The voice of the energy industry

Rebuilding consumer confidence: Improving the transparency of energy company profits

Energy UK response

Energy UK is the trade association for the energy industry. Energy UK has over 80 companies as members that together cover the broad range of energy providers and suppliers and include companies of all sizes working in all forms of gas and electricity supply and energy networks. Energy UK members generate more than 90% of UK electricity, provide light and heat to some 26 million homes and last year invested £10billion in the British economy.

We too wish to improve information around energy company profits, to improve transparency and increasing understanding of the energy industry. Going beyond license requirements, the industry is making significant efforts to meet these objectives:

- ***Energy Made Clear*** – we have launched the website to help consumers understand the energy market and the options they have available to make the best choice;
- ***Electricity Policy Interactions*** – the policy framework is complex with more than 30 policies impacting the electricity sector. We have a published a report explaining the policies and analysing their impact;
- ***Powering the UK*** – the energy industry is vital for the economy. We have published a report setting out our contribution to growth, investment, tax and jobs in the UK.

We aim to build on these initiatives to further promote transparency and understanding of the energy market. We are looking to achieve progress on making bills clearer, explaining the different costs that impact the bill including policy costs, improving the understanding of energy wholesale market.

While some of these efforts are part of the Retail Market Review, others have been implemented at the suppliers' initiative. Indeed, we believe transparency is a first step in bringing back trust and will ultimately result in a positive outcome, both for the industry and the consumer. However this effort alone will not be sufficient. We need other stakeholders to work towards the same goal. In particular, we expect regulators, government and politicians to support transparency initiatives by using data in a rigorous, consistent and honest way. This has not always been the case in the past and over recent months.

Therefore we welcome this consultation and most of the recommendations proposed by Ofgem.

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

The evidence presented by BDO to Ofgem in 2011 suggested that the current approach of requiring reconciliation was a sufficient means of verifying the information in the Statements as being robust.

The information reported in the Statements is reconciled with individual companies' accounts, which are themselves audited by an independent third party in compliance with financial regulations. It is robust and provides a fair description of the revenues, costs and operating margins of the generation and supply businesses of energy companies. Hence, our view is that the accuracy of the segmental statements would not be greatly enhanced by a full financial audit. It would add costs but with little benefits.

The cost of the audits would vary by companies. The variation is likely to be high, given that some companies already have their accounts audited at UK level, while others do not. The cost of any additional financial audits therefore would not equally impact all companies and their customers.

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

The evidence presented by BDO to Ofgem in 2011 concluded that the transfer pricing policies used by the companies were 'fit for purpose and transparent'. We do not have further information in relation to this statement.

3. **What information could the companies usefully provide on their trading 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 recognise that trading has been highlighted as one area where the public perceives a need for reassurance. There is a mistaken belief that companies may be obscuring the real level of profits earned by not disclosing trading activities. BDO stated in its latest published review that the current transfer pricing is 'fit for purpose and transparent'. However, in order to rebuild public trust and increase the understanding of energy trading, we welcome Ofgem effort to explore possible options.

Companies are likely to differ in terms of which information they would be able to provide on their trading activities. This is because of the way trades are being executed and recorded, with some companies managing their entire European portfolio from the UK and others from headquarters located abroad. In some cases, trading activities are being executed by the UK licensees, while in other cases trading activities are being carried by separate legal entities. Similarly, the possibility to distinguish between trading for hedging and speculative purposes would vary across individual companies and their business structure.

Yet requiring companies to report their trading profit and loss is not the only way to promote understanding of energy trading and ultimately increase trust. We believe more can be done with existing data by explaining more clearly how the energy wholesale market works. Therefore, Energy UK has established a working group to look at improvements to trading transparency. It brings together representatives from exchanges, brokers, price reporting agencies and energy companies. The objective of this working group is to promote the understanding of the realities of the wholesale market to external stakeholders such as government, regulators, politicians and journalists and ultimately the public. We believe the realities of the wholesale market are misunderstood by these stakeholders. For example, it is generally accepted in the public debate that there is no clear price for electricity in the wholesale market when actually the day-ahead auction power price increasingly serves as a reference price in the industry.

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?**

Yes, we agree with the proposal. Companies typically take three months to release their own accounts, so an earlier publication date for the Statements should be achievable. Yet this would depend on any new requirements resulting from this consultation. For example, were Ofgem to go ahead with the requirement of a separate audit, this would increase the delay.

5. **Do you consider that there is merit in calculating a Return on Capital Employed (ROCE) for the generation business 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?**

Yes, there is merit and in principle we support calculating the return on capital employed for the generation segment. The operating margin for generation is not a good measure of actual profitability given that this is a capital intensive business. We would welcome a move to calculate such a metric for the generation businesses of the obligated companies.

Two implementation issues should be carefully dealt with:

- It should be made clear that the metric that would be calculated would only be for the UK generation segment of the obligated companies. It would be different from the return on capital employed that companies report for their entire business in the financial statements. Therefore we believe it would not help to call this figure ROCE, which is the term used by companies to describe the latter in their accounts. We think this figure should be called ROGSCE for Return on Generation Segment Capital Employed.
- As companies aggregate their balance sheets in different ways, and may have widely varying asset age profiles, a consistent definition of the generation segment capital employed would need to be adopted. The data would then need to be compiled according to the methodology. This is likely to create data collection and reporting costs that would not impact equally on companies.

As for the supply segment, ROCE is not an appropriate measure for retail activities, where business is not capital intensive. Ofgem should therefore continue to measure the level of profitability for retail activities based on operating margin.

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

Regarding the annual Summary Document, some methodological clarifications would be welcome, in particular:

- It is not clear whether Ofgem has deducted the double counting of the 20% that Centrica owns in British Energy, reported by Centrica at 20% and EDF at 100%.
- It is not clear whether Ofgem has adjusted the data in order to account for SSE different reporting timeframe and if so, what methodology has been used.

In addition, Ofgem could refine the way it communicates revenues, costs and margins in the energy industry:

- Being clear about what profits are and are not, based on consistent measure across sources. For example, Ofgem is clear that SMI are not an estimate of individual suppliers' profits because, for example, costs such as debt and corporate tax are not included. However it uses EBIT margin as a measure of profit in the Summary Document, while EBIT still does not include costs such as debt and corporate tax. This consistency issue could be addressed by using the exact terms. For example, EBIT is earnings before interests and tax not profit.
- Ofgem should provide an annual assessment of its SMI forecast against the actual values reported in the Consolidated Segmental Statements. Our analysis has shown that on average, Ofgem SMI tends to overestimate supplier's net margin. However the revision to margin estimates are done well past the point of media attention and there is limited awareness in the public that SMI estimates, being forecasts, are prone to errors. We would support an annual assessment of SMI forecasts.
- The current presentation of the SMI should clarify that the Supply Market Indicator (SMI) is a forecast rather than an estimate of actual values. For example, the table showing the estimate of the bill should the start date and end date of the period of estimation rather than just the start date (i.e. instead of having 'November 2013' it would show 'November 2013 – October 2014').

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

Energy companies are working to improve confidence in the energy markets. They will approach it in different ways, but all agree that the contribution of each cost component to price increases should be clearly explained to consumers. Companies have started to engage more directly with consumers through alternative modes of communication such as Twitter[1], which has increased the levels of consumer engagement.

Confusion about profits is a particular issue. Different parties use different figures on industry profitability. The industry and Ofgem should work together on developing a consistent framework to assess energy companies' margins and profits. This should involve all parts of the policy community, including consumer groups and political parties. Energy UK would be happy to assist with this initiative. Agreeing on and using a consistent approach to describe companies profitability would greatly enhance trust and promote an honest, constructive debate.

Energy UK, as the industry trade association, has made significant efforts to improve transparency and understanding of the industry. For example, we are currently undertaking some work in order to gather and simplify currently available information about the wholesale market so that it can be understood by a wider audience. We have done some work on the impact policy costs have on the bill, and what they help pay for. We have launched the *Energy Made Clear* website[2] to make it easy for consumers to understand energy, and give all the facts needed to make the best choice for their energy. It has received 2,500 visits over the first two weeks after it went live on 12 November 2013.

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[1] Energy UK's account is @eukcomms and has 3,199 followers as of November 29, 2013
[2] http://www.energymadeclear.com/#