Mr Diego Villalobos
Ofgem
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6 December 2013

Dear Mr Villalobos

Response to consultation, "Rebuilding consumer confidence: improving the transparency of energy company profits"

Thank you for providing us with an opportunity to respond to this consultation. Our submission is entirely non-confidential and may be published on your website.

We provide more detailed responses to the specific questions posed in the annex to this document, but would first like to set these responses in some context.

The Consolidated Segmental Statements ("CSS") are used to inform the public debate around the level of profits of the firms. The yardstick for whether they are a success or not is therefore whether there is evidence that they are useful or reassuring to that public audience.

In their current form, we would argue that they are not. The CSS are significantly aged by the time of their release; the absence of data on trading activity means that they only give a partial picture; and the absence of full independent audit and difficulties in reconciling them with statutory accounts mean that it is hard for a third party to have confidence in their validity.

We think that these deficiencies can be tackled, however their existence is not new and Ofgem has previously rejected changes in these areas. When you last consulted on amending the segmental statements in 2012, making clear that you would only partially enact the BDO recommendations, we noted that:

> *"For the avoidance of doubt, we do not consider the CSS to be of significant use to a consumer audience at this time – or that this would be altered by the recommendations you propose to take forward"*

We specifically challenged whether anyone actually found the CSS useful, and argued that their value to stakeholders should be explored.

Only six bodies responded to that consultation, only one of whom (our predecessor body, Consumer Focus) was not a Big 6 licensee who was subject to the obligations.

Separately, the recent report and recommendations of the Energy and Climate Change Committee (ECCC) in its enquiry on Prices, Profits and Poverty make it clear that it found the current format of the CSS unsatisfactory,

> *“The actual level of profit in, for example, the energy supply arm is therefore difficult to establish. Greater transparency is urgently needed to reassure consumers that high energy prices are not fuelling excessive profits.*
>
> *[…]*
>
> *That the regulator has not taken up accountancy firm BDO’s recommendations to improve energy companies reporting … is astonishing and lays it open to criticism that it is unwilling to use the teeth it has.”*

We retain the belief that the CSS could potentially be of limited use if BDO’s recommendations are fully adopted. But for the avoidance of doubt, we would rather you entirely scrapped the licence requirement on the Big 6 firms to provide separate segmental statements than that they either stayed as they are, or that you went forward with the limited package of changes that you propose. Incomplete segmental statements are worse than no segmental statements at all - because they leave consumers paying for something that they do not find useful.

More positively, we find the weekly supply market indicators a very useful contribution to the energy debate and to public understanding of what is driving their bills because they provide a more contemporaneous view of profitability and costs than the CSS. We think they should be continued, and that they could be improved further if the headline cost categories were broken down to show their sub-components.

Yours,

Rich Hall

Richard Hall
Director of Strategic Infrastructure

Answers to consultation questions

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

It is important that you get a rounded view on costs, so in the event that only the obligated licensees provide evidence on this point we would expect you to seek independent advice before forming a view in order to mitigate the risk of gaming.

We consider that a full financial audit would provide greater reassurance about the robustness of these statements. As ECCC highlighted[1]:

> *'Auditors are subject to a regulation and supervision regime governed by the Financial Reporting Council. Audits must follow International Standards on Auditing, whereas accountants' reports can follow any format agreed in terms of reference. Auditors are also subject to ethical standards that are designed to limit conflicts of interest and maximise quality assurance. Non-audit engagements are not subject to these limitations. BDO recommended that an independent auditor provide an opinion on these statements.'*

BDO highlighted[2] four key benefits of this approach:

- Independence: that the opinion is not clouded by existing relationships with the companies;
- Context: that the auditor could usefully comment on the external factors and wider market conditions that influenced the results;
- Assurance: the results would be certified as accurate, complete and fair in a way that is not assured by the current process; and
- Continual improvement: that the auditor could provide feedback and commentary on best practice, implicitly to improve the quality of future reports.

BDO highlighted that there would be issues to resolve regarding how the audit was paid for, how its scope was defined in order to ensure that a useful and binding opinion can be reached, and the willingness of companies to open up confidential data to the auditor. On balance, it felt the benefits outweighed these barriers. ECCC concurred, noting that *'The potential cost and inconvenience to the large vertically integrated businesses would be eclipsed by the gains in confidence an audit would bring.'*

We agree with both BDO and ECCC, with two key reasons particularly influencing our views.

The first is trust. Polling repeatedly suggests that consumer trust and confidence in energy suppliers is incredibly low:

- In December 2013 yougov reported that only 3% of the public fully believed suppliers' explanation for price rises, while 30% only partially believed it, and 57% did not believe their justification[3].

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[1] Page 36, "Energy Prices, Profits & Poverty. Fifth report of Session 2013-14".
[2] This list is a truncated interpretation of the benefits shown on page 14 of "Ofgem Segmental Statements Review: BDO LLP Final Report – Version 5 – Non-confidential extract – 16 January 2012". http://tinyurl.com/pqc4vsw
[3] "The tricky politics of cutting our energy bills" yougov, 2 December 2013. http://tinyurl.com/nucmfom

- In November 2013 the Which? Consumer Insight Tracker suggested that only one-in-seven consumers' trust energy companies to act in their best interests[4].
- Edelman's 2013 Trust Barometer suggested that trust levels in UK energy suppliers are very low by international standards - only 37% of UK consumers trust energy firms to do the right thing (the global average trust score for the energy sector was 57%).
- A February 2013 uswitch poll[5] suggested that only four-in-ten consumers trust energy suppliers. 45% of those polled suggested their levels of trust in energy suppliers had decreased in the preceding two years, while just 10% suggested it had improved.

This backdrop means that a full financial audit of the CSS is necessary. Without this, consumers are being asked to take them on trust – and it is quite clear this trust does not exist. The halfway house of an independent review is not satisfactory, for the reasons identified by BDO; *'it is a desktop review with no enquiries made of the companies or their auditors […] it does not give an assurance'*[6].

The second reason is that in many cases it is difficult for a third party to relate the CSS back to the statutory accounts of the firms. You highlight this issue yourself in and around paragraph 2.14 and 2.15 of the separately published summary of the 2012 CSS:

> *'for three of the companies only the total UK revenue and profit has been reconciled. Even where segmental information has been reconciled, the statements include adjustments for excluded activities (such as the energy trading segment) which, without access to the underlying records, cannot be reconciled with the audited group accounts. Similarly, reconciling items, where shown, cannot be agreed with audited group accounts unless the company has chosen to include this information [...]*
>
> *To address this, BDO recommend that either the statements should be audited by the companies' statutory auditors, or the companies should be required to publish this supplementary information in their group accounts.'*

We have found reconciling CSS with group accounts frustrating and may not be alone in this. There is risk that it causes confusion and may actually further distrust in the companies, eg if there are unexplained mismatches. We think a full audit could remove that problem, not least because the auditor could set out an independent explanation of the differences to remove that gap in understanding.

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?

We remain of the view that you should adopt BDO's recommendation that the means to provide assurance on transfer pricing is to incorporate the results of trading

[4] "Consumer trust in the energy industry industry hits new low", 3 November 2013. http://tinyurl.com/nkh7dwk
[5] Press release, 22 February 2013: "Cold war: Just four in 10 trust their energy supplier, research finds". http://tinyurl.com/op59g23
[6] BDO verbal evidence to ECCC Prices, Profits & Poverty enquiry.

functions (in so far as they apply to UK activities) in the CSS. A full financial audit of the CSS should be carried out, as part of which the auditor should be asked to comment on the appropriateness of the companies transfer pricing policies. This would help to provide appropriate reassurance.

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?

Please see our answer to question 2.

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 agree with the proposal to reduce the deadline from six to four months. Indeed, we would challenge you to consider whether this deadline could be shorter still. We also think that Ofgem should commit to producing its annual analysis of the CSS earlier in the year.

Our reason for holding these views is that the utility value of this information is – not wholly, but in considerable part – time-limited. The more dated it is, the less informative it is in gauging the current level of competitiveness and profits in the energy sector. It still retains some value for trend analysis, but is of less use in understanding the contemporary activities of the suppliers.

A practical example of this can perhaps be seen in the recent publication of your analysis of the companies 2012 CSS on 25 November 2013. Understandably, media attention focused on the headline rise in average supplier profits from £30 (2011) to £53 (2012). The £53 figure was roughly in line with the estimated rolling average net margin at the end of 2012 shown by the supply market indicators (SMI). However, on the same day, 25 November, the SMI were showing an estimated current rolling average margin of £105 – approximately double the £53 figure which was heavily touted across the press.

We recognise that SSE having a March financial year end while the other five firms have a calendar year financial year complicates the picture. It would be beneficial if it could consider voluntarily producing CSS at the same time as the other firms. While there may be expense involved in this we think this should be considered in the context of the dismal level of trust suppliers currently enjoy. Put simply, mistrust also comes with a cost to suppliers – transparency may actually be the cheaper option.

If a voluntary approach is not possible, we think that mandation of the same year end should be treated as a serious option. While Ofgem appears to hold the view that this would be unreasonably expensive for limited further gains we are yet to see any quantification of these costs. Indeed, while we note that BDO did not formally quantify these costs either, its verbal evidence to ECCC suggested that it thought these would be limited and that the movement of ScottishPower's financial year reporting (when it was taken over by Iberdrola) may provide an evidence base to understand the quantum of these costs:

> *'Scottish[Power] changed its year-end not long ago from March to December, and you could probably find out from it how much it cost. I doubt that it cost a lot given the overall size of such businesses[7].'*

It is implicit that BDO considered that the benefits would exceed the costs given that they recommended aligning financial years. As professional auditors, we think you should give higher credence to its views – it is likely to have a much better intuitive understanding of the likely quantum of moving a financial year end than you do.

We consider that removing the three month lag in reporting years between SSE and the other firms would both improve comparability in results and also allow for analysis of all six sets of accounts to be published earlier in the year. This would make the results more informative and directly relevant to understanding current supplier financial performance. We think this would help in ensuring public trust in the sector – or in diagnosing and tackling problems earlier.

We note that suppliers typically produce their annual results far quicker than even the four months you propose. The following table shows the lag time between financial year end and results publication for 2012 (2012/13 in the case of SSE).

Company	Financial Year End	Annual results published	Lag time
Centrica	31 December 2012	Preliminary results 27 February 2013	1 month 27 days
SSE	31 March 2013	Full year results statement 22 May 2013	1 month 22 days
Npower (RWE)	31 December 2012	Annual report 2012 5 March 2013	2 months 5 days
E.on	31 December 2012	Annual report 2012 13 March 2013	2 months 13 days
ScottishPower (Iberdrola)	31 December 2012	Full year results 14 February 2013	1 month 14 days
EdF	31 December 2012	Full year results 14 February 2013	1 month 14 days

[7] Verbal evidence of Gervase MacGregor of BDO to ECCC, 9 May 2013.

These results may be unaudited at that time. However we consider that they should already have been subject to significant scrutiny given that all of the organisations are publicly listed and that there are serious consequences in giving misleading information to stock markets.

We would expect that the firms have systems set up to allow them to capture and report the items that they need to report in the CSS in the same way that they capture and report the items needed for their annual reporting. Given the separate proposal that the CSS are fully audited, we would expect the data to be "firm" for both purposes at the same time – because the two should be reconcilable against each other. We therefore consider that it should be possible for the suppliers to provide indicative CSS at the same time that they publish full year results. These statements could be subsequently affirmed – or corrected if necessary – with audited CSS within the four month window you propose.

Finally, we would suggest that Ofgem should commit to producing its annual analysis within two months of the publication of the audited CSS. This would appear to allow a reasonable amount of time for it to turn around this analysis while nonetheless ensuring the publication is sufficient quick for the data to remain relatively contemporary.

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?

Generation has different characteristics to supply in its capital intensiveness. We therefore recognise that there may be merit in calculating a ROCE for the generation businesses, though we regard this as a much lower priority than making improvements in other areas of the CSS such as their timeliness and ensuring they are fully audited.

In the event that ROCE is calculated, we would like to see this being produced as well as, rather than instead of, operating margin figures. This would help to ensure that trend analysis remains possible with the first four years of CSS where this data was not available.

We think that you would need to contextualise ROCE when producing your annual analysis as it has a significant 'lay' audience and ROCE may be a less intuitive concept to non-economists than profit margin is.

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 found this year's annual Summary Document engaging though of comparatively limited use to our work because it reflects a dated picture of supplier profitability. The principal area where we would suggest improvement is not in format and content but in timing. We would like to see the Summary Document produced much earlier in the year as part of a general truncation in the timetable for CSS production that should make their contents more relevant to the public debate – see our answer to question 4 for more details.

The main content improvement we would suggest is that we would welcome greater interrogation and contextualisation of the reasons why trends may be emerging. For example, in the 2012 report two areas stood out.

The first is on Operating costs. The data in Figure 16 shows a remarkable convergence in domestic supply operating costs across the first four years of the CSS. In 2009 there was a ratio of roughly 7:1 between the most expensive and the cheapest. By 2012 this had declined to roughly 2:1. The report offers no opinion on why this might be. We think that in any area where there are clear signs of a pronounced underlying trend it would be useful to understand your views on what may be causing that trend.

Secondly at the time the report was published its record of supplier profits in 2012 (£53) was roughly half that being shown as the current rolling average margin (£105) in the SMI. The CSS and the SMI differ in that one is a snapshot record of the past while the other is a contemporary estimate of the present. It is therefore quite possible that there will always be big differences between the margins they are showing – and that such differences are entirely legitimate. But where the two are divergent at the time of the annual Summary Document – whether because margins have increased, or decreased, since the year covered by the CSS – it would be useful to set out this context. It may be useful to give a summary of the two different tools and how they differ – the CSS and the SMI – and to signpost where the latter can be found.

As previously highlighted in the answer to question 4, we find it hard to reconcile a number of the CSS to annual reports. Whilst reconciliation is impossible, the CSS are not fully audited, and they are dated by the time of publication, we would not make any use of these Statements. Put simply, we do not regard them as a useful or particularly credible source of data - when doing analytical work, we normally refer to the SMI instead. For the avoidance of doubt, we would rather see the CSS scrapped than continued in their current form.

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

<u>Adoption of ECCC recommendations</u>

We provided very detailed views on this matter in our submission to the ECCC enquiry on Prices, Profits and Poverty – we retain those views; you may wish to read our submission. We found ECCC's final report an excellent synopsis of the contributory factors to the current crisis in consumer trust and would suggest that full adoption of its recommendations by Ofgem and the energy companies would go a long way to improving consumer confidence.

Treatment of tax and internal loans

In the last year, there have been several allegations that major suppliers use legal tax avoidance tools in order to mitigate their exposure to UK taxation.

In November, a documentary by Channel 4's Dispatches alleged that E.on's UK arm was loaned money at non-commercial rates by its parent company, and that this might have the effect of relocating where some profits relating to its UK activities effectively accrue. Dispatches argued that *'This could have resulted in the company reducing its taxable profits by as much as 50 per cent, with a potential UK tax saving as a result.'*[8]

In April, similar allegations were made against npower – that the repayment of internal group loans to a related Maltese shell company allowed it to avoid £108m in UK corporation tax[9].

It should be stressed that in both cases the companies deny any wrongdoing and there has been no suggestion of any illegality.

However, we think it is important that the impact of any use of such tax avoidance tools on the reported profitability of their UK activities is taken into account when the CSS are produced. This is because the nature of the alleged behaviour would appear to have the effect of artificially deflating the profitability of these organisations UK activities – making it look like participating in the UK market is less profitable than it actually is.

If the CSS are intended to provide confidence in the true level of profits in the UK then any artificial expatriation of profits, even if entirely legal, needs to be taken into account. We would like to see the full financial audit of the CSS include the auditor's opinion on whether the terms of any internal loans between group companies may have the effect of artificially deflating (or inflating) the reported profits within segments of firms' activities.

Cost drivers

The debate around the industry's revenues, costs and profits is normally at its most febrile during pricing rounds, particularly when these are price rises. Third party stakeholders such as Consumer Futures are particularly keen to understand what is driving these price changes in order to ensure adequate scrutiny of whether they are fair.

There are a number of areas where the opacity of the sector currently impedes this.

The influence of wholesale market price changes has featured heavily in price movement justification in recent years, however the absence of any credible public information on the hedging strategies of different suppliers makes it hard to reconcile the extent to which such cost pressures exist. We simply do not recognise the picture of price movements that is often portrayed by the suppliers from the wholesale price information that we track. We note that it does not appear that you do either; the

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[8] "Channel 4 Dispatches. Energy Bills Exposed". Monday 4 November 2013. http://tinyurl.com/otoyc9h

[9] "npower are avoiding tax despite all their claims to the contrary" - article on the Tax Research UK website. http://tinyurl.com/q5zeods

inferred hedged wholesale cost used in your supply market indicators (SMI) does not appear to support the magnitude of price rises we have seen in recent years.

Ofgem has tended to adopt the line that it is for suppliers to justify their own price rises. In ordinary circumstances, in a sector where price inflation was limited and the public was not unduly concerned that it was being taken for a ride, this would be quite a reasonable position. However, these are not ordinary circumstances and there may be more you can do to try and reassure the public. Ultimately, you are the regulator – you need to be prepared to regulate. We have challenged Ofgem in the past to consider using its information gathering powers under Article 40 (electricity) and Article 44 (gas) of the EU 3rd package to force suppliers to disclose their actual trading strategies and costs to you. We repeat that challenge. We think those powers could allow you to force the suppliers to reveal their actual costs to you – allowing you to take action if the data suggests their public claims are misleading.

In the area of network charges, these are known through the networks charging methodologies however these are split across many documents. It would help if there was a simple one-stop source that a user could go to that shows the estimated annual network charge per household, per region, by year. It may be that this is something that could be developed on a voluntary basis by the Energy Networks Association, or something that you would wish to consider developing. Such a tool might help mitigate the risk that network charges become a disputed cost in future price rounds as they did in the most recent price round[10].

Mismatches between justification for price rises and publicly available data – the example of ECO

The Energy Company Obligation, ECO, was heavily blamed by several suppliers for causing cost inflation in the most recent round of price rises. Suppliers need to be aware that their statements on the costs of delivering environmental and social programmes often appear mystifying and badly justified to an external audience. They need to do a better job if they are to convince consumers that they are incurring these costs and that they do justify bill rises.

To use a practical example of this, in its Autumn 2012 price rise announcement npower set a clear expectation that the introduction of ECO would cause it significant cost inflation in 2013 and that a need to cover these costs was a major causal factor of needing to hike prices:

> *"There are three main reasons why customers' energy bills are rising, which are:*
>
> - *Implementing government schemes such as CERT/CESP/ECO. Costs for this area will be approximately double in 2013 when compared to 2011.*
> - *[...][11]"*

[10] "Ofgem clashes with energy companies on impact of network charges" Financial Times, 14 November 2013. http://tinyurl.com/qfblen6

[11] "Press release: npower announces changes to gas & electricity prices" npower, 12 October 2012. http://tinyurl.com/bcref8k

It is hard to reconcile these claims against the ECO data that is publicly reported. The most recent data published by Ofgem[12] (based on the supplier's own submissions) suggests that by the end of August 2013 npower had met only 3% of its obligations against the CERO target, only 2% of its obligations against the CSCO target and only 18% of its obligations against the HHCRO obligation.

The most recent data published by DECC (again based on suppliers' own submissions, this time on an anonymised basis), covering ECO costs up to and including August 2013 suggests that the scheme remains on budget and that its costs are equivalent to its predecessor scheme, CERT[13].

We note that in its Autumn 2013 price rise announcement[14], npower has again suggested that runaway costs in meeting ECO obligations are a cause necessitating bill rises:

> *"Our forward view of the energy market shows that there are three main reasons why customers' energy bills are rising, these are:*
>
> - *Realising the full costs of implementing government schemes and policies. This forward view shows an increase of 31%.*
>
> *[...]"*

Suppliers should be aware that interested third parties will try and hold them to account for their claims, and that where they appear to deviate markedly from publicly available data this is a recipe for diminished consumer trust. If suppliers are genuinely confident that the facts do bear out their claims on the cost of environmental and social schemes they simply must start doing a much, much better job of justifying this in future.

Breaking down the cost categories in the Supply Market Indicators

The SMI currently bundle costs into two very broad categories: "wholesale energy cost" and "VAT, operating and other costs". In practice, supplier price rises (or falls) are normally attributed to movements in both, but in the case of the latter usually to specific sub-components, i.e. that the cost of a specific environmental or social scheme, or charges for one type of network, have changed.

It would therefore be useful if SMI data could be provided in a disaggregated form so that the constituent cost drivers of the "VAT, operating and other costs" category could be tracked. Specifically, we would like to see network charges and the cost of delivering environmental and social policies unbundled, given that these are often attributed as causal factors in retail price movements. This would facilitate better public scrutiny of suppliers' cost drivers.

We recognise that you have a trade-off to make here, and may have concerns that a proliferation of categories could make the charts and tables confusing. We would ask you to consider whether there are ways around this. For example, could you have

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[12] "Quarterly annex: energy company progress" Ofgem, 11 October 2013. http://tinyurl.com/pg7cvyo
[13] "Energy Company Obligation Delivery Costs" DECC, October 2013. http://tinyurl.com/q3d5dtr
[14] "Press release: npower increases household energy tariffs from 1 December", npower, 21 October 2013. http://tinyurl.com/nmt4j7c

simplified "headline" charts / tables but with an ability for users to click through to see a breakdown of costs within the categories?

Publication of Electricity Market Reform ("EMR") policy costs by central counterparty

The EMR bill passing through Parliament will introduce additional new policy costs that suppliers will have to pass through to consumers; in relation to liabilities for Contracts for Difference and the Capacity Mechanism. These liabilities will be calculated by a central counterparty.

To avoid the risk that these new policy costs join the list of disputed costs in future, it would be extremely useful if the central counterparty were tasked to publicly report on these in a manner that can be easily related back to household bills, i.e. that it produces and regularly updates an inferred charge per household relating to the policies that it is administering.