Promoting choice and value
for all gas and electricity customers

Improving Reporting Transparency

Consultation

Reference:	09/12
Publication date:	31 January 2012
Response deadline:	27 March 2012

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Overview:

As part of the Retail Market Review Ofgem appointed the accountancy firm BDO to review the way that companies report information about the profitability of different parts of their vertically integrated businesses. As a result of this work, we are proposing to make changes to the way that companies provide this information.

Our aim is to make it easier for stakeholders to understand the profitability of the different components of the Great Britain gas and electricity markets. We believe that this information will provide greater transparency for consumers, independent market participants and other stakeholders. This, in turn will lead to increased confidence in the market and thereby greater and more effective competition. We believe our proposals strike the right balance between increasing transparency and allowing companies to determine how best to run their businesses.

Subject to views on our proposals received during consultation, we aim for the 2011 Consolidated Segmental Statements to be prepared under the new requirements. Our deadline for responses to this consultation is 27 March 2012.

Context

Ofgem's principal objective is to protect the interests of consumers, present and future, by promoting effective competition wherever appropriate. The Retail Market Review (RMR) represents Ofgem's attempt to enhance competition in the retail energy markets and make it work more effectively so that the benefits can be realised by more consumers than at present.

The proposals presented in this document are the results of one of the five workstreams initiated in the March 2011 RMR consultation. The proposals aim to improve the quality of information available to stakeholders about the profitability of different parts of the large, vertically integrated companies.

Proposals on three of the five workstreams were published in November and December 2011[1]. Proposals to improve market liquidity are expected to be published in early 2012.

Appended to this consultation document is the draft impact assessment on the proposals covered herein and the draft legal text for the amended licence conditions and guidance.

In conjunction with this consultation document we have also published the high level findings and recommendations of BDO, the accountancy firm we commissioned to analyse how the companies were meeting the requirements to produce the segmental statements, and how well the statements were meeting their original objectives.

We have also published our summary of the 2010 segmental statements.

Associated documents

All documents are available at www.ofgem.gov.uk

- Financial Information Reporting: 2010 Results, January 2012, Reference: 10/12
- The Retail Market Review – Domestic Proposals, December 2011, Reference: 166/11
- The Retail Market Review – Non Domestic Proposals, November 2011, Reference: 157/11
- Ofgem's Retail Market Review – update and next steps (non-liquidity proposals), June 2011

[1] Please see the following link: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=70&refer=Markets/RetMkts/rmr

- Ofgem’s Retail Market Review – update and next steps (liquidity proposals), June 2011
- Financial Information Reporting: Amended Guidance, May 2011, Reference number: 69/11
- Financial Information Reporting: 2009 Results, March 2011, Reference number: 41/11
- The Retail Market Review – Findings and Initial Proposals, March 2011, Reference: 34/11

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Executive Summary

Since 2009, the large vertically integrated energy companies have been required to publish Consolidated Segmental Statements, which present the profitability of generation and different supply activities separately. As part of the March 2011 Retail Market Review (RMR), we appointed accountancy firm BDO to review how the companies are producing the statements.

This consultation marks the culmination of that review. We are proposing to improve the way that companies provide information about the profitability of different parts of their vertically integrated businesses. This information provides transparency for consumers, independent market participants and other stakeholders leading to increased confidence in the market and thereby greater and more effective competition.

Specifically, we asked BDO to analyse four areas which we set out in turn below:

The transfer pricing methodologies employed by the Big 6

The review has highlighted that although the companies follow a broadly similar structure there are significant differences in the functions carried out in each part of the business. As a result, each company follows a somewhat different transfer pricing policy. Broadly, BDO view the transfer pricing policies of the companies to be fit for purpose, although differences in approach make it difficult to make comparisons.

How the Big 6 account for long term hedges

We asked BDO to examine whether the way the Big 6 account for long term hedges was appropriate. The companies have excluded mark-to-market gains and losses from the segmental statements as the underlying transactions do not relate to the year covered in the statements. BDO are content that this method of accounting for long term hedges is appropriate.

How each firm represents energy trading activities

Most companies have a single body trading with the markets. The extent to which these trading activities are reflected in the segmental statements varies between companies. For two of the companies, the cost of procuring fuel for generation is not included. This makes it difficult to compare the statements of different companies, and to compare the per unit generation revenues and electricity supply fuel costs. BDO note that speculative energy trading activities are excluded from the segmental statements.

How each company treats exceptional items

The 2009 segmental statements results raised concerns about the use of 'exceptional items'. BDO confirm a lack of consistency across companies.

In addition to analysing the specific areas above we asked BDO to recommend any changes they considered could significantly improve the usefulness of the segmental statements in providing transparency to the market. Below we set out their recommendations and our proposed way forward.

Recommendation	Proposed Way Forward
1. Require the companies to publish their segmental statements to the same year-end	We do not intend to take forward this recommendation
2. An independent auditor to provide an opinion on the segmental statements	We propose obtaining an independent opinion, at least for the first year, but not necessarily from an auditor
3. Instruct reconciliation of the segmental statements to an audited IFRS income statement	We propose to take forward this recommendation
4. Require the reporting of trading function results, including disclosure of the risk each trading function assumes	We do not propose to take forward this recommendation, although we do propose companies identify a checklist to identify where functions are undertaken
5. Perform further work to assess current transfer pricing policy	We do not intend to take forward this recommendation at this stage
6. Introduce uniform reporting treatments for generation fuel costs and free EU ETS allowances	We propose to take forward this recommendation
7. Guidance on scope and definition of exceptional items	We propose to take forward this recommendation
8. Specify consistent profit base for reconciliation	We propose to take forward this recommendation

We believe the package strikes the right balance between improving transparency and allowing companies to determine how best to run their businesses. We invite views on our proposals by 27 March 2012. Dependent on views received during consultation our aim is that the 2011 results will be prepared under the revised requirements.

We have also published a summary of the 2010 segmental statements alongside this document.

1. Introduction

1.1. In the March 2011 Retail Market Review (RMR) consultation document we set out five proposals to help make the energy markets in GB work in the interests of consumers:

- Proposal 1: Improve tariff comparability
- Proposal 2: Enhance liquidity
- Proposal 3: Strengthen Probe remedies – domestic
- Proposal 4: Strengthen Probe remedies – non-domestic
- Proposal 5: Improve reporting transparency

1.2. The proposals presented in this document relate to Proposal 5. In the March RMR consultation we set out our objective to further improve transparency and consumer trust in the market. As part of this, we said we would appoint an accountancy firm to undertake a review of the segmental statements. In the summer we announced that BDO would perform the review. We asked BDO to analyse four areas:

- The transfer pricing methodologies[2] employed by the Big 6
- How the Big 6 account for long term hedges
- How each firm represents energy trading activities
- How each company treats exceptional items[3]

1.3. We also asked BDO to provide recommendations to improve the segmental statements, including improvements to cross-company comparability.

1.4. We have reviewed BDO's recommendations and set out our proposals for reform for consultation in this document. We are proposing a number of measures to improve the way that the large vertically integrated energy companies provide information about the profitability of different parts of their vertically integrated businesses. This information provides greater transparency for independent market participants and other stakeholders leading to increased confidence in the market and thereby greater and more effective competition.

1.5. In addition, we have also published a summary of the 2010 segmental statements alongside this document. The 2010 statements follow the new Guidelines implemented last year following a separate consultation.

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[2] Transfer pricing refers to the attribution of a price to transactions between related parties. The transfer pricing methodology is a key determinant of the allocation of profits between different parts of the value chain. Given the vertical integrated business models of the Big 6, transfer pricing is a key issue in the preparation of the CSS.
[3] In the context of the CSS, the term 'exceptional item' does not have the standard accounting definition and is not used by every company. It should be understood in this context as an item not included in the CSS results.

1.6. This consultation document consists of three sections: Section 2 presents a summary of BDO’s findings. Section 3 presents BDO’s recommendations and our proposed way forward. Finally, in Section 4 we present the next steps.

2. BDO's findings

Chapter Summary

This chapter summarises BDO's findings. Further details can be found in the BDO report published alongside this document.

Question box

Question 1: Do stakeholders agree with, or have any comments on, BDO's findings on the transfer pricing methodologies employed by the Big 6?

Question 2: Do stakeholders agree with, or have any comments on, BDO's findings on how the Big 6 account for long term hedges?

Question 3: Do stakeholders agree with, or have any comments on, BDO's findings on how each firm represents energy trading activities?

Question 4: Do stakeholders agree with, or have any comments on, BDO's findings on how each company treats exceptional items?

Question 5: Do stakeholders agree with, or have any comments on, BDO's findings on the consistency of treatment regarding Joint Ventures and Associates?

2.1. We asked BDO to analyse four areas:

- The transfer pricing methodologies employed by the Big 6
- How the Big 6 account for long term hedges
- How each firm represents energy trading activities
- How each company treats exceptional items

2.2. BDO used a variety of sources in undertaking their review. These included publically available documents such as the segmental statements and the companies financial reports alongside information made available to BDO by the companies themselves. BDO held bilateral meetings with all of the companies and requested internal documents, including those regarding transfer pricing methodologies.

2.3. We asked BDO to provide recommendations to improve the segmental statements, including through improvements to cross-company comparability. Details of their recommendations, and our proposed way forward, can be found in Section 3.

2.4. BDO found that while most companies follow a broadly similar business model, with separate generation, trading and supply arms, there are significant differences in the functions these components undertake.

2.5. For example each generation arm maintains and operates generation plant, each trading arm interacts with the wider market and each supply arm sells energy to end consumers. However, some functions such as procuring fuel for generation plant, deciding when to run individual plant, and interacting with the balancing market sit in the generation arm for some companies but the trading arm for others. Likewise, other functions such as forecasting customer demand sit in the supply arm for some, but not all, companies.

2.6. These differences in company structures reflect different choices by the Big 6 in how to best manage the range of different functions they undertake. However, only the results from the generation and supply arms of the companies are included in the segmental statements. Companies do not report the trading arm results in the statements. Different company structures, therefore, mean there are differences in the number of functions that are shown in each company's segmental statements.

2.7. This has significant implications for the usefulness of the segmental statements in providing a picture of profitability of different segments of the industry. Some companies do not report generation fuel costs in their segmental statements. This makes it difficult to compare the statements of different companies, and to compare the per unit generation revenues and electricity supply fuel costs.

2.8. BDO also found that companies reconcile to different audited documents, using different accounting standards and different profit measures. This is allowed under the current licence conditions but is not helpful for comparability or for transparency of the industry as a whole. For example, while most companies carried out their reconciliation using their audited EBIT[4] figure, one company used EBITDA[5,6]. Furthermore, most companies reconciled their accounts to an audited IFRS[7] income statement, while one company used an income statement compiled under UK GAAP[8].

2.9. The remainder of this section provides more detail on each of the four main areas BDO were asked to review:

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[4] EBIT stands for earnings before interest and tax.
[5] EBITDA stands for earnings before interest, tax, depreciation and amortisation.
[6] One company provided reconciliation to both EBITDA and EBIT. Only three companies provided a revenue reconciliation. Two companies provided a cost reconciliation.
[7] International Financial Reporting Standards - see Glossary for further information.
[8] UK Generally Accepted Accounting Principles - see Glossary for further information. UK GAAP and IFRS differ most significantly in terms of potential treatments of derivatives, pension costs.

The transfer pricing methodologies employed by the Big 6

2.10. Transfer pricing is a key issue in the preparation of the segmental statements. Given the vertically integrated business models of the largest energy companies the price attributed to transactions between different parts of a company is a key determinant of the allocation of profits between different parts of the value chain.

2.11. Based on the information they have analysed, BDO view the transfer pricing policies to be broadly fit for purpose. That said, the review did raise a number of issues on transfer pricing.

2.12. One issue that lowers confidence in the companies' transfer pricing methodologies, is the liquidity of the market when the generation companies start hedging (up to 3 years out). Even though one generally accepted transfer price methodology is to base the price of internal transactions on the market price of the product, if market liquidity is low then there could be questions as to the reliability of the price used for the product by the companies.

2.13. Another issue highlighted by the review is how companies adjust market prices when calculating a transfer price to incorporate payments for transfers of risk to different parts of the business. This could have the effect of moving risk or duplicating a trading operation's reward for risk. However, BDO note that while this area is relatively opaque, the amounts involved are limited and so it is unlikely to cause material distortion to the numbers presented in the segmental statements.

How the Big 6 account for long term hedges

2.14. We asked BDO to review whether the Big 6 account for long term hedges (i.e. purchases of electricity and gas outside the year it is delivered) appropriately. The companies have excluded mark-to-market gains and losses[9] from the segmental statements as the underlying transactions do not relate to the year covered in the statements. BDO are content that this is appropriate because the hedges they relate to will directly effect the results of subsequent years.

How each firm represents energy trading activities

2.15. BDO note that speculative energy trading activities[10] have been excluded from the segmental statements but that other costs relating to hedging activities (such as the sale of generation output and supply fuel costs) are included in the statements.

[9] Mark-to-market gains and losses refer to unrealised profits and losses associated with open positions at the end of the financial year.
[10] BDO define speculative trades as those taken in pursuit of profit, rather than for the cost effective management of supply for consumers.

2.16. As we note above, the differences in how the companies run their business leads to a difference in which functions are undertaken in the trading arm. As a result two companies report minimal fuel costs in the segmental statements. This makes it difficult to compare the statements of different companies, and to compare the per unit generation revenues and electricity supply fuel costs.

2.17. BDO also note that the energy companies have group policies regarding hedging, generally including a specified time by which the position should be hedged. BDO note that the generation businesses tend to hedge their output, capability and capacity earlier than the supply business will hedge its requirement.

How each company treats exceptional items

2.18. A concern was raised in the analysis of the 2009 segmental statements results regarding the use of exceptional items. BDO note that in compiling the statements the companies have presented a number of reconciling items, some of which are termed exceptional items[11].

2.19. Companies are required to reconcile their segmental statements to statutory or Group accounts. BDO found that there was lack of consistency about the type of profit measure used for reconciliation and that this is likely to have contributed to the inconsistent treatment of items which the companies have excluded from the statements, for example one-off write downs.

2.20. BDO also noted that there were inconsistencies in how the results of certain entities which are part owned by the Big 6, or whose activities are significantly influenced by the Big 6 were included in the segmental statements and recommended that the guidance require common treatment of these.

[11] BDO note that the term exceptional items in the context of the CSS is being used to describe items which have been excluded from the CSS.

3. BDO's recommendation and our proposals

Chapter Summary

This chapter sets out which of BDO's recommendations we propose to take forward and why.

Question box

Question 6: Do stakeholders agree with, or have comments on, our proposal to not take forward recommendation 1?

Question 7: Do stakeholders agree with, or have comments on, our proposal to take forward recommendation 2?

Question 8: Do stakeholders agree with, or have comments on, our proposal to take forward recommendation 3?

Question 9: Do stakeholders agree with, or have comments on, our proposed way forward on recommendation 4?

Question 10: Do stakeholders agree with, or have comments on, our proposal to not take forward recommendation 5?

Question 11: Do stakeholders agree with, or have comments on, our proposal to include generation fuel costs in all the segmental statements (recommendation 6)?

Question 12: Do stakeholders agree with, or have comments on, our proposal to include the revenues associated with the free EU ETS allowances in the segmental statements (recommendation 6)?

Question 13: Do stakeholders agree with, or have comments on, our proposal to take forward Recommendations 7 and 8?

Question 14: Do stakeholders have comments on our proposal to request information on capital employed?

Question 15: Do stakeholders have any comments on, or additional evidence related to, our draft impact assessment in Appendix 6?

Question 16: Do stakeholders have any comments on our proposed increase in the customer threshold in the draft licence condition?

3.1. BDO identified eight recommendations that they believe could improve the segmental statements. We are proposing to pursue those that we feel work best as a package and which strike the right balance between improving transparency and imposing additional costs to the companies.

3.2. BDOs recommendation and our proposed way forward is summarised in the table below and discussed in more detail in the remainder of this chapter.

Recommendation	Proposed Way Forward
1. Require the companies to publish their segmental statements to the same year-end	We do not intend to take forward this recommendation
2. An independent auditor to provide an opinion on the segmental statements	We propose obtaining an independent opinion, at least for the first year, but not necessarily from an auditor
3. Instruct reconciliation of the segmental statements to an audited IFRS income statement	We propose to take forward this recommendation
4. Require the reporting of trading function results, including disclosure of the risk each trading function assumes	We do not propose to take forward this recommendation, although we do propose companies identify a checklist to identify where functions are undertaken
5. Perform further work to assess current transfer pricing policy	We do not intend to take forward this recommendation at this stage
6. Introduce uniform reporting treatments for generation fuel costs and free EU ETS allowances	We propose to take forward this recommendation
7. Guidance on scope and definition of exceptional items	We propose to take forward this recommendation
8. Specify consistent profit base for reconciliation	We propose to take forward this recommendation

3.3. **Recommendation 1** would require the companies to publish their segmental statements at the same time and to the same year-end. Using the same reporting period could lead to an improvement in comparability, particularly as the quarter that does not overlap across companies covers January to March, which is often the most important in terms of revenue and profits.

3.4. However, recommendation 1 would result in a large, disproportionate impact on the one company that currently reports to a different financial year-end. Shifting reporting period from a financial year-end to one that covers the calendar year would result in substantial costs to this company and require a fundamental shift in their business planning. Furthermore, one of the key benefits of the segmental statements is to provide transparency on profits over a longer period. This means that over time the different reporting periods will become less important. As a result, we do not propose to take forward recommendation 1.

3.5. **Recommendation 2** would result in an independent auditor providing an opinion on the segmental statements. BDO view that the report would:

- offer expert advice from a position of independence,
- provide commentary on the results disclosed by the companies in the context of wider market conditions,
- provide feedback and commentary with regard to recommendations for best practice, and
- provide assurance that the statements are accurate, complete and a fair reflection of performance.

3.6. BDO note that there would be a financial cost to this work.

3.7. We consider Recommendation 2 would be useful for the first year following implementation of the changes to the segmental statements and as companies adapt to the new requirements. However, we are of the view that the key aspect of this recommendation is providing expert independent commentary on the results. At this stage, we do not feel that the work would necessarily be performed by an audit company.

3.8. We propose that the assessment occurs after the publication of the segmental statements and that the report would be published alongside Ofgem's summary of the results. Further, we note that this assessment might not be necessary on an ongoing basis. We will return to the option of procuring an independent opinion for later years, following the 2011 segmental statement publications from the companies.

3.9. **Recommendation 3** would instruct the companies to use an audited IFRS income statement as the base for their segmental statements reconciliations. BDO view that the main benefit would be increased comparability across the Big 6 and thereby more transparency across the industry as a whole. In particular, BDO believe it would reduce the number of cases where one company includes an item in its reconciling statement while another has already excluded the same item at its starting point.

3.10. BDO note that there would be some process costs for a number of companies who currently reconcile to the segmental accounting note in their financial statements. However, one option to offset these costs would be to prepare a consolidation to the highest UK parent company level.

3.11. We believe that Recommendation 3 is an important step which, (especially when combined with Recommendations 7 and 8), will help to provide consistent accounting treatments across the companies.

3.12. **Recommendation 4** would result in the additional reporting of trading function results in the segmental statements and the disclosure of the risks each trading function assumes. BDO present two options under this recommendation:

- "Basic inclusion" would include the complete details for trading operations.
- "Detailed inclusion" would separate out speculative trading activities to show only the details of non-speculative activities which relate to supply and generation in the segmental statements.

3.13. The reporting of non-speculative trading function results would increase the visibility of income and profits across a wider part of the value chain. However for either form of recommendation 4 to be practicable, we would need to provide clear guidance on the income and costs to include. Furthermore, the resource and cost implications of either form of recommendation 4 could be large and could vary between companies.

3.14. We set out some further considerations of each approach below.

3.15. BDO consider that "basic inclusion" would offer greater visibility of profits along the supply chain. However, a limitation to this approach is that it would not improve transparency or comparability of the individual segments, given the differences in how companies allocate key functions (such as deciding when to run plant) between the trading arm and other segments.

3.16. Also, it would not provide clarity of what trading profits relate to speculative trades (which do not relate to the generation or supply of energy) and what relates to procurement and hedging for generation or supply purposes.

3.17. BDO believe that "detailed inclusion" would provide a clearer and more complete picture of functions undertaken in the energy supply chain. However BDO note that this option would require a clear and legally robust definition of both speculative and non-speculative trading. BDO also note that the additional work required to present trading results separately could lead to high implementation costs for companies.

3.18. As a result, we are not minded to pursue this recommendation in the proposed format. Instead, we believe the proposed requirement to report fuel costs in the generation segment (recommendation 6) is proportionate to our policy objective of improving transparency for the reasons outlined below.

3.19. However, we still consider there is merit in the proposal for greater visibility of the functions carried out by each part of the business. Therefore, we propose requiring the companies to produce an additional checklist of business functions in their segmental statements[12]. Our checklist would require companies to show which of a number of predefined functions are being performed in individual business

[12] See our draft guidance for a draft checklist of functions.

areas. For example, we would ask companies to tell us which part of the business (generation, supply or trading) is responsible for generation scheduling decisions.

3.20. **Recommendation 5** would perform further work to assess current transfer pricing policy. The work would examine how current practices compare to other potential transfer pricing methodologies and explore the most appropriate methodology within the GB energy sector.

3.21. BDO found that companies' transfer pricing methodologies are broadly fit for purpose. They also note that the alternatives to current methodologies would have their own limitations and could not be expected to offer any clear improvements. BDO also found no incentives for the companies to manipulate their transfer pricing and that there appear to be sufficient barriers to prevent manipulation. For these reasons, we do not propose to take forward recommendation 5 at this time.

3.22. **Recommendation 6** would introduce a uniform treatment for generation fuel costs and free EU ETS allowances. BDO view that a uniform treatment for disclosure of these key items would allow both consistency and transparency of reporting.

3.23. Recommendation 6 would require those companies that do not currently report their generation fuel costs within the generation segment of their segmental statements to do so. As we note in section 2 the lack of complete information about the fuel costs of the companies makes it difficult to compare the segmental statements and get an industry wide picture of profitability of the supply and generation activities. We therefore propose pursuing this recommendation.

3.24. With respect to free EU ETS allowances, we agree with BDO that there should be a consistent treatment across companies. We feel that the most consistent way of valuing allowances in the segmental statements is the price paid for them. This will have the effect of showing the profit related to the allocation of these allowances in the segment that owns the assets that led to the allocation of the free permits.

3.25. BDO note that the costs involved could be comparatively high for some companies and that the benefit from common treatment of free allowances will finish by the end of 2012. We believe that the benefits to transparency are sufficient to pursue this recommendation. We discuss the broader benefits and costs in our draft impact assessment, in Appendix 6.

3.26. **Recommendations 7 and 8** would provide clear guidance on the scope and definition of exceptional items, and specify EBITDA pre any exceptional items as the base for reconciliation with each companies' IFRS income statement. BDO identify appropriate items to be excluded and provide a template for reconciliation. They also provide views on how to treat Joint Ventures and Associates.

3.27. BDO view that recommendations 7 and 8 would increase comparability across companies by ensuring a common starting point and enhancing consistency in the preparation of the segmental statements. BDO view that while there could be some costs associated with this, these costs should be low. We believe that these recommendations, along with Recommendation 3, would help to ensure consistency of information across companies. We propose to take forward both recommendations 7 and 8.

3.28. Given the differences in the way the Big 6 run their businesses there will always be a constraint on how much information the segmental statements can provide. However, we believe the package strikes the right balance between improving transparency and allowing companies to determine how best to run their businesses.

Further issues

3.29. As part of this consultation document, we have included the draft licence conditions and guidance to clarify how we plan to implement these measures. We note that the draft licence conditions introduce a new, higher, activation threshold. In addition to holding a generation licence, the requirements of the draft licence conditions apply when a licensee has more than 250,000 customers in any one of the four supply segments (domestic and non-domestic, gas and electricity).

3.30. We have also decided to explore with the companies the possibility of providing a capital employed figure for their generation and aggregate supply activities to help calculate the return on capital employed (ROCE). We welcome views on this.

4. Next steps

4.1. We believe that, taken as a package, the proposals set out in this document strike the right balance between increasing transparency and adding additional costs to the companies.

4.2. We invite responses to our proposals by 27 March 2012. We are particularly interested in specific evidence on the costs and benefits of our proposals.

4.3. During this consultation period, we will be engaging with stakeholders to seek initial views and to ensure that an effective discussion takes place.

4.4. If, following consultation, we are minded to implement our proposals as set out in this document, we expect the 2011 segmental statements to be prepared under the revised requirements.

4.5. The existing deadline for the 2011 segmental statements for five of the companies is the end of June. Should the implementation date of our decision be after the deadline for these companies, we will issue a waiver from the deadline in the licence conditions to allow these companies to present their information by a date to be specified by the Authority.

Appendices

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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. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

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

Tim Wyndham
Energy Market Research and Economics
9 Millbank
London
SW1P 3GE
020 7901 7146
css@ofgem.gov.uk

1.4. 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.

1.5. 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.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish a decision document and final impact assessment. Any questions on this document should, in the first instance, be directed to:

Tim Wyndham
Energy Market Research and Economics
9 Millbank
London
SW1P 3GE
020 7901 7146
css@ofgem.gov.uk

CHAPTER: Two

Question 1: Do stakeholders agree with, or have any comments on, BDO's findings on the transfer pricing methodologies employed by the Big 6?

Question 2: Do stakeholders agree with, or have any comments on, BDO's findings on how the Big 6 account for long term hedges?

Question 3: Do stakeholders agree with, or have any comments on, BDO's findings on how each firm represents energy trading activities?

Question 4: Do stakeholders agree with, or have any comments on, BDO's findings on how each company treats exceptional items?

Question 5: Do stakeholders agree with, or have any comments on, BDO's findings on the consistency of treatment regarding Joint Ventures and Associates?

CHAPTER: Three

Question 6: Do stakeholders agree with, or have comments on, our proposal to not take forward recommendation 1?

Question 7: Do stakeholders agree with, or have comments on, our proposal to take forward recommendation 2?

Question 8: Do stakeholders agree with, or have comments on, our proposal to take forward recommendation 3?

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Question 13: Do stakeholders agree with, or have comments on, our proposal to take forward Recommendations 7 and 8?

Question 14: Do stakeholders have comments on our proposal to request the provision of information on capital employed?

Question 15: Do stakeholders have any comments on, or additional evidence related to, our draft impact assessment in Appendix 6?

Question 16: Do stakeholders have any comments on our proposed increase in the customer threshold in the draft licence condition?

Appendix 2 – Draft licence condition

1. The Relevant Licensee must prepare and publish on its Website a Consolidated Segmental Statement in respect of information relating to the revenues, costs and profits of its activities in the generation and supply of electricity and the supply of gas to any premises taking account of the Guidelines.

2. Where applicable, the Relevant Licensee must prepare and publish the Consolidated Segmental Statement referred to in paragraph 1 in conjunction with any Affiliates.

3. The Relevant Licensee must, in conjunction with any Affiliates, prepare and publish a Consolidated Segmental Statement
(a) no later than six months after the end of the Relevant Licensee's financial year; or
(b) no later than a date specified by the Authority, which can be no earlier than six months after the end of the Relevant Licensee's financial year.

4. Subject to complying with this paragraph the Relevant Licensee may, for the purpose of preparing the statement pursuant to paragraph 3, prepare and compile the information according to the licensee's annual accounting procedures. The Relevant Licensee must include in every such statement an explanation of:
(a) how it defines the terms revenues, costs and profits;
(b) how the revenues, costs and profits can be reconciled with an income statement prepared and audited under International Financial Reporting Standards;
(c) its transfer pricing methodology and how this relates to the revenues, costs and profits information published;
(d) where individual business functions are captured in the segmental statements, as specified by Appendix 2 of the Guidelines.

5. The Relevant Licensee must ensure that the information prepared and made public pursuant to paragraph 3 includes the cost of fuel used to generate electricity and its share of revenues, costs, profits and volumes of Joint Ventures and Associates.

6. For the purpose of Paragraph 4(b) the Relevant Licensee must ensure that the starting points of any reconciliation are the revenues, costs and profits prepared and audited under International Financial Reporting Standards before any exceptional items.

7. Subject to complying with Paragraph 5 the Relevant Licensee must ensure that all the information prepared and made public pursuant to paragraph 3 is in all material respects consistent with the information prepared pursuant to paragraph 4 and the information is presented with a clear and full explanation.

8. (a) The Authority shall prepare Guidelines in relation to the requirements of this condition and may modify, in whole or in part, the Guidelines following consultation with the Relevant Licensees
(b) The Authority shall modify the definition of Consolidated Segmental Statement as described in Appendices 1 and 2 of the Guidelines in accordance with section 11A of the Act.

9. For the purposes of this condition:

“Affiliate” means any holding company or subsidiary of a holding company of the Relevant Licensee, in each case within the meaning of sections 1159 and 1160 of the Companies Act 2006.

“Associate” means an entity, including an unincorporated entity such as a partnership, over which the Relevant Licensee has significant influence and that is neither a subsidiary nor an interest in a joint venture.

“Consolidated Segmental Statement” means a statement as described in Appendices 1 and 2 of the Guidelines.

“Joint Venture” means a contractual arrangement whereby the Relevant Licensees and one or more parties undertake an economic activity that is subject to joint control.

“Relevant Licensee” means the holder of an electricity generation licence granted or treated as granted under section 6(1)(a) of the Act if it or any of its Affiliates:

i. jointly supply electricity to more than 250,000 domestic customers; or
ii. jointly supply gas to more than 250,000 domestic customers; or
iii. jointly supply electricity to more than 250,000 non-domestic customers; or
iv. jointly supply gas to more than 250,000 non-domestic customers, respectively.

“Website” means a website controlled and used by the Relevant Licensee or an Affiliate for the purposes of providing information and communication.

Appendix 3 – Draft guidance

1.1. These guidelines relate to Standard Condition 19A of the Gas and Electricity Supply Licences and Standard Condition 16B of the Electricity Generation Licences (collectively referred to as 'the Conditions' for the purposes of these guidelines).

1.2. The guidelines have been prepared by the Office of Gas and Electricity Markets ('Ofgem') pursuant to paragraph 8/19A.8 of the Conditions (throughout this document the first paragraph number relates to the generation licence and the second relates to the supply licences).

Scope and Application of the Licence Condition

1.3. The Conditions only apply to those companies that are "Relevant Licensees" as defined in the Conditions.

Financial Year

1.4. Under paragraph 3/19A.3 of the Conditions, the financial year should be taken to mean the Relevant Licensee's current financial reporting year. For the avoidance of doubt this may differ between companies.

Interpreting the Financial Information

1.5. Under paragraph 4(a)/19A.4(a) of the Conditions a clear and full explanation of how the Relevant Licensee defines the terms revenues, costs and profits should be set out, so as to enable understanding of what the information published pursuant to paragraph 1/19A.1 does and does not represent. The licensee should describe the methodology or methodologies used to allocate marketing, shared and corporate costs across generation, supply and other activities. Where issues pertaining to the data are unexpected or unusually complex these issues should be set out in full.

1.6. Under paragraphs 4(b)/19A.4(b) and 7/19A.7 of the Conditions a clear and full explanation of the reconciliation should be provided, so as to enable an individual to understand as much as can be reasonably expected as to how revenues, costs and profits reconcile to the Relevant Licensee's audited income statement prepared under International Financial Reporting Standards. If a licensee separately identifies a column which it attributes to trading or portfolio optimisation, the explanatory notes should contain a detailed description of its significant component parts. An explanation of any reconciliation would be expected to take the form of a numerical table and a written statement.

1.7. Paragraph 7/19A.7 of the Conditions provide for the information required pursuant to paragraph 1/19A.1 to be presented with a clear and full explanation. This clear and full explanation should be sufficient to inform an industry stakeholder of the financial data's proper interpretation and context (eg any structural constraints the business operates within, such as tolling agreements).

Transfer Pricing Methodology

1.8. Under paragraph 4(c)/19A.4(c) of the Conditions a clear and full explanation of the Relevant Licensee's and Affiliates' transfer pricing methodology should be provided, so as to enable an industry stakeholder to understand as much as can be reasonably expected about the transfer pricing methodology adopted. The transfer pricing methodology used to calculate WACOE and WACOG should reflect how each licensee actually acquires energy. This explanation should include:

- how the methodology relates to open market prices and/or a cost plus methodology;
- the treatment of allocated costs and corporate charges (eg head office charges); and
- the allocation of financial risk between group companies and / or business segments (eg treatment of internal tolling agreements/capability payments).

Treatment of Joint Ventures and Associates

1.9. Under paragraph 5 of the Conditions the Relevant Licensee must ensure that the information provided in the segmental statements includes its share of revenues, costs, profits and volumes of any Joint Venture and Associates. In preparing the segmental statements, the Relevant Licensee should account for Joint Ventures and Associates (which hold a generation or supply licence relating to the generation or supply of gas or electricity in the UK) as follows:

- the share of revenues of Joint Ventures and Associates to be included within revenue;
- the share of the profit before tax of Joint Ventures and Associates to be included with EBIT and EBITDA; and
- the share of the generation volumes of Joint Ventures and Associates to be included within the generation volumes.

1.10. For each of the items, the Relevant Licensee's share of the income and expenses of a Joint Venture or Associate should be combined line by line with similar items in the Relevant Licensee's segmental statements or reported as separate line items in the Relevant Licensee's segmental statements.

1.11. The remainder of the guidelines consist of Appendix 1 and 2.

Appendix 1

	Unit[1]	Generation	Electricity supply		Gas supply		Aggregate supply business[10]
			Domestic	Non-domestic	Domestic	Non-domestic	
		2010	2010	2010	2010	2010	2010
Total revenue	£M	£0	£0	£0	£0	£0	£0
Revenue from sales of electricity and gas[2]	£M	£0	£0	£0	£0	£0	£0
Other revenue[3]	£M	£0	£0	£0	£0	£0	£0
Total operating costs	£M	£0	£0	£0	£0	£0	£0
Direct fuel costs[4]	£M	£0	£0	£0	£0	£0	£0
Other direct costs[5]	£M	£0	£0	£0	£0	£0	£0
Indirect costs[6]	£M	£0	£0	£0	£0	£0	£0
WACO F/E/G[7]	£/MWh, p/th	0	0	0	0	0	NA
EBITDA[8]	£M	£0	£0	£0	£0	£0	£0
DA	£M	£0	£0	£0	£0	£0	£0
EBIT	£M	£0	£0	£0	£0	£0	£0
Volume[9]	TWh, therms	-	-	-	-	-	NA

Notes

1. The financial data should be provided to the nearest £million, WACOE and WACOF to the nearest pence in £/MWh, WACOG in p/therms to 1 decimal place and volumes to 1 decimal place in TWh. The grey shadings denote summations that can be calculated by using other information within the statement, eg EBITDA can be calculated using the total revenue and total operating cost lines in the statement.

2. For the generation business segment this means revenue from sales of electricity output generated; or if the business operates in a tolling-agreements structure, the revenues received from the capability or capacity payments including the account of associated fuel costs (an explanation/clarification of the latter type of revenues should be provided). For the respective supply segments this means electricity and gas sales. Dual fuel discounts should be deducted from revenue for domestic supply, with the discount split evenly between electricity and gas. Social tariff costs should also be deducted from domestic supply revenue directly.

3. Other respective segmental revenues not covered in Note 2, eg in the generation segment may include capacity payments, other physical options and ancillary services.

4. Direct fuel costs for supply should include aggregate electricity and gas costs as outlined in Note 7. Direct fuel costs for generation should include an associated input cost for fuel, irrespective of the business model of the Relevant Licensee or its Affiliate.

5. Other direct costs for supply should include network costs, BSUOS, environmental costs (including ROCs, CESP and CERTs) and the transport element of Reconciliation-by-Difference (RBD) costs.

6. Indirect costs should be defined as licensees' own internal operating costs including sales and marketing costs, bad debt, costs to serve, IT, staffing costs, billing and all meter costs.

7. For generation this means the weighted average input cost of fuel (eg gas, coal, uranium, etc) used by the generation business, shown as £/MWh. For the supply businesses, WACOE/G should cover the wholesale energy cost, losses, the energy element of RBD costs, balancing and shaping costs incurred by supply licensees.

8. EBIT means earnings before interest and tax; and EBITDA means earnings before interest, tax, depreciation and amortisation. Under paragraph 4(b)/19A.4(b) the only permitted reconciliation items are:

(a) mark to market adjustments,

(b) restructuring costs which have been disclosed as such in the income statement prepared and audited under UK International Financial Reporting Standards, and

(c) disposals.

9. Volumes should be supplier volumes at the meter point (ie net of losses). Generation volumes should be the volume of power that can actually be sold in the wholesale market, ie generation volumes after the losses up to the point where power is received under the Balancing and Settlement Code but before subsequent losses.

10. The supply aggregation column (aggregation of domestic and non-domestic electricity and gas supply businesses) sums the horizontal supply figures and thereby helps facilitate reconciliation to group accounts.

Appendix 2

Business function	Generation	Supply	Not included in segmental statements
Operates and maintains generation assets			
Responsible for scheduling decisions			
Responsible for interactions with the Balancing Market			
Responsible for determining hedging policy			
Responsible for implementing hedging policy			
Interacts with wider market participants to buy/sell energy			
Holds unhedged positions (either short or long)			
Procures fuel for generation			
Procures allowances for generation			
Holds volume risk on positions sold (either internal or external)			
Matches own generation with own supply			
Forecasts total demand			
Forecasts wholesale price			
Forecasts customer demand			
Determines retail pricing and marketing strategies			
Bears shape risk after initial hedge until market allows full hedge			
Bears short term risk for variance between demand and forecast			

Appendix 4 – 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.

H

Hedging

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

I

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.

M

Mark-to-market

Mark-to-market gains and losses refer to unrealised profits and losses associated with open positions at the end of the financial year.

N

Non-speculative trading

In this report non-speculative trading is taken to mean trading for the purpose of cost-effective management supply for customers.

R

Return on Capital Employed (ROCE)

A measure of the returns that a company is realising from its invested capital. It represents the efficiency with which capital is being utilised to generate revenue.

S

Speculative trading

In this report speculative trading is taken to mean trading for the purpose of profit and not for the cost-effective management supply for customers.

T

Transfer pricing

Transfer pricing refers to the attribution of a price to transactions between related parties.

U

UK GAAP

UK Generally Accepted Accounting Principles. The basis under which all UK companies operated before 2005. Companies listed on the stock exchange must now use International Financial Reporting Standards.

Upstream

In this document when we refer to upstream we mean the electricity generation sector.

V

Vertically integrated businesses

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

Appendix 5 - 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:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk

Appendix 6 – Draft Impact Assessment

Our proposals

1.1. We have set out proposals in the main document above. In this section we set out our initial, high level, impact assessment of our proposals.

Impacts on consumers

1.2. The benefits of our proposals to consumers will arise predominantly from the positive impact of the transparency measure on competition. We expect the effectiveness of competition to be strengthened as a result of our proposals.

Impacts on competition

1.3. We believe that our proposals, taken as a package, will strengthen transparency and provide enhanced information to independent market participants and other stakeholders of the profitability of different segments of GB electricity and gas markets. We believe that this transparency will strengthen the effectiveness of competition.

1.4. To maintain proportionality we will continue to require segmental statements information only from large vertically integrated companies.

Impacts on sustainable development

1.5. We do not envisage any impacts on sustainable development at this stage.

Risks and unintended consequences

1.6. We invite views from stakeholders on possible risks and unintended consequences.

Other impacts (including implementation costs)

1.7. At this stage it is hard to quantify precisely the implementation cost of our package, although we have taken into account the approximate scale of costs in considering BDOs recommendations. Table 1 below summarises our current view on implementation costs for each of the component parts. We welcome views from stakeholders on our comments.

Table 1: Costs associated with our proposals

Component of Proposals	Comment on implementation costs
Recommendation 2	This would have a financial cost to Ofgem of up to £150k for each year a report is required.
Recommendation 3	We do not envisage this having a significant incremental cost for many of the companies. For the company that currently uses UK GAAP the costs may be more significant, particularly in the first year.
Recommendation 4	In our version of recommendation 4 companies will need to fill out a checklist identifying which sectors report which function. The financial cost on each company is therefore minimal.
Recommendation 6	For the companies that currently report fuel costs within the segmental statements there will be no additional costs. For the companies that do not currently report fuel costs there is likely to be a cost in providing this information, however we do not consider that this cost is likely to be large.
Recommendations 7 and 8	This recommendation is unlikely to lead to any incremental costs, as it will strengthen guidance on what can and can't be excluded from the segmental statements. If costs do arise, then these are likely to be one-off costs in the first year to change processes. We do not consider that such costs are likely to be large.

Post-implementation review

1.8. Should we implement our proposals we will review how they have progressed following the first year of results.

Conclusion

1.9. We believe that our proposals, taken as a package, will strengthen transparency and provide enhanced information to independent market participants and other stakeholders of the profitability of different segments.

1.10. At this stage whilst there are likely to be some costs to our proposals, we do not consider them to be significant to the extent they outweigh the benefits of improved transparency.