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Dear Diego

Rebuilding consumer confidence: Improving the transparency of energy company profits

Please find enclosed our response to the consultation.

Transparency is to the benefit of the industry and its consumers and stakeholders and we support Ofgem's work in enabling and promoting transparency.

At high level we support a high level or transparency, whilst ensuring particularly that forward looking transparency and prediction does not adversely impact healthy competition in the market or accidentally mislead as events unfold differently than anticipated.

This response is not confidential

Yours sincerely

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Question 1: Would a full financial audit provide greater reassurance about the robustness of the Statements?

Duplication of audit whilst using different definitions would add confusion, and reassurance can be achieved more efficiently

How much would these audits cost?

Well into six figures for large firms

Our Consolidated Segmental Statement (CSS) is prepared from the Group Annual Report that has been subject to a full and comprehensive audit under International Auditing Standards.

Any full audit on the CSS will duplicate work already done by the external auditors for the purposes of the group annual report. This would be inefficient and costly.

We believe that it would be useful for Ofgem to seek advice from the Audit firms. A full audit on the CSS would require the auditor to publish an opinion. This will lead to questions as to who their opinion is to, to whom they owe a responsibility and legal duty. This is likely to be a contentious area.

The cost of a full external audit and opinion on the CSS will be very significant. It would be possible to get a view on this from the audit firms when it is clear to whom their opinion would be addressed, however, this would be significant and be well into six figures.

Our suggestions;

We support the use of an independent external body to review the basis of preparation of the CSS and to report to Ofgem. This should focus on the reconciliation between the UK Generation and Supply Revenues and profits disclosed in the segmental analysis of their group reports and that disclosed in the CSS.

The segmental analysis in the Group reports has been subject to audit and this should be made clear to readers. A detailed review of the reconciliation to the CSS by an external, independent Ofgem appointed firm would ensure that the adjustments made by the companies are appropriate and consistent with the Ofgem guidelines. For YE 2011 the review performed by PKF was "desk-top" only (they held no discussions with the Companies) and fell short of them reviewing the support and justifications for the adjustments made. We would advocate a more inclusive, participative review by the chosen firm.

We believe that this approach, focussing on a review of the reconciling items made to the audited segmental disclosures, will improve the robustness and integrity of the CSS in the eyes of consumers and other users.

We believe that the addition of some CSS elements to the regular annual audit of suppliers may be helpful, although not necessarily cluttering the published accounts.

However, noting our point on to whom the auditor is bound, we do not believe that it is viable at this point for the auditor to have two clients here. Hence a step by step approach to addition of “CSS useful” items to the annual audit would be best.

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?

As stated in the Ofgem paper Transfer Priding Policy has already been subject to review as part of the BDO investigation on the Year End (YE) 2010 CSS.

All our transactions are at arms length and at commercial terms that would have been agreed with external companies under comparable business conditions.

Not only is this our business model, to which we are positively incentivised for transfer pricing to reflect market rates, but there are tax requirements for transparency of any cross subsidy.

We would support any further enquiries Ofgem wish to make in this area.

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?

RWE Supply and Trading (RWEST) is an international business with activity that goes far beyond inter-group trading, in terms of asset class, product, derivative type, tenor and geography.

Inter-group trading may be a zero sum game at the point of execution, but the activities associated with the trades are so different on either side as to make ultimate profit or loss from the trade in each company to be entirely indistinguishable within a company, let alone between companies.

So for example the RWE generation company might “sell power and buy gas” (the arrangement in practice being somewhat more complicated) with RWEST. RWEST may conduct a variety of offsetting activities such as trading power and gas (or other asset classes such as carbon allowances) in different countries and for different delivery dates and with different physical or derivative products. It is quite possible for both companies to gain, or lose, or one of each. The ultimate profit and loss is almost unrelated to the profit/loss that would result from the holding of the trades to maturity.

Whilst it is indeed possible for retail supply companies and trading companies to speculate, and for the trades to be separately earmarked in the accounts, it is our business model that they do not speculate. All transactions are done for hedging purposes.

It may help the illustration to consider what happens with trading losses. As with any trading business RWEST does not make money in all days or even all years. To repatriate speculative trading losses to retail supply or generation businesses does not really make sense. The same argument then must apply to profits.

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?

No, but five months could be considered

We would not object to a four month requirement

What are the costs and benefits of doing so?

We are of the firm view that integrity is far more important than speed. Any conclusions that may be drawn from the CSS must be of a considered and long term nature and hence accelerating the CSS by one or two months in order to rush for comment has no merit.

We do of course recognise the benefits of timeliness of reporting for considered interpretation.

Whilst bringing the CSS a month forward would have little impact on integrity, as the resource allocation to the statutory accounting or CSS is not compromised, a further month would cause a resource clash with the statutory reporting.

As mentioned in Q1, it may be that some “CSS useful” elements could be incorporated into the process of statutory accounting..

Whether the entire CSS could ultimately be incorporated into the statutory accounts is somewhat dependent on the degree to which the statutory accounts and the CSS necessarily have different detailed requirements for the information. The more that the CSS can be tailored to statutory information the better. However the statutory accounts and the CSS have very different purposes and hence the usefulness of the CSS may be compromised by incorporation into the statutory accounts

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?

Capital employed has a wide variety of definitions according to business model.

Broadly speaking, a trading business is measured using ex ante risk capital and ex post risk as a denominator, a generation business is measured on market capital (debt and equity), and a retail supply business on earnings and turnover.

These are the natural measures of the businesses and an unnatural aggregation (for example generation profits over turnover, or supply profits over working capital) are meaningless at the very best and otherwise actively misleading.

Within each company type (retail, trading, supply) we do recognise the benefits for consistency in the CSS on items such as depreciation, amortisation, goodwill, non core business earnings, excluded transactions, provisions, pension deficits. This consistency may not be sought in the statutory accounts (the companies having different parentage and domicile).

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?

The format and content appear to us to be fit for purpose. At the same time we believe that since the CSS is constructed for the stakeholders in the industry, that any comments from them would be helpful.

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

We recognise that statutory accounts, the CSS, the Supply Market Indicators (SMI), and other vehicles/events/media narrative about prices, costs and profits serve different purposes and have different timeframes.

We believe that it would be helpful to make broad connections between these. For example the SMI and CSS are leading and lagging respectively and have different definitions. Nevertheless there can at least be a narrative explanation of their differences. Examples include the actual evolution of wholesale costs and energy tariffs between the SMI and CSS publications, the difference between average and median consumption volumes and the effect of ex post consumption volume variation relative to ex ante expectation.