

## Financial Information Reporting: Guidance



**Document Type:** Guidance

**Ref:** Insert Reference

**Date of Publication:** 20 October 2009

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**Target Audience:** Energy suppliers and generators, consumers, consumer organisations and representatives, academics and other interested parties.

### Overview:

This guidance document has been prepared by the Office of Gas and Electricity Markets ('Ofgem') and relates to improving the transparency of supply and generation businesses of the large vertically integrated companies. This measure is a part of the 'Promoting market transparency' remedy of the Energy Supply Probe, intended to give stakeholders confidence that the market is working in a fair and competitive manner.

This document sets out guidelines for the relevant GB licensed gas and electricity suppliers and electricity generators in relation to Standard Conditions: 19A of the Gas and Electricity Licences and 16B of the Electricity Generation Licence ('the Conditions'). The guidelines were prepared following consultation with the relevant licensees and interested stakeholders. The Conditions will come into effect on 21 October 2009.

The guidelines included in this document are intended to assist the reader in understanding the requirements of the Conditions, including to whom it applies and relevant timeframes.

This guidance is not intended to be legally binding but rather intends to assist the licensee in preparing the relevant financial information.

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## Context

Ofgem's principal objective is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition. In keeping with this objective, Ofgem launched a study of the state of GB energy supply markets ('the Energy Supply Probe') in February 2008. The final proposals were presented for statutory consultation in August 2009. Following approval by the Gas and Electricity Markets Authority ('the Authority'), the Conditions will come into effect on 21 October 2009.

One of the measures introduced is to require the major vertically integrated supply companies to publish detailed financial information on their profits, underlying costs and revenues based on their own transfer pricing methodology. This segmental reporting and increased transparency on transfer pricing aims to provide better visibility to existing market participants and potential new entrants regarding margins in different parts of the value chain.

This document sets out guidelines, and is expressly not intended to be legally binding in itself. Rather, it is intended to assist the relevant licensees to interpret and prepare the relevant information to comply with the Conditions.

## 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

The above documents are available via the Ofgem website at the following location:

<http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Pages/Energysupplyprobe.aspx>

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## Background

1.1. In February 2008, Ofgem launched the Energy Supply Probe, a study of the state of the retail energy supply markets in Great Britain.

1.2. We published our Initial Findings Report in October 2008. This document identified a number of important areas where competition could work more effectively, and proposed very initial range of remedies to address the issues. The document recognised the need for further clarity with regard to the relationship between supply and generation activities of the large vertically integrated companies. This was highlighted in relation to liquidity and in terms of potential cross-subsidisation.

1.3. Following this, in April 2009, we published for consultation our initial proposals to remedy the identified issues. This included a proposal for the large vertically integrated companies to report segmental accounts for gas supply, electricity supply and electricity generation. The aim of remedy was to provide better visibility / transparency regarding: (1) the profitability of different activities in the value-chain, and (2) the transfer price used by the supply and generation businesses to exchange wholesale energy, to alleviate concerns about cross-subsidisation. We put forward four alternative options, in relation to the amount and detail of the information to be collected, and the form and means of reporting/publishing it to a wider audience.

1.4. Based on a detailed appraisal of the benefits and costs of the four options and the responses to a wide-scope consultation, in August 2009 we proceeded to a statutory consultation with the proposed licence condition modifications for option 1. In summary, this option requires the vertically integrated companies to publish separate segmental financial information no later than six months after the end of the licensee's financial year. The information should be reconcilable to group or GB statutory accounts and be readily available on the companies' websites

1.5. Following the closure of the final statutory consultation on 15 September 2009, the Authority issued statutory notices on 19 October 2009, which bring the Conditions into effect on 21 October 2009.

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## Guidelines

1.1. These guidelines relate to Standard Condition 19A of the Gas and Electricity Supply Licences and Standard Condition 16B of the Electricity Generation Licences (collectively referred to as 'the Conditions' for the purposes of these guidelines) which came into effect on 21 October 2009. These guidelines are intended to assist the reader in understanding the requirements of the Conditions.

1.2. The guidelines have been prepared by the Office of Gas and Electricity Markets ('Ofgem') pursuant to paragraph 6/19A.6 of the Conditions (throughout this document the first paragraph number relates to the generation licences and the second relates to the supply licences). This version of guidelines takes into account comments received as a result of the August 2009 consultation with licensees and interested stakeholders.

### **Completing the Consolidated Segmental Statement**

1.3. The guidelines for completing the Consolidated Segmental Statement referred to in the Conditions should be taken to mean completing Table 1 overleaf in the Appendix. The Notes to the table provide further details.

### **Scope and Application of the Licence Condition**

1.4. The Conditions only apply to entities that hold both supply and generation licences, and who supply electricity to more than 50,000 customers or gas to more than 50,000 customers ('Relevant Licensees').

### **Financial Year**

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

### **Interpreting the Financial Information**

1.6. Under paragraph 4(a)/19A.4(a) of the Conditions a clear and full explanation of how the Relevant Licensee defines the terms revenues, costs and profits should be set out, so as to enable an industry stakeholder to understand what the information provided pursuant to paragraph 1/19A.1 does and does not represent. Where issues pertaining to the data are unexpected or unusually complex these issues should be set out in full.

1.7. Under paragraph 4(b)/19A.4(b) of the Conditions a clear and full explanation of the reconciliation should be provided, so as to enable an industry stakeholder to understand as much as can be reasonably expected as to how revenues, costs and

profits reconcile (or do not reconcile, as a result of complexities in the group's financial reporting structure) to the Relevant Licensee's UK statutory or consolidated group accounts. This explanation would be expected to take the form of a numerical table and a written statement.

1.8. Paragraph 5/19A.5 of the Conditions provide for further information pertaining to the interpretation of the financial information provided required pursuant to paragraph 1/19A.1. This further information should be sufficient to inform an industry stakeholder of the financial data's proper interpretation and context (e.g. any structure constraints the business operates within, such as tolling agreements).

### **Transfer Pricing Methodology**

1.9. Under paragraph 4(c)/19A.4(c) of the Conditions a clear and full explanation of the Relevant Licensee's and Affiliates' transfer pricing methodology should be provided, so as to enable an industry stakeholder to understand as much as can be reasonably expected about this transfer pricing methodology adopted. This explanation should include:

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

## Appendices

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## Appendix 1 - Template for the Consolidated Segmental Statement

	Generation		Supply - Electricity				Supply - Gas			
	2009	2010	2009		2010		2009		2010	
			Non		Non		Non		Non	
		Dom <sup>4</sup>	Dom <sup>4</sup>	Dom <sup>4</sup>	Dom <sup>4</sup>	Dom <sup>4</sup>	Dom <sup>4</sup>	Dom <sup>4</sup>	Dom <sup>4</sup>	Dom <sup>4</sup>
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
<b>Total Revenues</b>										
Revenues from sales of electricity and gas <sup>1</sup>										
Other Revenues <sup>2</sup>										
<b>Total Operating Costs</b>										
Direct Costs										
WACO(E)(G) <sup>3</sup>										
Volume (TWh)										
Other Costs										
Indirect Costs										
<b>EBIT<sup>5</sup></b>										
Adjustment for D&A										
<b>EBITDA<sup>5</sup></b>										

### Notes:

1 For the generation business segment this means revenue from sales of electricity output generated; or if the business operates in a tolling-agreements structure, the revenues received from the capability payments (an explanation/clarification of the later type of revenues should be provided). For the respective supply segments this means electricity and gas sales.

2 This means other respective segmental revenues not covered in footnote 1. For example, for the generation segment this would include capacity payments, other physical options and ancillary services.

3 For generation this means the weighted average input cost of fuel (e.g. gas, coal, uranium, etc) used by the generation business, shown as £/MWh. For electricity and gas supply this means the weighted average cost of electricity or gas ("WACO(E)" or "WACO(G)") used by the business, shown as p/kWh or p/therm respectively.

4 The table includes a domestic and non domestic market breakdown. The split between the two must be made on a reasonable endeavours basis. For example, the



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split may be made on the basis of customer numbers, revenue, or metering profile classes. The methodology used should be explained.

5 The terms: EBIT means earnings before interest and tax; and EBITDA means earnings before interest, tax, depreciation and amortisation. Companies may elect to use their own equivalent descriptions of these items to achieve consistency with their own financial reporting standards.

## Appendix 2 – The Authority’s Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.<sup>1</sup>

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly<sup>2</sup>.

1.4. The Authority’s principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them<sup>3</sup>;
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.<sup>4</sup>

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

<sup>1</sup> entitled “Gas Supply” and “Electricity Supply” respectively.

<sup>2</sup> However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

<sup>3</sup> under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

<sup>4</sup> The Authority may have regard to other descriptions of consumers.

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- promote efficiency and economy on the part of those licensed<sup>5</sup> under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
  - protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
  - secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- the effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation<sup>6</sup> and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

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<sup>5</sup> or persons authorised by exemptions to carry on any activity.

<sup>6</sup> Council Regulation (EC) 1/2003