Promoting choice and value
for all gas and electricity customers

Financial Information Reporting: 2010 Results

Consultation

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Overview:

This document gives an overview of the second set of Consolidated Segmental Statements (CSS) from the Big 6 companies relating to 2010 and 2010/11. The CSS show revenues, costs and profits across generation and individual supply segments.

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Context

The Financial Information Reporting Licence Conditions requires the large vertically integrated companies to publicly report Consolidated Segmental Statements (CSS) which provide separate revenues, costs and profits for generation and for domestic and non-domestic, electricity and gas supply.

We believe that this information should provide greater transparency for independent market participants and other stakeholders leading to increased confidence in the market and thereby greater and more effective competition.

The information is required to be reconcilable to consolidated group or UK statutory accounts, and be readily available on the companies' websites six months after their financial year-end.

Following a review undertaken by accountancy firm BDO, we are also consulting on a package of proposals that we believe will improve the usefulness of the information provided.

Associated documents

- Improving Reporting Transparency (09/12), 31 January 2012
- Financial Information Reporting - Amended Guidance (69/11), 23 May 2011
- Financial Information Reporting - 2009 Results (41/11), 24 April 2011
- Retail Market Review Consultation Document (34/11), 21 March 2011
- Energy Supply Probe - Retail Package decision document (99/09), 7 August 2009
- Energy Supply Probe - Proposed retail market remedies (41/09), 15 April 2009
- Energy Supply Probe - Initial Findings Report (140/08), 6 October 2008

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Executive Summary

The Financial Information Reporting Licence Conditions requires the large vertically integrated companies to publicly report Consolidated Segmental Statements (CSS) which provide separate revenues, costs and profits for generation and for domestic and non-domestic, electricity and gas supply.

The 2010 Consolidated Segmental Statements indicate that:

- There is a wide variation in margins between companies and across individual segments.
- Margins are higher in generation than in supply. Non-domestic supply margins are higher than domestic supply margins.
- 2010 saw an overall increase in aggregate supply margins compared to 2009, driven largely by an increase in gas supply margins. Generation margins fell compared to last year.
- Reported electricity wholesale costs for supplying domestic customers showed some variation across companies and were generally in line with the levels estimated for 2010 in the December 2009 Supply Market Report. Wholesale gas costs in the domestic sector showed greater variation across companies.

In March 2011 we consulted on changes to the Guidelines that accompany the Financial Information Reporting licence conditions and subsequently updated them. Compared to 2009 the quality and comparability of the information provided has improved. However, there remain limitations to the transparency and comparability of the CSS.

Given this we believe that there remains room for improvement and alongside this document we are publishing a consultation on our proposals to further improve the CSS.

1. Cross comparability of results

This chapter notes the limitations of comparing results across companies.

1.1. Licence conditions 19A of the Gas and Electricity Supply Licences and 16B of the Electricity Generation Licence (the Licence Conditions) came into effect in October 2009. The Licence Conditions require the large vertically integrated supply companies to publish Consolidated Segmental Statements (CSS). All six companies published their CSS within six months of their financial year-end for 2010[1].

Differences between the companies

1.2. The Licence Conditions allow the companies to reconcile their CSS to either their consolidated group or their UK statutory accounts, in line with their own accounting conventions. SSE, E.ON and Centrica reconcile to their consolidated group accounts whereas RWE Npower, EDF Energy and Scottish Power, reconcile to their UK statutory accounts. In addition to this we note below a number of limitations to comparing the results of the companies.

Differences in the reporting period of results

1.3. Five of the six companies have a financial year-end in December. SSE has a financial year-end in March. The SSE results therefore relate to a different time period compared to the other companies. The analysis in Section 2 therefore shows SSE after a dashed line to reflect this different reporting period for the company.

Differences in how the companies operate their businesses

1.4. There are various important differences between the companies in how they operate and therefore how they report their results. In particular, some companies use tolling agreements to organise and report on the relationship between their generation and trading businesses. In this case, the generation business receives capability or capacity payments for the generation assets from the trading arm of the business. The trading arm is responsible for fuel procurement, electricity sales, and operating decisions, and receives the earnings relating to these activities.

1.5. Vertically integrated companies face some shared costs across their business, such as corporate overheads. There is no common standard as to how to allocate

[1]The link below shows where the segmental statements of each of the Big 6 can be found. http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Publication%20of%202010%20statements.pdf

these costs back into the different segments of the business. The firms have used a number of different approaches to allocate these shared costs.

Treatment of particular cost items

1.6. We have noted the treatment of four notable items by companies in Sections 2 and 3.

Improving the comparability of the results

1.7. Alongside this document we are publishing our proposals to further improve the information provided by companies. We believe that this information will provide greater transparency for independent market participants and other stakeholders leading to increased confidence in the market and thereby greater and more effective competition.

Comparison between 2009 and 2010

1.8. Differences in accounting treatments and our new guidance introduced last year both contribute to a lack of direct comparability of results between 2009 and 2010. However, for interest, we provide a high-level comparison of the 2009 and 2010 results at the end of Section 2.

2. Results

This chapter sets out the main findings from the 2010 CSS.

These results show that:

- **Generation margins** were higher than energy supply margins.
- **Domestic supply margins** were positive for the industry as a whole but showed significant variation between companies. For several suppliers they were low or negative.
- Centrica and SSE had the highest **domestic electricity supply margins**. Centrica had relatively low per unit costs while SSE had higher per unit revenues.
- Centrica had the highest **domestic gas supply margin** and the highest per unit revenues.
- **Non-domestic supply margins** for electricity and gas were positive for all companies. However, the range for non-domestic gas margins was greater than for electricity.
- Reported domestic WACOE showed some variation across companies and were broadly similar to the levels predicted for 2010 in the December 2009 Supply Market Report. WACOG showed greater variation across companies.

Margins

2.1. This section looks at aggregate margins across the Big 6 and provides company specific margins from the 2010 CSS in generation, and for each of the four supply sectors (electricity and gas, domestic and non-domestic supply). It also provides some of the drivers behind the domestic supply margins, and presents the wholesale costs (WACOE and WACOG[2]) of the supply sectors, comparing them to the figures of fuel cost hedges in our Supply Market Report (SMR) analysis.

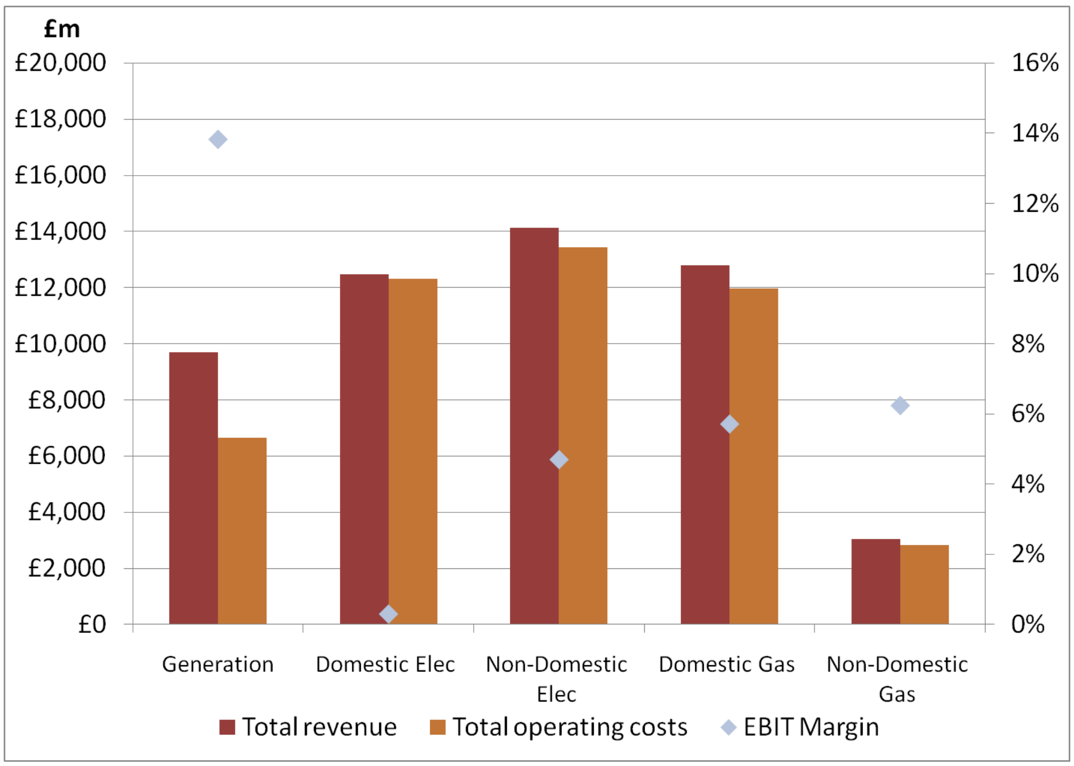
[2] WACOE (G): Weighted Average Cost of Electricity (Gas). The volume weighted average cost of electricity (gas) is a measure of the average wholesale costs faced by the supply business. They include the wholesale energy cost, losses, the energy element of Reconciliation-by-Difference costs and balancing and shaping costs incurred by the supply business.

2.2. In this section we use the terms margin and earnings. "Margin" refers to profit as a percentage of revenue whereas "earnings" refers to the profit measure in £ sterling[3].

Aggregate margins across the Big 6

2.3. Aggregate EBIT margins of around 6% were seen in two of the four supply sectors (domestic gas and non-domestic gas). Non-domestic electricity was slightly lower with an aggregate EBIT margin of 4.7% while domestic electricity saw an aggregate EBIT margin of only 0.3%. Aggregate generation margins were around 14%.

Figure 1: 2010 Aggregate revenues, costs and margins



Generation

2.4. Generation margins showed a high level of variation between companies, in part reflecting different generation portfolios and business models. Two companies (RWE Npower and SSE) sell generation capacity to their trading arm while one company (E.ON) sells generation capability. The two companies that sell capacity

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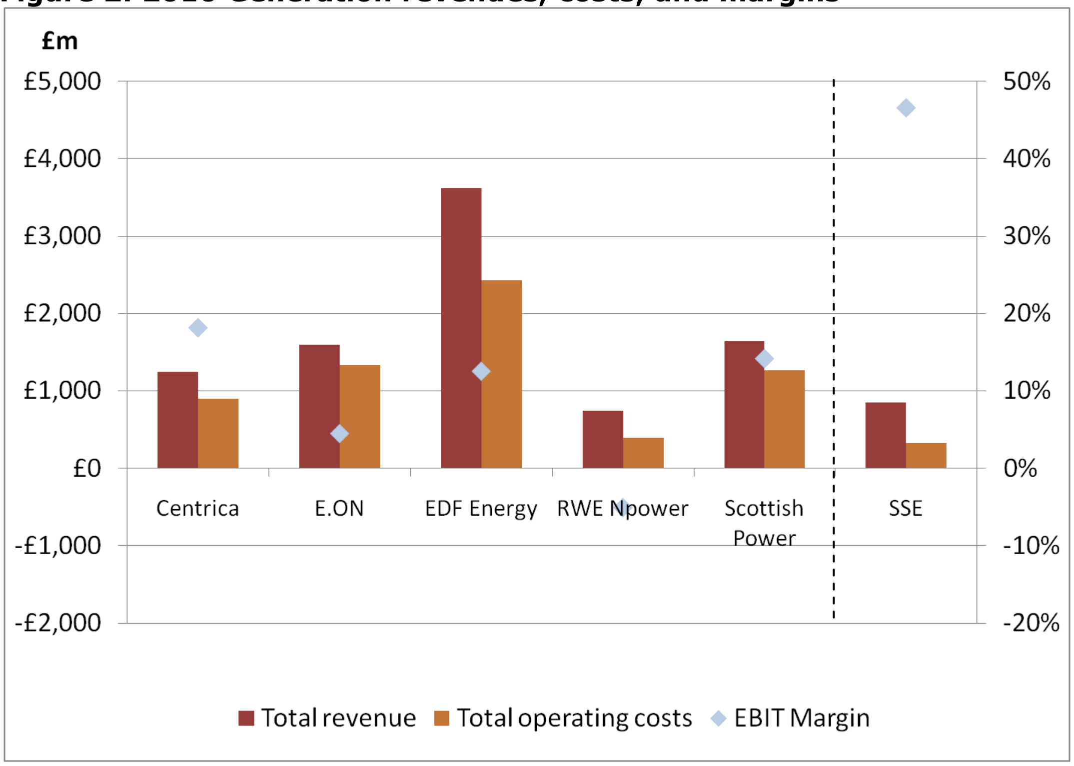
[3] Unless we specify otherwise we use EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation) as our profit measure, except for the generation segment, where we use EBIT (Earnings Before Interest and Taxes).

show minimal fuel costs and, as a result, their generation revenues closer reflect the value of their capacity rather than their electricity output.

2.5. This variation should be kept in mind when comparing the performance of different companies.

2.6. EDF Energy reported the largest earnings, whilst SSE reported the highest margin of 47%. Unlike in their original 2009 CSS, EDF Energy included their nuclear generation in their 2010 results[4].

Figure 2: 2010 Generation revenues, costs, and margins



2.7. RWE Npower reported a loss of £38m in its generation business, equivalent to a margin of -5.1%. The reported loss includes a £249m non-cash impairment charge on certain generation plants (see Section 3 for further details). Without this impairment charge, the generation margin of RWE Npower would be 28%.

2.8. Similarly, E.ON reported earnings of £71m in 2010, equivalent to a margin of 4.5%. These earnings include a non-cash impairment charge of £71m (see Section 3 for further details). Without this impairment charge, the generation margin of E.ON increases to 8.9%.

[4] EDF Energy's 2010 CSS included a restatement of their 2009 results, including their nuclear generation, and based upon the updated Guidelines. In 2010, EDF Energy's non nuclear generation made a loss of £95m (6.3% of non nuclear revenue).

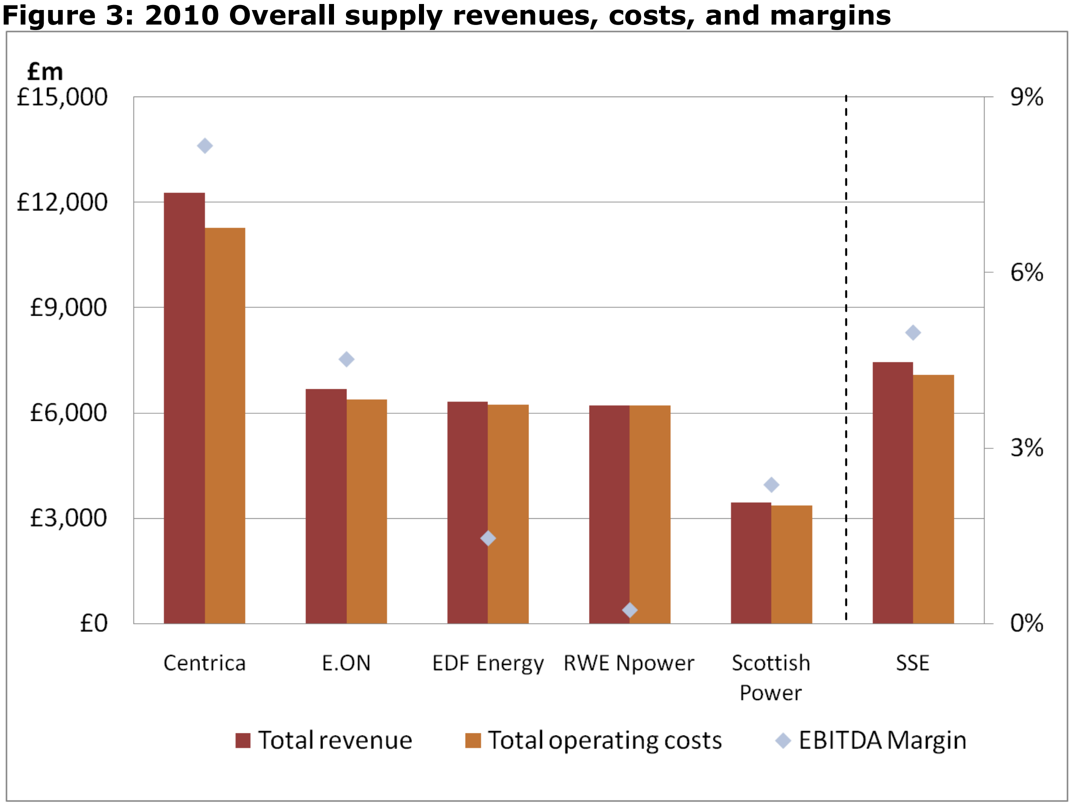
2.9. Scottish Power reported earnings of £233m, equivalent to a margin of 14%. Compared to their Statutory Accounts Scottish Power moved £119m worth of freely allocated carbon emission permits from individual generation companies to the trading activity section (see Section 3 for further details). Without this treatment, the generation margin of Scottish Power would be 21%.

2.10. EDF Energy reported earnings of £453m in 2010, equivalent to a margin of 13%. EDF Energy note that the profit figure used in their reconciliation already takes into account a £340m impairment charge against the non-nuclear generating assets of the Group (see Section 3 for further details). Without this impairment charge the generation margin of EDF Energy would be 21%.

Overall supply

2.11. Centrica had the highest margin and the highest absolute earnings in 2010 for overall supply. Centrica's absolute earnings exceeded the cumulative total of the other five companies while only accounting for around 30% of sector revenues. RWE Npower had the lowest overall supply margin, achieving 0.2%.

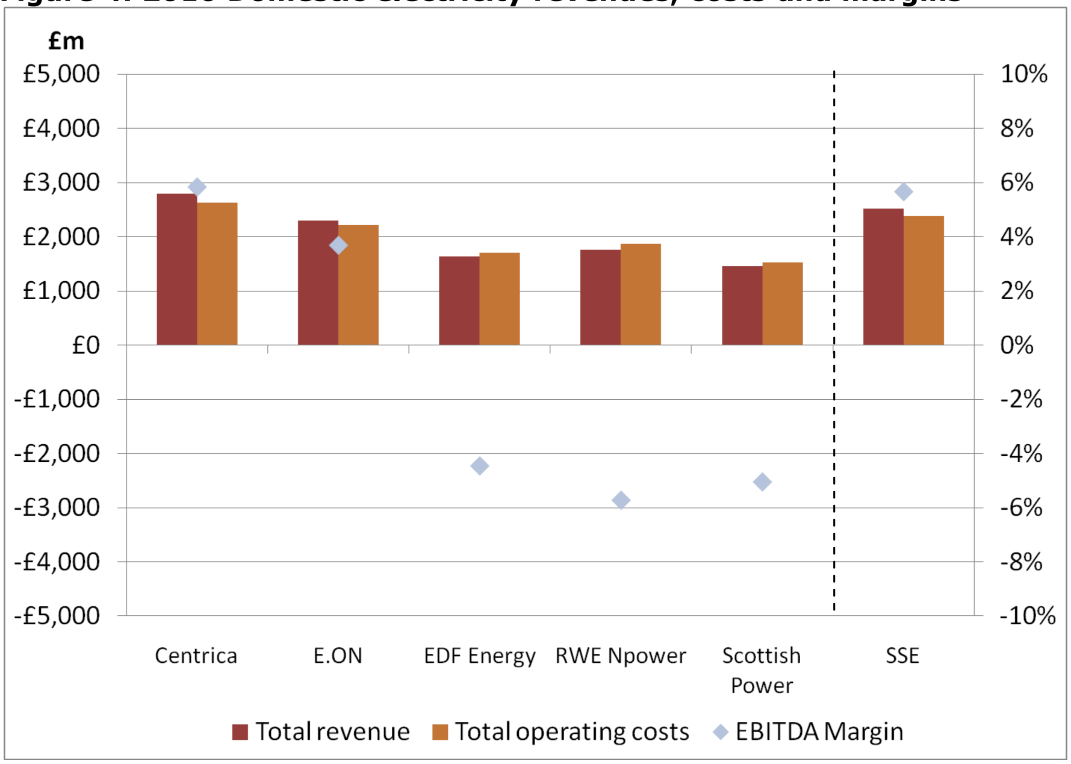
Figure 3: 2010 Overall supply revenues, costs, and margins



Domestic electricity

2.12. In 2010 for domestic electricity supply three companies reported losses (EDF Energy, RWE Npower and Scottish Power). Centrica and SSE continued to be the most profitable in this sector with margins of 5.8% and 5.7%, respectively.

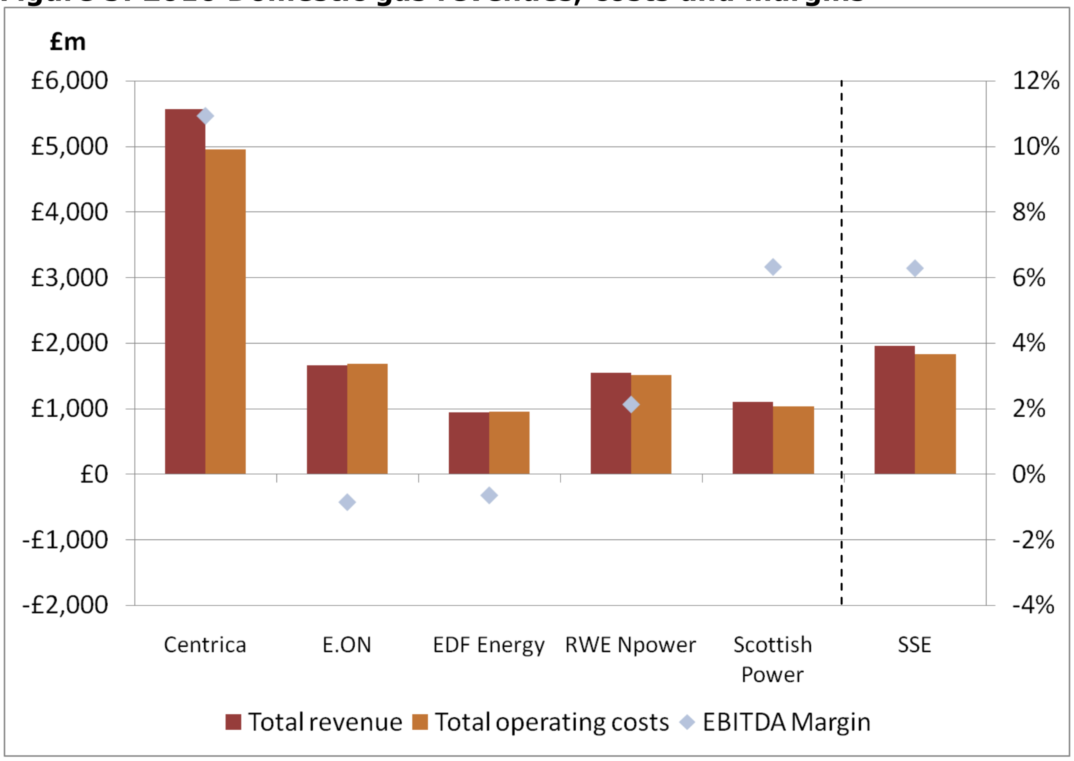
Figure 4: 2010 Domestic electricity revenues, costs and margins



Domestic gas

2.13. Centrica reported almost half of total domestic gas sector revenues and a margin of 11%. SSE and Scottish Power both earnt margins of around 6% whilst E.ON and EDF Energy reported negative margins.

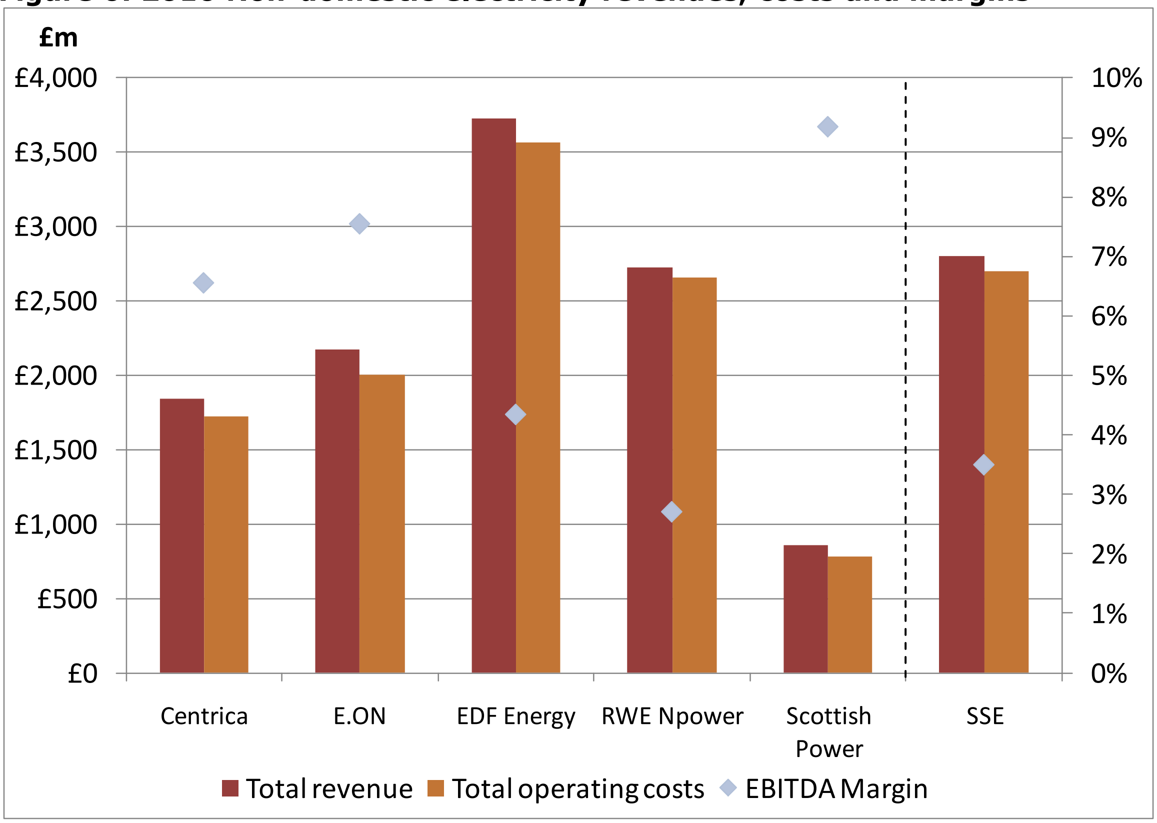
Figure 5: 2010 Domestic gas revenues, costs and margins



Non-domestic electricity

2.14. All six companies reported positive margins in the non-domestic electricity sector. E.ON and EDF Energy had the highest absolute earnings. Scottish Power had the highest margin, but this was earned on the smallest revenue base.

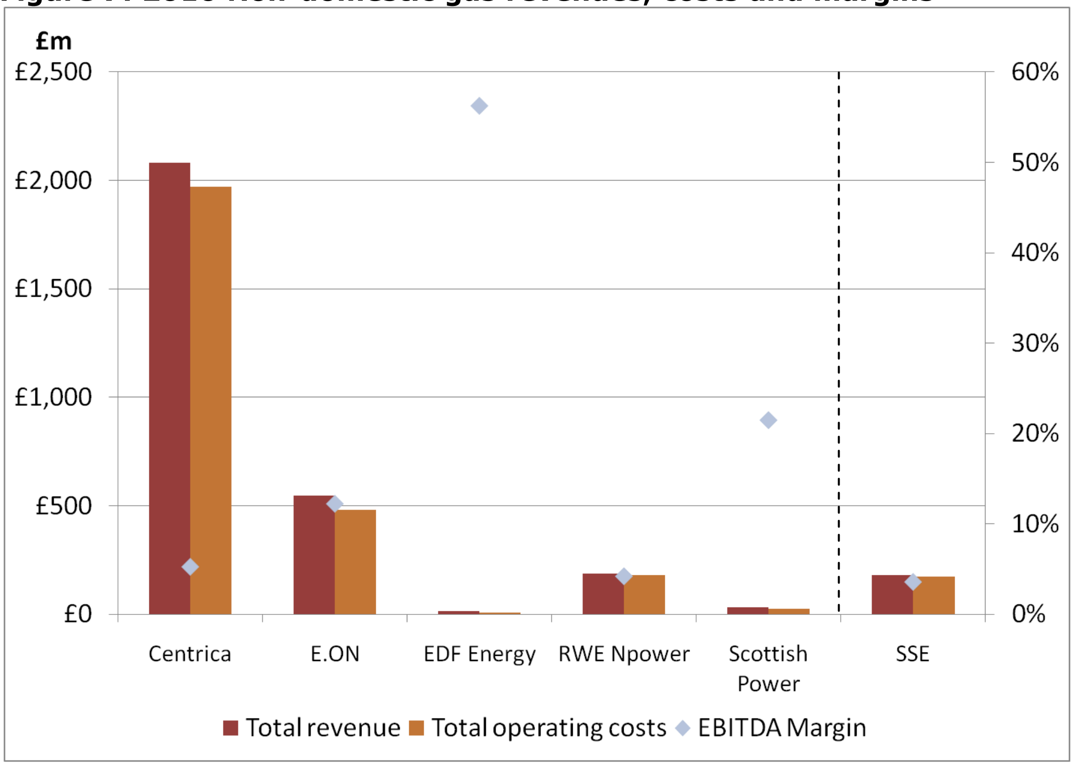
Figure 6: 2010 Non-domestic electricity revenues, costs and margins



Non-domestic gas

2.15. Centrica continued to be the largest non-domestic gas supplier with almost two thirds of total sector revenues and half of total sector earnings. However, its margin performance was fourth lowest, at 5.3%. EDF Energy and Scottish Power had significant margins, but these were earned on very small revenues.

Figure 7: 2010 Non-domestic gas revenues, costs and margins

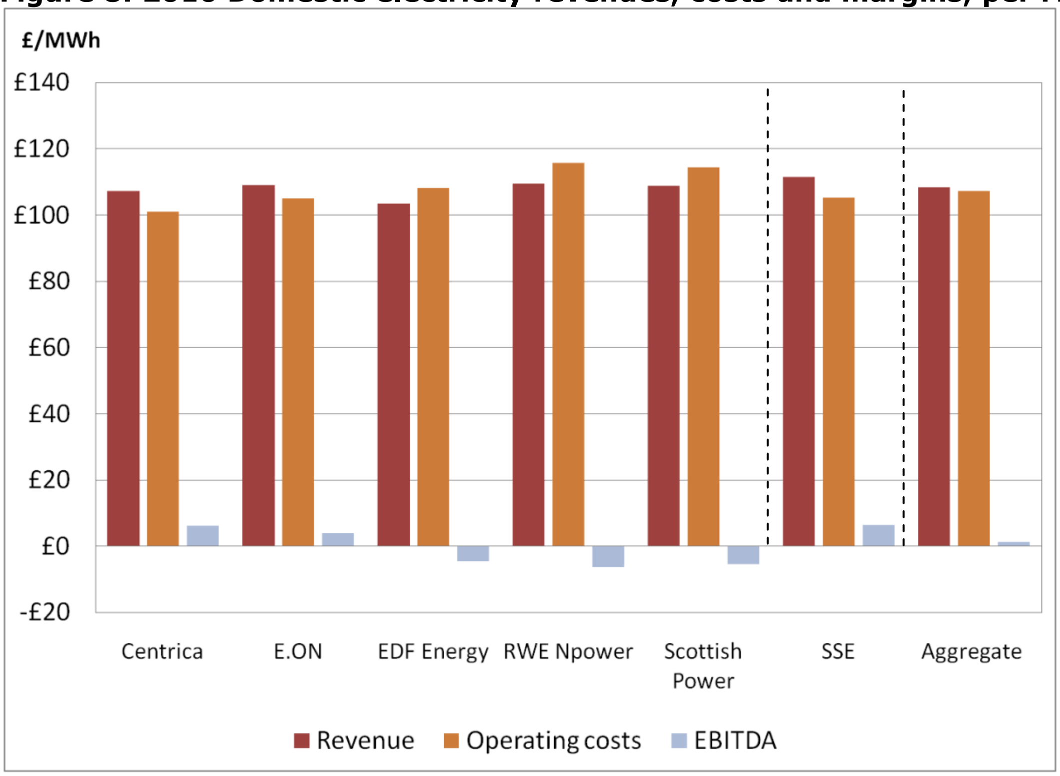


Domestic margin analysis

2.16. In addition to presenting the domestic revenues, costs and profits as we have set out above it is also informative to look at this information on a per unit basis. This helps remove differences in the data related to the volumes of supply among the companies[5].

2.17. Figure 8 shows a high level of variability in per unit revenues, costs and profits among the companies. Interestingly, Centrica and SSE had similar margins in the domestic electricity sector, although their earnings appear to have different drivers. Centrica had lower per unit costs[6], while SSE had higher per unit costs but also had higher per unit revenues.

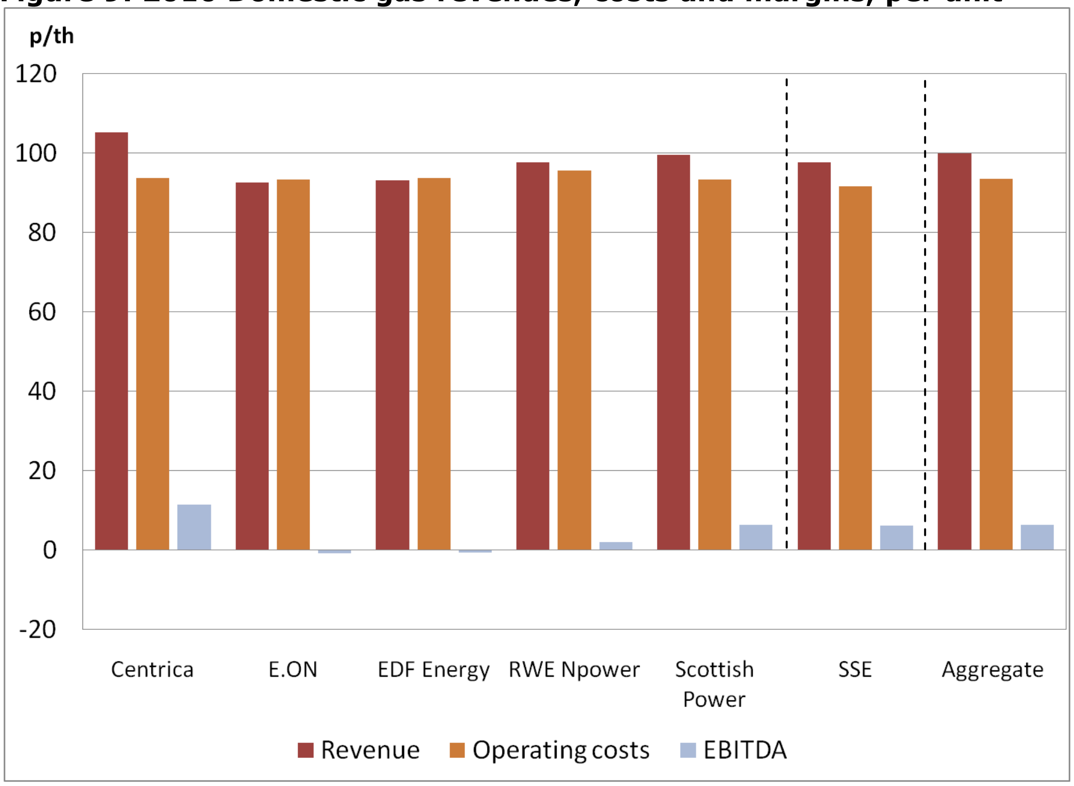
Figure 8: 2010 Domestic electricity revenues, costs and margins, per MWh



[5] We note that this analysis remains high level in its nature. It is based solely on information presented in the CSS, and does not take into account other differences across companies eg different average consumption levels.
[6] Centrica's CSS show that this was driven largely by lower per unit fuel cost than its rivals.

2.18. A different story emerges in the domestic gas sector where cost performance was more similar across companies. SSE, Scottish power and Centrica report the highest margins with Centrica's margin the highest.

Figure 9: 2010 Domestic gas revenues, costs and margins, per unit

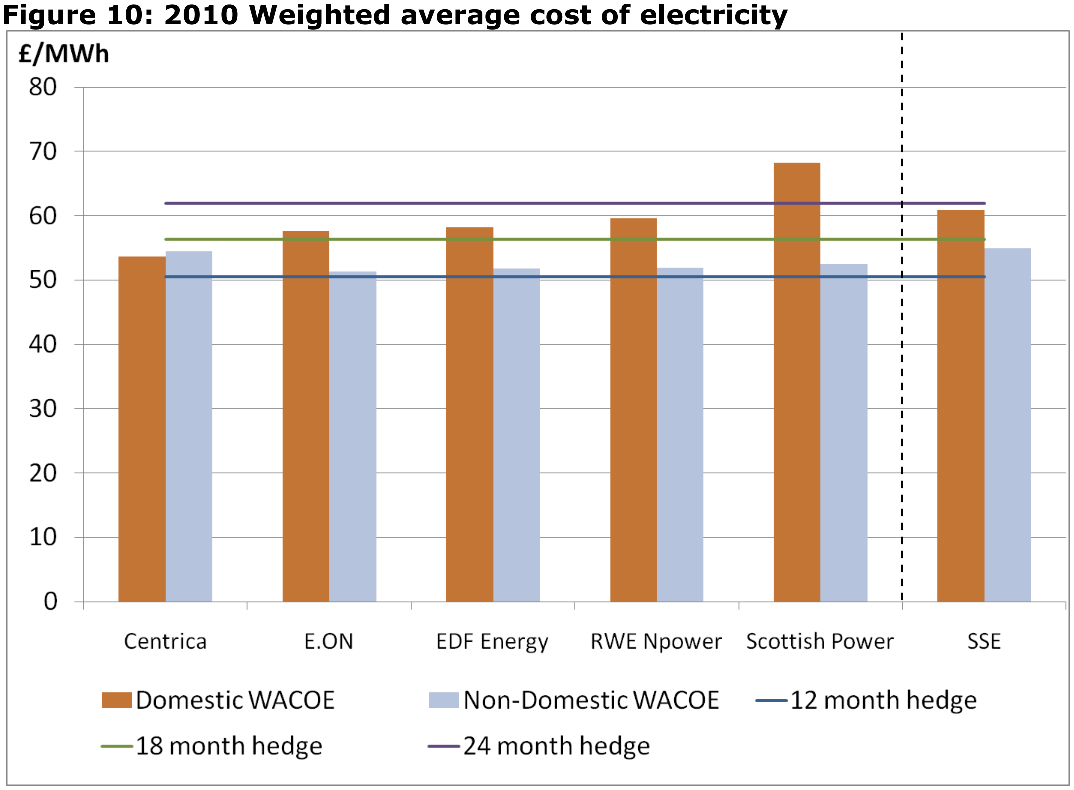


Domestic and Non-domestic supply fuel costs

2.19. In the domestic sector, Weighted Average Cost of Electricity (WACOE)[7] showed some variation across the companies, with Centrica achieving the lowest WACOE. With the exception of Scottish Power, the companies WACOE in the domestic sector were broadly similar to the levels projected for 2010 in the December 2009 SMR (shown as the 18 month hedge in Figure 10, the green line).

2.20. In the non-domestic sector, Centrica and SSE had similar WACOE, while the other four companies were slightly lower, all very similar and close to the projected cost of electricity in the December 2009 SMR under a 12-month hedge.

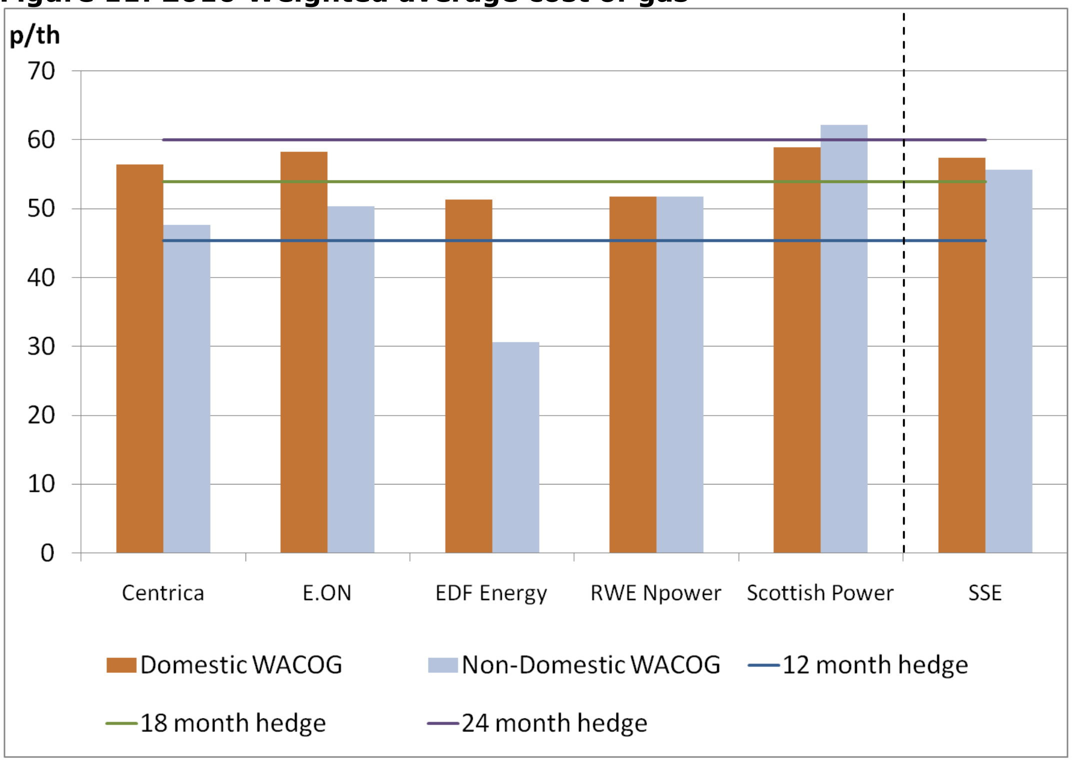
Figure 10: 2010 Weighted average cost of electricity



[7] WACOE and WACOG are the average cost of electricity and gas for the supply businesses.

2.21. In the gas supply market, there was greater variation of WACOG among the companies, particularly in the non-domestic sector. Overlooking EDF Energy[8], Centrica had the lowest average wholesale cost in the non-domestic sector. In the domestic sector, EDF Energy and RWE Npower had the lowest wholesale gas costs.

Figure 11: 2010 Weighted average cost of gas



[8] EDF Energy had the lowest WACOG in the non-domestic sector, however they accounted for less than 0.5% of the volumes supplied.

Comparison between 2009 and 2010

2.22. The table below presents the margins comparison between 2009 and 2010. As discussed in Section 1, business models and changesOfgem guidance make comparison across companies and years difficult. Therefore we advise caution when interpreting the data below.

Table 1: 2009 and 2010 EBIT margin by sector

	2009 Aggregate margin	2010 Aggregate margin
Generation	22.5%	13.8%
All Supply	1.8%	3.8%
Domestic Electricity	2.1%	0.3%
Domestic Gas	-0.4%	5.7%
Non-domestic Electricity	4.0%	4.7%
Non-domestic Gas	-0.5%	6.2%
All segments	5.8%	5.7%

2.23. The overall increase in aggregate supply margin in 2010 has most significantly been driven by increased margins in gas supply (in part driven by high demand and low wholesale purchase costs during the 2009-2010 winter). This is despite a lower margin in aggegragte domestic electricity supply.

3. Accounting treatments

This chapter provides an overview of four notable items by companies within the segmental statements and how they affect the results.

3.1. In this section, we briefly comment on four notable accounting items.

3.2. In our 2009 Financial Information Report[9] we identified the use of exceptional items and special adjustments in preparing the 2009 CSS. We noted that these treatments had a material impact on the reported numbers, including the profits attributed to individual segments reported in the CSS.

3.3. As a result, we published amended Guidelines[10] for financial information reporting with the aim of increasing transparency and cross comparability of results.

3.4. We note the 2010 CSS contain fewer exceptional items and adjustments. However, there were four noteworthy company-specific treatments; which are shown in the table below. In Section 2 we discuss the impact these treatments have on individual results. The table summarises these treatments and shows the effect these treatments had on reported EBIT in the CSS.

[9] http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_Financial_Information_Report.pdf

[10] http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Final%20Guidance%20publication%20EH.23.05.pdf

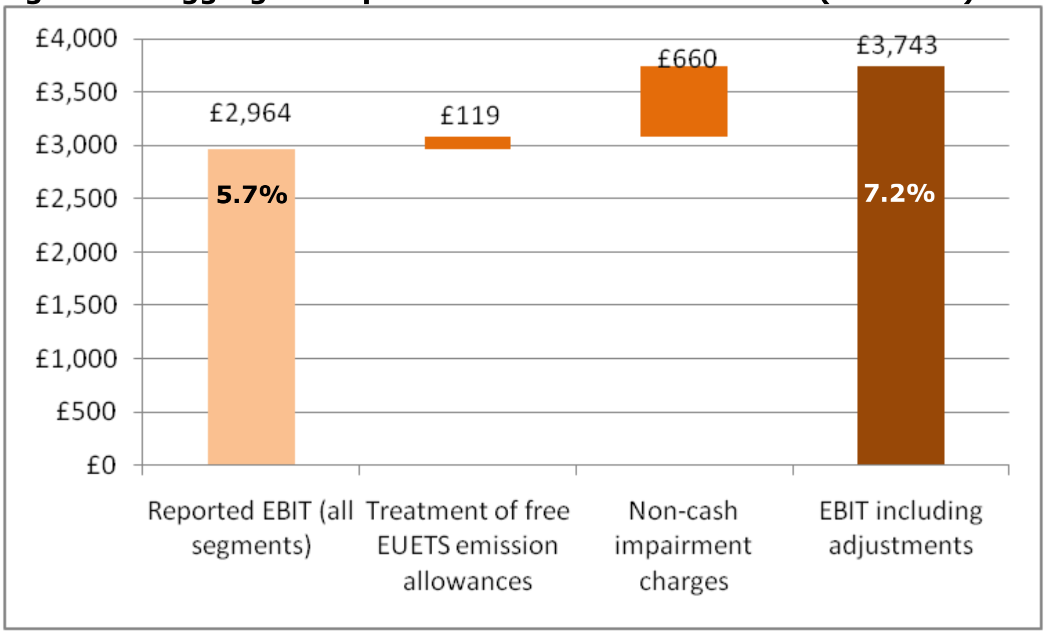
Table 2: Four notable items in the 2010 CSS

Company	Amount	Description and impact on reported EBIT in the CSS
RWE Npower	£249m	A non-cash impairment charge reduces the generation EBIT reported in the CSS. This charge is caused by the projected value of certain coal and oil plants falling below net book value.[11]
Scottish Power	£119m	Value of free carbon permits has been moved from individual generation companies to the trading activities section. This reduces the generation EBIT reported in the CSS.
E.ON	£71m	A non-cash impairment charge reduces generation EBIT reported in the CSS. This is caused by a Kingsnorth impairment and the write-off of business development costs relating to Kingsnorth and the Seal Sands projects.
EDF Energy	£340m	A non-cash impairment charge reduces generation EBIT reported in the CSS. This charge relates to non-nuclear generation assets.

3.5. Removing these adjustments from the numbers reported in the CSS would increase aggregate EBIT within the segments by £779m, equivalent to an extra 1.5% on the reported margin (across generation and supply). The figure below shows the aggregate impact.

[11] The RWE Npower impairment charge of £249m was included in the audited and published statutory accounts of RWE Npower plc for the year ended 31 December 2010 in accordance with Financial Reporting Standard 11, "Impairment of fixed assets and goodwill". RWE Npower was very concerned, in order to ensure transparency and aid cross-comparability of results, to show the impairment charge on the face of its Consolidated Segmental Statement as a separate item. Indeed RWE Npower specifically contacted Ofgem to do so. RWE Npower has shown it clearly as a separate item so that all users can make an informed analysis, it has also included two very full bullet points in its CSS explaining in detail the impairment charge.

Figure 12: Aggregate impact of the four notable items (£ million)



4. Next steps

4.1. Alongside this document we have published a consultation on the findings of the BDO review and our proposed way forward. We would welcome any comments on this document either in response to this consultation or as part of the response to that consultation.

Appendix 1 Consultation response and questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. Responses should be received by 27 March 2012 and should be sent to:

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1.3. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.4. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.5. Any questions on this document should, in the first instance, be directed to:

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Appendix 2 Glossary

E

EBIT

Earnings before Interest and Tax: Operating Profit, in Profit & Loss account.

EBITDA

Earnings before Interest, Tax, Depreciation & Amortisation: Operating profit excluding non-cash items, in Profit & Loss account.

EU ETS

European Union Emission Trading Scheme: The EU-wide greenhouse gas emissions trading scheme, under which governments must set emission limits for all large emitters of carbon dioxide in their country.

Appendix 3 Feedback questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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