Accountants & business advisers

Private & Confidential

Ofgem
9 Millbank,
London,
SW1P 3GE

Our ref: DH

18 March 2013

Dear Sirs,

Re: Improving Transparency – Review of Consolidated Segmental Statement – E.ON UK plc

In accordance with the terms of our agreed proposal of October 2012 setting out our scope of work, we have carried out an independent review of E.ON UK plc's Consolidated Segmental Statement (CSS) for the 12 months to 31 December 2011.

1. Scope of our review

The aim of the work is to review the submission of the 2011 Statement covering relevant licensees (e.g. generator and supply licence holders but excluding the energy trading business) to:

- assess whether the licence condition (and Guidelines) has been interpreted appropriately, with particular attention paid to the modifications made in August 2012; and
- assess whether the Statement's reconciliation with the company's group accounts has been carried out appropriately. Part of this should be to assess the suitability of the use of notable items in the reconciliation on a per-company basis.

The review was specifically limited to E.ON UK's published CSS and the published group accounts. In undertaking the review, no information or explanation was sought from E.ON UK or its auditors and we have not considered the accuracy of information provided in the CSS or tested its reasonableness.

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2. Results of our review

We have presented the results of our review under the following sub-headings:

- *CSS profit and loss table*[1] *and financial information interpretation* reviews the information submitted in the CSS profit and loss table and its supporting notes, which explain what the various volume, cost and revenue items represent.
- *Transfer pricing* reviews the explanation of the transfer pricing methodologies that E.ON UK employ and are required by Ofgem to include in their CSS. Transfer pricing applies to sales and purchases between companies within the same group (i.e. generator, supply companies and energy trading arms).
- *Joint ventures and associates* reviews the requirement for the CSS to include the proportions of volume, cost and revenue for joint venture and associated companies that are represented by E.ON UK's investment in these licensed businesses.
- *Business function statement* reviews the table and supporting notes that show the separation of the specified business functions across generation, supply and another part of the business.
- *Reconciliation to group accounts under IFRS*[2] reviews how the CSS segmental information may be reconciled to audited segmental information in the group accounts.

2.1 CSS profit and loss table and financial information interpretation

E.ON UK is one of the world's largest investor-owned power and gas companies and is represented in the UK by E.ON UK plc. E.ON UK plc disposed of its Energy Trading business to E.ON Energy Trading SE (EET) on 1 January 2009 and since then E.ON UK has operated with separate UK generation and UK supply businesses. E.ON UK plc has contracts with EET for the production capacity of its generation fleet. EET trades fuel, electricity and gas, and sells it to its UK generation and supply businesses.

The CSS profit and loss table has been prepared in accordance with the licence condition and shows generation, electricity and gas supply by domestic/non domestic/aggregate and is in line with the Guideline notes on revenue, cost, EBITDA[3], DA, EBIT and volumes. We confirm notes on revenue from sales of electricity and gas, other revenue, direct fuel costs, other direct costs, indirect costs, WACO E/F/G[4], volume and aggregated supply business are included. We note that E.ON UK explains the components of the WACO E/G but does not indicate whether this list is exhaustive.

A high level description is provided of how shared costs[5] have been allocated across the segments, although more information on the cost drivers that are used would be useful. There is also an explanation of how Renewable Obligation Certificate (ROC) costs are allocated across the segments, although no mention of the basis of the allocation of Feed in Tariffs (FITs) is made. There is also no information on the treatment of the Reconciliation by Difference (RBD) costs and no explanation on the lack of 'Other Revenue' in the supply businesses. The relevant licensees are listed within the CSS but we have not considered whether the list is complete.

[1] See Annex 1 to Ofgem's Guidelines
[2] IFRS – International Financial Reporting Standards
[3] EBITDA – earnings before interest, taxes, depreciation and amortisation
[4] WACO E/F/G – weighted average cost of electricity / fuel / gas
[5] Shared costs are those which are relevant to more than one segment

2.2 Transfer pricing

E.ON UK provides an explanation of the transfer pricing methodology used by the relevant licensees and how this relates to the revenue, cost and profit information in the CSS. E.ON UK explains that its trading arm pays its generation segment for its generation output ahead of time. This payment includes a contribution to pay for the use of generation capacity (the capacity payment) as well as payment for fuel and the value of EU allowances. E.ON UK explains that the value of the capacity payment is related to the relevant market forward prices of electricity at the time of the sale.

With respect to the transfer prices between the trading arm and supply, E.ON UK explains that their supply business buys nearly all their electricity and gas from EET on an arm's length contract using traded market arrangements. E.ON UK provides no definition of these two terms, which would be helpful to a reader of the CSS. E.ON UK states that the full costs of these contracts are included in Direct Fuel Costs, but any profits/losses through changes in the valuation of contracts are excluded from the CSS. They do not confirm that the transfer pricing methodology reflects how each licensee acquires energy, which is required by Ofgem.

2.3 Joint ventures and associates

E.ON UK plc ensures that the information provided in the CSS includes any Joint Ventures and Associates. A clear and full explanation is given and there are only two relevant joint ventures, namely inclusion of its 50% shareholding in Corby Power until 4 May 2011, and exclusion of its 30% stake in the London Array offshore wind farm because it is not yet operational. These appear to have been dealt with in accordance with the Guidelines.

2.4 Business function statement

The business function statement[1] has been completed by E.ON UK and explanatory notes included.

2.5 Reconciliation to group accounts under IFRS

E.ON UK has reconciled its earnings before interest and taxes for the generation and supply segments within the CSS to its group accounts for E.ON UK plc (page 55). The reconciliation between these two sources is mathematically correct. Furthermore, we have not identified any further reconciling items from our review of the group accounts. While the CSS includes revenue by segment extracted from the E.ON UK plc accounts, this has not been reconciled to the CSS segmental revenue.

We note that because this review has only focused on the CSS and group accounts there may be items that are not published by E.ON UK in either document that would be apparent from a review of the underlying records. While including these items would increase the accuracy of the reconciliation we do not believe they would affect the level of profitability that E.ON UK reports.

[1] Annex 2 to Ofgem's Guidelines

3. Opinion on E.ON UK's CSS submission

As a result of our review, which was limited to the information within the published CSS for 2011 and the related published group accounts, we confirm that, in our opinion, the relevant licence conditions (19A of the electricity and gas supply licences, and 16B of the generation licence) and supporting Guidelines issued by Ofgem have been interpreted appropriately and the Statement's reconciliation with group accounts has been carried out appropriately other than any exceptions stated above.

This letter has been prepared for the information and benefit of the addressees subject to their agreement to the terms and conditions of our engagement and the aggregate limitation of liability set out therein and no other party may place reliance on any matters contained herein.

Yours faithfully,

PKF (UK) LLP.

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