each point along the value chain; including fuel used for generation does not achieve this.

For the supply information, like the generation information, the data requested would seem to contradict keeping the amount of information requested to a minimum; rather it would be introducing additional arbitrary allocations, which reduce reliability and consistency and require a disproportionate effort relative to the benefit. The split between customers should only be between domestic and non domestic. To split non domestic into SME and I&C would introduce consistency issues. Not all suppliers use the same definitions for SME and I&C, if indeed they do actually make such a difference. It should be noted that the market commentator Datamonitor has stopped reporting on SME and I&C separately for some time in response to market developments. Datamonitor now only splits non domestic into half hourly metered and non half hourly metered and then only reports in terms of sites and volume.

Ofgem suggests that within Option 2 it would be seeking to introduce a consistent methodology for dealing with transfer price components such as wholesale energy market risk. We doubt such an approach can be meaningful, as explained in our comments on Option 4 below.

In estimating the costs of implementing Option 2, it must be remembered that Ofgem would be committing to expend resources in its role of collating and publishing the data. This expenditure will ultimately have to be paid for by the end consumer. E.ON estimates that for it to deliver the requirements of Option 2 for the E.ON UK Generation Business and E.ON UK Supply Business; for 2010 onwards reporting it would annually incur costs in the order of twelve man days for preparing the Generation Business data sheets, twenty eight man days for preparing Supply Business data sheets and eight man days for reconciliation and signatures. Considerably more effort would be required to retrofit Ofgem's requirements to 2008 or 2009, notwithstanding the simplification compared to the probe information request.

In summary, when compared to Option 1, Option 2 without providing any additional meaningful information increases the regulatory burden on the 'Big 6'.

The level of detail required for Option 2 means that E.ON would not wish to see the data being published on a supplier specific basis. Rather, as proposed by Ofgem, the data should be published on an industry-wide basis. However, the aggregated data would less transparent than in Option 1, where the data would be published on a supplier specific basis.

Option Three

Ofgem's Option 3 seems to recognise that the provision of generation data does not provide consumers and firms with any greater confidence that the market is competitive and fair or any clarity in the relationship between the supply and generation activities of the 'Big 6'. Omitting generation obviously reduces the regulatory burden on the 'Big 6'. We would therefore support this and indeed recommend seriously considering it for Option 1.

Option 3 still carries the requirements for large amounts of detailed information on the supply business. As with Option 1, E.ON would be reporting on the E.ON UK Supply Business, which would not necessarily cover all of E.ON's supply activities in Great Britain. Also, any separate reporting of electricity and gas in the supply business would be subject to arbitrary allocations. If required, the broad description of the transfer pricing arrangements would also be as in Option 1.

Ofgem presents two mutually exclusive sub-options for Option 3. We have no strong view as the simple average weighted cost of electricity and gas, as discussed in relation to Option 1, it is relatively easy to calculate, but of course does nothing to resolve the inherent arbitrariness in splitting energy purchases between the domestic and non-domestic sectors. It is not fully clear what Ofgem intends, but we would welcome any reduction in the amount of information being requested. We would therefore like to explore further with Ofgem what is meant here.

The level of detail required for Option 3 means that, as for Option 2, E.ON would not wish to see the data being published on a supplier specific basis. Rather, as proposed by Ofgem, the data should be published on an industry-wide basis. However, the aggregated data would still be less transparent than in Option 1.

E.ON estimates that to deliver the requirements of Option 3 for E.ON UK Supply Business, it will annually incur costs in the order of twenty eight man days for preparing supply business data sheets and eight man days for reconciliation and signatures.

In summary, Option 3 does reduce the regulatory burden relative to Option 2 and offers an example of how Option 1's regulatory burden can be reduced. However, when compared to Option 1, Option 3 is still requiring large amounts of detailed information on the supply business without adding to reliability or consistency of information.

Option Four

The fourth option carries the greatest concerns for E.ON. It introduces an extra level of burden on the 'Big 6'. Here the companies are required to provide financial information

in the form of Option 1 or Option 2 and also compile financial information on the basis of a specified market-based transfer pricing methodology. This is hardly inline with the principles of good regulation; in particular, proportionality and the need for solutions to be appropriate for the perceived problem or risk. Having Option 4 overlaying Option 1 or Option 2 really is using sledgehammer to crack a nut.

Considering Option 4 as an option that could be used on its own, reporting against a standard model rather than the actual process is removing real transparency and reliability from the figures presented. It also fails to build on established reporting procedures and so, unless a very basic model, risks introducing a very significant drain on the resources of the 'Big 6', as they each have to introduce new, duplicate, reporting systems.

A standard transfer pricing arrangement only offers the illusion of transparency. It actually risks being misleading, since a standard transfer pricing arrangement would inevitably reward elements of performance that were different from those of the transfer pricing arrangement used by each company. Where companies have transfer pricing, the arrangement will reflect that company's view of what is the appropriate balance of risk and reward at each stage in the supply chain. Further, as described above, for companies such as E.ON the arrangements have to be sufficiently arms length to meet tax requirements for trades between companies and between countries, which means that the arrangement has to be even handed between the various parts of the supply chain. Thus, transfer pricing arrangements become very bespoke to a particular company's situation and so will produce different outcomes to any standard model.

The different hedging strategies companies have can affect the prices they offer to the market. A standard transfer pricing model is unlikely to reflect this, resulting in outputs that would not be consistent with the outputs from companies' business models. Deriving outputs, in the form of different prices to the actual for the end customer, seems to defeat the ultimate goal of improving transparency and making it easier for potential entrants to assess market opportunities.

A standard transfer pricing model producing results different to the actual, not only carries the real risk of confusing those it is intended to help, but it could, over time, reduce competition between the companies having to report against it. Because the standard transfer pricing model would be seen as Ofgem's, it could easily become the standard benchmark. Instead of developing independent offerings focused on customers' needs, companies could find that they needed to align their offerings to the drivers of the standard transfer pricing model so as to avoid regulatory risk. Such forced alignment would inevitably reduce in the level of scope for competition between the 'Big 6'.

It must be recognised that the outputs from a standard transfer pricing model running parallel to the companies' own model will not be reconciled back to audited financial statements of the companies. Ofgem seems to recognise this issue with the requirement that the outputs from the standard transfer pricing model would be signed off by the companies' Finance Directors. However, this does not ensure that there would be consistency of application and accuracy across the industry and raises the question as to if external audit is required. Clearly introducing external auditing of the standard transfer pricing model's outputs would introduce significant costs.

We estimate that for E.ON to report on Option 4, with the companies having responsibility for modelling market prices for each half hour period, it would require annually between one man year, for a basic arrangement, potentially rising to five man years if a full blown model was introduced. A full blown model would also require capital investment in systems compatible with the model. These requirements are in addition to the resources that would be required for Option 1 or Option 2, which would be running in parallel, and do not include any external audit costs that may be required. The high level of resources reflects our belief that half hourly pricing would be used in the standard transfer pricing model. The five man years would be required for operating the more complex models similar to the ones companies, such as E.ON, are already using. Also, with the standard transfer pricing model running in parallel to a company's own processes the company, and in particular its Finance Director, would need to be comfortable with the values and explanations presented for the differences between the two methods' outputs. This again would require resources and thus increase the costs. If Ofgem was to take responsibility for all of the modelling of market prices and then provide the 'Big 6' with the standard data to be used, the level of resources required by each of the 'Big 6' would be significantly reduced.

A more appropriate approach to deliver the aims of Option 4 may be to have the 'Big 6' present details of their transfer pricing arrangements on a confidential basis to Ofgem. Such an approach would provide confidence that the broad descriptions presented in Option 1 and Option 2 fairly describe how each company operates its transfer pricing arrangements, reduces the risks of confusion that a standard transfer pricing model would introduce and would avoid much of the unnecessary costs that a standard transfer pricing model would impose on the 'Big 6'.

Conclusions

Of the four options presented by Ofgem, E.ON believes that a modified version of Option 1 is the most appropriate way forward. A modified version of Option 1 would be proportionate between providing information of value to existing and potential new entrants to the market and the regulatory burden that this imposes on companies having to provide such information.

Option 4 raises the most concerns because it introduces an extra level of burden on the 'Big 6' while carrying the greatest risk of creating unforeseen outcomes.