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The revenues, costs and profits of the large energy companies in 2012

Information

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Overview:

Ofgem requires the large energy companies to publish annual statements showing separately the revenues, costs and profits of their generation and supply businesses. This document summarises the results of the six large energy companies in 2012 and compares them across companies and over time.

The statements show that total profits across supply and generation fell by £133m, or 3.4%, on the previous year. This was a result of generation profits falling more than supply profits rose. Profits increased in the domestic supply market, providing an average profit margin of 4.3%.

Ofgem is firmly committed to improving transparency and rebuilding consumer trust in the energy market. This summary document is part of our work to increase transparency of energy company profits.

Context

For the third year in a row, some consumers are facing increases in electricity and gas prices. There is a widely held belief that soaring profits are the main cause of the price rises.

Energy suppliers have pointed to increases in costs as the cause of these price rises and have rejected claims of profiteering. Consumers are suspicious about these explanations and their confidence in the energy market has fallen. They are looking for independent verification of energy companies' profitability.

This is where Ofgem has an important role to play. We want this public debate to be based on facts. This should give opinion-formers and consumers a more accurate understanding of energy prices and profits. Promoting transparency of energy company profitability is an important aspect of our efforts to rebuild consumer confidence in the energy market. It is also important because this information may signal to potential new suppliers that it may be profitable to enter the market, increasing competition and benefiting consumers. That is why we are consulting on ways to improve transparency of energy company profits.

Vigorous competition benefits consumers by keeping a check on costs, prices and therefore profits. Our Retail Market Review reforms aim to improve competition by giving customers the tools they need to engage effectively in the market. Our liquidity proposals will provide a more level playing field for independent suppliers and generators.

Associated documents

Wholesale market power liquidity: statutory consultation on the 'Secure and Promote' licence condition (20 November 2013)

Rebuilding consumer confidence: Improving the transparency of energy company profits (31 October 2013)

Energy companies publish 2012 segmental generation and supply statements (3 July 2013)

The Retail Market Review – Statutory consultation on the RMR domestic proposals (20 June 2013)

Financial Information Reporting: 2011 Results (11 April 2013)

Financial Information Reporting: 2010 Results (31 January 2012)

Financial Information Reporting: 2009 Results (24 March 2011)

Contents

Executive Summary

As part of our efforts to promote transparency of energy company profitability, Ofgem requires the large energy companies to publish annual statements showing separately the revenues, costs and profits of their generation and supply businesses. The companies have now all published their 2012 statements. These show that total profits across supply and generation fell by £133m, or 3.4%, on the previous year. The table below summarises profit information for the last three years.

	2012		2011		2010	
	EBIT (£m)	**EBIT margin (%)**	**EBIT (£m)**	**EBIT margin (%)**	**EBIT (£m)**	**EBIT margin (%)**
Supply	1,600	3.6	1,249	3.1	1,623	3.8
Domestic supply	*1,190*	*4.3*	*681*	*2.8*	*769*	*3.0*
Non-domestic supply	*410*	*2.6*	*568*	*3.6*	*854*	*5.0*
Generation	2,134	19.9	2,619	24.4%	2,120	21.9

The fall in generation profits (by £484m or 18%) was largely the result of higher depreciation and amortisation charges rather than movements in fuel costs or market prices. Profit levels before these charges are taken into account were very similar to those earned in 2011.

Lower generation profits were partly offset by a rise in overall supply profits (by £351m or 28%). This was mainly due to strong profit growth in the domestic supply market (by £509m or 75%). This resulted in part from higher household consumption (due to cold weather) and higher prices. The combined profit margin for supply to households and businesses was 3.6% (up from 3.1% in 2011).

The average dual fuel household customer bill in 2012 was £1,174, while the average supplier profit was £53 per customer, providing an average profit margin of 4.3%. Profits on the supply to household customers have increased from 2009 to 2012 mainly as a result of loss-making suppliers moving to profitability. In 2009, three of the six large suppliers were loss-making in this segment of the market. In 2012, only EDF made a loss on domestic supply.

We commissioned the accountancy firm BDO to do an independent review of the 2012 statements. They found that overall the companies had completed their statements appropriately. BDO also noted an improvement in disclosure compared to last year. However, they have highlighted scope for further improvements. We will discuss these with the individual companies.

To improve transparency and help rebuild confidence in the energy market, we want to continue improving the usefulness and accessibility of companies' statements and our own summary document. To that end, we are consulting on ways the statements could be improved and on other steps that could be taken to improve transparency. That consultation closes on 6 December. We welcome feedback on this document and encourage participation in the consultation.

1. Results

Chapter Summary

This chapter presents the results from the 2012 statements. The first section focuses on trends in the domestic supply market. The second section shows profits across companies and over time in generation and supply. The third section focuses on the 2012 revenues, costs and profits for every segment. Finally, the last section presents the suppliers' wholesale costs and trends in operating costs.

1.1. The six largest energy companies in GB are active in both the generation of electricity and the supply of electricity and gas.[1] These are different activities, with different cost structures and operational goals.

1.2. With such an industry structure it is difficult for consumers and other stakeholders to know where profits are made: generation, supply or elsewhere. Therefore, we require the companies to publish an annual set of Consolidated Segmental Statements. These statements show separately the revenues, costs and profits of their electricity generation business and each one of their four supply businesses (gas and electricity, domestic and non-domestic).

1.3. We do this to ensure consumers and other stakeholders have access to robust, useful and accessible information on profitability. The aim is to promote better understanding of the profitability of the different parts of the companies.

Domestic supply market – in focus

1.4. Table 1 shows that household customers of the large energy companies paid on average £1,174 for their electricity and gas in 2012. That is £167 more than in 2011, or a 17% increase.

Table 1: Bill breakdown 2009-2012

£/customer/year	**2009**	**2010**	**2011**	**2012**
Average bill	£1,043	£1,063	£1,006	£1,174
Wholesale costs	£646	£588	£537	£612
Other costs	£265	£288	£294	£354
Supplier costs	£123	£152	£146	£154
Operating profit	£8	£35	£30	£53

Note: See glossary for a description of the individual cost elements in each category.

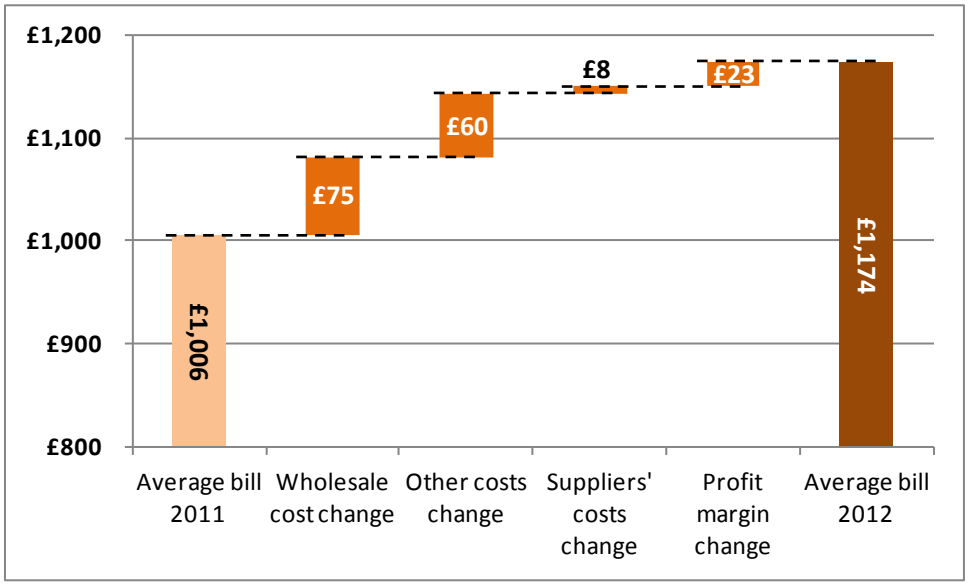
[1] Centrica (called British Gas in the supply market), E.ON, EDF Energy, RWE npower, ScottishPower and SSE.

Why are bills rising?

1.5. Figure 1 shows that the main causes of the increase in household bills in 2012 were the costs of buying gas and electricity in the wholesale market (up 14%) and the cost of paying for the use of the transmission and distribution networks, and delivering the government's environmental and social policies (up a combined 20%).

1.6. The profit margin that suppliers on average earned from each consumer also increased, from £30 in 2011 to £53 in 2012. This can be partly attributed to higher domestic gas consumption during 2012, which was 12% above that of 2011. Average temperature in the UK during 2011 was the second highest since 1910, which explains low domestic gas consumption that year. In contrast, 2012 was colder than average. In fact, 2010 and 2012 were the only two years of the last 16 with temperatures below average.[2] This drove higher consumption and profit margins in these two years, despite generally falling consumption over the last decade.[3]

Figure 1: Reasons for the 2011-2012 bill increase



Why are profits important?

1.7. Transparency of the profits companies make is important to support consumer confidence, as it helps consumers and other stakeholders to understand the facts. It is also important because this information may signal to potential new entrants that it may be profitable to enter the market, thereby increasing competition and benefiting consumers.

[2] Met Office weather summaries
[3] For more information, see our Review of typical domestic consumption values (July 2013)

1.8. There is no right or wrong profit margin for a business to earn in a competitive market. If the market is working well, the margin will reflect a company's ability to attract and retain customers though offering competitive prices and good products and service levels, and its ability to reduce its costs.

1.9. Our Retail Market Review analysis has shown that competition is not working as well as it could, such that there is not enough competitive pressure on the large energy suppliers. To tackle this, we have implemented a significant package of reforms to make the retail market simpler, clearer and fairer. We are also pushing ahead with changes to open up the wholesale electricity market. Our aim is to make it easier for existing independent suppliers and new entrants to compete effectively with the large suppliers.

1.10. We are currently undertaking an assessment of the state of the retail market. This will look at a range of indicators of how well the market is working in the interests of consumers, including profits. We will publish our findings in March 2014.

Why are domestic supply profits rising?

1.11. Figure 2 and table 2 show that domestic supply profits and profit margins have increased over the period 2009 to 2012.

Figure 2: Domestic supply profit margins over time

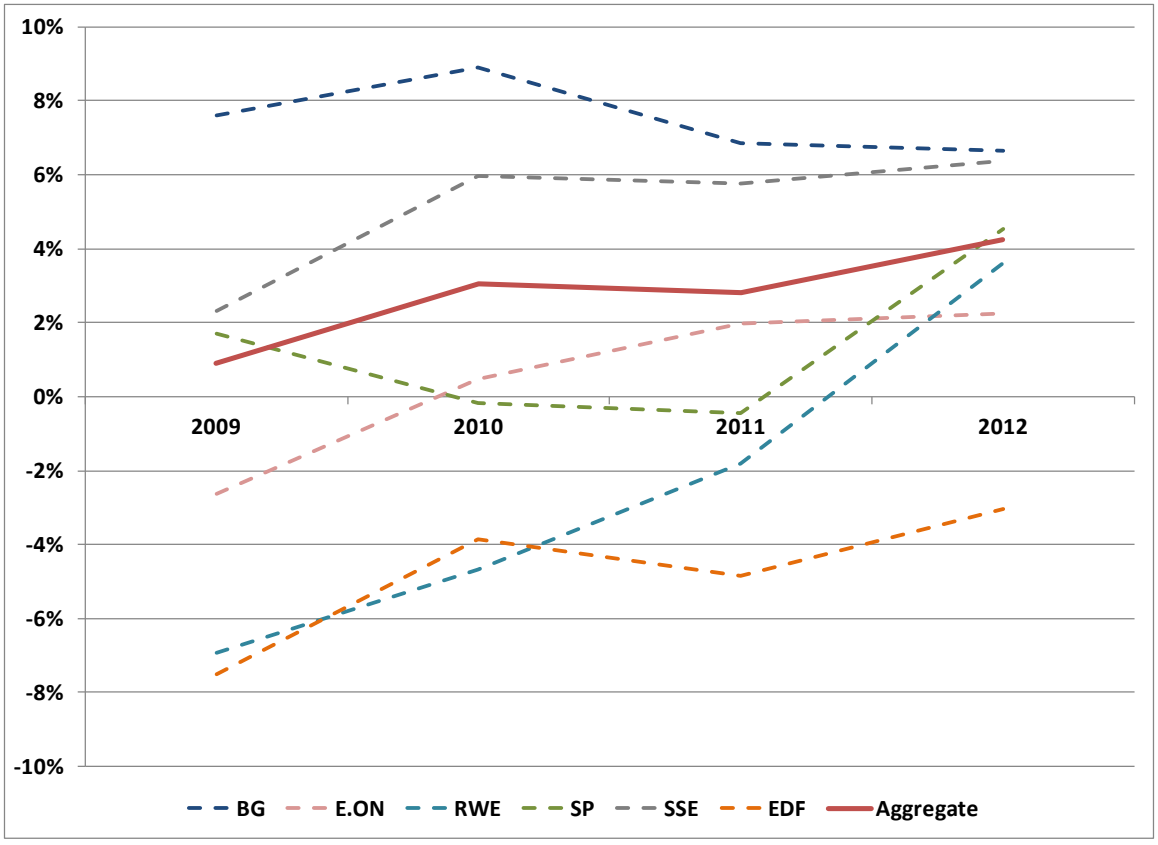


Table 2: Domestic supply profits for the large energy companies

EBIT (£ million)	**2009**	**2010**	**2011**	**2012**
Aggregate	**221**	**769**	**681**	**1,190**
BG	595	742	544	606
E.ON	-100	19	78	98
EDF	-186	-100	-124	-92
RWE	-238	-154	-56	131
SP	46	-4	-11	129
SSE	104	266	250	318

Note: EBIT stands for earnings before interest and taxes

1.12. Profits in the domestic supply market have increased mainly as a result of loss-making suppliers moving to profitability. In 2009, three of the six large suppliers were loss-making. By 2012, only EDF made a loss on its domestic supply business.

1.13. Table 1 shows that between 2009 and 2012, revenues rose by an average of 4% every year, while total costs rose by only 2.7%.[4] In other words, revenue has been growing about 50% faster than costs.

1.14. The revenue suppliers earn depends largely on the prices they charge for every unit of electricity and gas, and the volumes of gas and electricity they sell.[5] Suppliers have increased prices significantly in the past few years.

1.15. Importantly, 2010 and 2012 were unusually cold years. This meant consumers used more gas, mainly for heating. Higher prices combined with higher consumption resulted in higher revenues and profits in those years. Conversely, 2011 was particularly warm, resulting in revenues for suppliers that were 5% lower than in 2010; the average consumer bill fell by about 5% in 2011 despite higher prices. We would need to look at a longer period to determine whether there is a sustained upward trend in profits, or if they have resulted from two unusually cold years.

1.16. In conclusion, there is some evidence of rising profit margins. This rise has been due to a combination of higher prices and volumes (ie revenues) rather than lower costs. However, it is not yet possible to assess whether this is a sustained trend or the result of unusual weather over the past three years.

[4] This is the compound average growth rate between 2009 and 2012.
[5] Suppliers also earn revenue from standing charges, which do not vary with volumes sold.

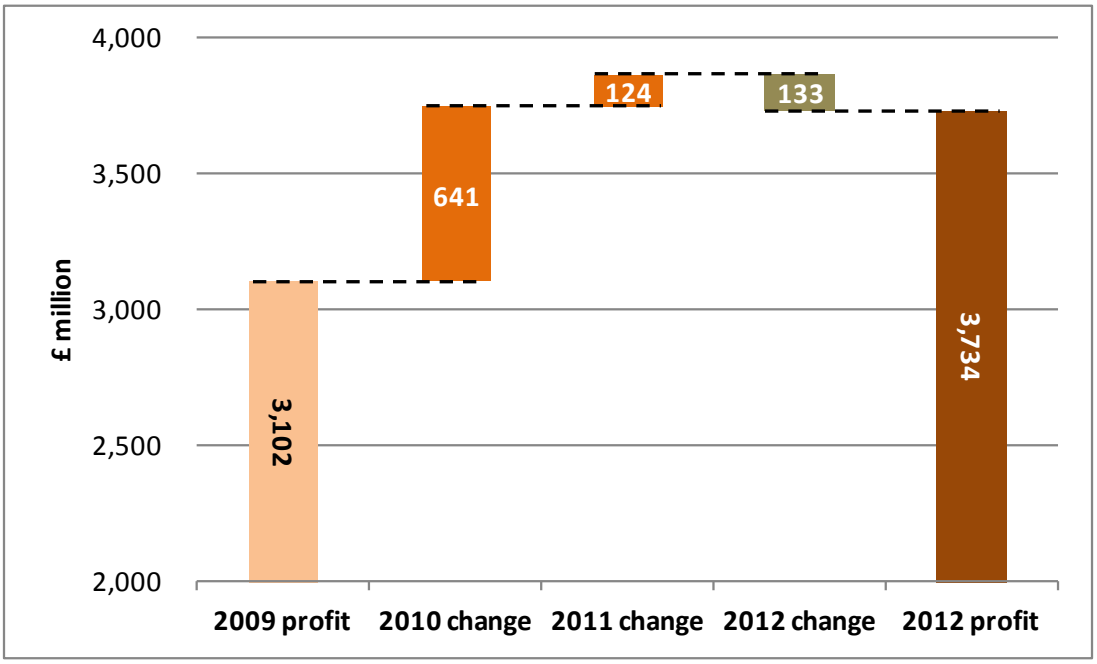
Comparison of profits between market segments and over time

1.17. This section presents the profits for electricity generation and supply, both jointly and separately, aggregated across the largest energy companies.

Combined generation and supply profits

1.18. Figure 3 illustrates the change in profits over the period 2009-2012 across both generation and supply for the six large companies. The profit levels rose from £3.1bn in 2009 to £3.9bn in 2011 before falling back to £3.7bn in 2012.

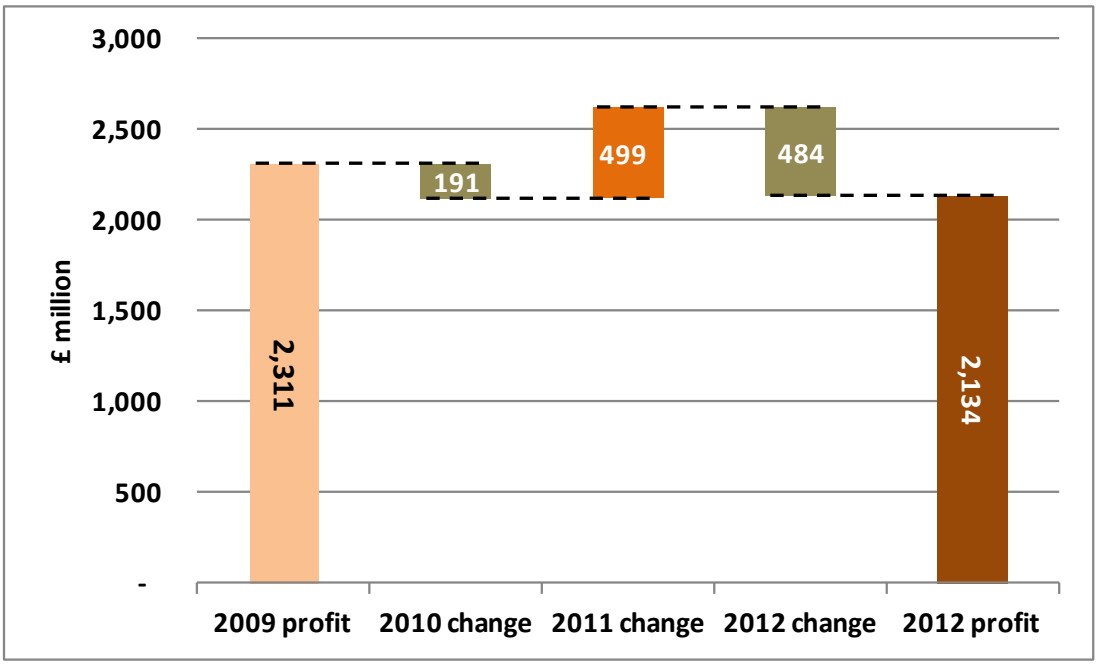
Figure 3: Aggregate generation and supply profits



Electricity generation profits

1.19. Figure 4 shows how generation profits over the reporting period 2009-2012 have also risen and fallen across six large suppliers. The 2009 generation profit was £2.3bn, but falling £191m in 2010 before rising £499m in 2011. Profits then fell £484m in 2012 to £2.1bn. The profit fall in from 2011 to 2012 reflect the effect of depreciation and amortization (DA) on EBIT and low profitability of gas-fired power generation.

Figure 4: Aggregate generation profits



1.20. Translating these generation profits into margins shows the same pattern. Table 3 shows how profit margins across the six large suppliers were 22.5% in 2009 and fell to 21.9% in 2010. Profit margins then rose to 24.4% in 2011, and fell again in 2012 to 19.9%.

Table 3: Generation profit margins

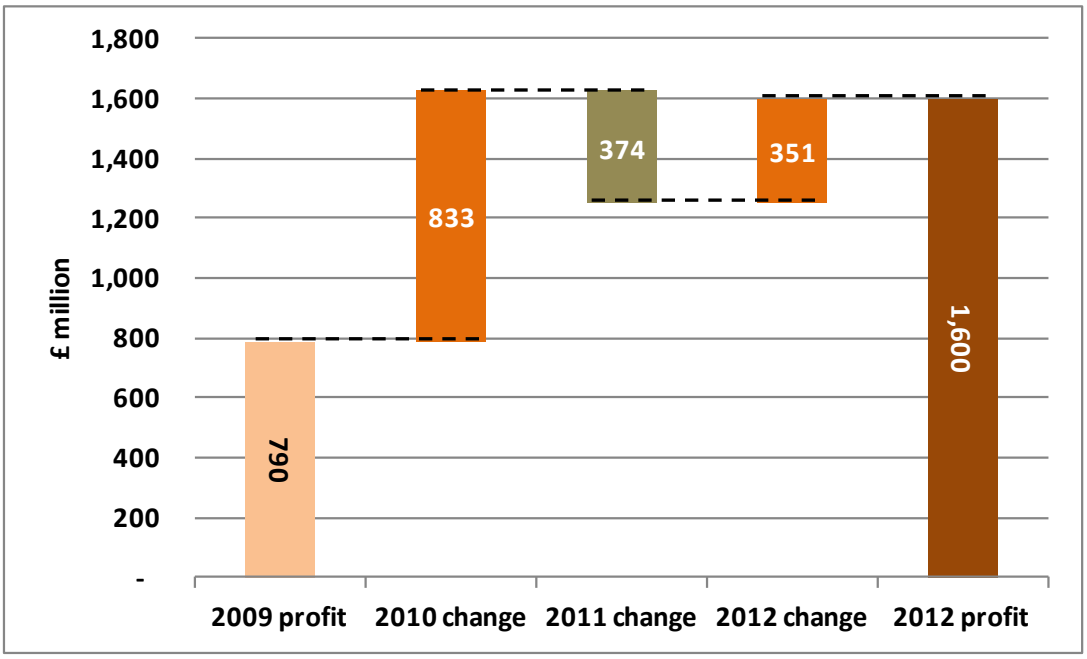
	2009	2010	2011	2012
Profit margin in generation	22.5%	21.9%	24.4%	19.9%

1.21. The electricity generation business requires large sums of capital to build power plants. Since a profit margin like the one above (profit divided by revenue) does not take into account capital employed, it is not too meaningful in representing the economic profitability of the sector. We are consulting on how best to represent the profitability of electricity generation.

Overall supply profits

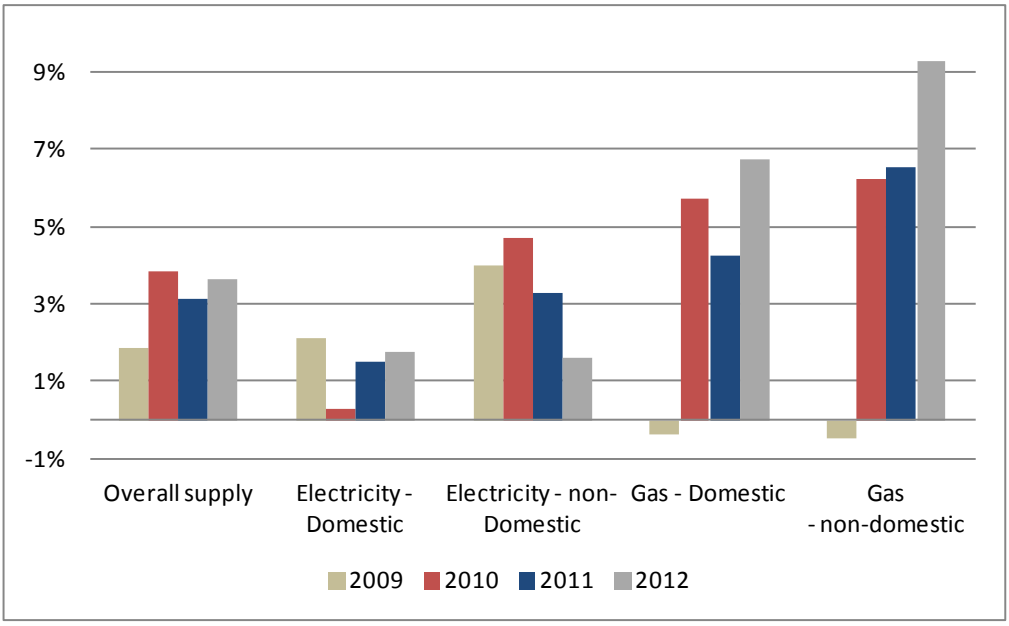
1.22. As shown in figure 5, supply profit levels of the six large suppliers across both the domestic and non-domestic sectors have fluctuated since 2009. Profits of £790m in 2009 rose by £833m in 2010, falling £374m in 2011. In 2012 profits then rose £351 to £1.6bn.

Figure 5: Aggregate supply profits



1.23. Suppliers report higher profit margins in domestic supply (4.3%) than in non-domestic supply (2.6%). This could be partly explained by greater competition in the non-domestic market, where the largest six energy companies have a much lower market share (eg only around 22% in gas), compared to the domestic market (eg about 97% in electricity).

Figure 6: Supply margins



1.24. The supply margins for the six large suppliers are shown in figure 6 for overall supply, and disaggregated by segment. Overall supply profit margins rose in 2010, fell in 2011 and then rose again 2011-2012. This was partly the reflection of margin changes in domestic supply. Non-domestic gas has seen a year-on-year rise since 2009. Non-domestic electricity margins rose in 2010 and have fallen each year since. The generally higher margins for non-domestic supply, especially for gas, result from very small volumes. So a small difference between revenues and costs can result in a high margin, even when the profit in pounds is small.

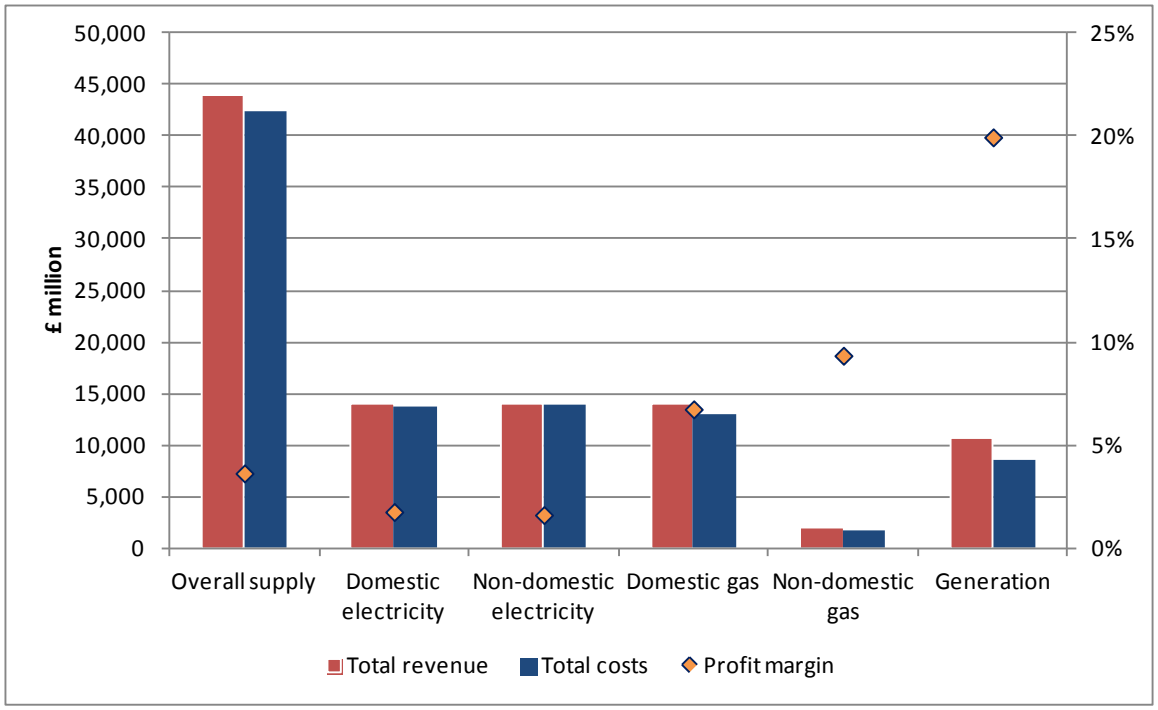
Revenues, costs and profits in 2012

Aggregate results

1.25. Figure 7 shows the revenues, costs and profit margins in generation and the four supply segments, summed across the large energy companies. The average profit margin for overall supply to domestic and non-domestic customers was 3.6%. It was 19.9% for generation.

1.26. It can be misleading to directly compare these two margins. The risk associated with supplying gas and power is much smaller than the risk attached to, and capital employed in constructing and operating a power station. Higher risk attracts higher returns. Higher margins also help to finance investment in the generation segment. This means that while the margin is higher, the economic profitability is not necessarily so.

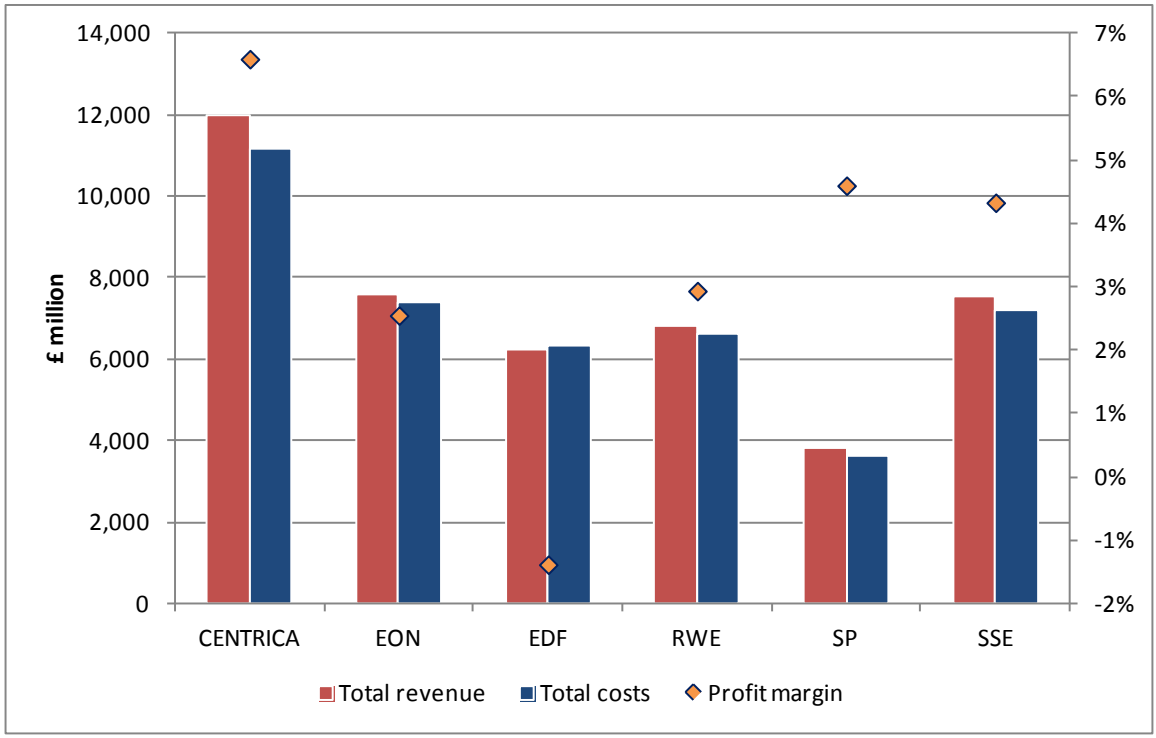
Figure 7: Aggregate industry revenues, costs and margins for each segment



Overall supply of gas and electricity

1.27. Figure 8 shows that, within the average margin on overall supply of 3.6%, the individual suppliers earned between 6.6% to -1.4%. Centrica and EDF are at the top and bottom of the scale respectively. Despite having the lowest revenue, ScottishPower had the second highest margin.

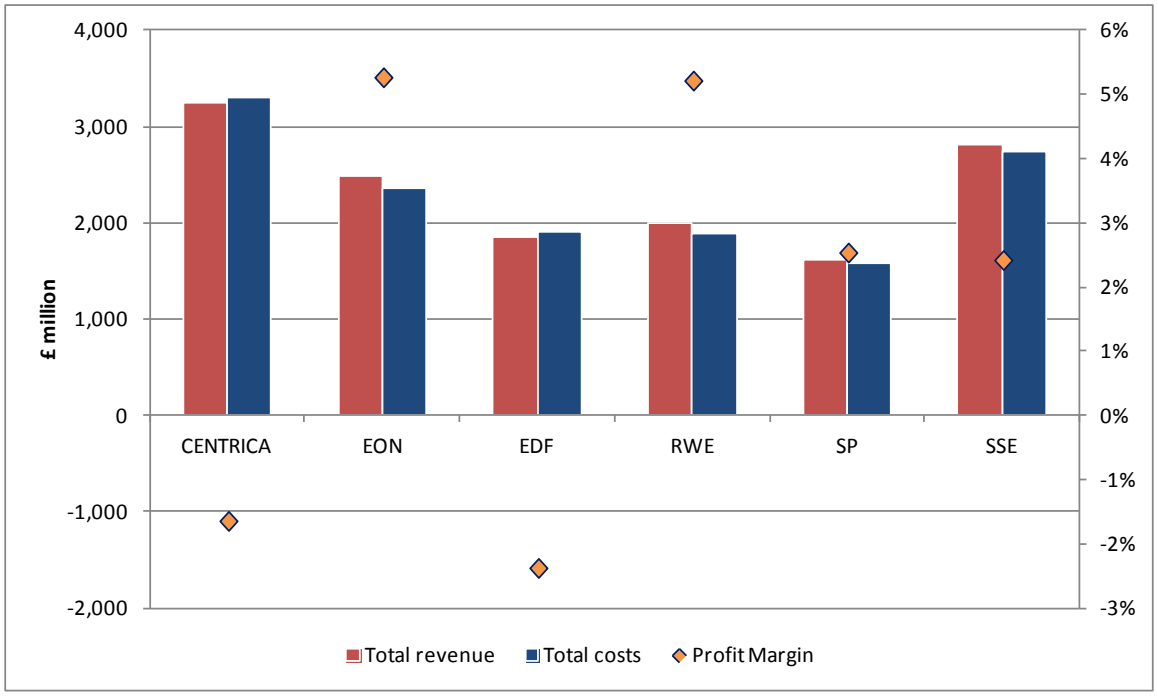
Figure 8: Overall supply of gas and electricity



Electricity supply to domestic customers

1.28. Figure 9 shows that the average margin on domestic electricity supply was 1.9% across the six companies. The costs of Centrica and EDF costs were greater than their revenues, so they had negative profit margins of -1.6% and -2.4% respectively. E.ON and RWE npower had the highest profit margins of 5.3% and 5.2% respectively.

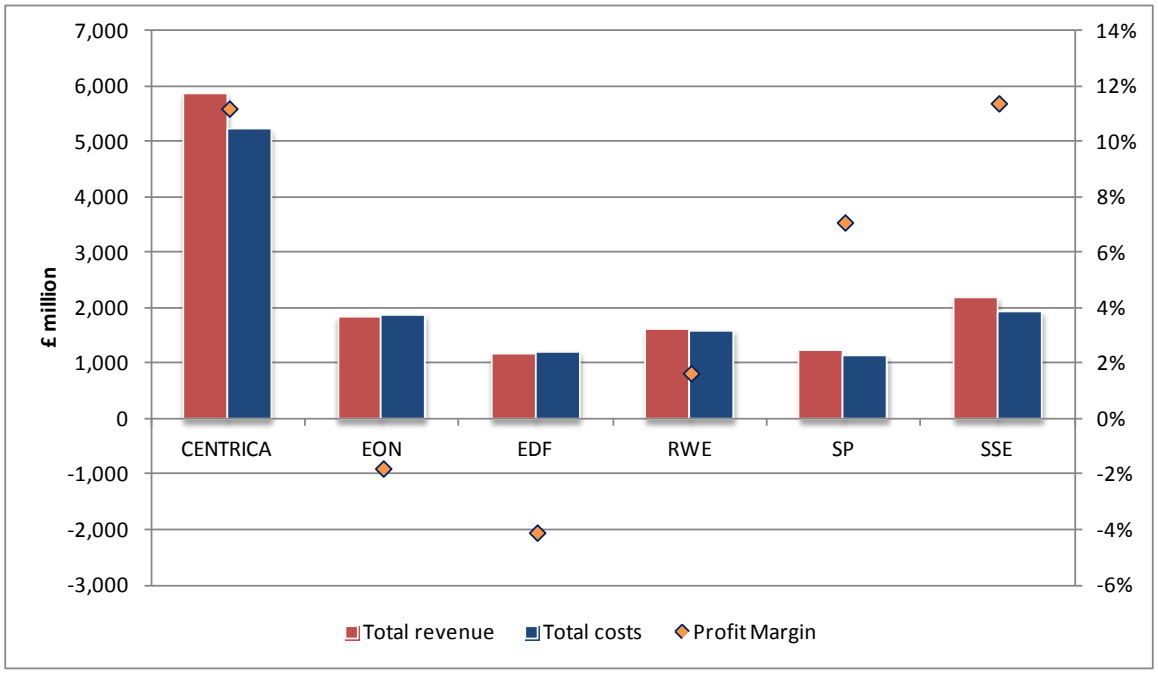
Figure 9: Electricity supply to domestic customers



Gas supply to domestic customers

1.29. Figure 10 shows that, as in previous years, the margin on domestic gas supply varies considerably between suppliers. Centrica leads in terms of revenue but its margin of 11.2% is slightly smaller than SSE's 11.4%. E.ON and EDF have consistently had negative margins since reporting began in 2009, with EDF reporting negative margins for both domestic gas and electricity supply. The average margin across the six companies was 6.7%.

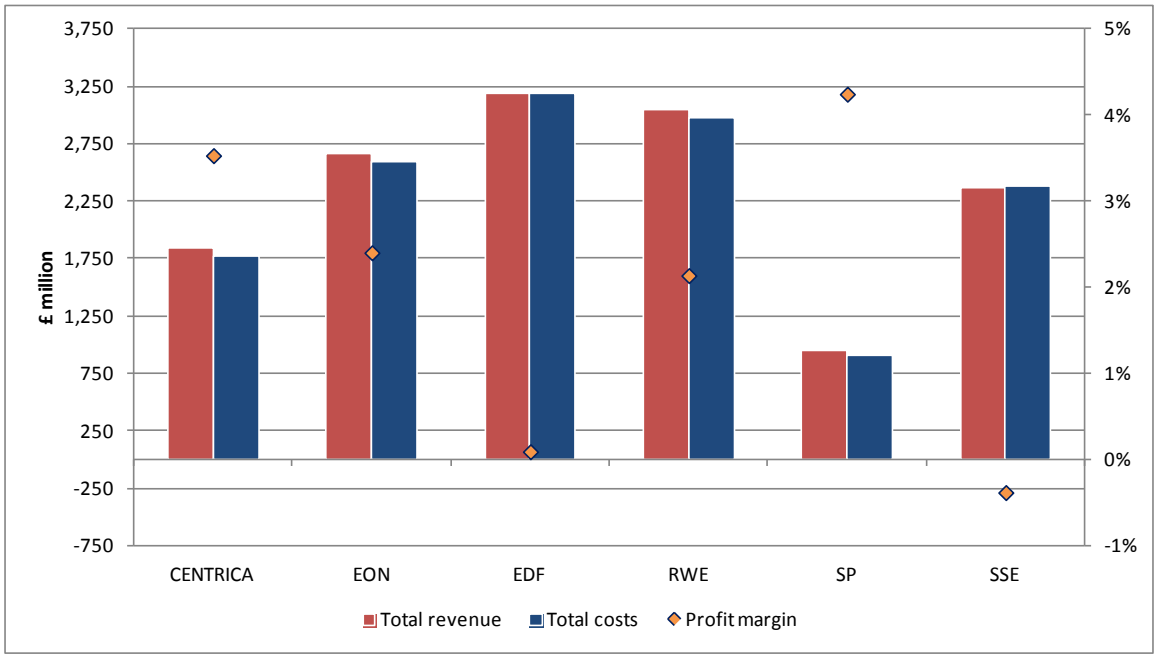
Figure 10: Gas supply to domestic customers



Electricity supply to non-domestic customers

1.30. Non-domestic electricity revenues are slightly lower than in the domestic supply market. Figure 11 shows that ScottishPower had the highest margin (albeit earned on the lowest revenue), followed by Centrica. SSE was the only company to report a negative margin in this market segment.

Figure 11: Electricity supply to non-domestic customers

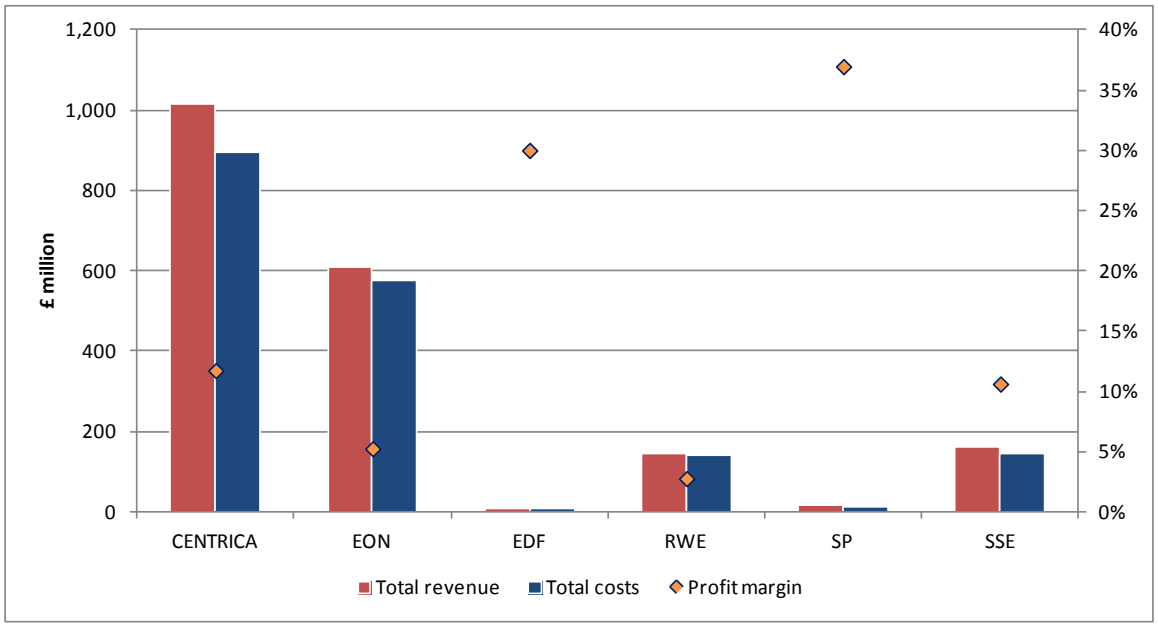


Gas supply to non-domestic customers

1.31. Figure 12 shows that some of the suppliers made high margins in the supply of gas to businesses. However, this was earned on very little revenues, so a small difference between revenues and costs translates into a big percentage margin.

1.32. Non-domestic gas supply brings in the least revenue for each supplier of all their supply activities. Centrica was the largest non-domestic gas supplier but the biggest margins – of 37% and 30% – came from ScottishPower and EDF respectively, which had very low revenues in comparison to the others.

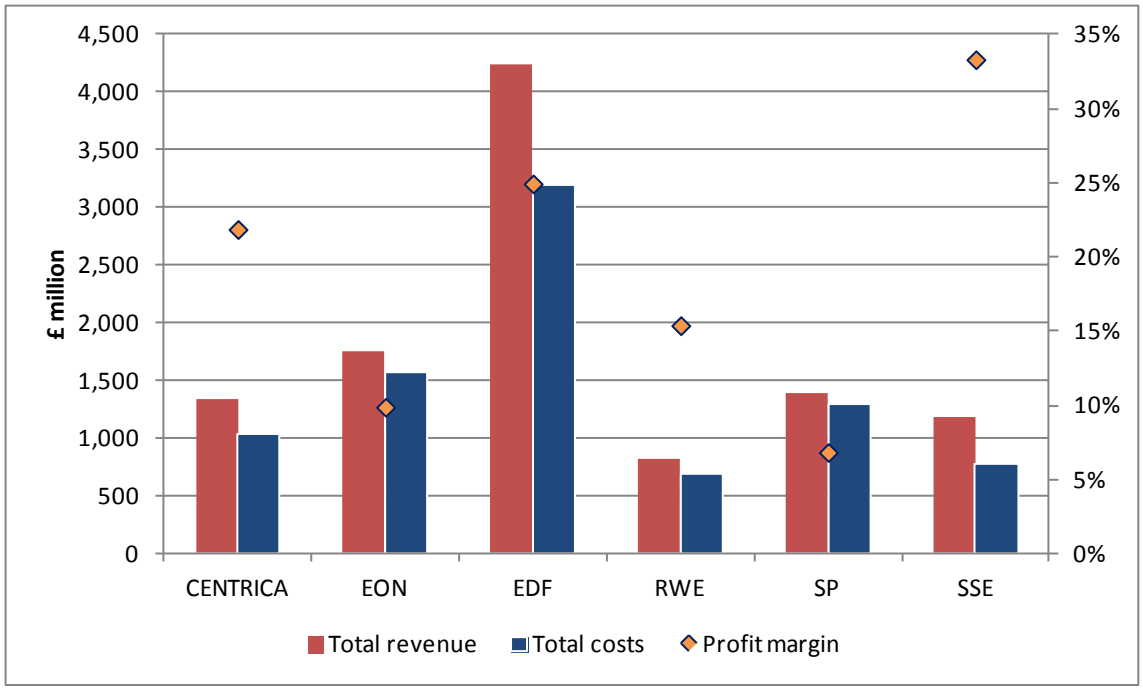
Figure 12: Gas supply to non-domestic customers



Electricity generation

1.33. Figure 13 shows generation results for 2012. RWE npower has continued to earn the lowest revenue. ScottishPower made the smallest margin while SSE had the highest.

Figure 13: Electricity generation



Suppliers' wholesale and operating costs

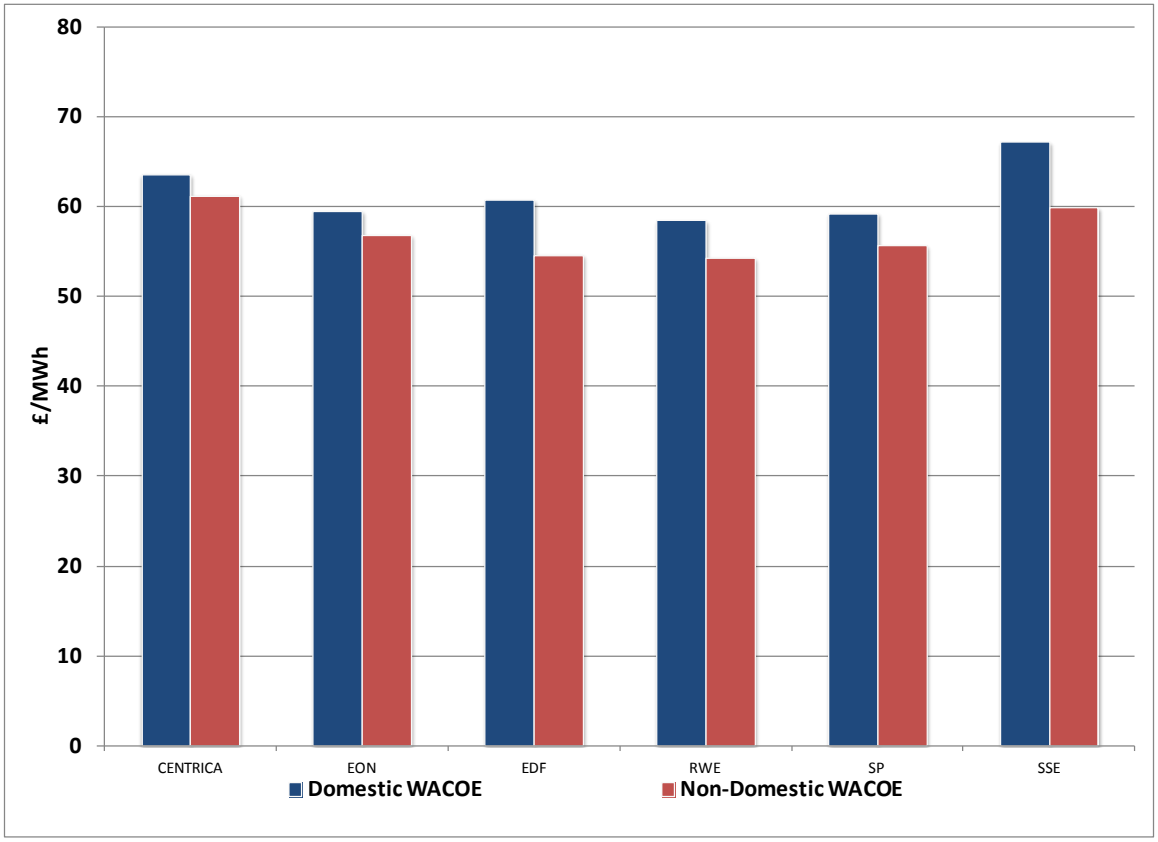
Wholesale electricity costs

1.34. Figures 14 and 15 show the weighted average cost of electricity and gas (WACO E/G) to domestic and non-domestic customers. WACO E/G corresponds to the costs the companies incur in purchasing electricity and gas for their customers. We ask the companies to include a number of specific items when calculating the WACO E/G (see glossary). Differences in the values of these elements will contribute to the variation of WACO E/G across the companies.

1.35. The WACOEs for non-domestic customers are, on average, slightly lower than those for domestic customers. One explanation for this is that companies might use different hedging strategies for sourcing the electricity they need to deliver to non-domestic and domestic customers, since these two customer types have different demand profiles. In contrast, three companies had lower domestic WACOGs.

1.36. Figure 14 shows that SSE had the highest WACOE in the domestic sector, and the second-highest in the non-domestic sector. Centrica had the second-highest in the domestic sector, and the highest in the non-domestic sector. RWE npower, by contrast, had the lowest domestic and non-domestic WACOE.

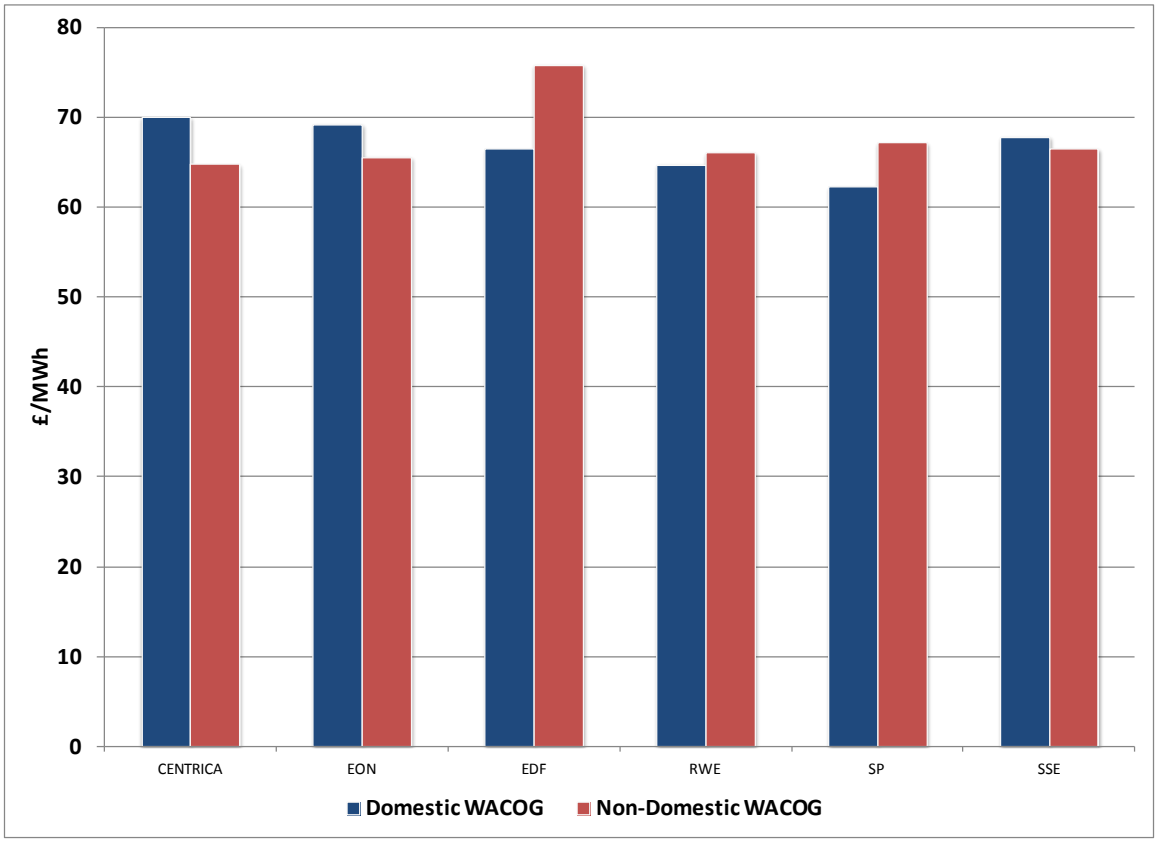
Figure 14: Wholesale electricity costs



Wholesale gas costs

1.37. Figure 15 shows that Centrica, E.ON and SSE all have a higher WACOG for domestic consumers compared with non-domestic consumers. The reverse is the case for EDF, RWE and ScottishPower. ScottishPower had the lowest domestic WACOG, while Centrica had the lowest non-domestic WACOG.

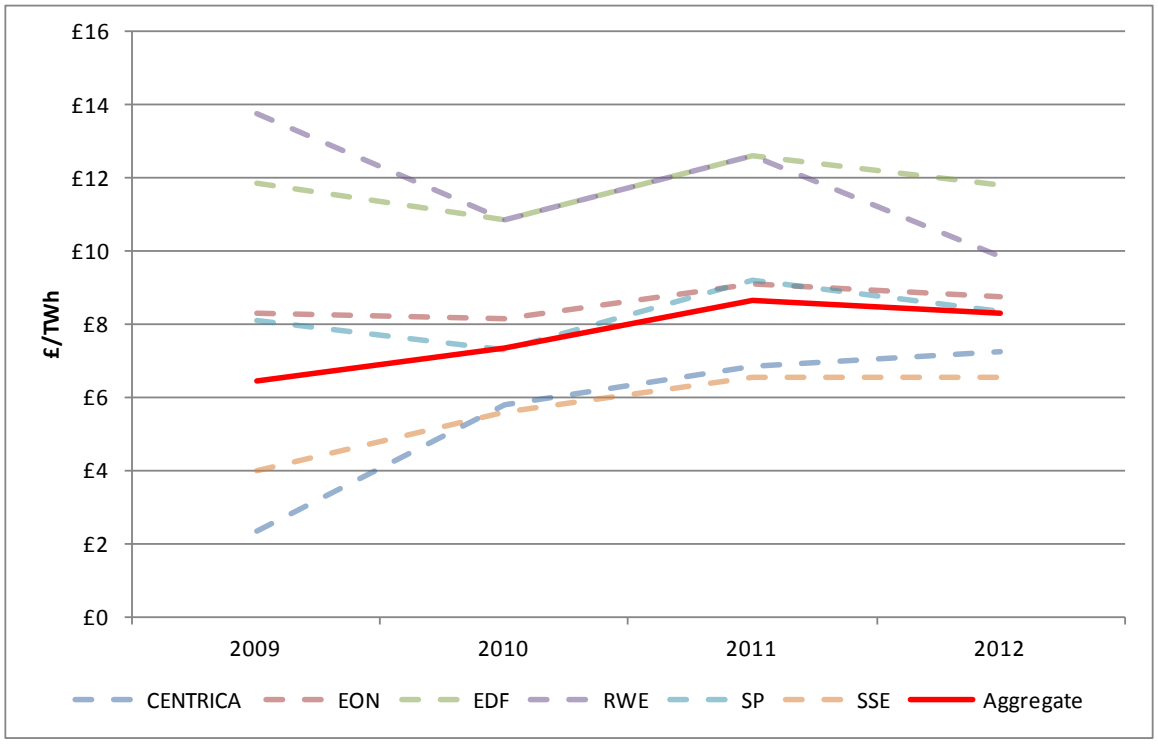
Figure 15: Wholesale gas costs



Operating costs for domestic supply

1.38. Figure 16 shows suppliers' operating costs per unit of output in the domestic supply sector. Between 2009 and 2012 operating costs across the large suppliers converged. In 2009, the difference between the highest and lowest cost was £11.40/TWh. In 2012 it had shrunk to £5.20/TWh. Centrica's operating costs, the lowest in 2009, increased from £2.37/TWh to £7.24/TWh in 2012. Conversely, RWE npower's costs fell from £13.77/TWh to £9.87/TWh.

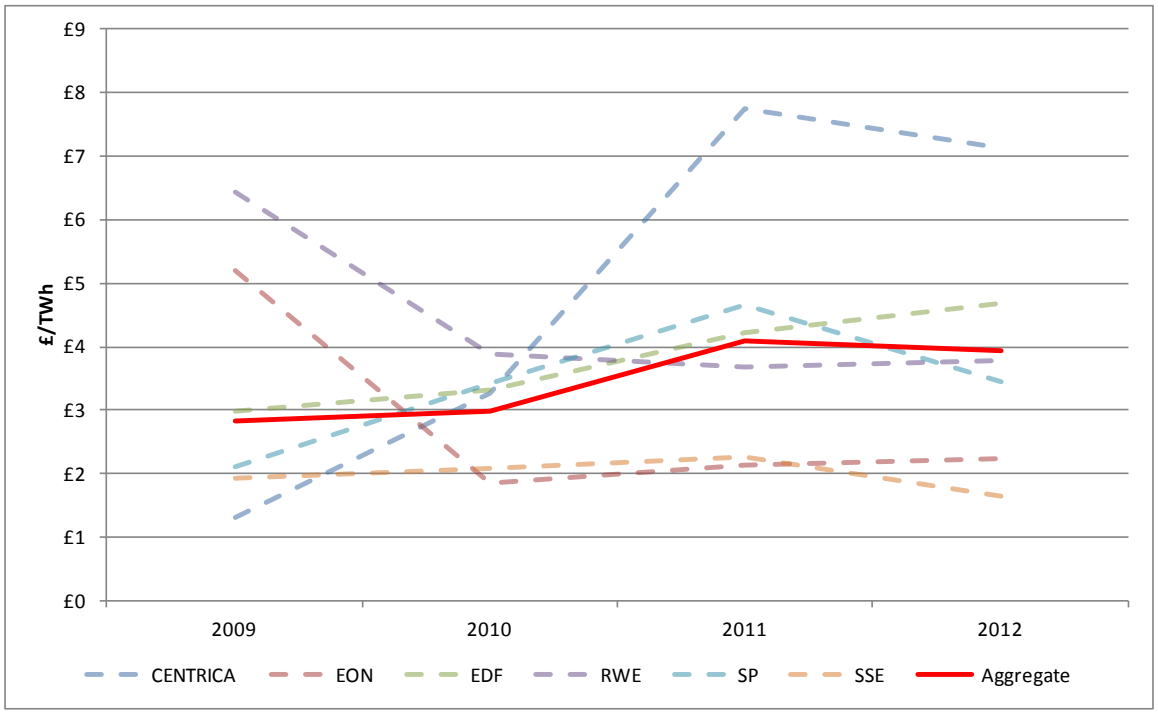
Figure 16: Operating costs for domestic supply



Operating costs for non-domestic supply

1.39. Figure 17 shows that operating costs for non-domestic supply across the large companies have increased since 2009. However, individual suppliers' costs have seen some large changes. Centrica's costs have risen from £1.32/TWh to £7.12/TWh. E.ON's have fallen over the same period from £5.19/TWh to £2.24/TWh. RWE npower's have also fallen, from £6.44/TWh to £3.78/TWh. SSE has maintained consistently low operating costs in the non-domestic supply sector, from a high of £2.27/TWh in 2011 to a low of £1.65/TWh in 2012.

Figure 17: Operating costs for non-domestic supply



2. Independent review findings

Chapter Summary

This chapter summarises the findings from the independent review of the 2012 statements. BDO carried out the review and found that overall the companies completed their statements appropriately. BDO also noted an improvement in disclosure compared to last year. However, they highlighted scope for further improvements.

2.1. The Consolidated Segmental Statements are our main initiative for promoting transparency of energy company profitability. We are determined to make them useful, robust and accessible so they can support our efforts to help rebuild consumer confidence.

2.2. Since the introduction of the statements in 2009, we have worked to improve their transparency and comparability. As part of this work, we have in the past commissioned two independent reviews, an extensive one from the accountancy firm BDO on the 2010 statements, and a narrower one from the accountancy firm PKF on the 2011 statements. The findings of these reviews have helped us improve them. Nevertheless, we consider that more can be done.

2.3. This year, as last, we commissioned an independent review of the companies' statements. This was undertaken by BDO. The main aims of the exercise were to:

- Assess whether the licence condition (and guidelines) have been interpreted appropriately. This includes the reconciliation to group accounts and the use of notable items[6] in the reconciliation.
- Assess whether there has been any improvement in the areas highlighted following the 2011 statements, and consider the implications for comparisons between companies and across time.
- Explore whether, using information currently available, more could be done to shed light on the companies' profitability and to increase the usefulness and accessibility of the statements.

The findings

2.4. BDO considered that the companies had completed their statements appropriately. They noted an improvement in disclosure resulting from companies addressing the issues raised in last year's review. However, they highlighted some continuing issues, mainly related to the companies' reconciliation to audited group accounts. We summarise their findings for each one of the requirements below.

[6] Notable items refer to the revenues, costs and profits resulting from exceptional operations that do not relate directly to the normal operation of the generation or supply segments.

Compliance with the licence condition

2.5. BDO considered that companies complied with the licence condition. Nonetheless, they note that the licence condition is open to interpretation in some areas. Therefore, compliance with the licence condition is a matter of degree, rather than black and white judgement. In practice, this means that some companies publish more information than others about their UK businesses and some provide clearer explanations than others to support the information they present in their statements.

2.6. BDO noted that the most significant variation across the companies was in how successfully the segmental results in the statements can be reconciled to audited segmental information in group accounts. In particular, there were variations on whether the same level of segmentation was used in the group accounts. For example, the most transparent outcome would be where the domestic gas supply profit reported in the statements can be reconciled to an audited domestic gas supply profit reported in the group accounts.

Improvements from last year

2.7. The independent review we commissioned from PKF last year found some areas for further improvement. In particular, it noted that greater transparency could be achieved if there was[7]:

- a clearer explanation of factors included in the calculations of the weighted average cost of electricity / gas (WACO E/G)
- more granular information regarding cost allocation across the segments
- more complete information on transfer pricing practices

2.8. Earlier this year we met each company individually to address their specific areas for improvement, in order to secure clearer and more useful statements this year.

2.9. In this year's review, BDO found an improvement in disclosure resulting from companies addressing the issues raised in last year's review. In particular, BDO considered that ScottishPower's statement is a big improvement from last year, and represents a genuine attempt to increase transparency. This went beyond what is required in the licence condition. For example, the company has volunteered to report its energy trading business as a separate segment. In addition, ScottishPower decided to include additional information in the UK group accounts that provides evidence that notable adjustments and reconciling items in the statements have been audited.

[7] For more details, see Financial Information Reporting: 2011 Results (April 2013)

2.10. We welcome ScottishPower's efforts to improve their statement. We encourage all companies to consider what actions they can take to further improve their statements. We look forward to all of them engaging in our ongoing consultation to improve the transparency of energy company profits.

Reconciliation to audited figures

2.11. The licence condition requires that the statements are prepared under International Financial Reporting Standards. The companies must also explain how the revenues and profits in their statements can be reconciled with audited figures published in group accounts.[8] We introduced this requirement to increase confidence by demonstrating the degree of consistency between the statements and publically-available audited information, and to provide an explanation for any variation between the two.

2.12. BDO found that the requirement is not fulfilling its original intent for all companies. This is because the five segments reported in the statements (specific to GB operations) are not always reported separately in the audited group accounts.[9] Therefore, some companies were able to align their group accounts with their statement better than others. Centrica was singled out as the best performer, since all of the segments in its statement are directly supported by audited segmental information in its group accounts and Directors' Report. SSE and ScottishPower followed, with reconciliations at a less granular level than Centrica, but more detailed than the other three companies.

2.13. Part of the reason for the differences in approach to reconciliation is that segmental information within group accounts is decided by the companies based on how they are structured and manage their business. There is no obligation to also publish in their group accounts the five segments reported in the statements.

2.14. This means that for three of the companies only the total UK revenue and profit has been reconciled.[10] Even where segmental information has been reconciled, the statements include adjustments for excluded activities (such as the energy trading segment) which, without access to the underlying records, cannot be reconciled with the audited group accounts. Similarly, reconciling items, where shown, cannot be agreed with audited group accounts unless the company has chosen to include this information (as ScottishPower has done with its 2012 statement).

[8] If group accounts are not prepared or published, the companies must show how the revenues and profits can be reconciled with their UK statutory accounts.
[9] The segments are electricity generation, domestic electricity supply, domestic gas supply, non-domestic electricity supply, non-domestic gas supply.
[10] BDO note that EDF, E.ON and RWE have either claimed exemption from producing UK group accounts or have produced them without segmental disclosure at the necessary level of disaggregation.

2.15. To address this, BDO recommend that either the statements should be audited by the companies' statutory auditors, or the companies should be required to publish this supplementary information in their group accounts. We are keen to explore these options with stakeholders as part of our ongoing consultation.

Treatment of notable items

2.16. We expect the results in the statements to reflect the outcome of normal business operating activities for the year in which they occur. One benefit of this is to facilitate consistent comparisons between the companies and through time.

2.17. Therefore, the revenues, costs and profits resulting from exceptional operations (ie "notable items") that do not relate directly to the normal operation of the generation or supply segments should be excluded from the statements. If companies include any such item, they must provide a clear and full explanation.

2.18. BDO concluded that all companies are careful to exclude major notable items such as impairment and restructuring costs. In some cases however while notable items are referred to, it is not clear whether they have been included or excluded from the normal business operating activities and a reader of the statements has to study the manner in which the reconciling items are presented to make this judgement. BDO note that there is little consistency in how companies present notable items and in how they present their reconciliations between the statements and group accounts. We would like to explore the best way to address this as part of our ongoing consultation.

Improving the use of the existing information

2.19. Every year, we produce this summary document, designed to make the results in the statements more accessible to our stakeholders.

2.20. This year, recognising the need to rebuild consumer confidence by providing greater transparency around company profits, we asked the consultants to advise on improvements we could make in the way we use the information currently available.

2.21. BDO suggested presenting the results on a per customer basis or on a per unit basis (ie £/MWh). We have done that in Chapter 1 and welcome feedback on whether this is useful. However the lack of consistency in whether the underlying segmental information is audited could undermine the analysis and BDO felt that this should be addressed before making further recommendations on improving the use of existing information.

2.22. Finally, BDO reiterated its recommendation from its 2011 review to increase the disclosed information on energy trading activities as a way to improve the transparency of how these complex businesses operate. This is an area we are consulting on and encourage views on feasibility, benefits and costs.

3. Comparability of the statements

Chapter Summary

This chapter sets out the limitations to comparability of the statements between companies and across time, and the mitigating actions we have taken. The main challenge to comparability is differences in company structures. Other factors include differences in reporting periods and use of accounting adjustments.

3.1. The format of the statements is primarily aimed at market participants, particularly smaller suppliers, and potential new entrants. However, the information they contain is important for all of our stakeholders. This document brings together the information contained in the six statements, summarising the results and comparing them to previous years.

3.2. Despite increases in the transparency and comparability of the individual company statements this document aims to bring, there are some important limitations. This section details the main reasons for this.

Differences in business structure

3.3. The most significant limitation is the difference in business structures among the companies.

3.4. The companies are able to structure and run their businesses as they best see fit to compete effectively. This challenge to comparability will therefore always prevail in liberalised competitive markets.

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

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

Impact on comparability

3.7. The existence of the trading function affects the comparability of the statements. This is because the companies use their trading function in different ways. They need to estimate what proportion of the results from the trading function's activities to allocate to each of the supply and generation segments. To do this, the companies use a transfer price.

3.8. An appropriate transfer pricing methodology should be sufficient to attribute the revenues and costs between generation, supply and the trading function of the companies. We require the companies to provide a clear and full explanation of the transfer pricing methodology they use. BDO reviewed these transfer pricing methodologies in 2011 and concluded that they were "fit for purpose and transparent"[11].

3.9. However, market movements between the times the trading function undertakes a transaction and when the product is transferred to either the generation or supply arm, mean that there is potential for the trading function to generate profits/losses that may not appear in the statements.

3.10. BDO raised this issue during their 2011 review. They suggested that one solution could be to require the statements to also include the full results of the trading function, a view they expressed again in the most recent review of the 2012 statements. Furthermore, the Energy and Climate Change Select Committee, in its report on energy Prices, Profits and Poverty also expressed views favourable to greater disclosure.[12] This is an issue we are currently consulting on, and welcome stakeholder views.

Mitigating actions

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

3.12. In addition, each company is required to include a checklist of business functions to show which of a number of predefined functions are being performed in individual business areas. It therefore provides additional information on how the different companies are structured and provides a useful narrative to read in conjunction with the information submitted by the companies in their statements.

[11] Page 56, *Ofgem Segmental Statements Review*, BDO LLP Final Report, 16 January 2012
[12] *Energy Prices, Profits and Poverty*, Energy and Climate Change Committee, 16 July 2013

Box 1: Trading in the energy market

There has been increasing interest in understanding the trading activities and results of the large energy companies. We are consulting on how to increase transparency around trading. This box aims to give a brief overview on what trading is and a broad sense of the scale of profits in this area compared to those in generation and supply.

All of the large energy companies are active in trading to various degrees. Most have a trading function that sits outside of their generation and supply businesses, and sometimes outside of Great Britain. The trading function for each of the companies performs two activities: hedging and proprietary trading. Proprietary trading does not have to be associated with supply or generation (eg some banks are active in energy trading). So it is trading for the purposes of hedging that is relevant but it is not always easy to separate the profits associated with each type of trading.

Some companies disclose the revenues and profits from their trading activities in the statements (it is not a requirement in the current rules). Others do so at a group level. It is often not possible to know what proportion of the trading profits is the result of proprietary trading, and how much is from hedging activities. Similarly, for global or EU-wide trading functions, it is not possible to know how much of the profits relate to the GB market.

Below we show some information on trading results. Most comes from companies' group accounts. The aim is to give a sense of magnitude in comparison to the £3.7bn of profits earned on generation and supply in 2012:

- Centrica[13]: £25m profit in the first half of 2013 and £20m in the whole of 2012. That is around 0.2% of the 2012 generation and supply revenues in their statement.

- E.ON[14]: €62m loss in 2012 and €42m profit in 2011. That is around 0.06% of trading revenues in 2012.

- EDF Trading[15]: €505m profit in 2012. That is around 0.3% of trading revenues in 2012.

- SSE[16]: £6m loss in 2012. That is around 0.03% of trading revenues in 2012.

- SP[17]: £2.8m profit in 2012. That is around 0.05% of trading revenue in that year.

[13] http://www.centrica.com/files/results/interim13/2013_interim_results.pdf
[14] http://www.eon.com/content/dam/eon-com/ueber-uns/GB_2012_US_eon.pdf
[15] EDF Trading Annual Review 2012
[16] 2012 Consolidated Segmental Statement
[17] 2012 Consolidated Segmental Statement

Differences in reporting periods

3.13. Five of the six companies have a financial year-end in December, while SSE has a financial year-end in March. SSE's results therefore relate to a slightly different time period than the other five companies. While there is still a 75% overlap with SSE's statement figures with the other five companies, this difference will affect the comparability of the six statements for a given year.

3.14. However, this becomes less important over time, where the focus is on distinguishing and understanding trends, which will be captured in the statements from one year to the next.

3.15. This is another issue we are consulting on. We encourage stakeholders to submit their views on the value of aligning the companies' reporting periods.

Other issues affecting comparability

3.16. Regarding year-to-year comparisons, there are also a number of factors that reduce the comparability of the results in the four years that Ofgem has received statements from the companies (2009, 2010, 2011 and 2012).

3.17. First, in 2009 and 2010, there were a number of examples where the companies used notable accounting adjustments in the statements, which significantly affected their reported profit[18]. In 2011 we saw less of these adjustments. For the 2012 statements, BDO found that companies used more adjustments again, although they noted that companies were careful to exclude major ones such as impairments and restructuring costs. They found little consistency in how companies present notable items. This may affect the detailed comparability of the statements between companies.

3.18. Second, various changes introduced by Ofgem since 2009 will mean that the Statements in each have been compiled on a slightly different basis. This reduces year-to-year comparisons between 2009/10 and 2011/12.

[18] Accounting adjustments refer to items that occur outside the companies' normal operation for a particular year, but have been included in the segmental statements, eg the revaluation of a power plant.

Appendix 1 - Glossary

Average bill

The average bill in table 1 includes all tariffs and is after VAT. It is calculated as realised revenue divided by customer numbers.

EBIT

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

Hedging

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

International Financial Reporting Standards (IFRS)

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

Operating profit

Operating profit in table 1 is earnings before interest and taxes (EBIT).

Other costs

Other costs in table 1 include network costs, balancing costs (BSUoS), environmental and social policy costs, transport element of the reconciliation by difference costs, depreciation and amortisation.

Reconciliation by difference (RbD)

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

Supplier costs

Supplier costs in table 1 include the suppliers' own internal operating costs like sales and marketing costs, bad debt, costs to serve, IT, staff costs, billing and all meter costs.

Transfer pricing

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

WACOE

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

WACOF

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

WACOG

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

Wholesale costs

Wholesale costs in table 1 include wholesale energy cost, losses, the energy element of reconciliation by difference costs, balancing and shaping costs.