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Financial Information Reporting: 2009 Results

Consultation document

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Overview:

The first set of segmental supply and generation statements from the Big Six companies have now been published, relating to 2009. This document gives an overview of these results. It covers some of the key accounting treatments and cross-comparability issues. It also sets out how these segmental statements can be improved in the future.

Context

The Financial Information licence condition requires the large vertically integrated companies to publicly report separate financial results for generation and for domestic and non-domestic electricity and gas supply. The aim of this remedy is to provide better transparency regarding how company revenues, costs and profits are split across different parts of their business.

The information is required to be reconcilable to consolidated group or UK statutory accounts, and be readily available on the companies' websites six months after year end. We published guidance together with the licence condition, to assist the licensees in preparing the relevant information.

Associated documents

- Energy Supply Markets Probe - Call for Evidence (30/08), 27 March 2008
- Energy Supply Probe - Initial Findings Report (140/08), 6 October 2008
- Energy Supply Probe - Proposed retail market remedies (41/09), 15 April 2009
- Energy Supply Probe - Retail Package decision document (99/09), 7 August 2009
- Financial information reporting: Guidance, 20 October 2009
- Retail Market Review Consultation Document (34/11), 21 March 2011
- Electricity and Gas Supply Market Report (36/11), 21 March 2011

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Executive Summary

The segmental information provided by the Big Six has been effective in providing consumers and other stakeholders with extra transparency and insight on their results. For the first time, data is available on all the companies' generation and supply revenues, cost and profit. It is possible to look across the companies' data to get insights on their relative performance.

The 2009 segmental statements indicate that:

- There was a wide variation in domestic supply margins in 2009, with several suppliers reporting low or negative margins.
- Reported supplier wholesale costs for domestic customers were broadly in line with the range of cost estimates derived from the hedging strategies assumed in our Supply Market Reports.

However, there are important limitations on the additional transparency and on the extent to which the companies can be compared with each other. The Big Six have different business models and use a range of accounting conventions in drawing up their segmental statements. And some of the companies have excluded significant profit elements from their segmental results. On the basis of the information available to us, we judge that all of the Big Six complied with the licence condition. However, we see scope to improve consistency across the companies by changes to the Guidelines and we are proposing a wide range of amendments to achieve this.

A particular area where there is limited transparency is in the treatment of wholesale energy costs. This is driven by differences in companies' transfer pricing approaches and how they report their wholesale trading. This is an area where the segmental statements do not provide consumers with sufficient clarity and transparency. We propose to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated firms in the sector and report to us on the likely impact of these practices on reported profits and transparency. We will also ask them to make recommendations about how we can improve reporting in future years, either through amendments to the segmental statements or through additional reports provided to Ofgem.

We request responses to the proposed changes to the Guidelines by 19 April 2011, to enable companies to prepare their 2010 segmental statements on the basis of revised Guidelines.

1. Cross comparability of results

This chapter notes the limitations of comparing results across the companies.

1.1 Licence conditions 19A of the Gas and Electricity Supply Licences and 16B of the Electricity Generation Licence came into effect in October 2009. These licence conditions require the major vertically integrated supply companies to publish detailed financial information on their costs, profits and revenues based on their own transfer pricing methodology and accounting conventions. All six suppliers published this information within six months of their financial year end for 2009, or for 2009/10 in the case of SSE[1].

1.1 Differences between the companies

1.2 The licence conditions allow the companies to reconcile their segmental statements to either their group or their statutory accounts, in line with their own accounting conventions. There are a number of issues to be aware of when making direct comparisons of the results between the companies.

Differences in the reporting period of results

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

Differences in how the companies operate their business

1.4 There are various important differences between the companies in how they operate and report their results. In particular, some companies use tolling agreements to organise and report their generation business. In this case, the generation business receives capability payments for their generation assets from the trading arm of the business. The trading arm is responsible for fuel procurement, electricity sales, and operating decisions, and receives the earnings relating to these activities. If this trading arm is pan European (as it is for E.ON and RWE), then these results do not form part of their GB business operations.

1.5 Vertically integrated companies face some shared costs across their business, such as corporate overheads. There is no common standard as to how to allocate these shared costs back into the different segments of the business. The firms have

[1]The link below shows where the segmental statements of each of the Big Six can be found. http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/location%20of%20these%20accounting%20statements%20on%20each%20suppliers%20website.pdf

used a number of different approaches to allocate these shared costs, which impacts on the comparability of the segmental results.

Treatment of particular cost items

1.6 SSE and Centrica reconcile to their group accounts whereas RWE Npower, EDF, Scottish Power, and E.ON reconcile to their statutory accounts. Some companies report additional costs in their segmental accounts relative to their group accounts. Details of these costs by individual supplier and their impact on margins are analysed in Chapter 3.

1.7 Companies define certain cost items in different ways. For example one firm may define a cost item as a direct cost, whereas another firm defines the same item as indirect. This will have no impact on overall margins, but will limit the comparability of individual cost items across companies.

1.2 Presenting the results for all six companies

1.8 The above paragraphs highlight key issues impacting the cross-comparability of the companies' segmental information. We judge that despite these issues, it is still insightful to look at the individual company results side by side, as many City analysts and commentators have done. The results are shown in Chapter 2.

1.9 To improve the comparability of the results shown in Chapter 2, we have made some minor adjustments to the companies' segmental data. These adjustments have no impact on overall company operating profit, as they only affect the allocation between different segments. These adjustments are shown in Appendix 3.

2. 2009 Results

This chapter sets out the main findings from the first set of segmental statements.

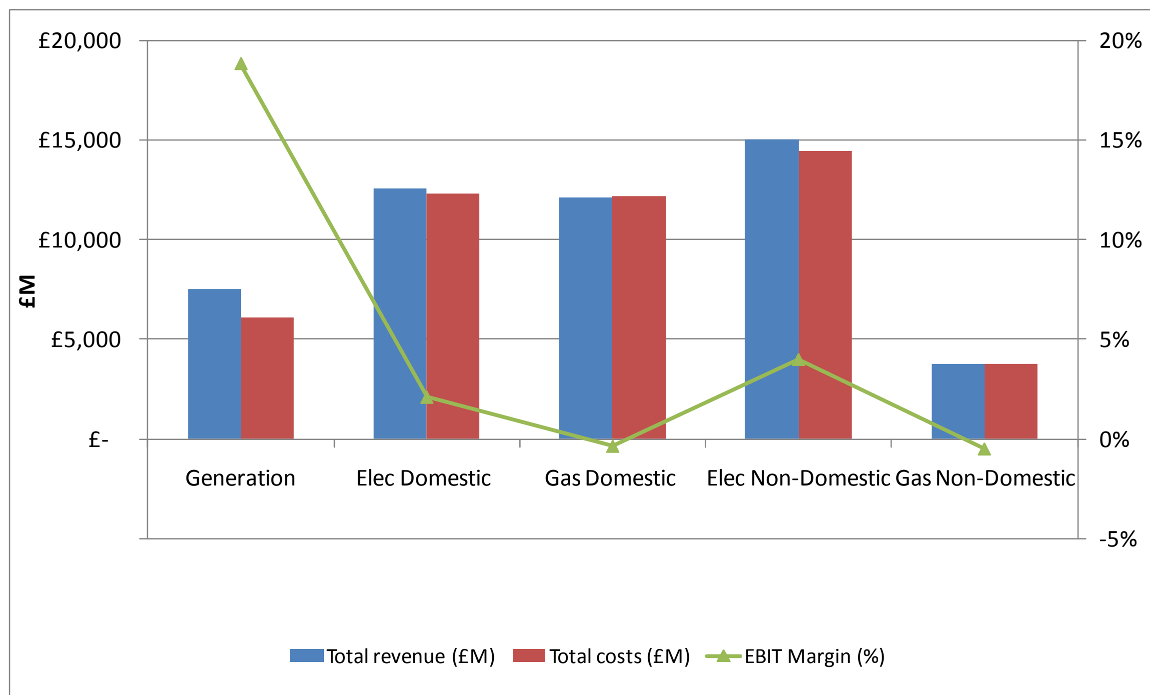
These results show that:

- Generation margins were much higher than energy supply margins.
- Domestic supply margins were low or negative for several suppliers in 2009, but positive for Centrica and SSE (at least for electricity).
- Reported supplier WACOE/G were broadly in line with the wholesale electricity and gas cost estimates derived from the hedging strategies assumed in our Supply Market Reports.
- Centrica recorded the highest margins in both domestic electricity and gas supply. Our analysis indicates that Centrica reported higher margins due to a combination of lower costs and gaining more revenue from gas customers.

2.1 Margins

2.11 margins across all five segments

Figure 1: 2009 Aggregate revenue, cost and EBIT margin by segment (£M, %)

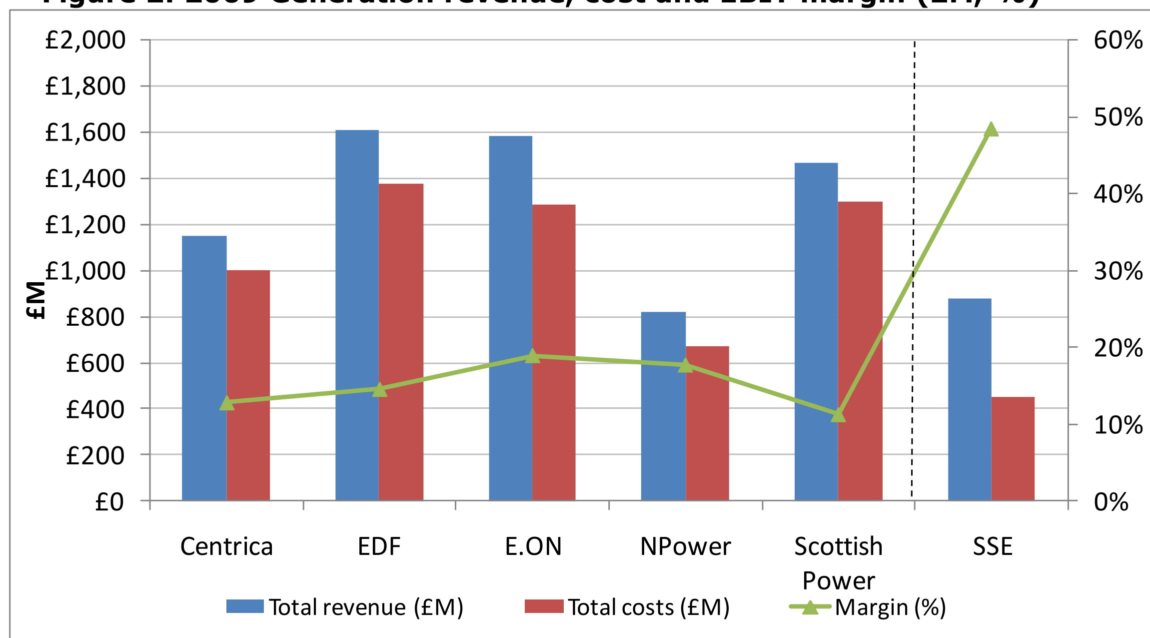


2.1 Figure 1 shows EBIT generation margins were much higher than margins in the supply segments. This would be expected because of the higher capital requirements of generation relative to supply[2].

2.2 Average margins were positive for electricity supply, both to the domestic sector and to the non domestic sector. Average margins were low/negative for gas supply, to both domestic and non-domestic sectors, although this aggregate result masks big differences across individual suppliers.

2.12 Generation margins

Figure 2: 2009 Generation revenue, cost and EBIT margin (£M, %)



2.3 Generation is treated in two distinct ways by companies in the segmental statements. The two treatments are:

- Generation revenue is based on payment for output, valued at market prices at the time when the contract is fixed. This is the case with Centrica, EDF Energy and Scottish Power.
- The generation business does not receive any revenue from external sales of electricity, but rather the transfer price is fixed by a tolling agreement and covers capacity payments, fuel sales and ancillary services, as is the case with E.ON, RWE and SSE.

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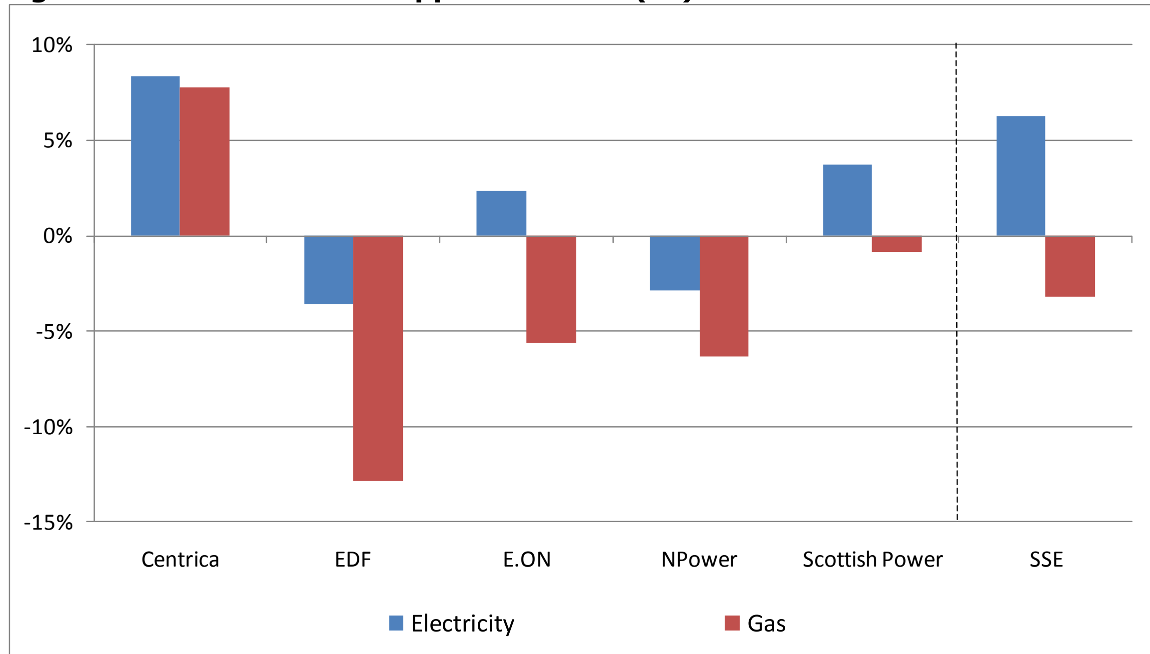
[2] To improve comparability EBIT margins are shown for generation profitability. The generation segment is highly capital intensive, so we want to measure profit after depreciation.

2.4 Figure 2 shows cross company generation EBIT margins. All generators returned an EBIT of over 10% in 2009, with SSE showing margins of nearly 50% due in part to around 3.3 TWh of low cost hydro in their generation output.

2.13 Domestic supply margins

Figure 3: 2009 Domestic supplier EBITDA (%)

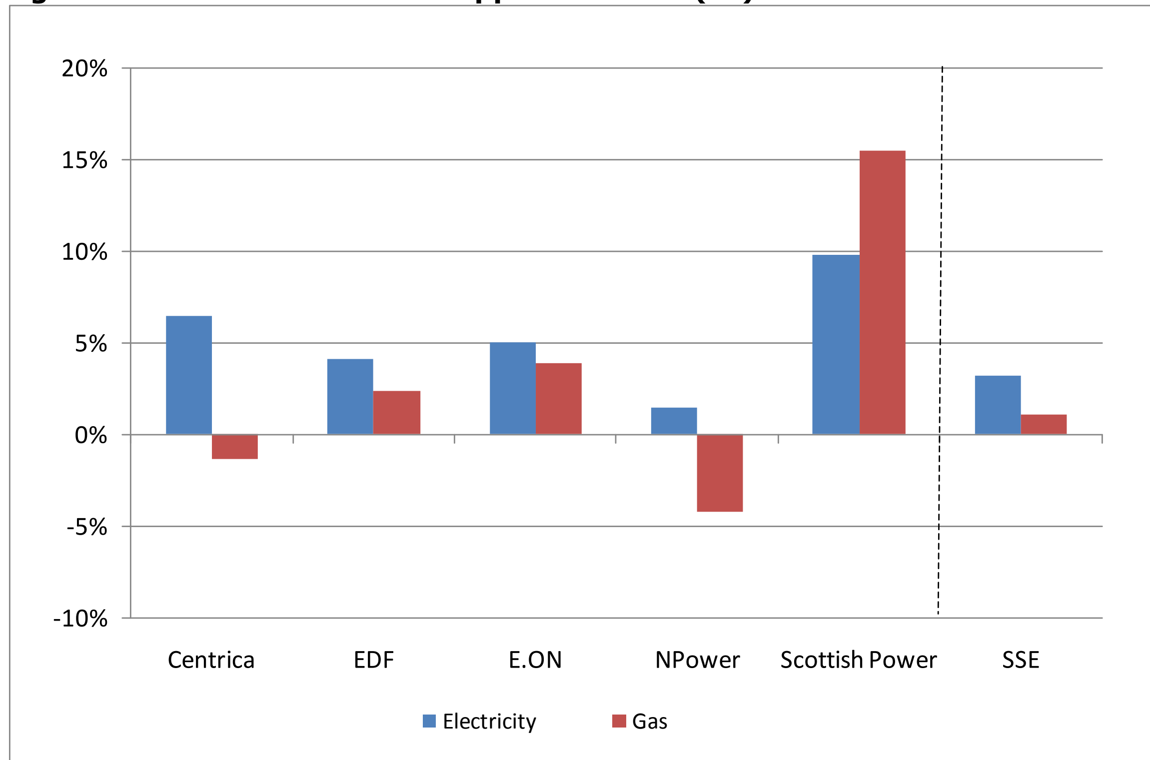


2.5 Figure 3 shows the supplier Earnings Before Interest Tax Depreciation and Amortisation (EBITDA) margins for electricity and gas supply to domestic consumers. In electricity supply, **C**entrica and SSE reported margins above 5%. Npower and EDF reported losses, where as E.ON and Scottish Power reported small positive margins.

2.6 In domestic gas supply, Centrica was the only supplier to report a positive margin. On average margins were only just above zero across suppliers. EDF reported the lowest margin in domestic gas supply but it also had the lowest turnover of the suppliers in this segment.

2.14 Non-domestic supply margins

Figure 4:2009 Non-domestic supplier EBITDA (%)



2.7 Figure 4 shows the non-domestic EBITDA margin for electricity and gas. Electricity non-domestic supply was consistently profitable across the six suppliers, with Scottish Power reporting the highest margin and Npower the lowest.

2.8 In gas non-domestic supply, Scottish Power made the highest percentage margin although its volumes were equivalent to only 2% of Centrica's non–domestic volumes.

2.9 Centrica reported a loss for non-domestic gas supply, driven off a high WACOG[3] for this segment (as shown in Figure 6). This result was influenced by Centrica's accounting allocation of out of the market legacy gas contracts to this segment.

[3] Weighted average cost of gas.

2.2 Costs

2.21 Wholesale electricity and gas costs

Figure 5: Comparison of 2009 electricity wholesale costs with Ofgem hedging strategy estimates (£/MWh)

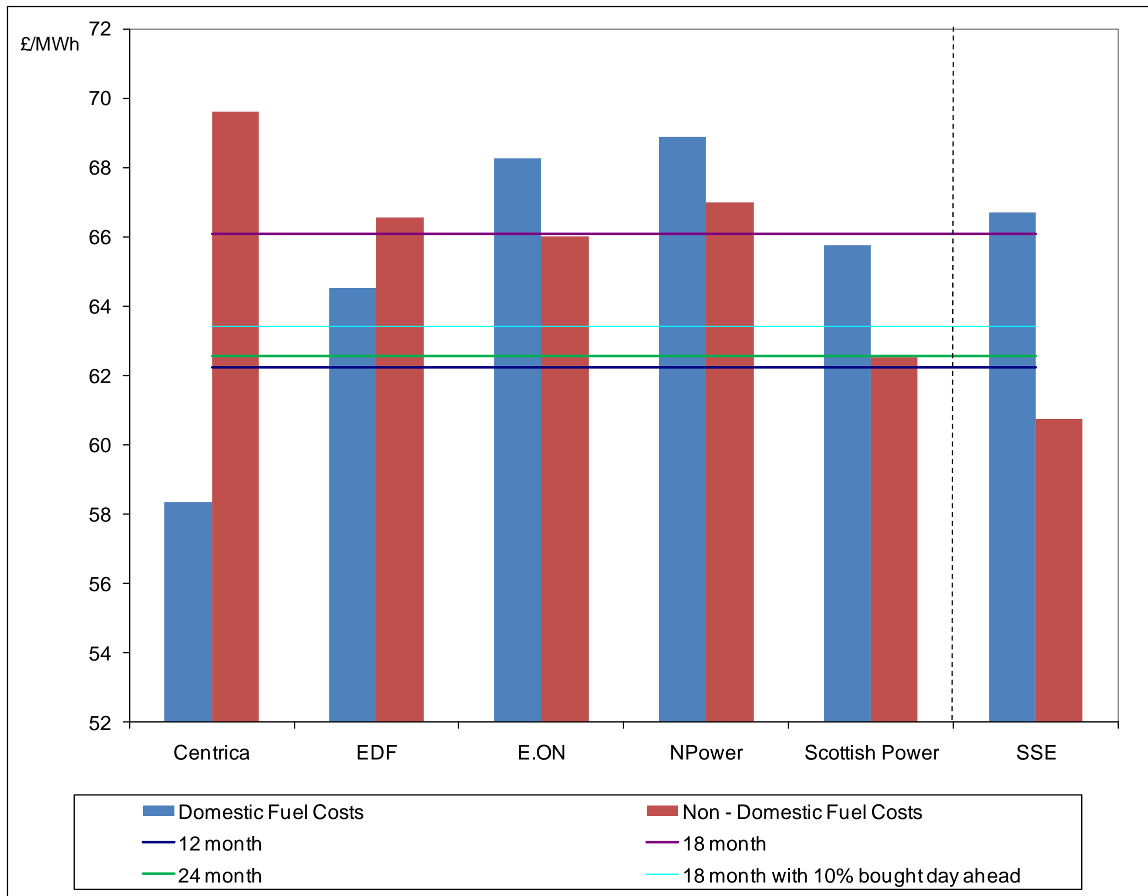
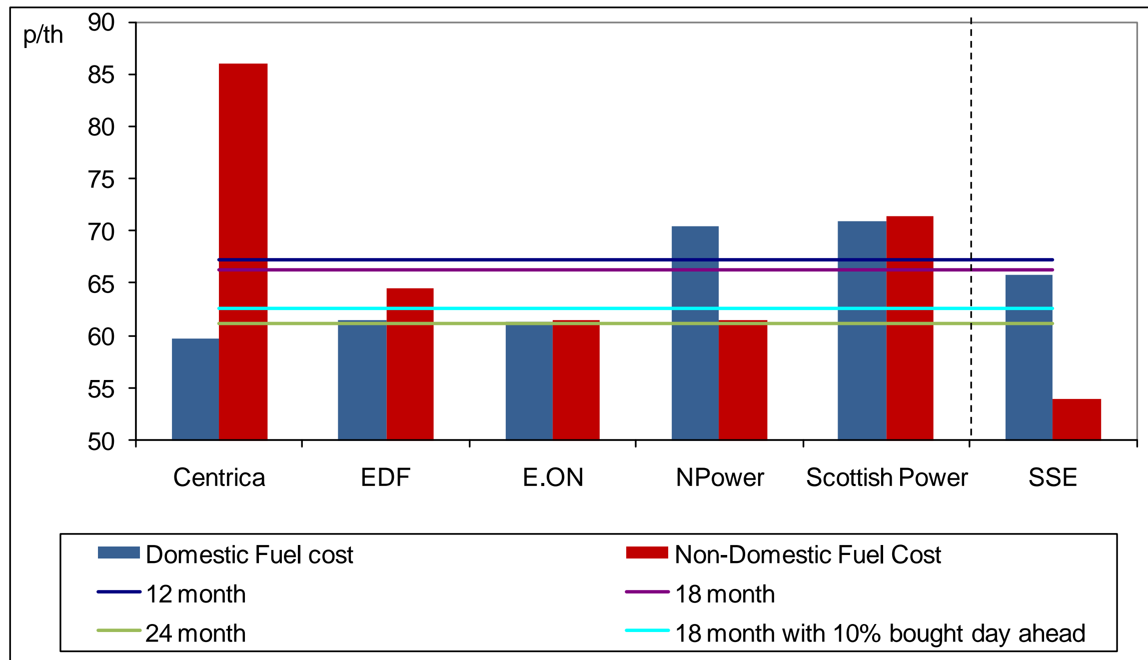


Figure 6: Comparison of 2009 gas wholesale costs with Ofgem hedging strategy estimates



2.10 Figures 5 and 6 show WACOE and WACOG across the companies.

2.11 There are significant differences between the domestic and non-domestic costs of electricity and gas. These differences are driven in large part by differences in the timing and duration of hedges. Domestic WACOE is higher than non-domestic WACOE for four of the suppliers, but not for Centrica and EDF.

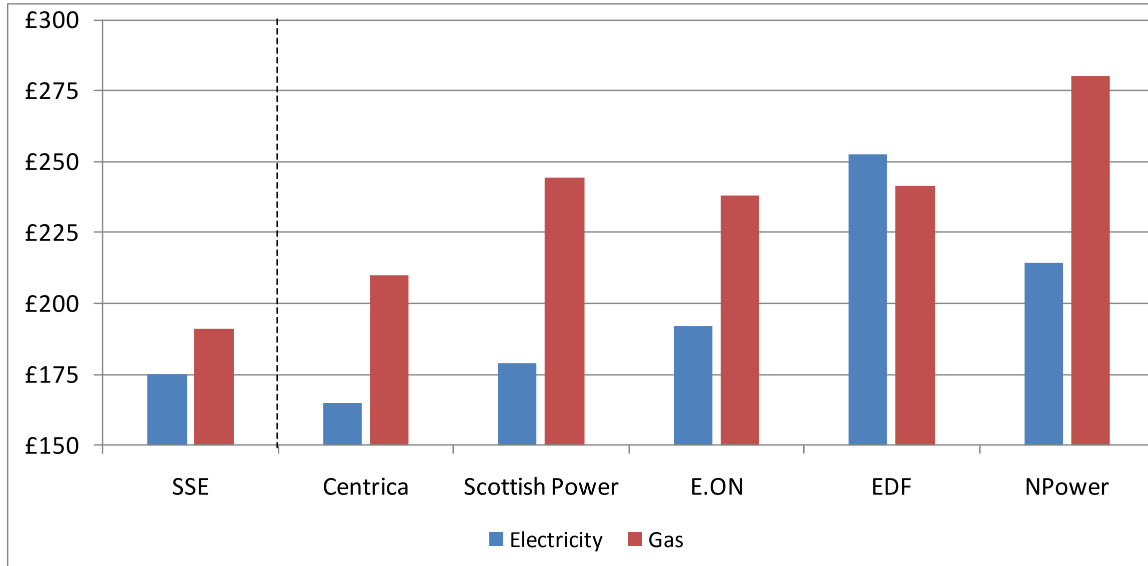
2.12 Figures 5 and 6 also compare suppliers' WACOE and EACOG against estimated fuel costs derived from the four hedging strategies used in Ofgem's Supply Market Report. Reported WACOE and WACOG are broadly in line with the assumptions used in the Ofgem Supply Market Report. The Market Report analysis (18 month hedge) indicated a WACOE of approximately £66/MWh for domestic electricity customers over 2009. This is slightly above the company average WACOE of approximately £65/MWh. For gas, the Market Report analysis indicated a WACOG of approximately 66p/therm for domestic gas customers over 2009 (18 month hedge), compared to a company average WACOG of 63p/therm.

2.13 However, we note that Centrica's domestic sector WACOE and WACOG were significantly below the Ofgem hedge assumptions. We also note Centrica's high WACOG in the non-domestic sector, driven off the accounting allocation of out of the market legacy gas contracts to this segment.

2.14 There are differences between the suppliers in how they have calculated WACOE/G. In particular, we note that SSE used a notional two year hedge in calculating its domestic sector WACOG (rather than the actual cost of its gas purchases).

2.22: Domestic supply non-fuel costs

Figure 7: 2009 Electricity and gas non-fuel costs per customer



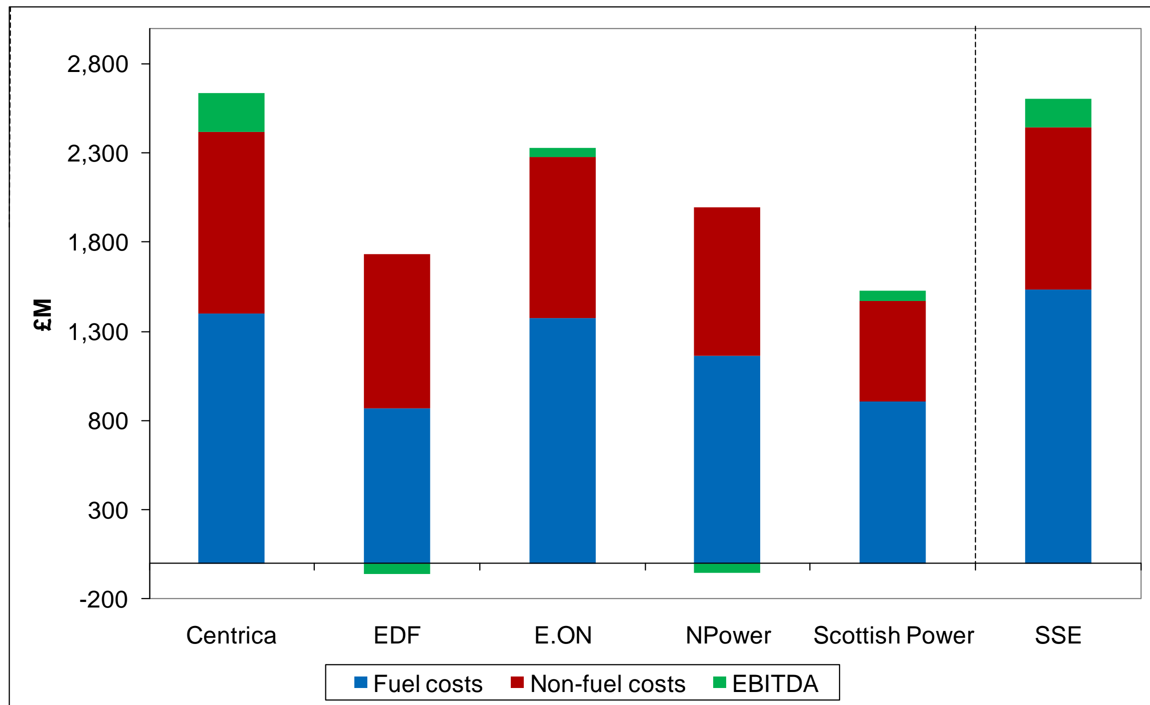
2.15 There is a substantial difference in electricity and gas non–fuel costs between suppliers on a per customer basis, with Centrica and SSE as the suppliers with the lowest non-fuel costs.

2.16 Figure 7 shows that EDF and Npower had higher non fuel costs than other suppliers and they both made losses in the domestic electricity sector. Reasons for the difference between suppliers include the effect of different average consumption levels between suppliers, efficiency of operations and economies of scale.

2.3 Domestic revenue across fuel, non-fuel and margin

2.31 Domestic electricity supply revenue breakdown

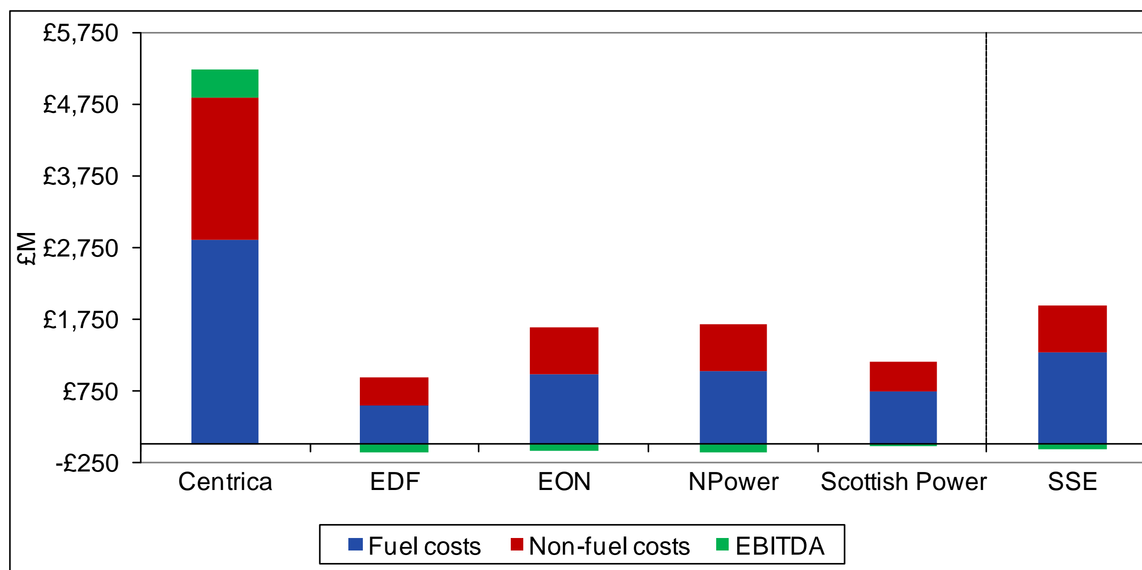
Figure 8: 2009 Domestic electricity supply revenue breakdown by cost and margin (£M)



2.17 Figure 8 shows domestic electricity supply revenue split into fuel cost, non-fuel cost and EBITDA components. A negative EBITDA figure indicates that the supplier made a loss in this segment. The chart shows that Centrica and SSE reported the highest margins, whereas EDF and Npower both reported losses in this segment.

2.32 Domestic gas supply revenue breakdown

Figure 9: 2009 Domestic gas supply revenue breakdown by cost and margin (£M)



2.18 Figure 9 shows domestic gas supply revenue split into fuel cost, non-fuel cost and EBITDA components. All suppliers apart from Centrica reported losses in this segment. Centrica reported the highest margins, and also had the highest revenues.

2.4 Market leader results relative to other suppliers

2.19 In this section we look at the supplier(s) with the highest margin in the domestic electricity and gas supply sectors and analyse the causes of this compared to the other five suppliers. In 2009, Centrica had the highest margins in both electricity and gas domestic supply.

2.20 Table 2.4 presents the analysis estimating the drivers behind Centrica's 2009 margins, benchmarked against an average of the other suppliers. A number of assumptions have been used in coming to these estimates[4]. The overall margin difference is broken down into a volume difference (ie the difference in average customer consumption), tariff difference, a fuel cost difference and a non-fuel cost difference. A positive figure represents a greater contribution to net margin for the

[4] Other suppliers' results are weighted by volumes to calculate an average of results from across the five companies. The table shows a breakdown of margins by component, estimated by assuming all consumers have the same consumption level as Centrica's customers. Volume differences are calculated through looking at Centrica average customer volumes against other supplier average customer volumes. This estimate also assumes that non-fuel costs do not vary by consumption, whereas fuel costs are assumed to be volume dependent.

average supplier compared to the market leader, whereas a negative figure indicates a lower contribution compared to the market leader.

Table 2.4: estimated breakdown of market leader's margin compared to the average of other five suppliers, 2009

Margin difference driver, £ per customer Average of Big 5 against the market leader		
	Electricity	**Gas**
Volume difference	£20	£10
Tariff differences	£19	-£51
Fuel cost difference	-£37	-£37
other cost difference	-£50	£2
Total difference	**-£48**	**-£77**

2.21 The analysis indicates that for electricity, Centrica's competitors generated £39 more revenue per average customer than Centrica in 2009, made up of higher volumes and prices per customer (£20 and £19, respectively). However fuel costs were £37 lower for Centrica and non fuel costs were £50 lower, with the result that Centrica's overall margin was £48 higher.

2.22 For gas, the analysis indicates that Centrica had higher prices per average customer and lower fuel costs, and these factors led to Centrica's margin being £77 higher. This difference could be due to Centrica having a different customer mix (eg more fixed price products, more pre-payment customers and lower consumption customers) than other suppliers on average, and apportioning the dual fuel discount to electricity rather than gas.

3. Accounting treatments

This chapter provides an overview of key accounting treatments relevant to the segmental statements and how they affect the results.

3.1. With the help of external accounting experts, we have assessed the companies' compliance with the specific terms laid down in the relevant licence condition and the validity of the accounting treatments employed in preparing their numbers. This chapter summarises key points from this analysis.

3.1 Compliance with the licence condition

3.2. On the basis of published information, the accountants concluded that the companies had complied with the relevant terms of the licence condition. Appendix 1 shows the specific terms of the licence condition and the results of this assessment.

3.2 Adherence to UK GAAP and IFRS

3.3. A notable feature of the accounting treatment used by the companies in preparing their numbers has been differences in the application of UK GAAP and IFRS standards. The reported results are based on the companies' own management information and published results which have then been adapted to meet the requirements of the segmental statement. In interpreting Ofgem's guidance notes, the companies have used different approaches, especially as regards to the application of UK GAAP and IFRS.

3.4. Npower apply UK GAAP principles whereas Centrica and EDF apply IFRS standards. E.ON and SSE apply their own business based principles and reconcile back to IFRS and UK GAAP based accounts respectively.

3.5. The UK Accounting Standards Board has proposed changes to UK GAAP to align it more closely with IFRS from July 2013 though these proposals are still subject to consultation and further changes. And whilst UK GAAP is converging towards IFRS, UK GAAP is not becoming identical to IFRS and nor will IFRS be mandatory for subsidiaries of listed companies. We believe that it would be unnecessary and unduly intrusive at this stage for Ofgem to mandate compliance with one of IFRS or UK GAAP in preparing the segmental statements. But Ofgem will keep abreast of developments and issue further guidance if it thinks this is necessary.

3.3 Exceptional adjustments

3.6. A distinctive aspect of the segmental accounts, from a transparency point of view, is the extensive use made of exceptional items and special adjustments in preparing the segmental statements. These are very material in terms of their aggregate impact on the reported numbers, particularly in terms of reducing the profit attributed to the individual segments.

3.7. There are pros and cons around special items. In their favour, it can be argued that, where they reflect sunk costs or income, they are not considered in decision making around ongoing operations. Both UK GAAP and IFRS legitimise the reporting of special or exceptional items. In some cases a special or exceptional item is not a "one off" but rather needs to be disclosed because of its size in order to help users have a proper understanding of the entity's performance. On the other hand it is arguable they are still part of the business and therefore need to be included in the segmental results, whether exceptional or not.

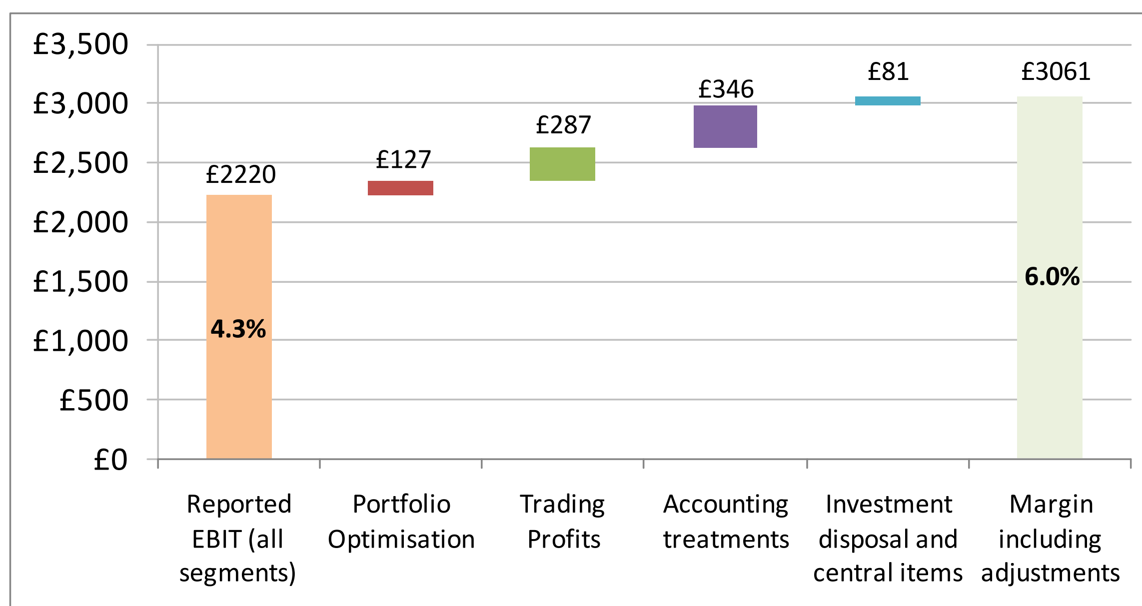
3.8. Table 3.1 lists the main accounting adjustments and related changes made within the companies' 2009 segmental statements. Figure 3.2 shows the aggregate impact. The net impact is highly material. Reversing these adjustments would effectively increase aggregate EBIT returns within the segments by £840m, equivalent to an extra 1.7% on the reported margin (across generation and supply). True aggregate margins across the companies effectively increase from 4.3% to 6.0%. We note that this EBIT is still largely reported within the companies' segmental statement, but effectively in an "other" column (variously titled by the companies) rather than within the specific segments.

Table 3.1: main accounting adjustments to 2009 segmental statements

Company	Item	Issue	Effect on segmental results	Impact on segmental EBIT (£m)
SSE	"Portfolio Optimisation"	Various profit items excluded from individual segments	Reduces margins within the segments	£127M
Centrica	Corporate overheads	Allocated on the basis of segmental profit	Smoothes margins over the segments	No impact on overall total
Scottish Power	Trading Profits	Separated from generation profit and put into additional column	Moves generation margins into other column	£287M
RWE	UK GAAP pension accounting	In group accounts but not in segmental statements	Reduces stated segmental margins relative to group accounts	£135M
RWE	UK GAAP amortisation	In group accounts but not in segmental	Reduces EBIT	£73M

		statements		
RWE	IAS to UK GAAP differences	In group accounts but not in segmental statements	Reduces reported segmental margins	£5M
E.ON	Other central items and profits on investment disposals	Margin reported in 'Other' segment.	Reduces stated segmental margins relative to group accounts	£81M
EDF	Accounting treatment of derivatives	Reallocation into supply segment for segmental accounts in line with IAS 7	Reduces segmental margins	£133M

Figure 3.2: Aggregate impact of adjustments made to 2009 segmental statements (£million)



3.9. Below we provide further detail on these adjustments.

- SSE included "Portfolio Optimisation" of £127m EBIT related to "profit arising from how SSE runs its business that are not directly attributable to Generation or Supply, but relate to these activities". The underlying components of this item include the residual between actual gas purchase costs and a hypothetical cost of gas based on a two year hedge for the domestic gas supply business; and the residual between actual electricity costs against a hypothetical hedge for the domestic electricity supply business. For some generation assets, SSE report estimated profits on hypothetical earnings based on a notional set of tolling agreements.

- At Scottish Power there is an adjustment for Trading Activities of some £287 million in respect of free carbon EU ETS permits, as well as in the money gas contracts acquired with CCGT purchases.

- E.ON has included £81M of profits from outside of the 5 reported segments. These include profits relating to disposal of investments, and other central items. This £81M is included alongside profits from E.ON's regulated business, their Energy services as well as parts of EC&R.

- RWE has an EBIT of £220 million profit in the RWE Group Accounts on an IFRS basis and a loss of £81 million in the segmental statement on a UK GAAP basis, a difference of £301 million of additional profit. £135 million of this relates to being unable to allocate assets and liabilities across the various legal entities of the pension scheme and booking a Defined Benefit scheme under IAS 19 as a Defined Contribution scheme under FRS 17. A further £73 million relates to amortisation of goodwill included in the segmental accounts.

- EDF has an additional £133 million cost item in the segmental accounts, comprising the impact of revaluing derivatives to market prices in line with IAS 39. They state that they do not form part of core activities and therefore have not been included in the segmental reporting results. They do not trade speculatively and contracts otherwise in the core business are entered into with the intention of helping hedging generation and supply of customers.

3.10. Although these adjustments are in the public domain and the data appears within the statements, the aggregate impact is to reduce the reported generation and supply margins and does threaten to reduce overall transparency. We are proposing changes to the Guidelines intended to encourage less of these special adjustments and, where they do occur, more transparent and comprehensive explanations. Our proposed changes to the Guidelines are set out in the next chapter.

3.4 Transfer prices

3.11. The licence condition requires the companies to explain their transfer pricing methodology and how it relates to the revenue, cost and profit results. Whilst the companies have complied with this part of the licence condition, the improvement in transparency has been limited by a number of factors. Specific issues that have been encountered in the 2009 segmental statements include the following inter-related issues:

- Legitimate concern from the companies about revealing commercially sensitive information in their reporting, such as details on the length of their hedging strategy. This level of detail on competitor costs has the potential to reduce competition in the market.

- Differences in the company business models. These can reflect the actual way in which companies operate and makes decisions, and are not deliberately intended to reduce transparency.

- RWE and E.ON use tolling agreements for their generation businesses, where revenues are based on asset availability. This assumption means that both fuel costs and profits from portfolio optimisation sit outside of the segmental reporting, in the companies' trading arms. Because the trading arms are not part of GB operations, they do not form part of their GB results.

- SSE assesses generation and supply as a single value chain within a vertically-integrated business. They use notional hedges when calculating their transfer price, which does not necessarily relate to their actual cost of purchases. They also use notional tolling agreements for their generation results, even though the company operates these assets internally.

3.12. Transfer pricing within vertically integrated enterprises is well known as an area where multiple treatments are possible and potentially applicable given the different business operating models. However, we are concerned that there is insufficient transparency in the area of reporting of wholesale energy costs. This is driven by differences in companies' transfer pricing approaches, as well as differences in hedging strategies, accounting conventions and business models. The segmental statements do not provide consumers with clarity about how retail prices relate to suppliers' wholesale costs. In the next section, we propose how we intend to address this issue.

4. Next steps

This chapter assesses the overall effectiveness of the Financial Information remedy, as demonstrated through the first full set of outputs; and it assesses ways in which it could be improved.

4.1 Overall assessment of the remedy and options for the future

4.1. The 2009 segmental results have provided increased transparency and insight into how the Big Six operate across the value chain. For the first time, data is available on all of the companies' segmental revenues, cost and profit. It is possible to look across the companies' data to get insights on their relative performance. The Financial Information remedy has aided transparency and provided a useful improvement.

4.2. However, the data only goes so far. The number of data items is limited. And on top of this, there are many reasons why strict cross-comparability between the companies is limited. The companies have different business models, and they have (legitimately) used different accounting treatments. In addition, some of the company-specific treatments have not served to promote transparency.

4.3. We identify two possible ways forward.

a) The first would be to keep to the broad outline of the current remedy, but to amend the template and the detailed Guidelines in ways that will improve cross-company comparability and discourage the least helpful accounting treatments.

b) The second would be to move to a more comprehensive set of regulatory accounts, supported by prescriptive rules as to exactly how each line item needs to be calculated. Because the data would be commercially sensitive, it would have to be provided exclusively to the Regulator.

4.4. Our broad preference is for the first approach, which we think is more likely to create the sort of transparency that is most helpful in promoting a competitive market. Regulatory accounts make more sense within the context of a regulated industry with controls on what is an acceptable outcome for particular parameters. However, there may be occasions or areas when supplementary segmental data needs to be provided to the Regulator.

4.5. It is worth noting that we do not favour an intermediate option, whereby there is a significant increase in the amount of data provided by the companies and this is put into the public domain. The data already provides the companies with information about each other, which could potentially be exploited in a way that is not helpful with regards promoting competitive intensity and the consumer interest[5]. It is clear from our discussions with the Big Six that they assess each others' segmental data in some considerable detail. At the moment, the balance between promoting transparency without damaging competitive intensity seems to be set at about the right level. A significantly more comprehensive public dataset risks creating a position which is damaging to competition without a sufficiently large gain in transparency because of continuing differences in companies' accounting treatments and business models.

4.2 Proposed changes to the Guidelines

4.6. We propose to amend the Guidelines to achieve better comparability and transparency. This section sets out our proposals to amend the Guidelines.

4.7. Definitions of direct costs, indirect costs, WACOE/G, volumes and revenue should be revised as follows.

1. Direct costs should be defined as electricity and gas costs (as defined in 3 below), network costs, environmental costs (including ROCs, CESP and CERTs) and Reconciliation-by-Difference (RBD) costs.
2. Indirect costs should be defined as firms' own internal operating costs including sales and marketing costs, bad debt, costs to serve, IT, staffing costs, billing and meter costs.
3. WACOE/G should cover wholesale energy cost, losses, BSUOS, balancing and shaping costs.
4. Volumes should be supplier volumes at the meter point (i.e. net of losses). Generation volumes should be generation before losses.
5. Revenue should be less dual fuel discounts where applicable. That is these discounts should be deducted from revenue, with a written description in the notes on how the discounts have been apportioned. Social tariff costs should also be deducted from revenue directly.
6. There should be a requirement to describe how marketing, shared and corporate costs have been allocated across the business segments.

[5] In economic theory, tacit collusion between firms is helped by detailed knowledge of competitors' cost structures. Changes in pricing can then be attributed to changes in costs rather than indicating a break in collusion.

7. A full description of treatment of JV's should be contained in the explanatory notes.

8. Where a company separately identifies a column which it attributes to trading or portfolio optimisation, the explanatory notes should disaggregate the earnings into its major component parts. The earnings from each significant component should be identified, where that component contributes [£10 million] or more. Wherever this is feasible, a best endeavours approach should be used to allocate the components to the business segments.

9. The data should be provided to the nearest £million, and WACOE/G should be to the nearest pence in £/MWh, or in p/therms to 1 decimal place.

10. The transfer pricing methodology used to calculate WACOE and WACOG should reflect how the business actually acquires energy.

11. We are also proposing to change the ordering of the template. The draft revised template is shown in Appendix 2. Changes to note include removal of DA from the cost section (and from the direct and indirect cost definitions) so that revenues less costs sum to EBITDA for each segment. DA to be included underneath EBITDA in the row above EBIT.

12. An additional change to the template will be to include a final aggregation column, which sums the horizontal figures and thereby facilitates reconciliation to group accounts.

13. With all the data changes, provide Ofgem with these results for the previous year on an equivalent basis. However, the companies will not be required to reissue publicly their 2009 statements on the same basis[6].

4.8. The Big Six have seen an earlier version of this list in the context of our discussions with them on their segmental statements. Nonetheless, we think it appropriate to initiate a more formal consultation process regarding these changes to the Guidelines, as required under the Licence Condition. We therefore formally invite responses on the proposed changes over the next four weeks, for response by 19 April 2011. A short response period is appropriate as five of the Big Six companies will need to publish their 2010 segmental results by the end of June 2011.

4.9. Following this consultation, we will publish a revised set of Guidelines.

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[6] Requiring the companies to publish amended 2009 results would allow competitors to identify individual cost items by supplier and this could be damaging to competition in the market.

4.3 Review of transfer pricing and hedge accounting practices

4.10. We are concerned that there is insufficient transparency in the area of reporting of wholesale energy costs. We propose to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated firms in the sector and report to us on the likely impact of these practices on reported profits and transparency. We will also ask them to make recommendations about how we can improve reporting in future years, either through amendments to the segmental statements or through additional reports provided to Ofgem.

4.11. Any future reporting requirements could build on articles within the EU 3rd package which require the companies to retain information about their wholesale transactions and to disclose this information to regulators and competition authorities if they request it.

4.12. Stakeholder views on this element of our proposed actions should form part of the feedback on the overall package of Retail Market Review measures, for which the deadline is 1 June 2011.

Appendices

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Appendix 1 – Company compliance with licence condition

REF	Licence Condition	Centrica	EDF	EON	RWE	SP	SSE
19A 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 the licensee's activities in the generation and supply of electricity and the supply of gas to any premises taking account of the Guidelines.	✓	✓	✓	✓	✓	✓
19A 2	Where applicable, the Relevant Licensee must prepare and publish the Consolidated Segmental Statement referred to in paragraph 19A.1 in conjunction with any Affiliates (the “Relevant Affiliates”) which hold any or all of the following: a) a supply licence granted or treated as granted under section 6(1)(d) of the Act; (b) a generation licence granted or treated as granted under section 6(1)(a) of the Act; (c) a supply licence granted or treated as granted under section 7A(1) of the Gas Act 1986 (“the 1986 Act”).	✓	✓	✓	✓	✓	✓
19A 3	The Relevant Licensee must in conjunction with the Relevant Affiliates prepare and publish a Consolidated Segmental Statement no later than six months after the end of the Relevant Licensee's financial year.	✓	✓	✓	✓	✓	✓
19A 4	The Relevant Licensee may for the purpose of preparing the statement referred to in paragraph 19A.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: (a) of how the licensee defines the terms revenues, cost and profits (b) of how the revenues, costs, and profits can be reconciled with the licensee’ s UK statutory accounts and where applicable or the consolidated group accounts; and (c) of the	✓	✓	✓	✓	✓	✓
19A 5	The Relevant Licensee must ensure that all the information prepared and made public pursuant to paragraph 19A.3 is in all material respects consistent with the information prepared pursuant to paragraph 19A.4 and the information is presented with a clear and full explanation.	✓	✓	✓	✓	✓	✓
19A 6	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.	✓	✓	✓	✓	✓	✓
19A 7	For the purposes of this condition: “Affiliate” in relation to the licensee 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 736, 736A and 736B of the Companies Act 19852006.“Consolidated Segmental Statement” means a statement as described in the Guidelines. “Guidelines” mean the document prepared by the Authority pursuant to standard condition paragraph 19A.6 setting out the nature of the information required and the template for the presentation of the financial information. “Relevant Licensee” means the holder of a supply licence granted or treated as granted under section 6(1)(d) of the Act if: (a) any of its the licensee's Affiliates holds a generation licence granted or treated as granted under section 6(1)(a) of the Act; and (b) the licensee together with any of its Affiliates, jointly supplies electricity to more than 50,000 customers.	✓	✓	✓	✓	✓	✓

Appendix 2 – Draft revised template

	Unit	Generation	Electricity supply		Gas supply		Total
			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	£M	£0	£0	£0	£0	£0	£0
Other revenue	£M	£0	£0	£0	£0	£0	£0
Total operating costs	£M	£0	£0	£0	£0	£0	£0
Direct fuel costs	£M	£0	£0	£0	£0	£0	£0
Other direct costs	£M	£0	£0	£0	£0	£0	£0
Indirect costs	£M	£0	£0	£0	£0	£0	£0
WACOE/G	£/MWh, p/th	0	0	0	0	0	NA
EBITDA	£M	£0	£0	£0	£0	£0	£0
DA	£M	£0	£0	£0	£0	£0	£0
EBIT	£M	£0	£0	£0	£0	£0	£0
Volume	TWh, therms	-	-	-	-	-	NA

Grey shading denotes an automatic calculation from other reported data.

Appendix 3 – Adjustments made to company data in Chapter 2

4.1 This appendix shows the changes made to the companies' published data when compiling the analysis in Chapter 2.

Table A1: Adjustments made to results to improve the comparability between companies

Adjustments made to improve comparability of data				
Supplier	**Segment**	**Line item**	**Assumption**	**Source**
EDF, E.ON and Scottish Power	Domestic electricity supply	Volumes	10% losses incorporated	DECC: DUKES
EDF, SSE and E.ON	Domestic electricity supply	WACOE	ROC costs moved into this line item	Ofgem SMR analysis
EDF	Domestic electricity and gas supply	Operating costs	Depreciation and amortisation moved into operating costs	NA
All	Domestic electricity and gas supply	Non-fuel costs	Calculated by deducting fuel costs from total costs	NA

4.2 Domestic electricity supply: some suppliers have included volumes at the meter point and others have used a volume figure before losses. To make the treatment of losses consistent, we have settled on measuring at the meter point (i.e. after losses). Where suppliers have provided figures before losses, 10% has been deducted to account for losses.

4.3 A Renewables Obligation Certificate (ROC) is a green certificate issued to an accredited generator for eligible renewable electricity generated within the United Kingdom and supplied to customers within the United Kingdom by a licensed electricity supplier. One ROC is issued for each megawatt hour (MWh) of eligible renewable output generated. Treatment has been different across the companies. Centrica, RWE and SP have put ROCs in WACOE whereas SSE, E.ON and EDF have put them in Direct Costs. SSE, E.ON and EDF data have been adjusted by taking ROC costs into fuel costs using publicly available ROC cost data.

4.4 Non-fuel cost calculation: Aggregate fuel costs have been calculated through summation of per unit WACOE/G with domestic volumes. These aggregate fuel costs have been deducted from total supplier costs to give 'non fuel costs'.