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 – SSE

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 SSE's Consolidated Segmental Statement (CSS) for the 12 months to 31 March 2012.

1. Scope of our review

The aim of the work is to review the submission of the 2011/12 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 SSE's published CSS and the published group accounts. In undertaking the review, no information or explanation was sought from SSE 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 SSE 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 SSE'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

SSE has changed its management and reporting structure for 2011/12. The published group accounts for 2011/12 were reported under three business segments -'Wholesale', 'Retail' and 'Networks':

- Wholesale includes EPM (the Energy Portfolio Management business that undertakes energy trading activities) as well as electricity generation,
- Retail includes Energy Supply, and
- Networks contain the monopoly distribution network operators that fall outside the scope of the CSS.

SSE state that this change has the benefit of more closely aligning the operating segments in the statutory financial statements with the CSS.

The CSS segmental 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 that 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. The listed cost components of electricity and gas supply appear to be fully listed. SSE provides a detailed list of the contributing components of the direct costs for supply that corresponds with the elements listed in Ofgem's Guidelines. We assume that the reference to direct costs should be to "other direct costs".

SSE's generation segment sells capacity rather than electricity to its trading entity Energy Portfolio Management (EPM). Fuel for electricity generation is purchased by EPM, which, as a trading entity, falls outside the scope of the CSS. SSE has included a notional weighted average cost of fuel for generation as a note as permitted by the Guidelines.

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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

A high level description is provided of how shared costs[1] have been allocated across the segments. 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 transport element of Reconciliation by Difference (RBD) costs.

2.2 Transfer pricing

SSE 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. SSE explains that its generation arm provides its trading arm the use of its capacity and charges this at market rates through a Power Purchase Agreement. As generation does not procure fuel, this payment does not include a cost of fuel charge. Output from its renewable fleet is charged at market rates.

With respect to the transfer prices between the trading arm and supply, SSE provides a description of the transfer pricing methodology and also includes a qualification that the methodology reflects how each licensee acquires energy, which is required by Ofgem.

2.3 Joint ventures and associates

The CSS states that revenues and earnings from joint ventures and associates are included but little detail is provided.

2.4 Business function statement

The business function statement[2] has been completed by SSE and explanatory notes included. While the table appears to have been compiled appropriately, SSE has labelled "P/L" as "Financial impact of that function recorded in that area". This contrasts with how "P/L" is recorded in the statements of four other companies, making the interpretation of the table more difficult.

2.5 Reconciliation to group accounts under IFRS[3]

SSE has reconciled its revenues and earnings before interest and taxes for the generation and supply segments within the CSS to its group accounts (pages 112 and 113). 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 SSE 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 SSE reports.

[1] Shared costs are those which are relevant to more than one segment.
[2] See Annex 2 to Ofgem's Guidelines
[3] IFRS – International Financial Reporting Standards

3. Opinion on SSE's CSS submission

As a result of our review, which was limited to the information within the published CSS for 2011/12 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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