E.ON's response to Ofgem's October 2013 consultation paper "Rebuilding consumer confidence: Improving the transparency of energy company profits"

Introduction

The E.ON SE Group has a number of companies competing in Great Britain's electricity and gas markets. To win new and retain existing customers we have to build and secure customers' confidence. That confidence is dependent upon a number of factors, not least in how we keep our existing and potential new customers informed about our offerings and operations. We use a number of channels to do this, selecting the most appropriate channel for the target audience and information to be presented. As part of delivering the Standards Of Conduct, which are focused on Treating Our Customers Fairly, we are committed to keeping all our communications with our customers and our processes simple, transparent and designed with our customers in mind. We see this as key in building trust, and confidence with our customers.

In addition to informing existing and potential new customers, for the wider group of stakeholders we publish the E.ON SE Group Report and Accounts, which can be accessed via the E.ON SE website. This report, which in 2012 consisted of some 216 pages, provides detail on the E.ON SE Group's activities and profits. The website also provides additional information about E.ON and its activities.

Under the Electricity Generation Licence Condition 16 - Financial Information Reporting, and the Electricity Supply and Gas Supply Licence Conditions 19A - Financial Information Reporting, certain qualifying generation, electricity supply, and gas supply licensees have to produce and publish Consolidated Segmental Reports. A Consolidated Segmental Report has within it:

1. A Consolidated Segmental Statement for the licensees' last financial year. The Consolidated Segmental Statement provides information relating to the revenues, costs and profits of the relevant licensees' activities in the licensed generation of electricity and the licensed supply of electricity and gas;

2. A reconciliation of the revenues and earnings before interest, tax, depreciation and amortisation (EBITDA), contained within the Consolidated Segmental Statement to relevant published audited accounts;

3. An explanation of the transfer pricing methodology used by the relevant licensees and how this relates to the revenues, costs and profit information in the Consolidated Segmental Statement; and

4. A table that forms an explanation of where individual business functions are captured in the Consolidated Segmental Statement, as specified by Appendix 2 of Ofgem's Guidelines to the licence conditions.

As Consolidated Segmental Reports are produced under, and in accordance with, the Electricity Generation Licence Condition 16 and the Electricity Supply and Gas Supply Licence Conditions 19A, they can only cover the generation and supply (electricity and gas) activities of generation licensees and supply licensees. This means that the Consolidated Segmental Reports do not necessarily cover all of the individual companies within a corporate group. Also, as only the activities of licensed generation and licensed supply are reported, the figures presented may not be the total generation and supply profits of a corporate group. This means that the Consolidated Segmental Reports are not appropriate vehicles for analysing corporate groups' energy profits or overall profits. To view the total profit of all companies within a corporate group, the Group Report and Accounts should be used.

Because the Consolidated Segmental Reports are not appropriate vehicles for analysing corporate groups' energy profits and company profits, these reports do not have a direct role in any rebuilding of consumer confidence, or in improving the transparency of energy company profits. Such rebuilding and improving has to be associated with actions that are mainly unrelated to the Consolidated Segmental Reports.

Rebuilding Customer Confidence

To rebuild customer confidence there are a number of actions that need to be taken. These centre on improving the ability to trade in the wholesale markets, in particular the electricity wholesale market, and securing more robust and factually correct communication about the electricity and gas markets.

To improve customer confidence in the wholesale markets, Ofgem should introduce, for all licensees, generation and supply (electricity and gas) licence requirements that introduce:

1. managerial separation of any licensed generation and licensed supply (electricity and gas) activities within a licensee's corporate group;

2. the trading of minimum volumes of electricity and gas with unrelated parties;

3. a prohibition on cross-subsidy between any licensed generation and licensed supply activities within a licensee's corporate group; and

4. a prohibition on discrimination in the buying and selling of electricity and gas.

To secure more factually correct communication about the electricity and gas markets, Ofgem should:

1. support the call for a full market investigation reference to the Competition Commission for it to look in depth at the gas and electricity markets and consider their features;

2. be very clear and promulgate the fact that that the Consolidated Segmental Reports are not the appropriate vehicles for analysing energy companies' profitability; and

3. be more rigorous in its use of terminology in relation to the Consolidated Segmental Reports.

These suggestions are fully addressed in our answers to Ofgem's questions below.

Ofgem's Questions

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

Within the existing Consolidated Segmental Reports there are transparent reconciliations between the Consolidated Segmental Statements and published audited accounts. It is difficult to see how a full financial audit would provide greater reassurance about the robustness of the Consolidated Segmental Statements.

To secure a full audit of the Consolidated Segmental Reports in their current format, we estimate that customers would be faced with an additional cost of around £30,000 per year, per group having to provide such audits.

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?

E.ON has separate management of its generation (E.ON Global Generation) and supply (E.ON Regional Unit UK, for the UK) businesses. Because CHP generation is often dependent upon the customer's heat demand, in the UK, management of

E.ON's CHP activities is within the supply business. The generation business does not trade power directly with the supply business. E.ON Global Commodities, which manages all of E.ON's European trading operations, has activities that include purchasing generation from the generation business and providing electricity and gas to the supply business. These arrangements are covered by cross border contracts, which are prepared on an arm's length basis (meaning that although the transactions are between two related or affiliated parties, they are conducted as if the two parties were unrelated) and are subject to examination by the tax authorities in Germany and the UK. These arrangements remain as reported on by BDO.

For a number of reasons we believe that there is a need for business separation of licensed generation and licensed supply (electricity and gas) within all vertically integrated groups that have licensed generation and licensed supply (electricity and gas). Our primary reason for this is to promote greater trading and thus confidence in the trading, but also to provide more reassurance on the whole area of transfer pricing. To achieve this, we believe that the business separation for vertically integrated groups should have the licensed generation activities and the licensed supply (electricity and gas) activities ring fenced from each other, such that an individual company could not be a generation licensee and a supply (electricity or gas) licensee. Also, as a minimum, there would also be:

1. a prohibition on the direct electricity and gas trading between related generation and supply (electricity and gas) licensees; and
2. a requirement that all internal procurement from related third parties of electricity and gas by supply licensees be matched by identical external trades on the wholesale market, plus a transparent agent's fee, which was reflective of market price.

With such an arrangement, all electricity and gas procurement by licensed suppliers would be wholesale products at wholesale price plus transparent agent's fees. This would give confidence that:

1. the procurement of electricity and gas by licensed suppliers (electricity and gas) was at wholesale market prices;
2. there was transparency over trading fees made to related companies; and
3. the issue identified by BDO, relating to the current estimations of wholesale market price used in transfer pricing arrangements of vertically integrated groups, would be removed.

With such licence conditions in place, Ofgem would have the powers to investigate and take appropriate action if such managerial separation of licensed generation and licensed supply (electricity and gas) was found not to be operating within a vertically integrated organisation. This would provide additional confidence that the licensed supply (electricity and gas) by vertically integrated groups was independent of any generation by generation licensees within the supply licensee's corporate group.

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?

To support customer confidence, generation and supply licensees (electricity and gas) would, ideally, not have within their company trading functions that carried out speculative trades. However, some licensees do have such arrangements, which may raise questions over the transparency of the profits in their generation and supply businesses. To address this, if a generation or supply (electricity and gas) licensee does have a trading function that carries out speculative trades; that trading function's activities, and any other trading of the licensee, should be clearly identified in the notes to the Consolidated Segmental Statement. Having the explanation in the notes would improve the transparency of the profits in the licensees' generation and supply businesses. We do not see any significant cost of including such trading in the notes to the Consolidated Segmental Statement.

E.ON's, and we assume other groups', generation and supply (electricity and gas) licensees do not have trading functions that are charged with carrying out speculative trades. The licensees will obviously trade as generators to sell and hedge production and, as suppliers (electricity and gas), procure energy and may trade to hedge that procurement. Such trading could be with related companies, as is the case for E.ON.

For the E.ON SE Group, trading that can involve speculative trades is carried out by E.ON Global Commodities SE (EGC) which, as explained in our answer to Question 2 above, centralises all of E.ON Group SE's European trading operations. While a wholly owned subsidiary of E.ON SE, EGC is not a generation or supply (electricity or gas) licensee. E.ON's transfer pricing arrangements mean that EGC's trading activities have no impact on E.ON's generation licensees' generation businesses' profit, or the transparency of that profit, or on E.ON's supply (electricity and gas) licensees' electricity and gas businesses' profit, or the transparency of that profit.

In relation to the transfer pricing arrangements of those producing Consolidated Segmental Reports, including E.ON, Ofgem has noted that it,

> *"commissioned the accountancy firm BDO to conduct a detailed review of the Statements in 2011. They concluded that the information in them was*

> *consistent with audited financial accounts. In their opinion, they saw "no evidence ... that profits are being unduly excluded from the [Statements]" and "no evidence that would suggest that the [Statements] do not represent a true and fair view of the split of profitability""*[1].

Given such findings it is difficult to see how there would be any benefit towards the support of competition, and thus customers, if details of the trading functions of EGC were now to be included in the Consolidated Segmental Report of E.ON's generation and supply (electricity and gas) licensees.

We acknowledge that there are some small concerns about the accuracy of the transfer pricing fully reflecting wholesale prices. However, this is an issue linked to low levels of liquidity in certain wholesale products, not the transfer pricing methodology. To address the liquidity levels greater trading of all energy wholesale products by suppliers is required, not a change in the format of the Consolidated Segmental Reports. For greater liquidity, we believe business separation within vertically integrated groups is required, as described in our answer to Question 2 above.

We would have very serious concerns if licence requirements were imposed on licensees that made them dependent upon the actions of other legal entities, such as EGC, which the licensees have no legal control over. It is difficult to see how such licence requirements could be accepted by the directors of the licensees. Further, EGC's operations are European trading operations. Given the level of integration of the Great Britain wholesale trading markets to other European trading markets it is difficult to see how such centralised trading could have its Great Britain activities meaningfully ring fenced from the rest of the market, let alone split into trading to support electricity and gas and then, within each of those, for domestic and non domestic supply.

Ofgem has asked how possible is it to distinguish between trading for hedging and speculative purposes. For trading in markets where churn is greater than one we see this as difficult and any rules would impose arbitrary distinctions. Therefore, any trading function that incorporates speculative trading should not form part of a company that is a generation or supply (electricity and gas) licensee.

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1 Ofgem's consultation paper "Rebuilding consumer confidence: Improving the transparency of energy company profits" October 2013

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?

Provided reducing the deadline for licensees to compile and publish their Consolidated Segmental Reports from six to four months was the only change to the current requirements and was on a reasonable endeavours basis, we could accommodate such a change. However, occasionally changes could make achieving four months very difficult. Therefore, we suggest that the relevant licensees give a commitment to four months using reasonable endeavours, but with the licence requirement remaining at the six month deadline.

At the moment not all corporate groups report at the same time. With such a situation there is no benefit to any party in reducing the reporting times of those licensees whose year ends finish more than two months before the last corporate group to report. A more practical reporting date, while there is a difference in reporting dates, would be for the relevant licensees to give a commitment to use reasonable endeavours to publish their Consolidated Segmental Reports by 1 August and have the licence requirement deadline set at 1 October.

If other changes were to be made to the licence requirements, such as having a full audit of the Consolidated Segmental Report before publishing, then we would wish to discuss reporting deadlines further. With changes, such as a full audit, it may be that the current deadline of six months would need extending.

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?

As a generation business is largely a long-term capital assets based business, reporting of return on capital employed (ROCE) may be of interest to potential new entrants and therefore should be considered for inclusion in the Consolidated Segmental Statements. However, there could be problems in determining the actual measurement of "capital employed" for the generation segment of a company.

Ideally, as described in our answer to Question 2 above, there would be complete business separation of all licensed generation such that all of Great Britain's licensed generation would be contained within separate generation only companies, some of which would be companies within vertically integrated corporate groups. With such business separation the capital employed for generation would be that of the company. This would provide for a simple and complete calculation of ROCE. However, many generation licensees do carry out additional activities to licensed generation and so break the direct link between licensed generation capital assets and company assets. To overcome this difficulty we suggested that the "capital employed" for licensed generation comprises only the net assets used exclusively in connection with generation activities (i.e. property, plant, equipment, inventory and debtors, less creditors and provisions) within the generation licensees. Clearly this would not be the consolidated set of companies' ROCE, but rather a return on generation segment capital employed (ROGSCE).

As well as reporting ROGSCE, there may be benefit to customers if the licensed generation business also reported on investment over the previous twelve month period. However, if this was done it would have to be made very clear that the level of investment by the generation licensees within a corporate group may be less than the total investment in generation by the corporate group. This is because there may have been investment in generation by companies within the corporate group that were not generation licensees, but operators of generation plant that did not require the operator to be a generation licensee.

There would be additional work in calculating a ROGSCE for the licensed generation companies. Consideration would have to be given if the current deadline for compiling and publishing the Consolidated Segmental Reports needed to be extended so as to accommodate this additional work.

The nature of licensed supply businesses is that there is little capital involved, relative to the company turnover. A supply equivalent of ROGSCE would therefore be unlikely to provide meaningful information in the support of competition. Consequently we see little benefit for customers through the calculation and publishing an equivalent of ROGSCE for licensed supply businesses. However, there may be benefit for customers if supply costs were broken down further than they currently are. This would give a clearer understanding of how the licensed suppliers' costs are being built up and help in comparison of different corporate group's licensed supply operating costs.

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?

Ofgem's paper '*The revenues, costs and profits of the large energy companies in 2012'* is a helpful document for comparing the relative performance between corporate groups' licensed generation and licensed supply (electricity and gas) activities over time. To support rebuilding customer confidence, for future years we would urge that the results are not presented as industry aggregated results, or that the report includes statements about industry aggregated values. The combining of corporate groups' results does not provide meaningful information for potential new entrants and thus is not supporting the development of greater levels of competition, or customer confidence.

For Ofgem's report to be more meaningful, Ofgem should make more transparent use of the Consolidated Segmental Reports. Currently Ofgem does not seem to build on the analysis it presents in its report. For example, the transparency that the Consolidated Segmental Reports now deliver has allowed Ofgem to present comparisons of performance in licensed generation and licensed supply (electricity and gas) between different corporate groups. However, Ofgem does not seem to then use the information it presents to consider if there are consistent differences between corporate groups. If there are differences, Ofgem should be investigating if this is down to operational efficiencies or distortions in the market that could be having an adverse effect on competition and thus customers.

Having been able to analyse the licensed generation and licensed supply (electricity and gas) markets, Ofgem needs to make a clear statement if it believes there are, or are not, patterns of relative performance. If there are, Ofgem needs to make clear statements as to why it believes such patterns exist and the next steps it will take if it has concluded that the patterns could be due to market distortions.

In relation to Consolidated Segmental Reports, Ofgem needs to be much more rigorous and clearer in all its communications:

- as to the purpose of Electricity Generation Licence Condition 16 and the Electricity Supply and Gas Supply Licence Conditions 19A and how this can help customers;
- that the contents of the Consolidated Segmental Reports, in particular the Consolidated Segmental Statements, are only for the licensed generation and licensed supply activities within corporate groups and that they do not cover the generation and supply activities of licensed exempt companies within the corporate groups; and
- that the Consolidated Segmental Reports do not present the profits of individual companies or of their corporate groups.

Only by doing this can confidence be gained that the Consolidated Segmental Statements are transparent and hide nothing in relation to their specific purpose of providing information on the licensed generation and licensed supply activities of corporate groups that have large numbers of electricity and/or gas customers.

Ofgem also needs to modify the Electricity Generation Licence Condition 16 and the Electricity Supply and Gas Supply Licence Conditions 19A to remove the current requirement for the table, which forms an explanation of where individual business functions are captured in the Consolidated Segmental Statement, as specified by Appendix 2 of the Guidelines to the Licence Conditions. Confidence in the presentation of E.ON's Consolidated Segmental Report would be much improved if the licence requirement for the inclusion of the table was removed. The terminology used by Ofgem when referring to that table is very confusing. Also, the rationale as to how the table helps customers and potential new entrants remains a mystery. If the requirements and purpose of this table are not fully understood by many of those preparing the Consolidated Segmental Reports, despite requests to Ofgem for clearer guidance, how can the reader of these documents be expected to understand? The current situation must be confusing for readers and therefore detrimental to improving the transparency of electricity supply and thus customer confidence.

There is still debate as to how "notable items" (non-operating items) should be addressed within the Consolidated Segmental Statements. We have consistently included certain notable items, such as restructuring costs or generation asset impairments, within our Consolidated Segmental Statements, and referred to them in the notes to the Consolidated Segmental Statements. We believe this to be correct, as the items we include are connected to the operation of our licensed generation and licensed supply (electricity and gas) activities. However, we recognise that others view such inclusions as potential distortions to the year on year comparison of the Consolidated Segmental Statements. To address this, and to add greater transparency, we recommend that Ofgem amends its template for the Consolidated Segmental Statements so that the main body of the Consolidated Segmental Statement remains with 'Direct Fuel Costs', 'Other Direct Costs' and 'Indirect Costs' (excluding all exceptional items) leading to a determination of EBITDA, with a further line item for 'DA' to arrive at Adjusted EBIT. An additional line should then be introduced for 'Exceptional Items', which would transparently show any appropriate notable items. This would lead to a final total of EBIT. If this was retrospectively applied to previous Consolidated Segmental Statements EBIT would remain unchanged, but there would be greater transparency as to the effects of notable items over time.

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

To rebuild customer confidence a number of actions could be taken by Ofgem. Three of these have been covered in our answers to the questions above, namely Ofgem:

1. introducing generation and supply licence requirements, to all licensees, for separation of any licensed generation and licensed supply (electricity and gas) activities within a licensee's corporate group;
2. being more rigorous in its use of terminology in relation to the Consolidated Segmental Reports; and
3. being very clear and promulgating the fact that the Consolidated Segmental Reports are not the appropriate vehicles for analysing energy companies' profitability.

In addition, the following four actions by Ofgem should be considered.

Introducing, for all licensees, generation and supply licence requirements for the trading of minimum volumes of electricity and gas with unrelated parties

In 2012 E.ON's Great Britain generation and supply licensees generated 27.4TWh and supplied 49.4TWh[2] of electricity respectively, meaning the licensed electricity supply activities supplied 80% more electricity than the licensed generation activities generated. Even after allowing for licence exempt generation and supply, this made E.ON a large net purchaser of electricity and gas. As a net purchaser of electricity and gas, we want to see greater volumes of electricity and gas being made available for trading between unrelated parties. This would provide greater transparency, fairer competition between all generators and all suppliers (electricity and gas) and secure larger potential volumes for hedging by all generators and suppliers (electricity and gas). Such a market improvement would benefit customers and thus help build their confidence in it.

Introducing business separation, as we described in our answer to Question 2 above, would probably be the most effective way of achieving this. However, to support business separation, or as an alternative should Ofgem not wish to introduce Business Separation, the introduction of generation and supply (electricity and gas) licence requirements, for all licensees, for the trading of minimum volumes of electricity and gas with unrelated parties should be considered. Here we would envisage:

1) all licensed generators to have sold to non related parties, or have secured the sale on their behalf, a volume for delivery in a calendar year that was no less than the volume they generated in the same calendar year, disregarding any generation used for onsite consumption or related to Balancing Service Contracts with the Transmission System Operator, including the UK Balancing Mechanism; and

2) all licensed suppliers to have procured from non related parties, or have secured the procurement on their behalf, volumes of electricity and gas for delivery in a calendar year that were no less than they supplied in the same calendar year.

Placing such a requirement on all licensed generators and licensed suppliers (electricity and gas) would provide the symmetry for a large number of willing buyers and willing sellers in each of the forums where trading would take place, while not precluding any particular contract arrangements. It would also ensure a diverse mix of buyers and sellers and trading needs.

[2] E.ON's UK Consolidated Segmental Report for the year ended 31 December 2012

Introducing, for all licensees, a prohibition on cross-subsidy between any generation and supply (electricity and gas) activities within a licensee's corporate group

Cross-subsidy between generation and supply businesses of vertically integrated companies could lead to economic inefficiency in the wholesale market. E.ON's own transfer pricing arrangements are designed to prevent cross-subsidy between its generation and supply activities. However, customers' confidence and the general market's confidence would increase if it was widely understood that cross-subsidy between licensed generation and licensed supply (electricity and gas) activities was prohibited and that, if it was suspected, Ofgem could investigate and take appropriate action.

To provide confidence that such cross-subsidy was prohibited, Ofgem should consult on amending and switching on the Generation Licence Condition 17A, *Prohibition of Cross-Subsidies*, and the Electricity Supply and Gas Supply Licence Conditions 19B, *Prohibition of Cross-Subsidies,* for all licensees. This would provide a clear and consistent prohibition of cross-subsidy between the licensed generation and licensed supply (electricity and gas) activities in common ownership.

Introducing, for all licensees, generation and supply licence prohibitions on discrimination in the buying and selling of electricity and gas

Customers and the general market must have confidence that there is no barrier to trading being created through discrimination in the trading of electricity and gas. E.ON UK plc is already prohibited from such discrimination in electricity under the existing Generation Licence Condition 17, *Prohibition of Discrimination in Selling Electricity*. If there was suspicion that E.ON UK plc was discriminating in the selling of electricity, Ofgem would be able to investigate and take appropriate action.

Licence Condition 17 does not deliver the required level of trust it could. This is because it is active only for a very limited number of licensees. To secure that all licensed generators are offering fair and reasonable terms when negotiating trading agreements, Licence Condition 17 should become active for all generation licensees.

To support small generators in particular, the principles of the existing Generation Licence Condition 17 should also be incorporated in all electricity and gas supply licences, in the form of a prohibition of discrimination in purchasing electricity and gas. Here the licence condition should set out that the licensee and its affiliates must not purchase or offer to purchase electricity and gas from any one provider or person seeking to become a provider on terms as to price that were materially more or less favourable than those on which it purchases or offers to purchase electricity and gas from comparable wholesale providers.

Supporting the call for a full market investigation reference to the Competition Commission for it to look in depth at the gas and electricity markets and consider their features

We ask that Ofgem supports E.ON's call for a full market investigation reference to the Competition Commission (to become the CMA in April 2014) to look in depth at the gas and electricity markets and consider their features. A Competition Commission inquiry would provide an in depth assessment of the market by a highly respected organisation, which has not looked into this market for a number of years, and never previously in the form of a market investigation reference. This could provide either a confirmation in relation to the proper operation of competition in the market or considered recommendations as to how competition could be improved. In either case it would help bring an end to the myths and misinformation that currently surround the market. We recognise that this will be a slow process, but if this had happened when we first proposed a reference in 2011, it would now probably be completed with confidence in the industry at a far better position than it currently finds itself.