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Rebuilding consumer confidence: Improving the transparency of energy company profits

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, and energy supply to end users. We have over 5 million electricity and gas customer accounts in the UK, including residential and business users.

EDF Energy is committed to rebuilding consumer trust in the energy market and a key part of this is dispelling myths of supplier profiteering. We believe that the consolidated segmental statements (CSS) provide robust information as to the size and source of energy company profits. We welcome the findings of BDO's review in 2012 that the statements are broadly fair and consistent with audited accounts and that there is no evidence of profits being unduly excluded, nor is there evidence to suggest that the CSS do not represent a true and fair view of the split of profitability.

Notwithstanding the above, EDF Energy is committed to working with Ofgem and other stakeholders to explore how the CSS could be improved. Making the CSS more transparent and accessible can help to reassure consumers and stakeholders that increasing energy prices are not fuelling excessive profits. However, we agree with Ofgem that improving transparency is not simply about publishing ever increasing information. Ofgem and industry should work together to improve public understanding of energy company profits, with information that is relevant, meaningful, robust and presented in a way that can be easily understood.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Steven Eyre on 01452 653741, or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

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Attachment

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EDF Energy's response to your questions

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

We are committed to rebuilding consumer trust in the energy market and a key part of this is dispelling myths of supplier profiteering. We believe the current consolidated segmental statements provide robust information as to the size and source of energy company profits, a view supported by the independent reviews from BDO, which were commissioned by Ofgem. However, we support moves to improve the transparency and accessibility of the statements by providing additional assurance on their robustness.

In terms of the existing requirement to reconcile the statements to Group accounts, we acknowledge that the differences in the way in which the obligated companies are structured and managed may impact the degree of stakeholder comfort.. We believe that the introduction of a requirement for the statements to be audited by the individual companies' statutory auditors prior to their publication (a BDO recommendation) should provide greater reassurance on thethe robustness of the statements. However, we do not support any moves to require a re-audit of our statements by an independent firm. Such duplication is not warranted and would introduce unnecessary additional costs.

Any full audit proposal would need to be accompanied by well defined and Agreed Upon Procedures to ensure a consistent approach and so that obligated parties are clear on the requirements. For example, such procedures should include the basis upon which an auditors report should be obtained.

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 note that the BDO review previously concluded that the six obligated companies' transfer pricing methodologies were broadly "fit for purpose and transparent" and the methodologies would likely meet the measure of 'best practice' set out in the OECD's Transfer Pricing Guidelines. Therefore, we do not believe that there is a significant deficiency in the statements in this respect.

However, it is important to provide stakeholders with reassurance that profits are not being hidden outside of the statements. We believe that such additional assurance could be provided if, as part of the full financial audit proposed under Question 1, suppliers are required to obtain from their auditors confirmation of the appropriateness of its transfer pricing methodology.

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 that any trading information to be included in the statements should relate solely to the nature of the services provided by the trading function to the generation and supply businesses. Consequently, it should be a requirement that any trading profit data included in the statements is accompanied with an appropriate description of the services the trading entity provides to the UK generation and supply businesses, similar to that which EDF Energy already provides within its statements.

We consider the most meaningful information that companies could provide would be the profit that the trading function makes specifically on transactions with the UK generation/supply business. This could be calculated as the difference between the transaction price and observable mid-market price for trades between the trading function and the UK generation/supply business. This information could be further broken down by commodity type.

This approach would improve transparency, as it shows the profit that the trading function makes on transactions specifically with the generation/supply business, separate from other activity. It would demonstrate that transactions between the trading function and the generation/supply business are carried out at arm's length and that profits are not being moved around entities. By definition, this approach would only include the relevant hedging transactions with the UK generation/supply business.

Given that the information would be based on recorded transaction prices between the trading function and the UK generation/supply business, and on observable market prices, the information would be fully auditable. Note also that if mid-market prices are used, then any profits shown will be over, rather than under, stated.

Given the portfolio of trades executed by the trading function across multi regional markets, other approaches, such as attempts to separate out the share of the trading function's profits that relate to the UK, would rely on significant arbitrary and non-auditable assumptions. Non-relevant trades, such as those which do not involve the UK generation/ supply business in any way, or speculative trades where the risks do not fall on UK consumers, should be excluded from any adopted approach.

In terms of costs versus benefit, providing information on trading function profits will clearly require that information is aggregated in a non standard way and this will involve additional costs, and offer little benefit to outweigh these costs. Therefore, in terms of benefits, our view is that our suggested approach would provide the most meaningful information.

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?

Subject to conducting an assessment of any new requirements that are introduced following the outcome of this consultation, we agree with the proposal to move the deadline for producing the statements from six months to four months from financial year end. Such a move will improve the relevance of the information at the time of publication and should not result in any significant additional costs to suppliers.

If the deadline for publishing the statements was the same for all parties, this would improve the comparability of the statements and improve the relevance of Ofgem's summary document. In terms of reviewing the statements and the licence obligation in general, it is important to consider the likelihood of additional suppliers becoming subject to the licence requirement due to the "relevant licensee" threshold being met.

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 agree that the introduction of a calculation of ROCE for the generation business only in the statements would provide a better representation of the level of profits within that business function than the current return on revenue model. We also agree that this would not be an appropriate measure for the supply business, which is characterised by low levels of capital employed.

If such a measure is introduced, Ofgem should develop a transparent, well defined and agreed methodology to ensure the calculation is robust and applied consistently by all parties. Furthermore, Ofgem should consider the introduction of this proposal in conjunction with any decision to introduce new audit measures. A continuation of the current reconciliation to audited statutory accounts may not deliver the required level of stakeholder assurance over the ROCE calculations.

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?

A clearer understanding and presentation of these statements and summaries of them would benefit everyone, most of all customers. Therefore, we support moves to improve the way that information is set out and are ready to engage fully with Ofgem on this. We note, and welcome, the fact that the latest Ofgem summary document (and accompanying material) of the 2012 segmental statements has included additional elements designed to improve the transparency of the information. For future summaries, t is important that the information is presented to stakeholders (including the media) in a manner which is in context and is not open to misinterpretation.

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

EDF Energy is committed to improving and maintaining consumer trust in our industry. We believe that it is critical that both the industry and the regulator work together constructively to achieve this aim. We welcome that improvements have been made to improve the accuracy of Ofgem's published Supply Market Indicators (SMIs) report by updating the typical consumption figures. However, there is still further room for improvement. In the context of the efforts to rebuild consumer trust, misleading and unhelpful reporting of supplier margins should be avoided.

We believe that at the very least Ofgem should commit to reviewing the SMIs in consultation with suppliers. Such consultation should include a transparent review of the model used by Ofgem and a reconsideration of the scope of the assessment i.e. a move away from the focus on dual fuel customers. After a process of review, if the SMIs can not be made fit for purpose, the focus should turn to using a clear and user friendly presentation of the segmental accounts as the primary vehicle to help consumers to understand margins and profits.

We believe that consideration should be given as to whether half yearly segmental statements are required. Along with the additional elements discussed in the consultation paper, more frequent information may improve stakeholder confidence in the statements and the energy market in general.

Finally, we believe that Ofgem and Government, together with the industry, could do more to better inform consumers about the drivers of energy costs to help reassure them that they are getting fair and competitive prices. It is widely acknowledged by energy industry experts that there is a need for significant investment in the UK's electricity infrastructure. In this context all those with an interest in energy and climate change policy have a duty to be open and honest with the public about the impact on consumer power bills, and to ensure that the goals of secure supplies and decarbonisation are achieved in the most affordable ways. In this respect, Ofgem could help by publishing the forecast impact on consumers of the forecast impact of network price settlements in a consumer friendly document.

EDF Energy
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