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 – ScottishPower**

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 ScottishPower'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 (eg 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 ScottishPower's published CSS and the published group accounts. In undertaking the review, no information or explanation was sought from ScottishPower 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 ScottishPower 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 ScottishPower'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*

ScottishPower has been part of the Spanish Iberdrola Group since April 2007. ScottishPower Generation operates generation assets in Great Britain and manages the group's exposure to the UK wholesale electricity and gas markets. It operates 6000 MW of generating capacity comprising coal, gas, and pump storage and hydroelectric. ScottishPower Renewables is the UK's largest developer of onshore wind farms with over 30 wind farms fully operational, under construction, or in planning. ScottishPower has a separate Energy Management function, which does not form part of the generation and aggregate supply segments.

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. We confirm notes on revenue, cost, EBITDA[3], DA, EBIT and volumes are included. We confirm that notes on revenue from sales of electricity and gas, direct fuel costs, other direct costs, indirect costs, WACO F[4], volume and aggregated supply business are included. ScottishPower also provides an explanation of the components of the direct costs of electricity and gas supply, but does not indicate whether this list is exhaustive, nor does it provide an explanation of how these costs relate to the calculation of the WACO E/G.

There is no 'other revenue' recorded in either the generation or supply numbers, however it is noted that generation revenue includes all ancillary services, balancing mechanism and constraint management revenue. 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 individual costs such as Feed in Tariff costs and Renewable Obligation Certificate (ROC) costs are allocated across the segments. There is, however, no information on the treatment of the Reconciliation by Difference (RBD) costs.

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[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*

ScottishPower 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. ScottishPower explain that internal transactions are charged based on open market prices at the time of transfer. It is not clear, however, when this point of transfer occurs with respect to the purchase or use of the product being transferred or which entities are involved. The Business Function table submitted by ScottishPower suggests this transfer occurs between the generation segment and ScottishPower's trading arm: Energy Management.

With respect to the transfer prices between the trading arm and supply, ScottishPower provides some detail but does not confirm that the transfer pricing methodology reflects how the licensee acquires energy, which is required by Ofgem; neither is it clear which entities are involved.

*2.3 Joint ventures and associates*

ScottishPower ensures that the information provided in the CSS includes any Joint Ventures and Associates. It correctly reflects that ScottishPower Renewables was 80% owned and, on 11 July 2011, became a 100% owned subsidiary of Iberdrola S.A.

*2.4 Business function statement*

The business function statement (Annex 2 to Ofgem's Guidelines) has been completed by ScottishPower and explanatory notes included.

*2.5 Reconciliation to group accounts under IFRS*

ScottishPower has carried out the reconciliation using the Iberdrola S.A.[1] group accounts of which the UK group is a part. The Iberdrola S.A. group accounts state that a change was made in 2011 to show the renewables and remaining businesses as separate segments geographically. The revenue and profit for the separate UK renewables and remaining businesses are stated in euros (page 65 of the group accounts) and translated to Sterling at an exchange rate of EUR 1.1523 to the GBP. The Sterling equivalent is aggregated and reconciled to the CSS. The profit figure used in the reconciliation is after deducting depreciation and is stated to be EBIT[2]. The reconciliation has not been undertaken at CSS generation and supply level because the Iberdrola S.A. 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 ScottishPower 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 ScottishPower reports.

[1] Iberdrola S.A – The parent company of ScottishPower
[2] EBIT – earnings before interest and taxes

**3. Opinion on ScottishPower’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.

**PKF (UK) LLP**