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Dear Andrew

REVIEWING THE CONSOLIDATED SEGMENTAL STATEMENTS - OUR INITIAL PROPOSALS

We welcome the opportunity to comment on Ofgem's initial proposals to revise SLC19A of the supply licences and SLC16B of the generation licence relating to reporting of Consolidated Segmental Statement (CSS).

We believe that the CSS have outlived their purpose. They were originally conceived as a way of ensuring that vertically integrated businesses did not cross-subsidise their supply and generation businesses. When concerns over vertical integration and cross-subsidy receded, the CSS remained a useful source of information for stakeholders on the overall profitability and cost structures of the supply sector. However, in recent years, with fewer large suppliers obliged to publish CSS, the data has become less representative of the sector, and the CSS no longer generate significant interest from external stakeholders. Ofgem therefore has two options: discontinue the CSS altogether or widen the scope to include the majority of suppliers.

We firmly believe that Ofgem should discontinue the CSS, but failing that:

- We agree that the market coverage should be expanded as proposed and that companies should only be required to obtain an audit of their CSS on request from Ofgem.
- We disagree strongly with Ofgem's decision to retain the requirement for vertically integrated companies to report on the generation segment. Ofgem's justification for doing so does not properly take into account the nature of transfer pricing and cross-subsidy risks. The most proportionate response to the issues identified is to insist on continued full disclosure of transfer pricing policies.
- We believe the proposed addition of the 'Other' category into the CSS table may be *ultra vires* (we request clarification of the proposed legal basis), but if not, it should

apply only to unlicensed supply segment activities and not unlicensed generation activities (should the generation reporting obligation be retained).

We have a number of additional questions and comments on the details of Ofgem's proposals as discussed in Annex 1.

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive style with a large initial 'R'.

Richard Sweet
Director of Regulatory Policy

REVIEWING THE CONSOLIDATED SEGMENTAL STATEMENTS - OUR INITIAL PROPOSALS – SCOTTISHPOWER RESPONSE

Q1. What are your views on proposal to expand the market coverage of the CSS?

We believe that the CSS have outlived their purpose. They were originally conceived as a way of ensuring that vertically integrated businesses did not cross-subsidise their supply and generation businesses. When concerns over vertical integration and cross-subsidy receded, the CSS remained a useful source of information for stakeholders on the overall profitability and cost structures of the supply sector. However, in recent years, with fewer large suppliers obliged to publish CSS, the data has become less representative of the sector, and the CSS no longer generate significant interest from external stakeholders. Whilst the information contained in the CSS may have been useful to Ofgem in previous years, the volume of information requested via RFIs has increased dramatically, and it is unlikely that the CSS contain any information that is not already available to Ofgem.

Furthermore, as discussed in response to Question 2 below, there is arguably even less purpose or stakeholder interest in the generation statements, and this requirement is particularly disadvantageous to vertically integrated generators who are obliged to disclose information that their competitors do not.

The current CSS regime is clearly unsustainable, and Ofgem has two options: discontinue the CSS altogether or widen the scope to include the majority of suppliers. It seems clear to us that if the CSS did not already exist, there would be little pressure on Ofgem to create them. It is always harder for regulators to withdraw regulation than introduce new regulation, but unless Ofgem does so it will result in an unnecessarily complex and cumbersome licence and impose avoidable costs on suppliers.

We firmly believe that Ofgem should discontinue the CSS, but failing that, we agree that the market coverage should be expanded.

Q2. Do you have any other thoughts on the CSS?

We are disappointed that Ofgem is proposing to retain the requirement on vertically integrated licensees to report on their generation segment. We disagree strongly with this proposal, which will impose additional and unnecessary costs on vertically integrated (VI) generators and put those generators at a competitive disadvantage compared to non-VI generators.

Ofgem justifies retention on the grounds that:

‘providing a split of profits between generation and supply allows companies to be transparent about the allocation of costs between the two activities; Government, consumer bodies and Ofgem expect this information to understand whether cost allocation is fair.’

However, the only area of cost allocation that has ever raised any significant concern is transfer pricing of wholesale electricity (in particular the concern that companies may use transfer pricing to move profits from supply to generation), and we do not believe that requiring publication of generation data will materially assist with transparency for the following reasons.

Joint ownership of generation assets

The risks of unfair transfer pricing and cross-subsidy are substantially reduced when generation assets are held by joint venture companies rather than being wholly owned by the VI company, since there are strong commercial incentives to trade on a fully arms-length basis. In the case of the four currently obligated VI companies a large proportion of assets are jointly owned (see Table 1).

Table 1: Joint ownership of generation assets

VI company	Joint ownership of generation assets (based on 2022 CSS)
Centrica	<ul style="list-style-type: none">Majority of generation capacity (98% by revenue) accounted for by 20% holding in UK nuclear power stations
EDF	<ul style="list-style-type: none">Majority of generation capacity (97% by revenue) accounted for by 80% holding in UK nuclear power stations;Remainder largely accounted for by windfarms, all of which are less than 50% owned
ScottishPower	<ul style="list-style-type: none">Generation capacity is 100% renewables, of which the two largest offshore windfarms, West of Duddon Sands and East Anglia 1, are 50% and 60% owned, respectively, with various smaller windfarms also jointly owned
SSE	<ul style="list-style-type: none">A number of windfarms are joint ventures (Beatrice Offshore, Clyde, Stronelairg, Dunmaglass Greater Gabbard Offshore, Seagreen), as are some thermal generation plants

The fact that all four currently obligated VI companies have substantial proportions of jointly owned capacity reinforces the view that transfer pricing is unlikely to be an area of concern for stakeholders going forwards.

Publishing generation statements does not help checking the fairness of cost allocation

Even if there was a concern about transfer pricing, requiring publication of generation statements does not assist in checking this. The only check which could reasonably be carried out using the generation and supply statements would be to calculate the average price at which wholesale electricity was sold by the generation business (revenue from sales of electricity divided by TWh volume) and compare this with the weighted average cost of electricity (WACOE) for the supply businesses. However this check is of no value in practice because there will typically be wide variations in these figures (see Table 2) for a variety of reasons:

- different timing of transactions, particularly during periods of market volatility;
- different mix of peak and baseload;
- different temporal weighting (renewable generation will be weighted towards windier periods when prices are typically lower);
- inclusion of shaping and imbalance costs in supply WACOE.

Table 2: Wholesale electricity prices and costs from 2022 CSS

	Aggregate Generation (£/MWh)	Domestic Supply (£/MWh)	Non-Domestic Supply (£/MWh)	Aggregate Supply (£/MWh)
Centrica	£141.2	£192.6	£141.1	£172.2
EDF	£68.1	£201.5	£129.3	£147.8
ScottishPower	£132.9	£202.3	£139.7	£171.2
SSE*	£222.3		£205.4	£205.4

*SSE is for a different period (April 2022 to March 2023) so not directly comparable with the others

Requiring full disclosure of transfer pricing is the best way of policing

The most effective way of monitoring transfer pricing is to require VI companies to provide full disclosure of their transfer pricing approach in their CSS. Over the period since the CSS were launched Ofgem has conducted various reviews of transfer pricing, and companies have responded with greater disclosure in the notes to their CSS as to their approach to setting internal transfer prices, which should provide comfort that there is no cross-subsidy. Indeed, in ScottishPower's case, we have voluntarily disclosed information about our energy trading business, to contribute to increased transparency.

If Ofgem wants to ensure transparency of cost allocation between generation and supply, so that Government, consumer bodies and Ofgem can understand whether cost allocation is fair, the best way to achieve this is to insist on continued full disclosure of transfer pricing approaches, with Ofgem standing ready to follow up with more detailed questions should anything be unclear. In ScottishPower's case we have committed voluntarily to informing Ofgem if we make any material changes to our transfer pricing, and Ofgem might consider making this a requirement.

Additional obligation places VI generators at a competitive disadvantage

As explained above, requiring VI companies to provide a generation statement does not add to the transparency of transfer pricing. However, it can place their generation businesses at a competitive disadvantage relative to other non-VI generation businesses because of:

- the additional resources required to prepare CSS for generation
- unequal disclosure of key financial information.

Conclusion

It is an important feature of good regulation that regulators are swift to remove obligations as soon as there is no longer a need for them. The findings of the CMA Energy Market Investigation and recent industry restructuring have provided ample evidence that vertical integration is no longer an issue, and the trend toward joint ownership of generation assets means that concerns over transfer pricing and cross-subsidy are less relevant today. Current levels of CSS disclosure on transfer pricing (refined as a result of previous work by Ofgem) should provide ample comfort to stakeholders in this regard.

Ofgem has already acted to remove the 'Secure and Promote' mandatory market making obligation, which was predicated on vertical integration. CSS reporting obligations on generators are less onerous than market making, but the same principle applies: obligations should be removed as soon as they are no longer needed.

Q3. Do you agree with our consideration that the current proposal will not impose significant costs upon newly obligated suppliers? If you consider otherwise, then please let us know and provide any supporting evidence.

We disagree that Ofgem's proposals will not impose significant costs upon newly obligated suppliers. Preparation of CSS has a significant internal resource cost, whether for existing or newly obligated suppliers. We do not believe the benefits are proportionate to the costs, and consider that Ofgem should discontinue the CSS obligation. Failing that it should extend the scope as proposed (but without an obligation for generation statements) and should provide an impact assessment to demonstrate why it considers the benefits exceed the costs.

Q4. What are your thoughts on our proposal to publish a list of obligated suppliers to our website in December each year?

If Ofgem proceeds with the proposed extension of the scope of the CSS, we agree it should publish a list of obligated suppliers to its website in December each year.

Vertical integration and threshold:

Q5. Do you agree with our proposal to remove the requirement for suppliers to be vertically integrated suppliers to submit a CSS?

Yes, if Ofgem is going to retain the CSS obligation, we agree with the proposal to remove the requirement for suppliers to be vertically integrated. However, as noted above, we are disappointed that Ofgem is proposing to continue the redundant reporting obligation on vertically integrated generators.

Q6. Do you agree with the proposal to lower thresholds for the domestic and non-domestic market?

Yes, if Ofgem is going to retain the CSS obligation, we agree with the proposal to lower thresholds for the domestic and non-domestic market.

Additional Financial Information

Q7. What are your views on our proposal not to request additional financial information?

We support the proposal not to request additional financial information. Ofgem already has access to highly granular financial information via ad hoc and regular RFIs. Requiring suppliers to provide more granular information in the CSS would increase supplier costs and the increased complexity may detract from any utility to external stakeholders.

'Other' Activities

Q8. What are your thoughts on our proposal to include an additional column for reporting 'other' activities separate to the supply or generation business?

Ofgem is proposing to add an additional column within the CSS template to record 'other' activities which do not form part of the supply or generation segment. It considers this is necessary to ensure transparency from suppliers on the revenues and costs associated with activities that impact on the energy costs for consumers, since the profits reported for the retail business segments depend on the allocation of costs between sale of energy versus other activities. In particular Ofgem considers it needs to have oversight of whether customers' money is being used to finance other business activities where there is a risk that the business will fail because of losses in those other activities, leaving costs to be recovered via the SoLR process.

Nature of new 'other' column

It is unclear to us whether Ofgem intends to amend the standard CSS table to include:

- a single 'other' column to include unlicensed activities from both supply and generation licensees;
- two separate 'other' columns for supply and generation; or
- a single 'other' column for unlicensed activities of the supply licensee.

We assume Ofgem intends (c) since its stated rationale is focused on the supply market. Option (a) would be of little value because there would be no transparency over the mix of generation and supply activities in the 'other' column and option (b) would require additional disclosure from VI generators for no obvious purpose.

To check our understanding of the requirement, Table 3 shows a mock-up of ScottishPower's 2022 CSS with an 'other' column added for supply (as in option (c)). In particular, we assume that the only entries in the new 'other' column that would need to be populated are total revenue, total operating costs, EBITDA, DA and EBIT.

Table 3: Mock-up of modified CSS table

		GENERATION	SUPPLY					ENERGY MANAGEMENT	
		Electricity ScottishPower Renewables	Electricity Domestic	Non-domestic	Gas Domestic	Non-domestic	Aggregate Supply	'Other' ScottishPower Energy Retail	ScottishPower Energy Management
Total revenue	£m	1,023.4	2,735.6	1,851.6	1,690.9	36.8	6,314.9	xxx.x	7,918.4
Revenue from sales of electricity and gas	£m	1,023.4	2,735.6	1,851.6	1,690.9	36.8	6,314.9	N/A	7,918.4
Other revenue	£m	-	-	-	-	-	-	N/A	-
Total operating costs	£m	(322.0)	(2,853.1)	(1,856.8)	(1,792.0)	(25.2)	(6,527.1)	(xxx.x)	(7,861.9)
Direct fuel costs	£m	-	(1,740.2)	(1,187.6)	(1,228.4)	(16.2)	(4,172.4)	N/A	(7,859.5)
Transportation costs	£m	(119.0)	(530.0)	(352.3)	(334.4)	(5.1)	(1,221.8)	N/A	-
Environmental and social obligation costs	£m	-	(327.2)	(276.4)	(20.7)	-	(624.3)	N/A	-
Other direct costs	£m	(120.2)	(0.4)	(4.2)	(0.3)	-	(4.9)	N/A	-
Indirect costs	£m	(82.8)	(255.3)	(36.3)	(208.2)	(3.9)	(503.7)	N/A	(2.4)
EBITDA	£m	701.4	(117.5)	(5.2)	(101.1)	11.6	(212.2)	xxx.x	56.5
DA	£m	(215.6)	(52.9)	(15.4)	(40.4)	(2.4)	(111.1)	xxx.x	(3.0)
EBIT	£m	485.8	(170.4)	(20.6)	(141.5)	9.2	(323.3)	xxx.x	53.5
Volume	TWh	7.7	8.6	8.5	N/A	N/A	N/A	N/A	N/A
	Mther	N/A	N/A	N/A	706.5	14.0	N/A	N/A	N/A
WACO F/E/G (calculated)	£/MWh	N/A	202.3	139.7	N/A	N/A	N/A	N/A	N/A
	p/th	N/A	N/A	N/A	173.9	115.7	N/A	N/A	N/A
Customer Numbers	000s	N/A	2,685	177	1,915	19	4,796	N/A	N/A
			Supply EBIT margin	-6.2%	-1.1%	-8.4%	25.0%	-5.1%	

As disclosed in our CSS for 2022, non-licensed activities of our supply licensee which would potentially fall under the 'other' heading included our Smart Solutions and hydrogen activities. Non-licensed activities of our generation licensees (which we assume would not be reported in the 'other' column) included generation activity outside GB and the results of a windfarm which was exempt from holding a generation licence as it was classed as a small generator.

Legal basis

We would also request that Ofgem clarifies the legal powers under which it proposes to require publication of this information. Ofgem says it has powers under s47(1)(b) of the Electricity Act to request this information. But s47(1)(b) merely places a duty on Ofgem, and the associated

information gathering powers are in s47A(1). However, the s47A(1) powers are limited to activities falling within s47(1C), and the s47(1C) activities do not include 'other' non-licensed activities.

Transition Period

Q9. What are your thoughts on our proposal not to include a transition period for the first year of reporting now that the additional financial information and the audit requirement have been removed?

If Ofgem proceeds with its proposals, we agree that there is no need to include a transition period for the first year of reporting.

Audit requirement

Q10. Do you agree with our proposal to remove the audit requirement and instead propose the CSS must reconcile back to statutory accounts?

Yes, we agree that the audit requirement should be removed. It will be sufficient to require that the CSS must reconcile back to statutory accounts (and that this reconciliation should be set out in the CSS). It is essential that guidance in this area is clear.

In our case, if required it is important to highlight that reconciliation back to statutory accounts will be a reconciliation to the Consolidated Statutory Accounts and not the individual legal entity accounts as the individual statutory accounts will not be prepared, audited and filed by 30 April each year. Given audit regulation and the time now taken to prepare and audit individual statutory accounts meeting a 30 April deadline would be impossible using current resources.

Q11. Do you agree with the proposal that Ofgem retains the right to request an audit where there may be cause for concern?

Yes, we agree that Ofgem should retain the right to request an audit where there is a cause for concern. This will be essential to maintain confidence in the integrity of the CSS.

In our case it has taken a number of years to evolve our internal processes and reporting structure to meet the CSS requirements in a robust and clear way, and the requirement for external audit has provided a useful discipline. We would encourage Ofgem to manage expectations with newly obligated suppliers so that the threshold for requesting an audit is not set too high. We would anticipate that Ofgem may wish to request a significant number of audits in the early years.

ScottishPower
September 2023