British Gas response to consultation on improving the transparency of energy company profits - Appendix A

We have set out below our comments on the specific questions Ofgem have asked in the consultation document. We would be happy to discuss these comments in more detail if that would be beneficial.

Question 1: Would a full financial audit provide greater reassurance about the robustness of the Statements? How much would these audits cost?

We agree that a full financial audit of suppliers' Consolidated Segmental Statement (CSS) submissions would provide additional assurance to users of the statements. We already instruct our independent auditors to provide assurance that our CSSs meet the requirements of the relevant licence conditions, and would be happy to extend the role of our auditors to also include a full financial audit[1] of the statements themselves.

We recognise this will represent an increase in costs for large energy companies[2], but argue this should be mitigated by allowing energy companies to use their existing independently appointed auditor to undertake the work. The existing level of knowledge these auditors would bring would enable greater scrutiny, and allow the work to complete as part of the full audit of annual group accounts.

Centrica are happy to make a voluntary undertaking to do this for our 2013 CSS.

Question 2: Do you have further information on the appropriateness of the companies' transfer pricing policies beyond BDO's detailed findings? Is there more that could be done to provide reassurance in this area?

No. All our trading is managed by independent teams operating at 'arm's length'. It is our policy that trades are conducted between business units at market prices. We therefore have confidence that our transfer pricing methodology is appropriate.

Question 3: What information could the companies usefully provide on their trading functions that would improve the transparency of the profits in their generation and supply businesses? What are the costs and benefits of including the trading function in companies' Statements? How possible is it to distinguish between trading for hedging and speculative purposes?

We believe it is straightforward for energy companies to separate out speculative trading activity defined as taking of a market position in pursuit of a profit from the trades themselves, rather than the management of cost effective supply for customers or the risk management of assets. Given this, we agree that the inclusion of speculative trading results from our generation business would improve the transparency of the CSS. Centrica already publishes this in our financial reports[3], and plan to change our CSS so that it follows the best practice adopted by Scottish Power on this point. This can be done at no additional cost.

The benefits of including the speculative trading function within the CSS will only be realised however if all companies are obliged to provide such data in a consistent format, using clear and unambiguous definitions which enable fair comparison. It is likely therefore that Ofgem will need to provide guidance on which products and which markets this applies to.

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[1] In accordance with ISAE805.
[2] An estimate of this cost is provided confidentially in Appendix B to this response.
[3] Link: http://www.centrica.com/index.asp?pageid=1175. Specifically, see the "Business Units Performance and Indicators" release.

Please note that energy companies also undertake hedging trades which are not speculative in nature, i.e. are designed to reduce the volatility of earnings arising from fluctuations in market prices. We do not consider that the profits and losses on these trades are associated with the trading function of energy companies and hence do not think these merit further disclosure. Energy companies should therefore be allowed to continue including them within the figures provided for generation activities.

Question 4: Do you agree with the proposal of reducing the deadline for companies to compile and publish their Statements from six to four months? What are the costs and benefits of doing so?

We believe that the earlier publication of the CSS will increase the value and relevance they have, and therefore support Ofgem's proposals in this area. As above, we plan to prepare our CSS alongside our 2013 financial accounts, due at the end of February. We are therefore happy to bring forward the publication of the CSS to April.

Question 5: Do you consider that there is merit in calculating a ROCE for the generation businesses of the six large energy companies, but not for their supply businesses? Are there any specific issues with how ROCE should be calculated for generation?

We support the inclusion of a return on capital employed (ROCE) for generation activities. This is a widely used metric which can be compared with weighted average cost of capital, generally regarded as the best indicator of the return required by investors in capital intensive industries.

We propose capital employed is defined as the monthly average of all generation capital excluding borrowings, cash and cash equivalents, pensions and any derivative related balances[4], and earnings is defined as earnings before interest but including tax. When calculating ROCE, the treatment of joint ventures and financing arrangements can differ, so consistency should be established for these items.

We agree with Ofgem that ROCE is not a relevant measure for supply businesses, given these are not capital intensive. We believe profit margin remains the most appropriate comparable measure for supply activities.

Question 6: Do you have any suggestions for improvements to the format and content of our annual Summary Document on the Statements? What more could the companies do to improve the presentation of their Statements?

We consider that the transparency, comparability and format of the statements could be improved in two key ways:

1) Generation activities should be split out further between nuclear, wind, thermal and other. This would significantly improve the comparability of the generation profits and commodity costs. As above, we will voluntarily include this in our 2013 CSS; and

2) Costs should be broken down into wholesale energy (fuel), delivery to home (transmission and distribution), environmental and social policy costs (for example Energy Company Obligation, Feed in Tariffs and the Warm Homes Discount), and operating costs. This would give users comparable numbers which they are increasingly familiar with through the wider energy debate, and reconcile costs with the values published on customer communications such as the bill and Annual Statement.

[4] IAS39

Question 7: How else could Ofgem or the energy companies themselves improve confidence in the energy markets?

See our response to question 6, above.