

Financial Information Reporting: 2011 Results

Information

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Overview:

This document gives an overview of the third set of Consolidated Segmental Statements from the six largest energy companies in GB, relating to the financial year 2011 or 2011/12. These show the separate revenues, costs and profits for the companies' generation and supply businesses.

The latest set of Statements show that the combined profits across the companies' supply businesses reduced to 3.1%, from 3.8% in 2010, but this varies among the supply segments and companies. Looking at total profits for both generation and supply, the 2011 Statements show an increase to 7.6% from 7.2% in 2010. This was driven by an increase in the profitability of electricity generation.

Ofgem is firmly committed to improving transparency and consumer trust in the GB energy market. This overview document is part of our work to increase transparency in the market around supplier profitability.

Context

Ofgem is committed to improving consumer trust and engagement with the energy market. The Consolidated Segmental Statements seek to improve transparency of energy company profitability, enabling consumers and other stakeholders to better understand, trust and engage with the market. In addition, more transparency on the profitability of large energy companies makes it easier for new firms to enter the market – or independents to enter different segments of it, improving competition.

To this end and since 2009, we have required the six largest energy companies to publish annual Statements, which show the separate revenues, costs and profits for the previous financial year of their generation and each one of their four supply businesses (domestic and non-domestic, electricity and gas supply).

Following our 2011 Retail Market Review, we commissioned accountancy firm BDO to review the methodologies used by the companies to compile the Statements. BDO's main finding was that the methods the companies used to produce the statements were broadly fair and appropriate.

BDO made recommendations to improve the transparency and comparability of the Statements. We consulted on a package of proposals based on BDO's recommendations. This led us to modify the licence condition, effective from 24 October 2012. The Statements that this document summarises were prepared under the modified licence condition.

Associated documents

- Improving Reporting Transparency - Final Decision Document, 29 August 2012
<http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Improving%20Reporting%20Transparency%20-%20Final%20Decision%20Document.pdf>
- Improving Reporting Transparency of Large Energy Suppliers (95/12), 13 July 2012
http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/IRT_Condoc_FINAL.pdf
- Financial Information Reporting – 2010 Results (10/12), 31 January 2012
http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/FIR_results_Final.pdf

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Executive Summary

The six largest energy companies in GB are active in both the generation of electricity and the supply of electricity and gas. To enable consumers and other stakeholders to better understand the profitability of these distinct parts of the companies, Ofgem requires them to publish annual Consolidated Segmental Statements, which show the separate revenues, costs and profits for the previous financial year of their generation and each one of their four supply businesses.

This document presents the results from the latest set of Statements for the financial year 2011 or 2011/12. Averaged across the six companies, they show that:

- Across the four supply segments, profit margins reduced to 3.1%, down from 3.8% in 2010.
- This included a lower profit margin for gas supply to domestic customers (4.3%, down from 5.7% in 2010), and for electricity supply to non-domestic customers (3.3%, down from 4.7% in 2010).
- The only supply segment showing a sizeable increase in profit margin was domestic electricity: 1.5% in 2011, compared with 0.3% in 2010.
- Profit margins remained highest across the segments in generation at 24.4%, an increase from 2010 (21.9%).
- Taking generation and supply together, profit margins increased to 7.6%, relative to 7.2% in 2010. This is driven by the increase in generation profit margins. Typical generation margins need to be higher than in supply to finance the capital investment needed to build power stations.

Following recent changes to the way Ofgem requests the Statements to be compiled, and as recommended by the BDO review in 2011, we commissioned an independent opinion of the 2011 Statements. The opinion, carried out by accountancy firm PKF, was to ascertain whether the companies had interpreted the licence condition correctly and whether their reconciliation to group accounts had been completed appropriately.

Overall, across the six Statements, PKF found that the companies had completed the Statements appropriately, although they highlight some areas of improvement. PKF also highlight a significantly reduced use in the Statements of accounting adjustments, which have degraded the accuracy of the Statements in the past. This marks a significant improvement in disclosure compared with previous years.

The areas in which PKF considered the companies could improve include the information presented on the methods of allocation of shared costs, and the consistency of information on energy purchase costs. PKF also noted that the licence condition, as it stands, allows three of the companies to present supply and generation information without linking it to separately audited figures for supply and generation.

The changes made following the BDO review mean that this is the first time the companies have been asked to provide the Statements in this way. Over the coming months, we will work to secure improvements for this year's submissions to ensure the Statements are clearer, more accurate and of even more use to consumers' and market participants. However, given the companies can structure their businesses in



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any way they want, there will always be limits to transparency and cross-company comparability of the information in the Statements.

1. Background

1.1. The six largest energy companies in GB¹ are active in both the generation of electricity and the supply of electricity and gas. These are different activities, with different cost structures and operational goals. The supply market can be further separated into two categories of consumer: domestic and non-domestic.

1.2. With such an industry structure it is difficult for consumers and other stakeholders to know which parts of the energy market profits are being made in. Therefore, to allow consumers and other stakeholders to better understand the profitability of these distinct parts of the companies, Ofgem requires them to publish annual Consolidated Segmental Statements, which show the separate revenues, costs and profits for their generation and each one of their four supply businesses (domestic and non-domestic, electricity and gas supply).

1.3. The Statements aim to improve transparency for consumers, independent market participants and other stakeholders. This should improve confidence in the market and lead to more effective competition and better outcomes for consumers. Each Statement contains:

- A table detailing the revenues, costs and profits in the generation and the four supply businesses.
- An explanation of how the company defines the terms revenues, costs and profits.
- An explanation of how the revenues and profits can be reconciled with audited figures (prepared under International Financial Reporting Standards, IFRS) published in group accounts.
- An explanation of the transfer pricing methodology² employed and how this relates to the revenues, costs and profits information published.
- A new checklist of functions to identify where individual business functions are captured in the Statements.

Recent changes to the Statements

1.4. The original licence conditions requiring the publication of the Statements came into effect in October 2009. In March 2011, as part of the Retail Market Review, we set out our objective to improve the transparency and comparability of the Statements³. To that end, we appointed accountancy firm BDO to undertake a review of the Statements. The review found that the methodologies used by energy companies to prepare their Statements were broadly appropriate. In particular, BDO noted that:

¹ Centrica, E.ON, EDF Energy, RWE nPower, ScottishPower, SSE

² Transfer pricing is the attribution of a price to internal transactions in the same organisation.

³ http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_FINAL.pdf

- The transfer pricing policies of the companies were fit for purpose, although differences in company structure and approach make it difficult to make direct comparisons.
- Adjustments to account for long-term hedges had been correctly excluded from the Statements.
- Speculative energy trading activities⁴, which should not feature in the Statements, were indeed excluded.
- There was a lack of consistency in the treatment of exceptional accounting items across the companies, making it difficult to compare the Statements.

1.5. BDO also made a series of recommendations to improve the transparency and cross-company comparability of the Statements. Taking these into account, Ofgem consulted on a range of proposals during the first half of 2012. We modified the licence condition in August 2012. Companies are now required to:

- Show how the information in their Statement can be reconciled to figures compiled using IFRS accounting standards and published in group accounts.
- Produce a checklist of functions, indicating where in their business a variety of activities are undertaken, to help demonstrate how companies are structured.
- Uniformly report generation fuel costs and free EU ETS allowances, although companies operating toll processing arrangements may present their fuel costs as a supplementary note to the main Statement.

1.6. To improve cross-company comparability, Ofgem also provided the companies with clearer guidance on which financial items we would not expect to see in the Statements⁵ and asked specifically for companies to report the methodology used to allocate Feed in Tariff and Renewable Obligation scheme costs⁶.

1.7. Furthermore, we commissioned an independent opinion of the 2011 Statements. The opinion, carried out by accountancy firm PKF, sought to ascertain whether the six companies had interpreted the licence condition correctly and whether their reconciliation to group accounts had been completed appropriately. A summary of PKF's results is given in chapter 4, and the separate opinions for each company can be found as associated documents to this report on our website.

1.8. The remainder of the document is structured as follows. Chapter 2 explains some of the limitations of transparency and cross-company comparability, arising primarily from differences in company structure. Chapter 3 summarises the financial information contained in the Statements for the calendar year 2011 (or financial year

⁴ Speculative trading is defined as the taking of a market position in pursuit of profit from the trades themselves rather than the management of cost-effective supply for customers. Any results associated with speculative trading should be excluded from the Statements, as they are not part of the licensable activities of generation or energy supply.

⁵ Paragraph 1.6 of the [Guidelines](#) to the Licence condition, 29 August 2012

⁶ Paragraph 1.5 of the [Guidelines](#) to the Licence condition, 29 August 2012

2011/12 in the case of SSE⁷). Chapter 4 summarises the opinion of the accountancy firm PKF on the companies' 2011 Statements.

1.9. Due to the consultation process undertaken in 2012, we delayed the submission deadline of the 2011 Statements to 31 October 2012⁸. For the 2012/13 results, to be submitted in 2013, we intend to revert back to the previous deadline of six months after the end of the reporting period.

⁷ The reporting year of five of the companies is to the end of December; for SSE, it is to the end of March.

⁸ The normal deadline is 30 June for five of the six companies (30 September for SSE).

2. Transparency and comparability

2.1. Despite increases in the transparency and comparability of the Statements, brought about by the recent modifications, there will always be limitations. This section details some of the reasons for this.

2.2. We start by describing the most significant limitation, which is the difference in business structures among the companies. The companies are able to structure and run their businesses in the way that is most suitable to them. This challenge to comparability will therefore always prevail in competitive markets. We then describe two further limitations to the comparability of the Statements: differences in reporting periods among the companies and complications with comparing the Statements between years.

Differences in business structure

2.3. There are important differences in how the companies structure and run their businesses and therefore how they report their results. In particular, some companies use a trading function that interacts with the market on behalf of its generation and supply segments, carrying out certain functions. This approach allows the companies to allocate activities to those parties that they deem best able to manage them.

2.4. Another difference is that a number of companies are structured so that the generation segment does not sell electricity, but instead sells the use of its capacity. Under these arrangements, the generation segment receives payments for maintaining and operating its generation assets, rather than for producing electricity. In these cases, it will then be the responsibility of the trading function to carry out all other activities associated with generation, such as fuel procurement and operating decisions. The trading function, not the generation arm, will then receive the earnings related to whichever of these activities it carries out. By transferring the responsibility of certain activities to the trading function, the generation segment is then able to focus exclusively on operating and maintaining its assets to maximise reliability and output.

2.5. For some companies, the trading function is also active at the supply end of the business. In these cases the trading function will be responsible for procuring electricity and gas on behalf of the supply business. It will then transfer the purchased fuel to the supply business using a transfer price, often based on prevailing market prices at the time of transfer.

2.6. The extent to which the companies use their trading functions, and how they separate certain activities between the generation and supply segments, varies among them. This reduces the comparability of the Statements. To mitigate this, Ofgem asks the companies to use transfer pricing methodologies that reflect how each licensee actually acquires energy.

2.7. These transfer prices are then used to calculate the weighted average cost of electricity (WACOE) and the weighted average cost of gas (WACOG). These values represent the average cost that the supply segments pay for these two fuels. We ask the companies to calculate WACO E/G in a specific way. It is then possible to compare these values among the companies to show how much the supply segments of the separate companies have paid for their electricity and gas. Electricity and gas purchases are the largest contributing element to end-user bills and therefore an important driver of profitability.

2.8. The existence of the trading function also affects the transparency of the Statements. This is because the companies will need to make an estimate of the financial impact of the activities undertaken by the trading function on each of the supply and generation segments, in order to include the appropriate revenues and costs in the Statements.

2.9. An appropriate transfer pricing methodology should be sufficient to attribute the revenues and costs between generation, supply and the trading function of the companies. However, market movements between the times the trading function undertakes a transaction and when the product is transferred to either the generation or supply arm, mean that there is potential for the trading function to generate profits/losses that may not appear in the Statements.

2.10. BDO raised this issue during their 2011 review. They suggested that one solution could be to require the Statements to also include the full results of the trading function. At the time, Ofgem was not convinced that the benefits to transparency would outweigh the costs and added complexity of this approach. In particular, there are questions as to whether it would be possible to successfully disaggregate trading function results to extract the relevant information.

2.11. Nevertheless, Ofgem remains committed to improving transparency and our 2012 changes to the licence condition were carried out with this specific intention in mind. In particular, the requirement for each company to include a checklist of business functions now requires the companies to show which of a number of predefined functions are being performed in individual business areas. It therefore provides additional information on how the different companies are structured and provides a useful narrative to read in conjunction with the information submitted by the companies in their Statements.

Other issues related to the comparability of the Statements

2.12. In addition to the issues raised above on the structure and operation of the different companies, there are issues which reduce the cross-company comparability of the Statements. These include differences in the reporting period used by one of the companies to compile its Statement and the recent changes to the Statements that degrade year-to-year comparisons.

2.13. Regarding the first issue, five of the six companies have a financial year-end in December, while SSE has a financial year-end in March. SSE's results therefore relate to a different time period than the other five companies. While there is still a

75% overlap with SSE's statement figures with the other five companies, this difference will affect the comparability of the six Statements. The analysis in section 3 therefore shows SSE after a dashed line to reflect this different reporting period.

2.14. Regarding year-to-year comparisons, there are also a number of factors that reduce the comparability of the results in the three years that Ofgem has received Statements from the companies (2009, 2010 and 2011).

2.15. First, in 2009 and 2010, there were a number of examples where the companies used accounting adjustments in the Statements, which significantly affected their reported profit⁹. We note that in 2011 this practice had all but disappeared and marks a significant improvement in disclosure compared with previous years. Where appropriate and possible, we have restated figures from earlier years to include these accounting adjustments to make these figures more comparable with the 2011 Statements.

2.16. Second, various changes introduced by Ofgem since 2009 will mean that the Statements in each have been compiled on a slightly different basis. While this reduces year-to-year comparisons, we hope that, going forward, the Statements will become more comparable.

⁹ Accounting adjustments refer to items that occur outside the companies' normal operation for a particular year, but have been included in the segmental statements, e.g. an irregular asset revaluation.

3. Results

Chapter Summary

The main results in the 2011 Segmental Statements show that:

- Across the four supply segments, the profit margin was 3.1%, down from 3.8% in 2010.
- This included a lower profit margin for gas supply to domestic customers (4.3%, down from 5.7% in 2010) and for electricity supply to non-domestic customers (3.3%, down from 4.7% in 2010).
- The only supply segment showing a significant increase in profit margin was domestic electricity: 1.5% in 2011, compared with 0.3% in 2010.
- Profit margins remained highest across the segments in generation at 24.4%, an increase from 21.9% in 2010.
- Taking generation and supply together, profit margins increased to 7.6%, relative to 7.2% in 2010. This is driven by the increase in generation profit margins.

3.1. In this chapter, we set out the main results from the latest set of Statements for the financial year 2011 or 2011/12. We first show the profit margins¹⁰ across generation and supply as a whole, then the four supply segments separately, followed by the generation segment. We present the companies' average electricity and gas supply costs for both the non-domestic and domestic sectors and provide a comparison of the results across the last three years. We conclude with a discussion on the companies' different business functions table submissions.

Revenues, costs and profits

3.2. The Statements present the revenues, costs and profits of the generation and four supply segments separately and aggregated across supply. This section includes charts for each one of these segments by company and one chart across the industry as a whole.

3.3. The charts show the absolute level of revenues and costs as bars¹¹. The difference in the size of these bars indicates the absolute level of EBIT profit in £m. Dividing this by revenue, we calculate the EBIT profit margin, expressed as a percentage. This is a useful indicator for comparing profitability across the

¹⁰ The profit margin is the proportion of profit relative to total revenue. We use EBIT (Earnings before Interest and Tax deductions) as our measure of profit. In the 2009 and 2010 summary documents we used EBITDA for the supply margins, where EBITDA adds back depreciation and amortisation to the profit figure. We have now chosen to present all the results on a consistent EBIT basis.

¹¹ We include depreciation and amortisation with operating costs in the charts.

companies, irrespective of the size of their total revenues. It is shown in the each of the charts as a grey chevron as is in reference to the right hand axis.

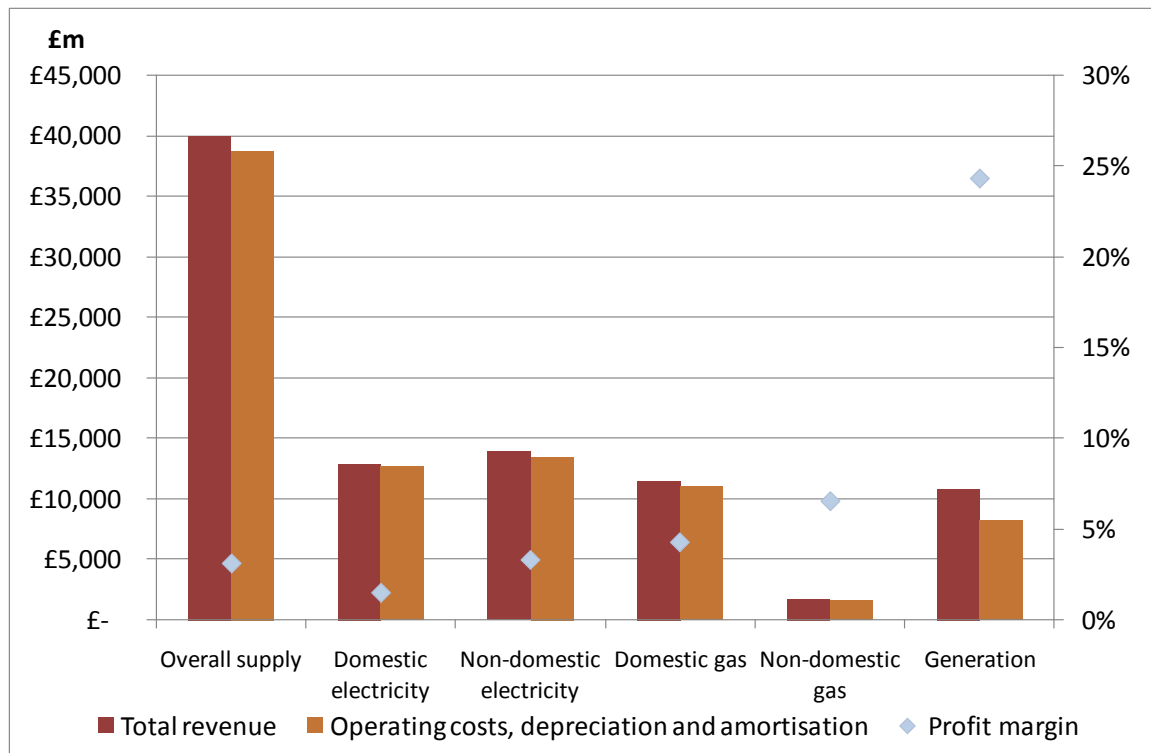
Total industry results

3.4. Figure 1 shows the revenues and costs combined across the six energy companies in supply as a whole, the four supply segments (non-domestic and domestic, gas and electricity) separately, and generation, in £million (left hand axis). It also shows the EBIT profit margin (right hand axis).

3.5. Across all supply segments the companies show an average profit margin of 3.1%. They are lowest in both electricity supply sectors: at 1.5% for domestic and 3.3% in non-domestic supply. Profit margins for gas were slightly higher at 4.3% in the domestic sector and 6.5% in the non-domestic sector.

3.6. Profit margins were highest in generation, where they average 24.4% across the six companies.

Figure 1: Total industry revenues, costs and profit margins for each segment



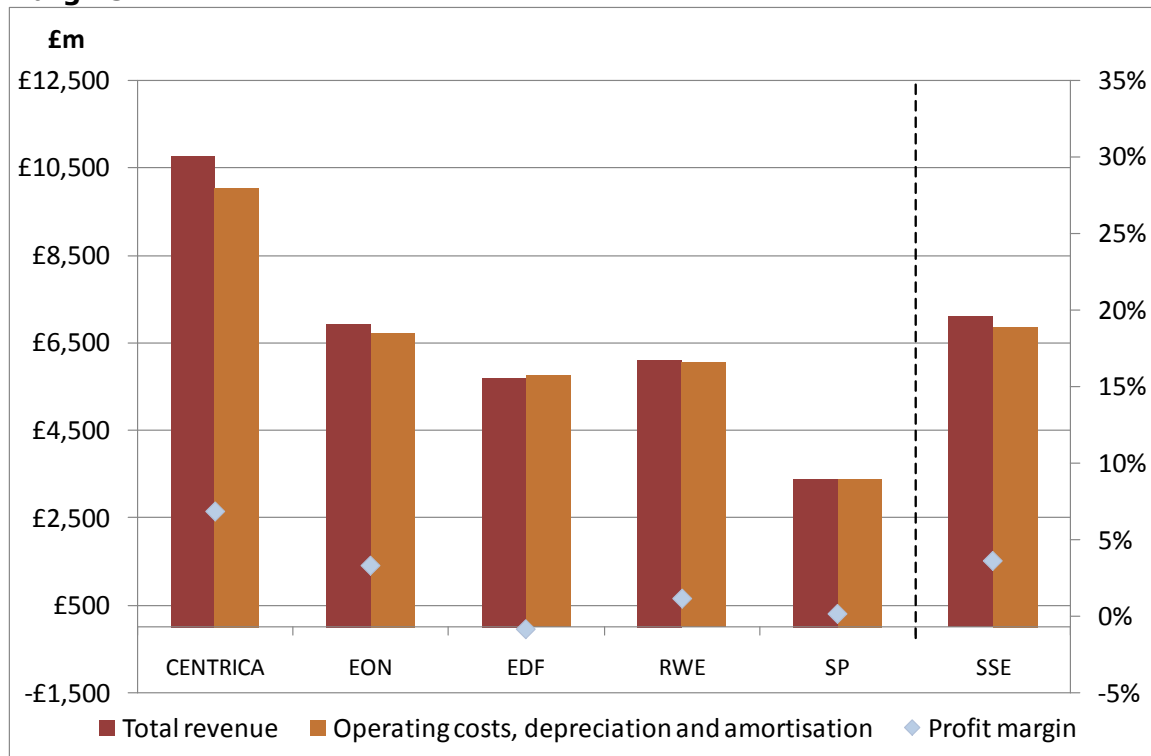
3.7. While profit margins in generation were considerably higher than in all four supply segments, there are a number of reasons why comparing generation and supply profit margins is inappropriate. For example:

- It is the generation segment that has to deliver considerable quantities of new investment in power generation over the coming decade. A significant proportion of the cash used for these investments will come from the companies' profit margin.
- The risks of power station construction and operation are higher than the supply of energy. With higher risks, companies need to make higher returns on their investments.

Overall supply of gas and electricity

3.8. Figure 2 presents the total revenues, costs and profit margins for each of the six companies across the four supply segments. In overall supply, only one company reported a negative profit margin, and no company exceeded 7%. Centrica made the highest margin, which also reported the highest absolute revenue. EDF and ScottishPower (SP) report margins of approximately zero.

Figure 2: Overall supply of gas and electricity - revenues, costs, and profit margins¹²



3.9. Across all six companies, the overall profit margin made in supply was 3.1%, down from 3.8% in 2010. To put this margin in context, our 2011 Retail Market

¹² SSE is shown after a dashed line to reflect the different reporting period of its Statements, which cover the financial year rather than the calendar year as is the case for the other companies

Review¹³ contained analysis comparing profit margins in domestic energy supply to those in other sectors, including supermarkets. This analysis indicated that across the largest companies operating in the supermarkets sector¹⁴, the margin for supply was over 5% in 2010¹⁵. While different features between the sectors limit comparability, the analysis shows that the average profit margin for energy supply in both 2010 and 2011 was lower than across a selection of large supermarkets in 2010.

3.10. We now turn to the results of the four separate supply segments that make up the supply market: electricity and gas supply to domestic customers and electricity and gas supply to non-domestic customers.

¹³ http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_Appendices.pdf

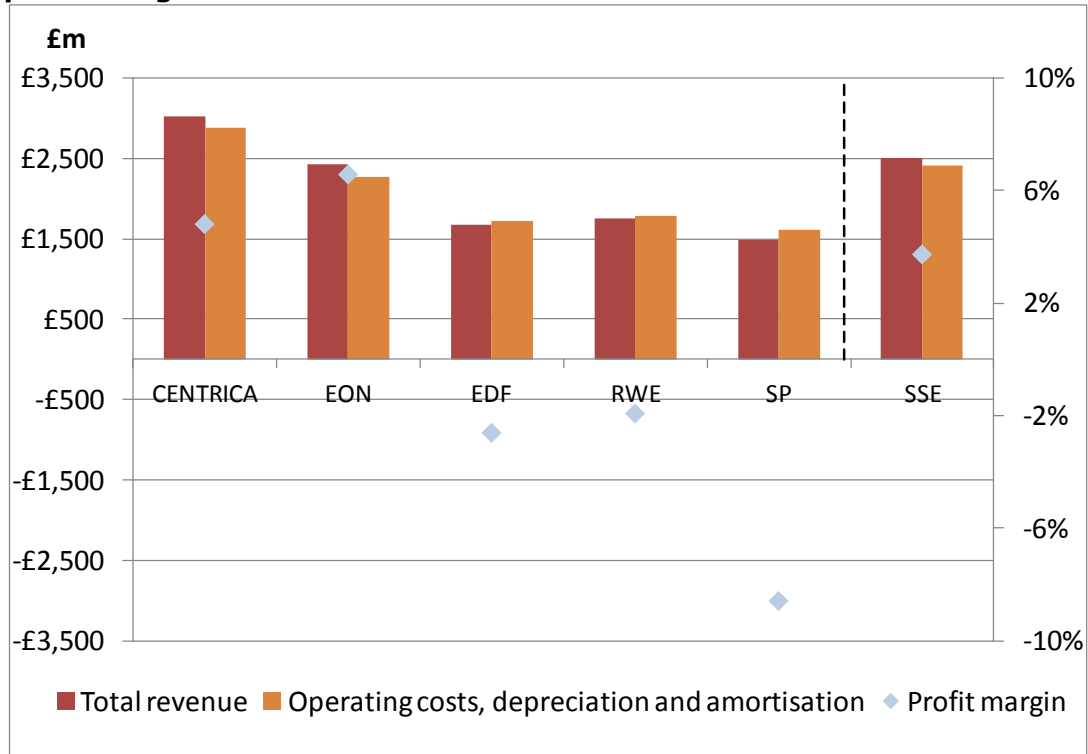
¹⁴ Tesco, Sainsbury's, Morrisons, Waitrose, Co-op, ASDA, Iceland

¹⁵ This margin was calculated on a proportional basis using the companies' 2010 revenues. For example, a company earning 50% of total sector revenues would contribute 50% to the proportional margin figure.

Electricity supply to domestic customers

3.11. Across the six companies, the average profit margin for the supply of electricity to domestic customers in 2011 was 1.5%, an increase from 0.3% in 2010. Figure 3 presents the revenues, costs and profit margins made by each company for the supply of electricity to domestic customers.

Figure 3: Electricity supply to domestic customers – revenues, costs and profit margins



3.12. The figure shows three companies’ costs exceeded their revenues, resulting in negative margins. Of these, ScottishPower had the largest negative margin (-9%). Of the three companies with positive margins, Centrica had the highest absolute revenue, but EON had the highest profit margin.

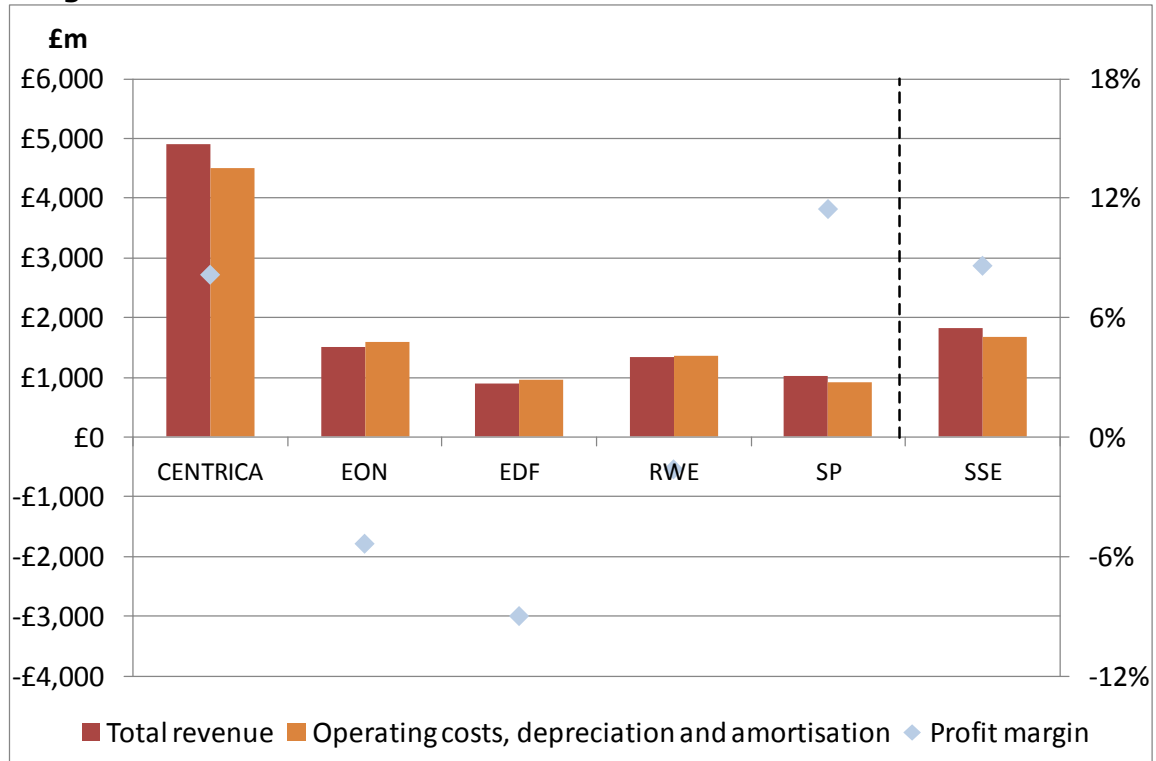
3.13. Later in the document we show the values the companies presented for the weighted-average cost of electricity (WACOE)¹⁶. This value reflects the price the supply segments of the companies pay for electricity. While we would expect the companies with higher WACOE to have lower margins, we notice this is not necessarily the case. For example, EON reported the highest margin but three companies had lower WACOE.

¹⁶ See glossary for a definition of WACOE/G.

Gas supply to domestic customers

3.14. Across the six companies, the average profit margin for the supply of gas to domestic customers was 4.3% in 2011, lower than 5.7% recorded in 2010. Figure 4 presents the revenues, costs and profit margins made by each company in the supply of domestic gas.

Figure 4: Gas supply to domestic customers – revenues, costs and profit margins



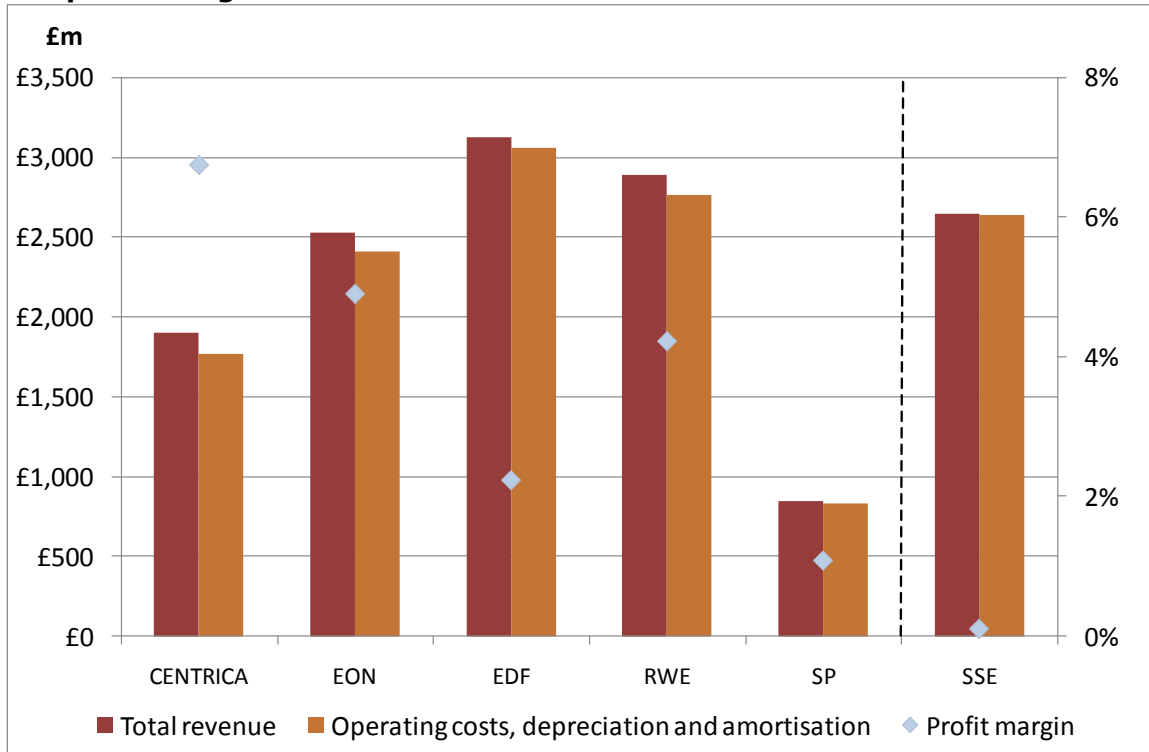
3.15. As in electricity supply, domestic gas supply margins also showed a high degree of variation between companies. ScottishPower had the highest margin at 11%; however this was earned on the second lowest revenue base. Centrica reported over 40% of revenues in the sector, and a margin of 8%. This was around the same margin as SSE, who was also the second largest supplier in this area by revenue. RWE, EDF and EON reported negative margins.

3.16. As in the case of electricity supply, the profit margins of gas supply to domestic customers do not relate straightforwardly to the costs of gas, although we note that ScottishPower reported both the lowest WACOG and the highest margin.

Electricity supply to non-domestic customers

3.17. Across the six companies, the average profit margin for the supply of electricity to non-domestic customers was 3.3% in 2011, down from 4.7% in 2010. Figure 5 presents the revenues, costs and profit margins made by each company in the supply of non-domestic electricity.

Figure 5: Electricity supply to non-domestic customers – revenues, costs and profit margins

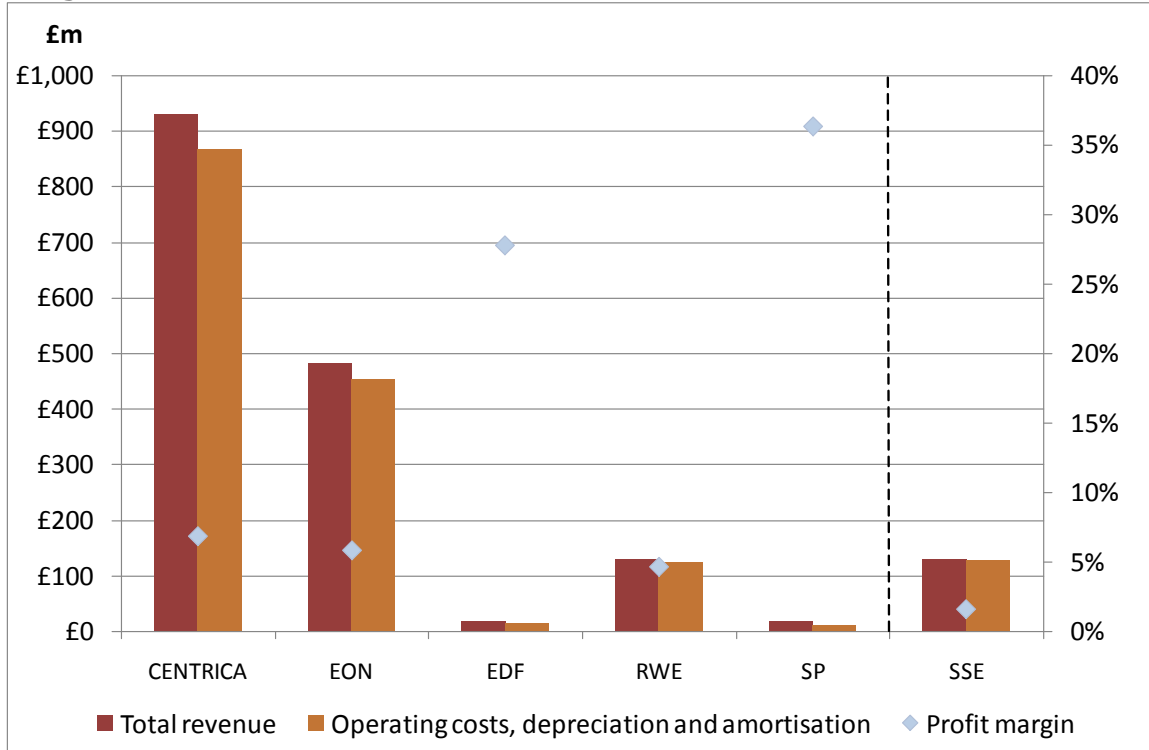


3.18. We note that no company reported negative profit margins and Centrica, with the second lowest revenue base, had the highest margin. Interestingly, the two companies with the highest revenues in non-domestic electricity supply, EDF and RWE, made up two of the three companies with the lowest revenues in domestic supply.

Gas supply to non-domestic customers

3.19. Across the six companies, the average profit margin for the supply of gas to non-domestic customers was 6.5% in 2011, a small increase from 6.2% in 2010. Figure 6 presents the revenues, costs and profit margins made by each company in the supply of non-domestic gas.

Figure 6: Gas supply to non-domestic customers – revenues, costs and profit margins



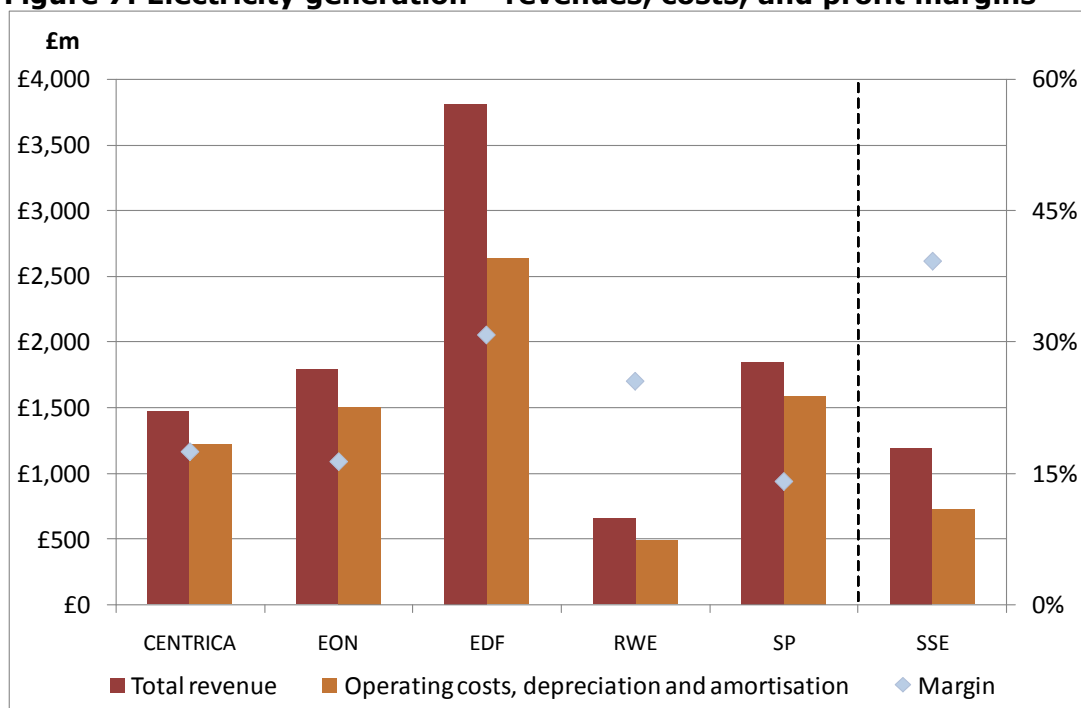
3.20. Centrica was the largest non-domestic gas supplier, accounting for over half of industry revenues, and had a 7% profit margin. All companies had positive margins in non-domestic gas supply. EDF and ScottishPower had margins of 28% and 36% respectively, although this was on very small total revenues.

Electricity generation

3.21. Figure 7 presents revenues, costs and profit margins for electricity generation across the six companies. The average generation profit margin across the six companies was 24.4%, but there was significant variation among companies. One reason for this is that companies have different generation portfolios and business models. For example, RWE and SSE sell generation capacity to their trading arm and therefore show no fuel costs; their generation revenue therefore only reflects the value of the capacity they sell rather than the full electricity output¹⁷.

3.22. In 2010, the average generation profit margin was 13.9%, although this included some accounting adjustment made by the companies. Modifying the published figure to take account of these adjustments would have put the 2010 profit margin to 21.9%.

Figure 7: Electricity generation – revenues, costs, and profit margins



3.23. There are a number of reasons why profit margins are likely to be higher in generation than they are in supply, as set out in paragraph 3.7. There are also different measures of profitability. We report profit margins as a proportion of revenue, but another way would be to compare profits to the quantity of capital

¹⁷ BDO looked at the methods used by the companies to value capacity payments. They concluded that it is difficult to confirm whether the prices charged for capacity are appropriate, even though from a transfer pricing perspective the approach may be sound. This is because, unlike for electricity, there is no 'market price' for capacity. It is therefore difficult to say whether the profit margins of the generation segments who sell capacity are higher or lower than they would be if their generation segments sold electricity.

invested in the business. This would give a figure for the return on capital employed (ROCE) or the percentage return a company was making on its investments.

3.24. While the Statements do not provide the necessary information to calculate this measure, we would expect it to be lower than the margin on revenues we present. This is because the amount of capital invested is often larger than the revenues of a company in any single year, and significantly so in the six generation businesses.

Fuel costs for domestic and non-domestic supply

3.25. Figures 8 and 9 show the weighted average cost of electricity and gas (WACO E/G) to domestic and non-domestic customers. WACO E/G corresponds to the costs the companies incur to supply either electricity or gas to their customers. The charts also compare the WACO E/Gs to Ofgem's calculated cost of electricity and gas purchased using a uniform 12, 18 and 24-month hedge. A uniform 12-month hedge reflects the cost of electricity or gas if the company purchased one twelfth of its supply requirement every month for the year before the date of delivery. The 18 and 24-month hedge costs are calculated in an equivalent way.

3.26. Ofgem asks the companies to include a number of specific items when calculating the WACO E/G¹⁸. While differences in the values of these elements will contribute to the variation of WACO E/G across the companies, we note that not every company has confirmed in their Statements the items included in the calculation of WACO E/G. This limits the degree of comparability of the WACO E/G of the six companies. We return to this point in Chapter 4, on PKF's findings on the Statements.

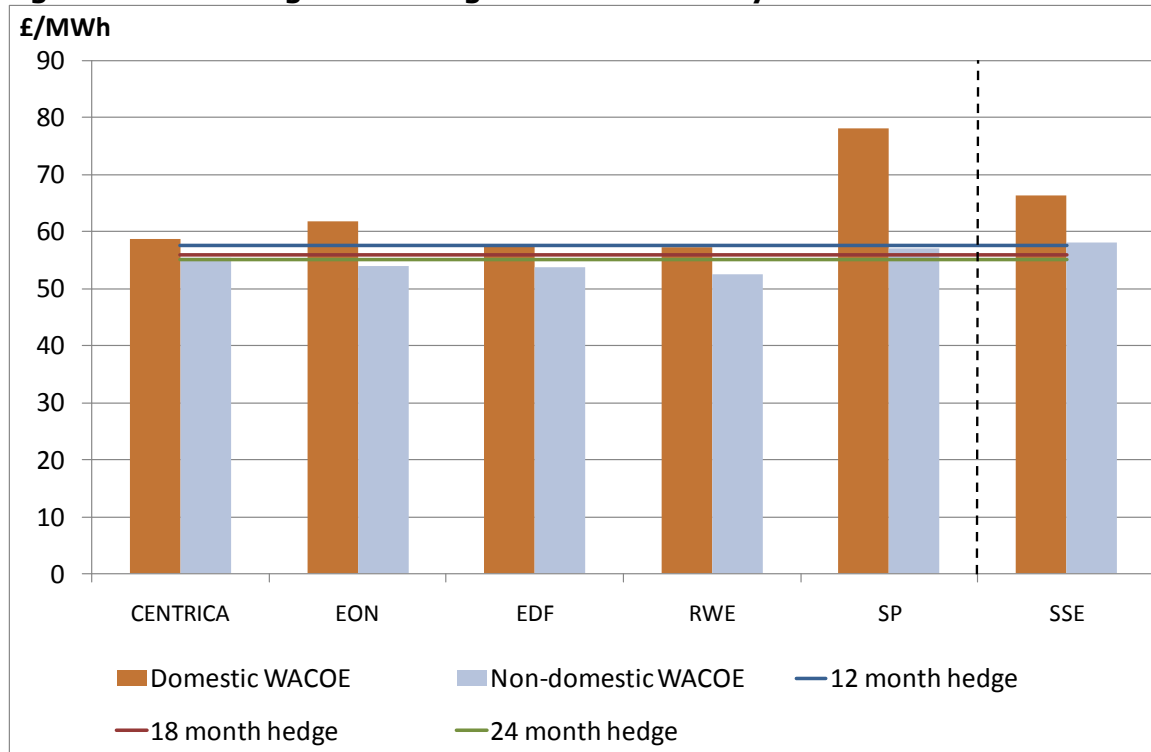
3.27. Even so, it is possible to make some high-level observations. The WACO E/Gs for non-domestic customers are, on average, slightly lower than those for domestic customers. One explanation for this is that companies might use different hedging strategies for sourcing the gas and electricity they need to deliver to non-domestic and domestic customers, since these two customer types have different demand profiles.

3.28. Focusing on the WACOE, Figure 8 shows that in the domestic electricity segment, ScottishPower stands out, with a WACOE almost 20% higher than the second highest company. ScottishPower's high domestic electricity cost is reflected in them having the lowest profit margin in this segment (see Figure 3). However across other companies, where the variation in WACOE is lower, there is no real evidence of correlation. In particular the two companies with the lowest WACO (EDF and RWE) showed negative profit margins.

¹⁸ These include wholesale energy cost, losses, the energy element of RbD costs and balancing and shaping costs. For a definition of RbD costs please see the glossary.

3.29. We also note that the reported WACOE in the domestic sector tended to be higher than Ofgem’s three calculated hedged costs. This suggests the companies may have included additional items that increase the value of their reported WACOE. In the non-domestic sector, the companies report very similar WACOE, which mirror the similar level of profit margins in this segment among the companies.

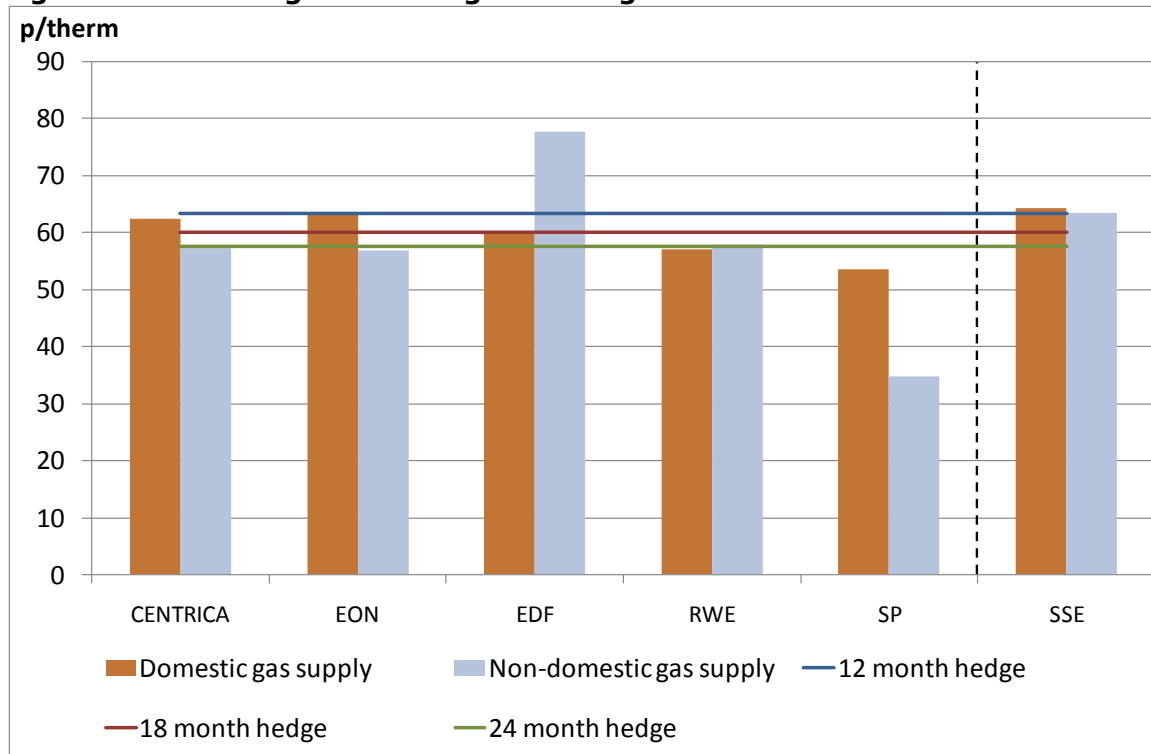
Figure 8: 2011 weighted average cost of electricity



3.30. Figure 9 presents the weighted average cost of gas (WACOG) reported by the companies. ScottishPower reported both the lowest WACOG in domestic gas supply and the highest profit margin in this segment (see Figure 4). This relationship, however, was not reflected at the high end of WACOG, where SSE reports the highest WACOG, but also the second highest profit margin.

3.31. In non-domestic gas supply, variability in WACOG was even higher among the companies. EDF was an outlier insofar as its WACOG was significantly higher than the others but also in that it supplied less than 1% of gas in this segment. ScottishPower had the lowest WACOG, and a high profit margin. The WACOGs in the non-domestic sector also tended to be lower than the WACOGs in the domestic sector.

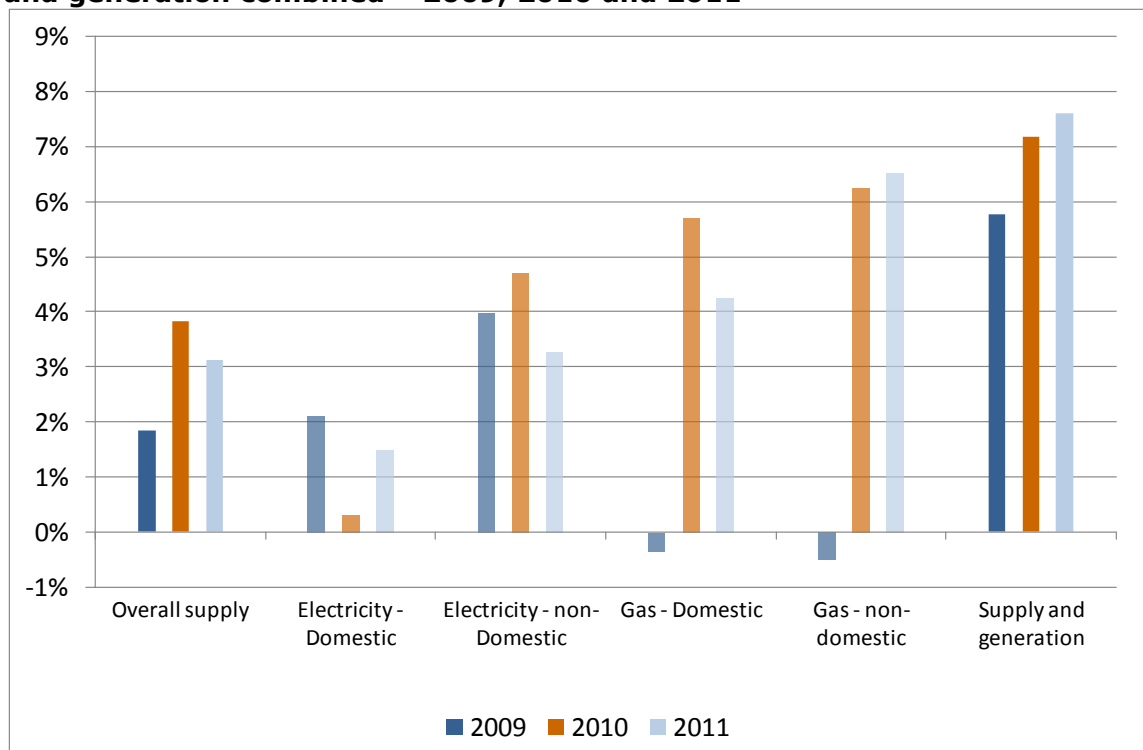
Figure 9: 2011 weighted average cost of gas



Comparison with 2009 and 2010

3.32. Figure 10 presents the profit margins calculated using the 2009, 2010 and 2011 Statements for overall supply, the four separate supply segments, and for generation and supply together. We advise caution when comparing results between years, for the reasons we set out in Chapter 2.

Figure 10: Profit margin for overall supply, each supply segment and supply and generation combined – 2009, 2010 and 2011



3.33. The profit margin for the overall supply segment was lower in 2011, at 3.1% compared with 3.8% in 2010, despite increases in the profit margin for domestic electricity and non-domestic gas supply. For supply and generation combined, the profit margin displays a year-on-year increase across the three years. The rise between 2010 and 2011 is due to an increase in the contribution to profits from the generation sector.

3.34. We separate out the margins earned in generation in Figure 11. After a small decrease from 2009 to 2010, profit margins in generation increase from 21.9% in 2010 to 24.4% in 2011. Typical generation margins need to be higher than in supply to finance the capital investment needed to build power stations.

Figure 11: Profit margin for generation – 2009, 2010 and 2011

	2009	2010	2011
Profit margin in generation	22.5%	21.9%	24.4%

Business functions table

3.35. In 2012, Ofgem amended the licence condition to ask the companies to provide a checklist to identify the parts of their companies that undertake a range of particular business functions. We included a table in the amended licence condition that asked companies to specify whether certain functions were undertaken by the supply or generation arms of the companies, or whether the function was performed by another part of the business.

3.36. The purpose of the table was to improve transparency of how different companies are structured. As discussed in Chapter 2, the six large energy companies structure their businesses in different ways, which has implications on the comparability of the information recorded in the Statements.

3.37. Each supplier has included a business functions table in its submission and in most cases the table is easy to understand and sufficient explanatory notes have been provided. However, in some cases, it has been difficult to interpret the table.

3.38. Ofgem recognises that this may be due to the complexity of the company structure being such that it is difficult to translate where certain functions are undertaken to a table. Furthermore, we recognise that this is the first time the companies have been asked to provide this information and so it may be reasonable to expect the companies to improve the way they present this information over time.

3.39. Even so, we expect the companies to do as much as possible to improve transparency in this area. To this end, we will be meeting with each company over the coming weeks to discuss their business functions tables and how they could be improved for the user. We will expect better quality submissions in next year's Statements.

3.40. The checklist of functions highlights a number of important differences between the companies. First, only Centrica uses a business model in which their separate generation and supply arms undertake a majority of business functions. This is because Centrica is the only company that does not make extensive use of an intermediary trading function. For the other five companies a large number of activities are shown to be performed in 'Another part of the business'. This reflects the importance of the trading function for these companies.

4. Independent opinion: summary findings

Chapter Summary

PKF found that the companies had completed the Statements appropriately. In no case did PKF highlight areas that could be considered as breaches of the licence condition. One area of considerable improvement noted was the reduced use of accounting adjustments. PKF also highlighted some areas for further improvement. They considered the companies could include additional information and explanations to improve the intelligibility of the Statements.

4.1. This year, following a BDO recommendation in their 2011/12 review of the 2010 Statements, Ofgem commissioned an independent opinion on the 2011 Statements. The terms of reference of the opinion were:

- Assess whether the licence condition (and Guidelines) had been interpreted appropriately, particularly the modifications made in August 2012
- Assess whether each Statement's reconciliation with the relevant company's group accounts had been carried out appropriately. This included assessing the suitability of the use of notable items in the reconciliation.

4.2. We commissioned the accountancy firm PKF to perform this task and the results are summarised in this section and included in full as associated documents to this report on our website. PKF presented the results of their review under the following sub-headings for each company:

- *CSS profit and loss table and financial information interpretation* reviews the information submitted in the profit and loss table and its supporting notes, which explain the various volume, cost and revenue items.
- *Transfer pricing* reviews the explanation of the transfer pricing methodologies that the company employs and are required by Ofgem to include in their Statements.
- *Joint ventures and associates* reviews the requirement for the Statements to include the proportion of volume, cost and revenue for joint ventures and associated companies that is represented by the companies' investment in these licensed businesses.
- *Business functions statement* reviews the table and supporting notes that show the separation of the specified business functions across generation, supply and "another part of the business".
- *Reconciliation to group accounts under IFRS* reviews how the segmental information may be reconciled to audited segmental information in the group accounts.

4.3. Overall, across the six Statements, PKF found that the companies had completed the Statements appropriately, although they highlighted some areas for

improvement. PKF found that the necessary amount of information was provided by the companies and, in most cases, with explanatory text. In no case did PKF highlight areas that could be considered as breaches of the licence condition.

4.4. PKF highlighted one area of considerable improvement compared to previous years, namely a significantly reduced use of accounting adjustments in the Statements. These adjustments arise as a result of actions which occur outside the companies' normal operations for a particular year. Ofgem specifically asks that such adjustments are not carried out in the Statements and PKF confirmed that the 2011 submissions contained no material additional items. This marks a significant improvement in disclosure in this area compared with previous years.

4.5. We summarise PKF's findings under each of the subheadings below:

CSS profit and loss table and financial information interpretation

4.6. PKF confirmed that each company had prepared a segmental profit and loss table in accordance with the licence condition and showing the appropriate figures for revenues, costs and profits separately for the relevant segments. PKF also confirmed that, in most cases, accompanying notes, which are requested by Ofgem, had also been provided.

4.7. One specific area that PKF highlighted for improvement was in the information presented by the companies in their calculation of WACO E/G. Ofgem asks the companies to include a number of specific items in this calculation¹⁹. PKF confirmed that not every company had provided a clear enough explanation to understand the contributing items in the WACO E/Gs included in the tables. This limits the degree of comparability of the WACO E/G of the six companies.

4.8. Another area that PKF highlighted for improvement related to the information some of the companies have provided on cost allocation across the segments. The Guidelines to the licence condition ask the companies to describe the methodology used to allocate shared costs²⁰ across the segments. PKF highlighted a number of instances where companies could have provided more information on the methods used to allocate shared costs across the segments. For example, one company said that costs had been apportioned to each segment based on 'appropriate cost drivers'.

4.9. In 2012, Ofgem amended the Guidelines to require the companies to describe how both Feed in Tariff and Renewable Obligation scheme costs are allocated across the segments²¹. In this area PKF noted the companies had performed well, with all but one company providing an appropriate description of the methods of allocation used.

¹⁹ These include wholesale energy cost, losses, the energy element of RbD costs and balancing and shaping costs. For a definition of RbD costs please see the glossary.

²⁰ Shared costs are those which are relevant to more than one segment.

²¹ Paragraph 1.5 in the Financial Information Reporting licence condition Guidelines

Transfer pricing

4.10. As detailed in Chapter 2, a transfer pricing methodology is needed to attribute the appropriate revenues and costs between generation, supply and the trading function of the companies.

4.11. The Guidelines to the licence condition ask the companies to provide a clear and full explanation of the companies' transfer pricing methodology. PKF confirmed that in all but one case the companies had provided information on the transfer pricing methodology used by the generation segment. For these companies, PKF confirmed that some reference to how the methodology relates to market prices was provided, which is required by Ofgem.

4.12. At the supply end, Ofgem also asks that the transfer pricing methodology, used to calculate the costs of energy, should reflect how each licensee actually acquires energy²². All companies included some description of the transfer pricing policy used for the supply business. Unfortunately, in only one case did a company include a qualification in their Statement that their transfer pricing methodology reflected how they actually acquire energy.

Joint ventures and associates

4.13. In all cases, PKF confirmed that the companies had included the relevant information for their joint ventures and associates.

Business functions statement

4.14. PKF confirmed that each supplier had included a business functions table in its submission. In most cases, the table is easy to understand and sufficient explanatory notes had been provided. One of the labels that Ofgem asks the companies to use in the table is "profit or loss" to reflect where the profit or loss of an activity is recorded. For two cases this was called "Financial impact of that function recorded in that area". This made interpreting the table more difficult for these two companies.

Reconciliation to audited accounts under IFRS

4.15. The licence condition asks the companies to provide a reconciliation of how the revenues and profits in their Statements relate to audited figures (prepared under consistent (IFRS) accounting standards) published in their group accounts.

4.16. PKF confirmed that all but one company had provided such a reconciliation. The one company that hadn't completed its reconciliation correctly had failed to reconcile its revenue figures in its Statements, but had correctly reconciled its profit figures.

²² Paragraph 1.8 in the Financial Information Reporting licence condition Guidelines

4.17. PKF highlighted a significantly reduced use of accounting adjustments in the Statements. They also confirmed that they had not identified any accounting adjustments from their reviews of the company group accounts that could have affected the figures published by the companies in their Statements. This marks a significant improvement in disclosure in this area compared with previous years.

4.18. However, PKF also showed that for three companies the reconciliation with audited accounts had not been completed at the segmental level of the Statements. This means that the separate information on supply and generation cannot be linked to values in audited accounts. The reason given for this was that, for these three companies, the information necessary to complete such a reconciliation did not exist in their group accounts. This means that for these three companies there was no independent verification that the allocation of revenues and profits between supply and generation had been completed appropriately.

Next steps

4.19. The changes made following the BDO review mean that this is the first time the companies have been asked to provide the Statements in this way. Over the coming months, we will work to secure improvements for this year's submissions to ensure the Statements are clearer, more accurate and of greater use to consumers' and market participants.

Appendix 1 – Glossary

Capacity payment

A payment to the generation arm of a company based on a fixed capacity fee for each plant regardless of use, plus a fee based on usage to cover variable costs.

EBIT

Earnings before Interest and Tax deducted. Used as Operating Profit, in Profit & Loss account.

EBITDA

Earnings before Interest, Tax, Depreciation and Amortisation deducted. Often used as Operating Profit excluding non-cash items, in Profit & Loss account.

EU ETS

European Union Emissions 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.

Hedging

Buying or selling energy ahead of the time the energy is actually delivered to reduce the risks associated with price movements.

International Financial Reporting Standards (IFRS)

A set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements.

Reconciliation by difference (RbD)

RbD is a method to allocate the costs of supplying gas between consumers without having to take the actual meter readings daily from all domestic consumers. It takes total supply minus the actual (metered) volumes of large industrial and commercial customers to give an estimate of the quantity of gas used by smaller gas consumers, such as domestic households.

Transfer pricing

Refers to the attribution of a price to internal transactions in the same organisation.

Vertically-integrated businesses

Where one energy group owns two or more parts of the energy supply chain. For example, where the same group owns generation capacity and also supplies energy to the retail market.

WACOE

Weighted average cost of electricity. It is likely to include wholesale electricity costs, losses, the energy element of the reconciliation by difference (RbD) costs, and balancing and shaping costs.

WACOF

Weighted average cost of fuel. This means the input cost of fuel (eg gas, coal, uranium, etc) used by the generation business, shown as £/MWh. This reflects the delivered cost of fuel.

WACOG

Weighted average cost of gas. It is likely to include wholesale gas cost, losses, the energy element of the reconciliation by difference (RbD) costs, and balancing and shaping costs.