Consumer Focus response to Ofgem consultation on Improving Reporting Transparency

March 2012

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

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General commentary

Increased transparency in financial reporting by the Big 6 has the potential to increase understanding of where the value – and profit – exists in these vertically integrated firms. The level of profitability and whether this is considered to be 'fair' has been of long standing concern to consumers. Historically Consumer Focus has been supportive of Consolidated Segmental Statements (CSSs). While the initial proposals were imperfect, we believed they could represent an important tool for increasing consumer confidence that Big 6 profits are 'fair'. We believe consumer concerns over profitability, and by implication the extent to which they believe the energy market is competitive, have significantly contributed to the low levels of consumer engagement with the market, as evidenced by declining levels of switching and the large cohort of 'sticky' customers. Poor consumer engagement with the energy market has been rightly identified by Ofgem as a major barrier towards effective and efficient market operation.

We would welcome greater clarity on the objectives and audiences of the CSSs. The greatest detail is found in the impact assessment which signposts consumers and 'independent market participants' as the principal beneficiaries from the CSSs (1.2 and 1.3, appendix 6).

For the avoidance of doubt, we do not consider the CSS to be of significant use to a consumer audience at this time – or that this would be altered by the recommendations you propose to take forward.

In our view, the failure to take forward BDO's recommendations for the reporting of trading activities will mean that the CSS continue to give a misleading picture of the value of generation assets. Noting that 'the other audience' for the CSS is intended to be independent generators and suppliers we would like to see you provide evidence that they value, and would use, the CSS in the form that you propose to retain them. In the event that they do not, we would prefer to see the CSS entirely scrapped rather than continued in a sub-optimal form. Put bluntly, there is a cost associated with maintaining the CSS and it is not clear to us that any of its perceived 'users' will actually find it useful in the form you propose.

While the CSSs offer simplified financial reporting (compared to financial statements required under law), they remain somewhat technical and are unlikely to be directly accessed by consumers. The media is likely to use CSSs as an information source to inform the public debate on Big 6 profitability. It is therefore important the CSSs provide a robust and transparent account of the profitability of the different components of the GB electricity and gas markets. We are concerned that the proposals will not be fit for this purpose. There still appears considerable scope for companies to under-report profitability, principally due to the continued opaqueness of trading arms, which represent something of an information 'black hole'. There is a risk that CSSs could introduce misleading information into the public sphere, which will ultimately serve to erode, rather than rebuild, consumer confidence in energy companies.

The other principal audience for the CSSs is new market entrants, who may benefit from a better understanding of the energy value chain of the Big 6. Ofgem has rightly identified that the entry of new market participant could deliver improved competition and hence better value for consumers. We agree: however, it remains unclear what value new market participants place on CSSs as a tool to inform their commercial decision making.

We would welcome explicit acknowledgment of the role that CSSs could play in helping new (and potential) entrants to make informed commercial decisions.

We believe there is a case for further efforts to engage with this stakeholder community to better understand how, or indeed whether, CSSs can meet their needs.

A key reason for Ofgem's decision not to proceed with BDO recommendations 4 and 5 is that it believes the method of financial reporting would adversely impact upon a company's ability to decide its own business model and that there could be disproportionate costs involved in doing so. We do not find these qualitative statements compelling. Companies' (published) financial reports exist to report business activity to key external stakeholders such as shareholders, not define their business model. Management accounting (generally treated as commercially sensitive) exists to inform and drive internal business decisions. We are disappointed that the BDO work does not provide greater clarity on what elements are already captured in companies' management accounts: paragraph 2.2 suggests that BDO only 'requested internal documents'. This information would have been very helpful to assess the likely costs associated with reporting information that would make the CSSs more informative. Using information already captured by management accounts to inform CSSs is likely to be less disruptive to companies and could be delivered at lower cost than 'new' information.

In summary:

- We welcome Ofgem commitment to implementing recommendations 2, 3, 6, 7 and 8
- We believe BDO's other recommendation could deliver real benefit to consumers through increased confidence that Big 6 profits are 'fair' and through helping new market entrants better understand the energy value chain
- We would urge greater clarity on the objectives of the CSS, in particular with reference to consumer and new market participants (these audiences are somewhat buried in appendix 6 and the process would benefit from more explicit explanation on the likely benefits of CSSs to these groups)
- Trading arms continue to represent a reporting 'black hole' and seriously undermine the ability of CSSs to deliver benefit
- The current proposals risk creating CSSs that could be misleading by providing the opportunity for the understatement of profits

Response to consultation questions

Chapter Two

Question 1: Do stakeholders agree with, or have any comments on, BDO's findings on the transfer pricing methodologies employed by the Big 6?

We agree with the statement on page 4 of the BDO report, where they observe:

'rigid hedging policies imposing volume and timing requirements on generation and supply businesses *may move the potential for profit around the group* [Consumer Focus italics]: 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'.

We feel that one purpose of the reports should be to provide greater clarity to consumers on the split in profits between supply and generation arms of vertically integrated energy companies. This will enable consumers to better judge whether profits generated by energy companies are 'fair'. Improving the perception that profits are 'fair' is essential for increasing consumer engagement with the energy market, which Ofgem has identified as being key to the energy market operating efficiently and in consumers' interests. Ofgem's current thinking is not to take forward BDO's recommendation 4 which would provide greater understanding of trading arm financial activities.

We feel that the trading arm represents a transparency and reporting 'black hole' under the proposals. Current transfer pricing, as identified by BDO, may allow for the movement of profit around the group, for example from supply to generation. The assertion that transfer pricing methodologies are 'broadly...fit for purpose' (page 5) does not provide reassurance because the outcome of that 'fair' transfer remains publicly invisible. This creates a risk that the accounts are as likely to mislead as inform the public on the level of profitability of generation assets.

Question 2: Do stakeholders agree with, or have any comments on, BDO's findings on how the Big 6 account for long term hedges?

Agree. It seems reasonable to exclude mark to market gains and losses from CSSs since the underlying transactions do not relate to the year covered in the statements.

Question 3: Do stakeholders agree with, or have any comments on, BDO's findings on how each firm represents energy trading activities?

We agree that 'current trading entities/divisions represent a 'missing link' between the generation and supply segments and the WACOE/WACOG shown in the supply segments' and there 'could be missing profits in the unreported areas' (page 8).

As noted in 2.16 the way energy trading activities are run 'makes it difficult to compare the statements of different companies, and to compare the per unit generation revenues and electricity supply fuel costs'.

This is another example of the current opacity in the CSSs which do not allow a clear and comparable assessment of where the value – either in generation or supply – lies in vertically integrated companies.

Such information would be invaluable in improving consumer confidence in energy companies, increasing engagement with the market and market function.

Question 4: Do stakeholders agree with, or have any comments on, BDO's findings on how each company treats exceptional items?

We agree that there is a need for a common treatment of how companies treat exceptional items to ensure comparability. However, the BDO report (page 9) notes that the purpose of the CSS still needs to be determined eg to show on-going profits. We agree there is uncertainty over what the objectives are and who the audience is for CSSs.

Question 5: Do stakeholders agree with, or have any comments on, BDO's findings on the consistency of treatment regarding Joint Ventures and Associates?

We agree that comparability between Big 6 companies is reduced because they reconcile to different line items for CSS to statutory information. BDO's recommendation to define Revenue and EBITDA pre exceptional column as the starting point of the reconciliation seems appropriate.

Chapter Three

Question 6: Do stakeholders agree with, or have comments on, our proposal to not take forward recommendation 1?

We do not agree at this time.

The consultation assumes that costs will outweigh benefits were this recommendation to be taken forward, but it does not plausibly quantify either. We feel that the benefit from increasing short-term comparability to the efficient market operation could offset the additional accounting costs.

While we accept that the difference in financial year-ends will be less significant when using CSSs for more long-term analysis of Big 6 profitability, we consider there would be some value in using CSSs to inform short-term analysis. For example, the recent interest in comparing the relationship between volatility in wholesale prices and supplier energy prices would be better served by CSSs reconciled to the same year-end.

We would like to see a more detailed assessment of the costs and benefits of this recommendation before you discard it.

Question 7: Do stakeholders agree with, or have comments on, our proposal to take forward recommendation 2?

We agree.

The limitations of the CSSs will require ongoing monitoring and improvement if they are to provide significant value to consumers and new entrants. A robust and critical annual appraisal of the reports should serve to improve them. However, we are concerned that even when recommendations that appear to offer improvement in the CSSs are made, they may not be adopted. Insufficient specificity in the CSSs' objectives makes this more likely. We would hope that further refinement of the CSS objectives would enable future audits to be more targeted in their recommendations and assessments.

There is some merit is agreeing – and 'fixing' – the CSSs framework early as continued change delays the establishment of a data set of comparable annual results. However, we are concerned that if the CSSs remain unfit for purpose, there is limited value in fixing them early.

Question 8: Do stakeholders agree with, or have comments on, our proposal to take forward recommendation 3?

We agree.

The application of accepted accounting rules and practices seems a prudent and necessary step in the establishment of robust and comparable CSSs. We feel that improved understanding on the elements already reported by the Big 6 – in particular those contained in management accounts – would provide information invaluable for the assessment of the degree of difficulty attributable to the reporting of commercial activities out of the current scope of CSSs.

Question 9: Do stakeholders agree with, or have comments on, our proposed way forward on recommendation 4?

We do not agree.

We agree that the reporting of non-speculative trading function results would increase the visibility of income and profits across a wider part of the value chain. The proposal to leave trading arm activity out of scope represents an accounting 'black hole'. BDO have highlighted a number of weaknesses from the current arrangements, for example:

'Trading entities represent a 'missing link' between the generation segment and the WACOE/WACOG shown in the supply segments' – this makes it harder to understand where the value is added within vertically integrated companies and provides more accounting 'flexibility' on where profits are reported.

We agree with BDO's observations that there 'could be "missing profits" in the unreported area'. This allows scope for the underreporting of profits; as we pointed out earlier, this risks producing CSSs which are misleading. This will be counterproductive in terms of restoring consumer confidence in the equitability of Big 6 profits.

We are reassured that BDO found the transfer pricing arrangement between generator and trading arm, and trading arm and supply, to be reasonably transparent and fit for purpose. However, the absence of transparency in the activities of the trading arm – which could both add or reduce value in the value chain – is a significant constraint on the ability of CSSs to shed light on where profits are made. The difficulty in distinguishing speculative and non-speculative activity within the trading arm is cited (3.17) as one reason not to seek progress recommendation 4. It seems rather that this is a very strong reason to progress recommendation 4 since value within the trading arm could (under the current proposals) legitimately be described as speculative activity – and hence outside the scope of the CSS – when in fact a more robust and enforceable definition of speculative activity might classify it as within scope and hence a contributor to profits. This represents another avenue which could lead to the under representation of profitability.

The media – and by implication the public – have an interest in understanding the profit margin that companies make. The continued opacity in trading arm activity means that when profit margins are inferred from the CSSs they are unlikely to offer a fair representation of actual levels of profitability.

One of the reasons Ofgem is proposing not to take forward recommendation 4 is the possible large resource implications. The absence of any quantitative assessment of the likely materiality of the resource required makes it hard to perform even a rudimentary Cost Benefit Analysis of the proposal.

The main value of the check list (appendix 2 of the consultation document) appears to lie in informing the scope of further transparency work. Greater value from the check list is prevented by the lack of materiality assigned to some of the individual elements.

However, new entrants may find some value in this information and we would welcome an assessment of whether this is the case. We feel further there may be merit in further examining the utility of a materiality assessment of some elements of the checklist for new entrants.

Question 10: Do stakeholders agree with, or have comments on, our proposal to not take forward recommendation 5?

We do not agree.

Transfer pricing methodologies are a major determiner of how value is accounted for, and transferred, within the value chains of the Big 6. While the wholesale market price is used by most energy companies as the basis for their transfer pricing, the inconsistent application of adjustments by the Big 6 reduces the comparability of the CSSs.

BDO highlights that further work is needed to increase confidence in the reporting based on current transfer pricing methodologies. We also feel that the determination in 3.21 that the 'alternatives to current methodologies...could not be expected to offer any clear improvement' is surprising. The transfer pricing methodologies have been developed independently by the Big 6 – to meet the needs of their business models – and it seems almost improbably serendipitous that alternative transfer pricing methodologies which offer superior comparability do not exist.

We support BDO's recommendation that further work is required to understand the extent to which transfer pricing in its present form is compatible with increased transparency. The liquidity of the energy market and the extent to which the market might be made only by the tested parties at any point seems a legitimate concern, as does the need for improved understanding of hedging policies. We note that BDO considers the cost to business of this proposal to be limited compared to recommendation 6 which Ofgem are minded to take forward.

Question 11: Do stakeholders agree with, or have comments on, our proposal to include generation fuel costs in all the segmental statements (recommendation 6)?

We agree: this represents an important step in improving the CSSs. We feel the greatest benefit will come from where the fuel costs for the generation segment can be clearly linked through to the supply business for the period covered by the CSS. Further work in understanding the fuel hedging strategies of the Big 6 will be necessary to achieve this.

We feel the first important step would be to establish reporting based on a £MWh energy price for both generation and supply arms.

We are unclear whether it will be possible to infer the fuel spread for the generation side of the business, but feel this would be an important addition to the transparency of the reporting.

Question 12: Do stakeholders agree with, or have comments on, our proposal to include the revenues associated with the free EU ETS allowances in the segmental statements (recommendation 6)?

We agree. The different treatment of EU ETS allowance in the 2010 results produced a significant source of disparity which reduced the comparability of the CSSs.

Question 13: Do stakeholders agree with, or have comments on, our proposal to take forward Recommendations 7 and 8?

We support the use of EBITDA pre any exceptional items as the basis for reconciliation with each companies. We note that BDO consider this complementary to recommendation 3 and unlikely to add additional cost burden to companies.

Question 14: Do stakeholders have comments on our proposal to request the provision of information on capital employed?

We would welcome greater transparency and information regarding return on capital employed. Electricity Market Reform will result in increased intervention and subsidy in the electricity market. This will require greater scrutiny of the Big 6's ability to provide value for money in their investments and give consumers confidence that profits are 'fair'. We do not believe that the current reporting structure provides sufficient confidence to underpin the £200 billion in investment that Project Discovery highlighted.

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