OFGEM SEGMENTAL STATEMENTS REVIEW

BDO LLP -FINAL REPORT - Version 5 - Non-Confidential Extract | 16 January 2012

CONTENTS

02. EXECUTIVE SUMMARY

(Non-Confidential)

02. EXECUTIVE SUMMARY
A. Transfer pricing

02.A.1 Describe the transfer pricing methodology used by each firm.

Most groups follow a broadly similar business model with a single body trading with the markets, through which the generation divisions sell power or capabilities and from which the supply segments acquire power and gas. However, within this model there are significant differences in how functions are located between divisions and how they interact.

The main variations are:

- Some generation divisions sell either their production capacity at fixed rates, or use a complex system of options over production to hedge their output
  - this gives a return to the generation division that is independent of the electricity volumes actually produced
  - the trading body, or supply segment, receives the benefit or cost of market movements
- In other cases the central trading body acts more like a broker, standing between the generation and supply segments and the wholesale markets/counterparties

Pricing of these transactions is in most cases based on the prices reported for market trades. This is typically either set to use a separate buy and sell price or to allow a transaction fee or premium for the trading body.

In other cases a measure of costs actually incurred, adjusted with premiums in some cases, are used for transfer pricing purposes.

02.A.2 Assess the strengths and weaknesses of each approach; including how it corresponds to recognised best practice; how it compares to assumptions used for internal management information; and how it meets HMRC requirements.

Wholesale energy market prices constitute a potential comparable uncontrolled price, the appropriate application of which would be likely to meet the measure of 'best practice' set out in the OECD's Transfer Pricing Guidelines.

To be fully appropriate and robust, however, a high degree of comparability with both the individual transaction and the allocation of functions, assets and risks in the business model is required. We have observed that:

- The use of market price as a basis to measure the sale of output (or capacity) by generation businesses does not match the Key Performance Indicators (KPIs) given to generation management which focus on plant efficiency
- Where the market is illiquid, data is insufficient, and/or the parties trading have different characteristics from those observed in the market, the market prices must be adjusted to be appropriate and this is what many groups do. If extensive adjustment is required, it becomes harder to demonstrate comparability and transfer pricing risk may increase
- In some cases, options over generation capabilities are transferred. This is inherently more complex than drawing comparable prices directly from the market, involving adjustment to and modelling of market data. As a result this is dependent on implementation and is not transparent. While this approach to setting prices may be considered sound from a transfer pricing perspective, the economic models and prices that result would be difficult to test. It may be prudent to test the impact of these pricing policies, however, and the most practical way to achieve this would be to review the generation and trading divisions over time to confirm that they behave as expected; including where possible comparison between groups
- Rigid hedging policies imposing volume and timing requirements on generation and supply businesses may move the potential for profit around a group: for example requiring generation to hedge earlier than supply. If there are any expected shapes to pricing and demand curves, these could be used to leave an expected profit or loss in a trading arm, which is not currently reported in the CSS
- Risk premiums charged by trading companies could have the effect of moving risk, or duplicating a trading operation's reward for risk. However, amounts involved are limited.

02. EXECUTIVE SUMMARY
A. Transfer pricing

02.A.3 Assess how companies deal with moderate liquidity along the curve, lack of market prices around shape, and the use of internal trades. To what extent are the resultant prices fully market-based?

Groups' use of market prices as a basis for transfer pricing places reliance on liquidity and sufficient market data. This is either managed or brokered by the trading arm in accordance with group policies.

- As noted above, timing differences in hedging policy may seek to manage profits and losses arising in the trading operations
- Anticipated generation volumes are predominantly hedged with markets or a central trading body rather than being matched against expected demand from the group's supply division.
  - This approach is intended to result in the most efficient / profitable positions being taken and thus might be considered good for the consumer
  - Vertical integration does not create any barrier between wholesale market prices and supply divisions
  - Trading costs and volatility might be higher under the current model than if a less open and market based approach were used
- As market data and liquidity improve, trading functions often actively manage hedge positions; meaning traded volumes are high compared to total generation and supply. Hedging decisions, whether at the day-to-day discretion of generation/supply divisions or based on more rigid group policies, require a view of markets to be taken and can be profitable or unprofitable. It is not clear whether constant amendments to hedged positions as opposed to, say, a one-off position based on netting predictable demand with supply, creates risk or cost benefit.

02.A.4 Assess whether companies face any incentives to take profits in one segment rather than another for tax minimisation reasons. Is there any evidence that this is distorting transfer pricing methodologies and reported profitability?

We have found no evidence of any incentives for tax minimisation, nor any evidence of other intentional distortion.

02.A.5 Identify possible changes to current transfer pricing reporting practices which could be helpful in improving the CSS.

We have identified four potential changes to the CSS:

- Uniform treatment of free allowances
- Consistency of fuel costs in generation businesses
- Inclusion of the trading division in reporting
- Implementing a notional adjustment to reflect a single business model

In practice, the last two changes in particular may be difficult to achieve, depending on the level of detail required. However further recommendations regarding the transfer pricing issues identified are included in Section 3.

To increase confidence in the CSS, the use of wholesale market prices as a basis for transfer pricing policies might be tested to ensure that it does not distort reporting or pricing decisions.

02. EXECUTIVE SUMMARY
B. Accounting for longer term hedges and derivative contracts

02.B.1 Describe the methodology used by each firm to account for long term hedges and derivative contracts in the CSS, including the estimation and allocation of mark-to-market profits and losses.

Five of the entities account for financial instruments in their audited financial statements in accordance with IAS 39 and complying with the own use exemptions and hedging exemptions therein. These firms have correctly excluded the fair value effect of these financial instruments in their CSS.

One of the entities accounts for financial instruments in its audited financial statements in accordance with UK GAAP and is not required to adopt FRS 26 (UK equivalent of IAS 39) and accounts for these financial instruments on an historical cost basis. Therefore, no adjustment is required to exclude the fair value of these financial instruments in its CSS.

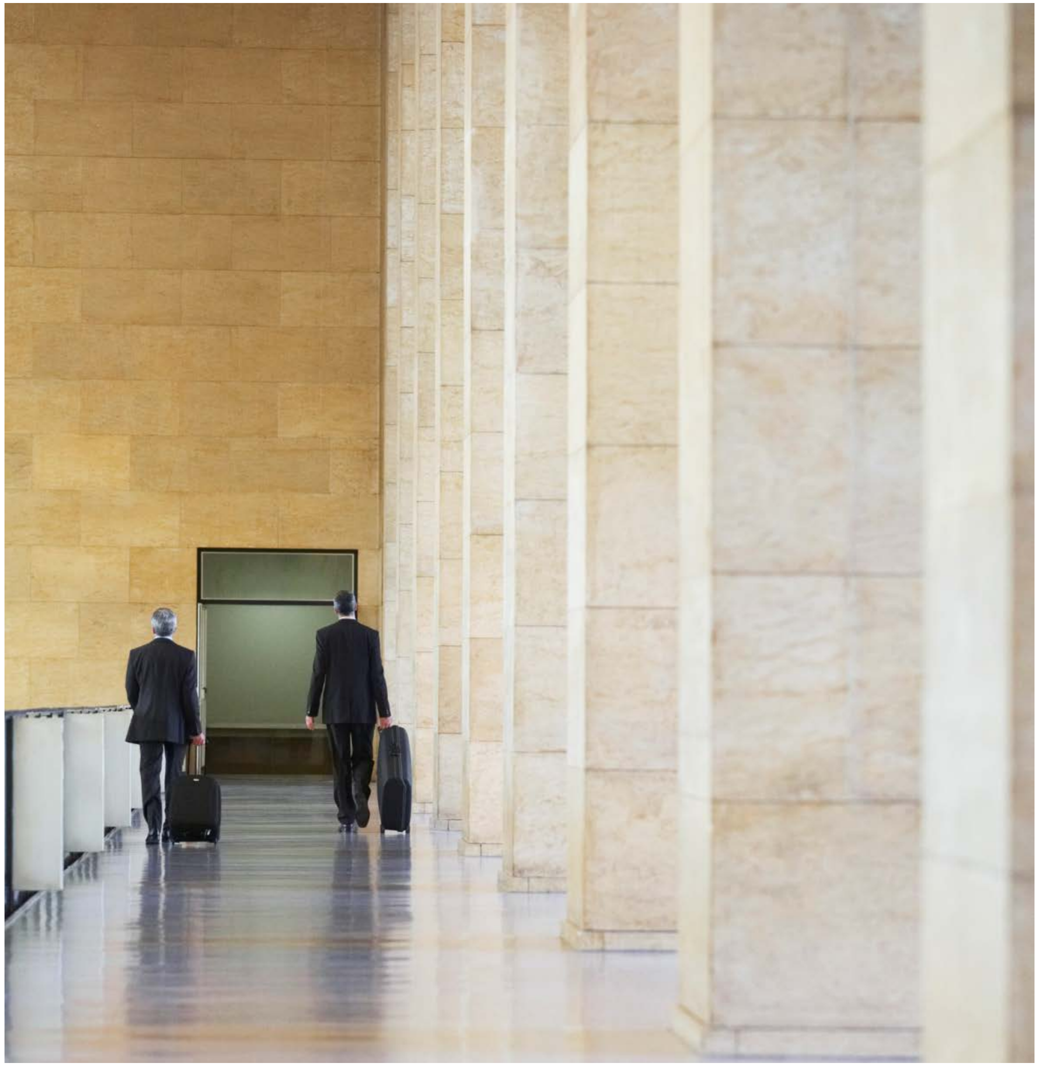
02.B.2 Assess whether it is practicable and beneficial to devise a common approach for estimating and/or allocating such profits and losses for the purposes of the CSS.

In complying with IFRS or UK GAAP a common approach for the treatment of financial instruments has been established.

Whilst we have not reviewed the fair value techniques adopted by the entities, comfort may be taken by the fact that the fair value techniques would have been audited by each entity's external auditor at each year end for the purpose of ensuring that the audited financial statements gave a true and fair view. This would also include the evaluation of hedging treatment and own use exemption, together with how embedded derivatives are identified. The descriptions given in the audited financial statements of each entity are in accordance with IFRS or UK GAAP.

02.B.3 Summarise any recommendations regarding hedge accounting arising from this analysis.

Whilst a more detailed review of the valuation techniques by an independent firm may highlight some inconsistencies between the valuation techniques and hedging strategies amongst the Big Six, as these fair value adjustments have been excluded from the CSS, the ability of each entity's hedge accounting treatment to affect the CSS is limited.



02. EXECUTIVE SUMMARY
C. Energy trading

02.C.1 Describe the extent to which trading activity is included within the CSS.

Any speculative energy trading activities of the Big Six have been excluded from the CSS, mainly due to the way that each company structures its business model.

There are costs and charges relating to other trading activities such as hedging that are included within the CSS, for example as indirect costs, as part of power and fuel costs or as a reduction in generation income. Corresponding costs and profits/losses may fall in parts of the groups outside the CSS. To this end we refer to the comparisons in relation to trading activity within the main body of this report.

02.C.2 Describe how firms distinguish between speculative trading and transactions undertaken for hedging purposes; and how this distinction is reflected in the CSS.

Speculative trading represent a very small element of the overall results currently shown in the CSS, as these figures are not considered material to the financial statements (or CSS). This is based on our evaluation and analysis of the disclosures within the financial statements (and CSS) of the Big Six and the trading which is undertaken not for hedging but for speculative purposes.

'Speculative' trading is defined for the purposes of this report as the taking of a market position in pursuit of profit from the trades themselves rather than the management of cost-effective supply for customers.

The energy businesses have group policies regarding hedging, which generally include specifying a time in advance of delivery by which the position should be hedged. Normally this is different for generation selling power into the market and supply drawing requirements out. Generation tends to hedge its output, capability and capacity earlier than the supply business will hedge its requirements. Due to the volatile nature of the market, hedging is utilised as a means of managing risk.

02.C.3 Describe how the companies allocate specific trades, especially those required within short term time horizons and within the Balancing Mechanism to balance the company's overall GB position. How are the costs of such trades allocated across Generation, Supply or Trading? What is the rationale for these allocation rules?

Transmission costs associated with both generation and the balancing mechanism are by and large recorded within the generation division of the GB accounts. However, the allocations of costs of such trades across the business are dependent on a variety of factors and the type of Transfer Pricing model employed.

02.C.4 Assess the implications of international business models and the extent to which they impact on reported CSS treatments.

An effective transfer pricing policy must appropriately reflect the business model used, as this will dictate how the functions, assets and risks of operations are divided between the divisions or companies in question.

Most groups follow a broadly similar business model with a single body trading with the markets, through which the generation divisions sell power or capabilities and from which the supply segments acquire power and gas. However, within this model there are significant differences in how functions are located between divisions and how they interact.

The main variations are:

- Some generation divisions sell either their production capacity at fixed rates, or use a complex system of options over production to hedge their output
  - this gives a return to the generation division that is independent of the electricity volumes actually produced
  - the trading body, or supply segment, receives the benefit or cost of market movements
- In other cases the central trading body acts more like a broker, standing between the generation and supply segments and the wholesale markets/counterparties

02. EXECUTIVE SUMMARY
C. Energy trading

02.C.5 Assess whether financial transparency requires additional information disclosure relating to energy trading activity.

Given that currently trading entities/divisions represent a 'missing link' between the generation segment and the WACOE/WACOG shown in the supply segments, an option to increase transparency may be to require the results of trading divisions to be included.

There are two ways in which the inclusion of trading divisions could be achieved:

- Basic inclusion – For the big six the majority of trading divisions are contained within a UK legal entity that undertakes no other activity, or are within a UK branch of an equivalent entity. Including the total GB figures for trading, including speculative trading activities, might therefore be relatively straightforward, although for two of the groups a greater degree of analysis is likely to be required than the others.
- Detailed inclusion – speculative trading does not form a part of the standard power and gas supply chain, yet the figures arising from it could easily mask the results of other functions of the trading entities. It is likely to be possible for each entity to identify which trades have been undertaken for speculative purposes and what has been done for other reasons, such as acting as a central broker or purchasing capability options and managing scheduling.

The 'detailed inclusion' option would allow for the inclusion of a wider range of activities to be presented in the CSS for each group that would capture all charges and profits paid to central trading bodies as well as associated costs for those trading entities. This should improve the confidence in the figures being provided by the Big Six; however it would be difficult and costly for at least some groups. In particular, the licensed entities in the UK would have no legal powers to require other group members to provide the necessary information.

A basic inclusion of all trading activity data is a halfway-house and could provide some comfort that profits are not being distorted in favour of trading entities, however the inclusion of speculative results is likely to reduce its usefulness and potentially to be confusing to readers of the CSS who would not be able to differentiate between speculative trading results and energy supply chain data.

Continuing without including trading results in the CSS is plausible and has least cost; however this retains current limits to the transparency of the statements with the concern that there is potential for it to appear that there could be 'missing profits' in the unreported areas.

This is discussed further in recommendation R.4.

02.C.6 Summarise any recommendations regarding the reporting of energy trading arising from this analysis.

Without exception, trading activities within the Big Six are closely aligned to either the transfer pricing or hedging policies, therefore, any recommendation in regard to energy trading is covered within our transfer pricing or hedging recommendations.

02. EXECUTIVE SUMMARY
D. Treatment of exceptionals

02.D.1 Describe the treatment of exceptional items (unless already covered in sections A,B or C).

In preparing the CSS the entities have presented a number of reconciling items. Some of these are termed exceptional items.

In UK GAAP, where the concept exists, it only relates to items which need to be separately disclosed because of their size or incidence if the financial statements are to show a true and fair view. Therefore, the term, where it is used, is used as a means of emphasising an item included in the measurement of profit.

In the CSS this is being used in a different way. In effect it is being used by some companies to describe items which have been excluded from the CSS.

Within the Big Six, half of the companies do not explicitly refer to the term 'exceptional' within their CSS whereas the remaining companies do use the term 'exceptional'.

In general these are a small number of the total reconciling items. The overall number and type of reconciling items is largely dependent upon the basis of GAAP adopted and the audited documentation to which the CSS is reconciled. As there is little or no similarity of these factors, the number and type of reconciling items varies significantly.

For example, in preparing statutory accounts, some of the firms analyse exceptional items into a separate column in their income statement, thus meaning that when they come to prepare the reconciliation these exceptional items do not need to be adjusted for.

Furthermore, the entities have all chosen to reconcile a variety of different line items on the CSS, with differences between whether EBIT, EBITDA and/or revenue are reconciled to statutory information.

In addition reconciling items arise to adjust the numbers from the financial statements to meet the requirements of the CSS eg. to exclude unlicensed activities. Other adjustments are to exclude items not considered appropriate by the companies for example one off write downs.

In reviewing the exceptional items and reconciling items, we also noted inconsistencies on how the results of Joint Ventures and Associates are included within the CSS.

02.D.2 Assess whether it is practicable and beneficial to devise a common approach to these items for the purposes of the CSS.

In order to do this it would be necessary to:

- Determine a common starting point e.g. revenue, costs and EBITDA
- Distinguish those items which are necessary to draw up the CSS
- Determine the purpose of the statements e.g. to show on-going profits and what adjustments are needed to show this

In preparing the CSS, the Relevant Licensee should account for Joint Ventures and Associates (which hold a generation or supply licence relating to the generation or supply of gas or electricity in the UK) as follows:

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

For each of the items, the Relevant Licensee’s share of the income and expenses of a joint venture or associate should be combined line by line with similar items in the Relevant Licensee’s CSS or reported as separate line items in the Relevant Licensee’s CSS.

Associate

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

Joint Ventures

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

02. EXECUTIVE SUMMARY
D. Treatment of exceptionals

02.D.3 Summarise any recommendations arising from this analysis.

In order to achieve more uniformity of statements we would ask you to consider the following:

- Define Revenue and EBITDA pre any exceptional column as the starting point of the reconciliation
- All reconcile to an audited IFRS income statement* (or set of statements)
- Divide reconciliation into items adjusted to ensure that statements relate to generation or supply
- Develop principles for other items to be excluded
- Review by independent auditor of all statements to ensure comparability
- Issue further guidance as above on the treatment of Joint Ventures and Associates within the CSS.

In developing principles for other items to be excluded, we would also suggest that only a limited number of items are allowed to be excluded. Although more work needs to be carried out on this, we would suggest:

- Mark to market adjustments;
- Restructuring costs which been disclosed as such in the original financial statements; and
- Items relating to disposals.

We would not include asset write downs as they would not be reconciling items to EBITDA.

** An IFRS Income Statement is in this instance is an Income Statement present in the statutory accounts of the group or relevant company prepared under International Financial Reporting Standards.*

In determining a common starting point for the reconciliation, we believe that the existing format adopted by one of the companies provides the most clarity and transparency on the reconciling items. We would suggest that guidance should be issued stating:

In reconciling the CSS to audited financial information, the reconciliation should adopt a columnar approach ensuring that each line item in the CSS (revenue, other revenue, direct fuel costs, other direct costs, indirect costs, EBIT, EBITDA and volume is reconciled to audited financial information. Narrative should be included for each reconciling column to enable the user of the CSS to understand the nature of the reconciling item.

	Per CSS	Reconciling item 1	Reconciling item 2	Reconciling item 3	Per audited financial information
Revenue	xxx	xxx	xxx	xxx	xxx
Other revenue	xxx	xxx	xxx	xxx	xxx
Direct fuel costs	xxx	xxx	xxx	xxx	xxx
Other direct costs	xxx	xxx	xxx	xxx	xxx
Indirect costs	xxx	xxx	xxx	xxx	xxx
EBITDA	xxx	xxx	xxx	xxx	xxx
Depreciation and amortisation charge	xxx	xxx	xxx	xxx	xxx
EBIT	xxx	xxx	xxx	xxx	xxx
Volume	xxx	xxx	xxx	xxx	xxx

03. SUMMARY OF RECOMMENDATIONS

(Non-Confidential)

03. SUMMARY OF RECOMMENDATIONS
Overview

Overview

Over the following pages we have provided details of our recommendations with regards to the recommended changes to the company reporting guidelines, and in some cases additional supporting actions that will support the goal of improved usefulness of the CSS and transparency and comparability of results.

For each recommendation we have included an analysis of the expected benefits and the potential cost and risks of the changes.

In summary, the key changes that we are recommending include:

R1. Require the Big Six to publish their CSS at the same time and to the same year-end

R2. Appoint an independent auditor to provide an opinion on the statements each year

R3. Instruct the Big Six to reconcile their CSS to an audited IFRS Income Statement

R4. Require the reporting of trading functions' results, including disclosure of the risk each trading function assumes

R5. Test that the use of wholesale market prices as a basis for transfer pricing policies does not distort reporting or pricing decisions

R6. Introduce a uniform reporting treatment for common recurring items in the CSS, in particular free allowances and fuel costs

R7. OFGEM to provide more detailed guidance on the scope and definition of exceptional items

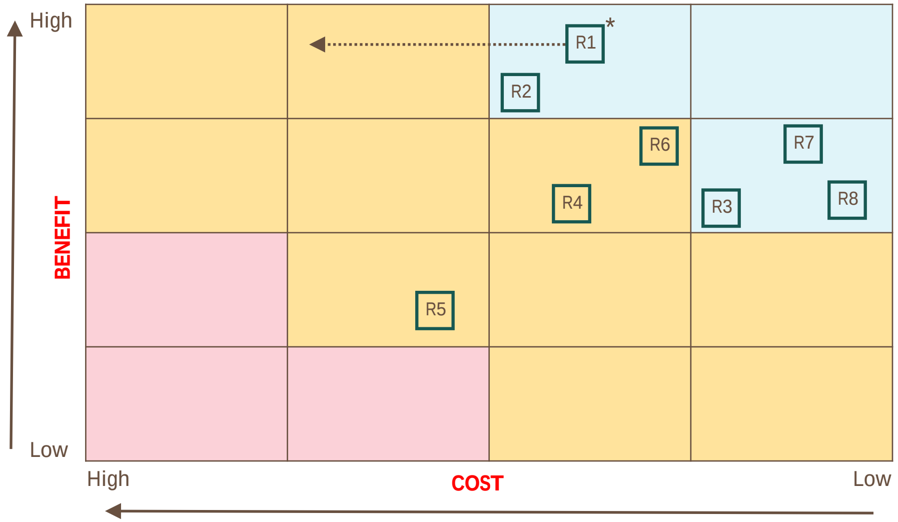
R8. OFGEM to instruct the Big Six to reconcile the CSS to the same starting point

Axis

The diagram below details our overview and perspective of the feasibility and desirability of each of the recommendations identified on the previous pages.

The 'Benefit Axis' refers to the expected benefits gained by implementing the recommendation as part of the revised guidelines for the CSS.

The 'Cost Axis' refers to the expected costs and barriers to implementation.



* For SSE the cost of implementation of this recommendation is significantly higher.

03. RECOMMENDATIONS FOR IMPROVEMENT

Expected benefits, costs, and risks of changes

OVERVIEW	KEY BENEFITS	KEY COSTS/BARRIERS
R1. Require the Big Six to publish their CSS at the same time and to the same year-end		
OFGEM should seek to impose a reporting deadline on the Big Six, to ensure that all CSS are produced at the same time, and set against co-terminus year ends to ensure that comparison across the firms is made easier.	The main benefit would be increasing comparability across the Big Six. BDO considered the impact of imposing a new reporting schedule on companies and any impact that it would have on investor confidence and information and management of expectations. At present, five of the six companies operate to the same year end, therefore the only impact that imposing co-terminus year ends would be to require the final company to either produce a separate statement at the year end, or provide a reconciliation to the CSS to enable comparison to be made across the firms. The benefits of this improvement recommendation would be: • Comparison between all six companies will be improved due to the results being for the same reporting periods and thus set against similar and comparable cost bases i.e. gas price fluctuations etc • Providing the statements to OFGEM at the same time would allow OFGEM the opportunity to quickly review the CSS submissions against one another and thus qualify any queries or concerns quickly • If aligned with a company's year end and annual reporting cycle, the companies could also modify the terms of engagement with their external auditors to help support the creation of the CSS.	The key significant barrier to imposing the same reporting deadline across the Big Six will be the extra burden that this would place on the company that does not have a common year end with its peers. In this case the company would be required to generate interim statements or reports that would allow for a useful and comparable reconciliation to be performed. There would be several ways of achieving co-terminus dates, all of which would have a cost for the company currently on a different reporting cycle. These are: • Changing the statutory reporting year end – this would impose a high cost and these are possibly other intangible reasons why this would be problematic, such as investor relations; • Prepare an interim statement at 31 December – this would impose less cost than changing the year end but it would not be audited, although this could be reviewed to the level that the half yearly financial results announcement is reviewed; and • Request that the company that reports to a different year end has an additional full audit for its results to 31 December – this would impose prohibitive costs on this company of up to £1m. Another way of achieving comparability and reducing the burden on finance teams during their busiest period would be to consider moving the reporting period to 30 June. If the reporting period for the CSS for all entities was changed to 30 June, then there would be no audited information to reconcile the statement to. However, for some of the entities, there would be a publicly available interim financial report to 30 June, but this would not be audited (although will have been reviewed by the auditors). A move to a 30 June reporting period could be considered in conjunction with R2 - Appoint an independent auditor to provide an opinion on the statements each year.

03. RECOMMENDATIONS FOR IMPROVEMENT

Expected benefits, costs, and risks of changes

OVERVIEW	KEY BENEFITS	KEY COSTS/BARRIERS
R2. Appoint an independent auditor to provide an opinion on the statements each year		
OFGEM should seek to implement an independent review of the CSS prior to their publication. Each company would have the opportunity to provide their statements to independent auditors with specific accounting expertise to provide comment on the completeness and accuracy of the CSS and also to provide high level commentary on key movements and comparisons between the firms.	Improved transparency will be achieved through continuous improvement and education. Through an independent review and opinion there can be incremental improvements over the long term through comparison, recommendations, review and assessment. We consider the key benefits of appointing independent experts to provide an opinion on the CSS are: • The ability to offer expert advice from a position of independence that is not clouded by existing relationships with any of the companies • Provide commentary on the results disclosed by the companies in the context of wider market conditions and external factors that may have influenced this eg volatility in fuel prices, natural disasters, weather conditions, hedging policies, new entrants to the market, changes in accounting policy or acquisitions/disposals • Providing assurance to the key stakeholders that the statements are accurate, complete and a fair reflection of the performance of each of the firms • Provide feedback and commentary with regard to recommendations for best practices, based on the auditors' broad experience and expertise gathered from audits in various industries, not exclusively limited to the energy sector	The key cost and barriers for providing the independent review are: • Determining who would be required to pay the fees of the auditors, if one firm is used across the board and the work is not included as an extension to the existing external auditors responsibilities • Ensuring that the scope of the review is sufficient to ensure that a useful and binding opinion can be reached • The key barrier would be the extent to which the firms would be willing to enable an additional company access to their confidential data in order to provide a detailed analysis of the CSS

03. RECOMMENDATIONS FOR IMPROVEMENT
Expected benefits, costs, and risks of changes

OVERVIEW	KEY BENEFITS	KEY COSTS/BARRIERS
R3. Instruct the Big Six to reconcile their CSS to an audited IFRS Income Statement.		
OFGEM should seek to ensure that the CSS are all starting from the same point of reference, in this case audited IFRS Income Statements.	The main benefit would be increasing comparability across the Big Six. This will allow greater comparability of statements and allow for an easier assessment of reconciling items between the IFRS Income Statement and the CSS. This would also reduce the number of cases where one company has to include an item in its reconciling statement whilst another has already excluded the same item at arriving at its starting point.	There would be costs for a number of the companies who currently reconcile to the segmental accounting note in their financial statements. This cost effect would be aggravated for those companies without a UK parent and who currently reconcile to a European consolidated statement. A problem here is that this would add extra lines to their reconciliations and make the disclosures more complex. To partially offset this each entity could prepare a consolidation to the highest UK parent company level. These companies exist in most of the group structures but no consolidation is carried out as there is a Companies Act exemption of which they take advantage. An alternative would be to require each entity to reconcile the CSS to each UK company within the group which conducts licensed activities. This is the existing approach taken by two of the energy companies, although one of these aggregates these companies within its CSS. One energy company's CSS already provides a highly informative reconciliation, as it reconciles not only EBIT or EBITDA but also each line item on the CSS to statutory accounts. The cost of reconciling to individual financial statement should not be prohibitive. The barriers are that: • It would add another layer of complexity for the larger groups; • More divisionalised entities would find this approach difficult.

03. RECOMMENDATIONS FOR IMPROVEMENT
Expected benefits, costs, and risks of changes

OVERVIEW	KEY BENEFITS	KEY COSTS/BARRIERS
R4. Require the reporting of trading functions' results, including disclosure of the risk each trading function assumes		
OFGEM should require the reporting of results for energy companies' trading functions, including the risk each trading function assumes in the supply chain. **There are two options with differing levels of cost and benefit - (A) including overall figures for trading divisions; and (B) detailed analysis to 'non-speculative' results.** **If the costs and barriers can be overcome and tolerated, we would recommend the detailed analysis option (B).** **If desired, these options could be combined through the basic inclusion of all relevant data (A) which is then analysed in detail (B).**	Option A – basic inclusion Including the complete P&L details for trading operations will present a picture of each group's total UK operations, missing only ancillary services. Implementing this allows: • Greater visibility of profit across the whole supply chain, including scheduling and acquiring generation options • Potential to reduce concern about profits being diverted or disguised Compared with Option B below, the data should be relatively easily available due to UK trading activities taking place in distinct entities or UK branches of overseas entities. There is one exception to this as all trading activities take place outside the UK.	The key costs and barriers for reporting trading results under Option A – basic inclusion are: • There are a variety of trading function models used by the Big Six; without requiring the same business model to be adopted comparability between groups will not be improved, only transparency of results • Speculative trading activities are not part of the energy supply chain, being something that unrelated businesses such as merchant banks can engage in, and their inclusion in the results would significantly reduce clarity of energy supply chain elements • The licensed UK entities of the Big Six have no legal authority to require other group members to provide profit and loss details (subject to their contractual arrangements); requiring the licensed entities to provide this information might therefore rely on goodwill and/or shareholder intervention • One of the energy companies would need to undertake comparatively detailed analysis to split out the activities of its trading body that relate to the UK market
	Option B – detailed inclusion Separating out the speculative trading activities to show only P&L details of other activities such as broking, acquiring generation options and/or managing scheduling would allow a clearer and more complete picture of activities undertaken in the energy supply chain. In particular this would allow: • An understanding of the transfer of risk and profits between entities where functions are shared, such as the toll generation models • A clearer picture of the effects of timing of hedging and transfers within the groups, such as whether there is likely to be a predisposition towards trading functions profiting and whether this has any impact on the supply divisions • A reduction in concern about profits being diverted or disguised without confusion caused by significant and variable speculative trading results	The key costs and barriers for reporting trading results under Option B – detailed inclusion are: • As above, the licensed UK entities have no legal basis to require other group members to provide them with details • Most groups would need to undertake detailed analysis, however if speculative portfolios are recorded separately this should still be possible • A clear definition of trading (as opposed to speculative trading) will be required from the Regulator; this is likely to be a qualitative rather than quantitative measure that could be difficult to substantiate These options will give rise to a cost to all businesses in the industry; for some energy companies this could be high. The method, impact and benefits may be determined in advance through a modelling exercise undertaken by the Regulator

03. RECOMMENDATIONS FOR IMPROVEMENT
Expected benefits, costs, and risks of changes

OVERVIEW	KEY BENEFITS	KEY COSTS/BARRIERS
R5. Test that the use of wholesale market prices as a basis for transfer pricing policies does not distort reporting or pricing decisions		
OFGEM should test that the use of wholesale market price as the main transfer pricing measure does not have a distorting effect on reporting or pricing decisions	The wholesale market price is used by most energy companies as the basis for their transfer pricing policy, although in many cases this is subject to adjustment. This type of comparable can be appropriate (even recommended) for transfer pricing purposes provided it is correctly applied. Testing the current policies, for example against the cost of generation, would allow: • More confidence in reporting based on these transfer pricing policies • Further insight into the impacts and role of groups' hedging strategies • More effective comparison of the performance of generation businesses	The key costs and barriers to analysing the effectiveness of using wholesale market prices for transfer pricing are: • A view of the effectiveness of the market will be required, especially at lower levels of liquidity (eg is the market made only by the tested parties at any point?) • A definition of alternative measures will be needed, for example should the cost base include provision for future refurbishment or fuel costs, and on what basis? The cost to businesses from this will be limited compared to recommendations R4 and R6 (so far as it relates to fuel costs); they are also likely to be one-off costs. These are likely to fall with the Regulator to ensure visibility across the tested businesses.

03. RECOMMENDATIONS FOR IMPROVEMENT

Expected benefits, costs, and risks of changes

OVERVIEW	KEY BENEFITS	KEY COSTS/BARRIERS
R6. Introduce a uniform reporting treatment for common recurring items in the CSS, in particular free allowances and fuel costs		

OFGEM should introduce a uniform treatment of common items, in particular free allowances and fuel costs, which are currently treated inconsistently and so create distortions.	Agreeing a uniform treatment for disclosure of certain key items would allow both consistency and transparency of reporting. To the extent these allocations are addressed under transfer pricing policies, this will also add beneficial clarity and aid comparability of statements:
	• Free allowances – currently most groups allow the benefit of allocations under the NAP to impact their CSS figures while others add the benefit in. Currently these are not allocated under the same segments.
	    • Removing all benefit from free allowances (including a cost at approximate market value where relevant) as one of the companies has done would give greatest uniformity but require most work; this would also allow most consistency with reporting from 2013 when free allowances cease and with new generators in the market who did not receive free allowances
	    • A more practical solution is to instruct companies not to add in a market cost, thus reducing its generation cost; however this will give less consistency either between the Big Six, as they calculate amounts differently, or future periods and new entrants
	• Fuel costs – again, the treatment of this varies, both regarding what segment of the CSS they fall in and how they are calculated.
		The extent of the change required for businesses will vary based on the similarity of their current models to the preferred model that is determined and selected. While it will depend in the method, this cost could be comparatively high for one of the companies in particular and would rely either on detailed information and analysis by their trading entity or estimates.
		The lifetime of the benefit from common treatment of free allowances is limited as they expire at the end of 2012.
		Costs to other businesses are expected to be limited, especially as it is understood that the relevant information should be easily obtainable. There may be additional up-front cost to the Regulator from defining the standard to be met.

03. RECOMMENDATIONS FOR IMPROVEMENT
Expected benefits, costs, and risks of changes

OVERVIEW	KEY BENEFITS	KEY COSTS/BARRIERS
R7. OFGEM to provide more detailed guidance on the scope and definition of exceptional items		
OFGEM should update the guidelines for the CSS to include instructions on the definition and treatment of exceptional items.	The main benefit would be increasing comparability across the Big Six. This would ensure statements are drawn up in consistent manner and are thus more comparable. Also by establishing the principles which apply to 'discretionary' reconciling items it will increase the information value of the CSS. If a more standardised method of preparation is established under R3 above, this will also make reconciling items comparable, as the starting and end point would be the same for all entities. This would enable reconciling items to be better analysed into reconciling items required by the license condition (e.g. non-licensed activities excluded) and exceptional items. The requirements should also state that any exceptional items are clearly labelled within the CSS together with an explanation of why they have been excluded. We would also suggest that only a limited number of items are allowed to be excluded. We would suggest: • Mark to market adjustments; • Restructuring costs which been disclosed as such in the original financial statements; and • Items relating to disposals or major plant disposals.	Further guidance could be issued on the treatment of exceptional items. This should take into account the points in R3 to ensure that there is a common starting point together with further guidance on the transparency of restructuring costs, disposals of business segments and fair value adjustments. For each of the entities, the cost of complying with additional guidance would be minimal as this is really just an extension on the existing disclosures given with the CSS. There would be no barriers to each of the entities complying with additional guidance.
R8. OFGEM to instruct the Big Six to reconcile the CSS to the same starting point		
OFGEM should define Revenue, Cost and EBITDA pre any exceptional column as the starting point of the reconciliation. This guidance should also deal with associated companies and joint ventures.	The main benefit would be increasing comparability across the Big Six. This will ensure a common starting point and it is what the majority of companies do anyway. In determining a common starting point for the reconciliation, we believe that the format adopted by one of the companies provides the most clarity and transparency on the reconciling items. We would suggest that guidance should be issued stating: "In reconciling the CSS to audited financial information, the reconciliation should adopt a columnar approach ensuring that each line item in the CSS (revenue, other revenue, direct fuel costs, other direct costs, indirect costs, EBITDA, EBIT and volume is reconciled to audited financial information, or other published information in the case of volume. Narrative should be included for each reconciling column to enable the user of the CSS to understand the nature of the reconciling item."	This would require change by companies which don't, and thus require additional work from their finance teams to comply with OFGEM's requirements. The cost should however be fairly minimal particularly if R3 is introduced.

www.bdo.co.uk