



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 – RWE npower

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 RWE npower'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 RWE npower's published CSS and the published group accounts. In undertaking the review, no information or explanation was sought from RWE npower 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 table¹ 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 RWE npower 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 RWE npower'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 IFRS²* 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

RWE npower, part of the RWE Group, is an integrated UK energy company. They supply gas and electricity to residential and business customers and operate and manage a portfolio of flexible coal, oil, biomass, and gas-fired power stations. They also manage a portfolio of co-generation plants.

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, EBITDA³, DA, EBIT and volumes. Out of scope activities include co-generation assets and energy services such as boiler installation, maintenance and consultancy and engineering and technical consultancy provided to third parties. We confirm that notes on revenue from sales of electricity and gas, other revenue, direct fuel costs, other direct costs, indirect costs, WACO F⁴, volume and aggregated supply business are included. RWE npower confirms that electricity and gas costs reflect the costs of procuring electricity and gas to meet customer requirements. However, there is no reference that these costs, or other contributing elements of the direct costs for supply, are included in the WACO E/G.

A high level description is provided of how shared costs⁵ have been allocated across the segments, although more information on the cost drivers would be useful. There is also an explanation of how individual costs such as Feed in Tariff costs and Renewable Obligation Certificate (ROC) costs are allocated across the segments. There is no explanation of why there is no Other Revenue recorded in the CSS table. There is, however, no information on the treatment of Reconciliation by Difference (RBD) costs.

2.2 Transfer pricing

RWE npower 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. RWE explain that their trading

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.

arm, RWE Supply and Trading (RWEST), pays their generation arm for the option to use the generation capacity. This agreement allows RWEST to deliver gas and coal to their power stations and have this converted to electricity. The agreement is tied to a market price one to two years ahead of time.

With respect to the transfer prices between the trading arm and supply, RWE npower explains that their retail business fulfils its wholesale commodity requirements via RWEST on an arm's length basis. RWE npower provides no explanation of what this means, which would be helpful to a reader of the CSS. Neither does RWE npower confirm that the transfer pricing methodology reflects how each licensee acquires energy, which is required by Ofgem.

2.3 Joint ventures and associates

RWE npower ensures that the information provided in the CSS includes any Joint Venture and Associates. There are two joint ventures, Horizon (a nuclear power development), which is excluded because it does not hold a licence, and Greater Gabbard (an offshore wind farm), which is included.

2.4 Business function statement

The business function statement¹ has been completed by RWE npower and explanatory notes included.

2.5 Reconciliation to group accounts under IFRS

RWE npower has claimed exemption under the Companies Act 2006 from producing UK group accounts. RWE has carried out the reconciliation using the RWE AG² group accounts of which the UK group is a part. Outside of the operations in Germany, the segments shown in the RWE AG group accounts are geographic with the UK as a separate segment. The UK segment revenue and profit are stated in euros (page 184 of the group accounts) and translated to Sterling at an exchange rate of EUR 1.148 to the GBP. The reconciliation is carried out for turnover and EBITA³ for the UK segment. The reconciliation has not been undertaken at CSS generation and supply level because the RWE AG group accounts do not include this information. 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.

We note that because this review has only focused on the CSS and group accounts there may be items that are not published by RWE npower 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 RWE npower reports.

¹ Annex 2 to Ofgem's Guidelines

² RWE AG – The parent company of RWE npower

³ EBITA – earnings before interest, taxes and amortisation

3. Opinion on RWE npower'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,

A handwritten signature in black ink that reads "PKF (UK) LLP." The signature is written in a cursive, slightly slanted style.

PKF (UK) LLP