SCOTTISHPOWER

Rupert Steele OBE
Director of Regulation

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Energy Market Monitoring and Analysis
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11 December 2013

Dear Diego,

IMPROVING THE TRANSPARENCY OF ENERGY COMPANIES' PROFITS

We are pleased to respond to Ofgem's consultation on improving the transparency of energy company profits issued on 31 October 2013.

We agree with Ofgem that improving transparency of profits is vital to restoring trust in energy companies and we welcome the thrust of Ofgem's proposals.

Our answers to the consultation questions are in Annex 1 attached. In summary:

- We agree it is important to give stakeholders further reassurance as to the robustness of the Segmental Statements, and that independent 'audit' assurance would be helpful. The precise terms of that assurance will need careful consideration in conjunction with the audit profession.

- We can see the benefit of publishing the Statements earlier and we believe the four month target is potentially achievable given sufficient notice. In our case there are interactions with our sign-off timetables for the group accounts that the Statements would reconcile to; this could affect what is practicable depending on when Ofgem's requirements are finalised.

- We agree that further consideration should be given to calculating a ROCE for generation (but not supply) businesses. Ofgem and the industry will need to work on a methodology that would ensure the values are meaningful and comparable, given the widely varying ages of different companies' assets and the need for prices over time to meet long run marginal cost.

Should you wish to discuss any issues arising from our response please do not hesitate to contact me. We look forward to engaging further with Ofgem on these issues.

Yours sincerely,

Rupert Steele

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Annex 1

REBUILDING CONSUMER CONFIDENCE: IMPROVING THE TRANSPARENCY OF ENERGY COMPANIES' PROFITS – SCOTTISHPOWER RESPONSE

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

We agree it is important to give stakeholders further reassurance as to the robustness of the Segmental Statements. In ScottishPower's case, we believe the steps we have taken to reconcile our Statements to audited UK group accounts should significantly increase stakeholder confidence - as is recognised in BDO's assessment for Ofgem[1]. However, we accept that this level of transparency in the reconciliation may not be possible in every case, and we therefore agree that some form of independent 'audit' assurance would be helpful.

The cost of audit assurance will depend on its nature and scope, which will need careful definition if the assurance is to be made a requirement. Auditors will need a clear statement of the framework under which the Statements have been prepared, and against which they are to assess and measure them with a view to providing an opinion. We would recommend that Ofgem explore this matter further with relevant firms of auditors who will be best placed to comment on the options and the nature of the guidance they will require.

On the assumption that the audit is conducted by the same firm that is auditing the statutory accounts on which the Statements are based, we think the cost could be in the range £30-50k, depending on the scope and the assessment framework.

It is also desirable, in the interests of comparability, for all six companies to apply consistent accounting policies - particularly in respect of large items such as ECO expenditure. We would encourage Ofgem to work with the industry and other stakeholders to facilitate this objective.

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 believe that transfer pricing policies should seek to maximise transparency and that transfer pricing based on the prevailing market price for the relevant time period (ie spot or forward) is generally an appropriate approach. Where it is necessary to adjust this position, eg in order to provide a more accurate view of the true costs of transactions and associated risks, we would expect companies to include a clear and transparent explanation of such adjustments.

[1] 'The revenues, costs and profits of the large energy companies in 2012', Ofgem, 25 November 2013, paragraph 2.9

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?

In our 2012 Statements, ScottishPower voluntarily provided equivalent information for the UK trading organisation alongside the generation and supply segments. We believe that the inclusion of our trading function is important in establishing transparency over the entirety of our business activities, therefore we recommend other companies follow our lead and disclose similar information.

All our hedging trading is performed for either the supply or generation business whilst all speculative trading is performed for our trading function (Energy Management). Accordingly, there is a clear categorisation of these activities within ScottishPower.

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 can see the benefit of publishing the Statements earlier and we believe this is potentially achievable dependent on the amount of notice we are given and whether any changes in approach are also required. In ScottishPower's case there are interactions with our sign-off timetables for the group accounts that the Statements would reconcile to; this could affect what is practicable depending on when Ofgem's requirements are finalised.

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 there could be merit in companies calculating a ROCE for their generation businesses, since this will provide a more meaningful measure of profitability than return on turnover. However, if this is to be a requirement it will be important for Ofgem and the industry to work on an appropriate methodology for calculating the ROCE, to ensure that values are meaningful and as far as possible comparable between companies. A key issue will be the basis on which assets are to be valued, eg depreciated historic cost or modern equivalent asset. This will be particularly important given the widely varying asset ages within different companies' generation portfolios. One option to achieve consistency and comparability might be for Ofgem to specify a nominal capital value (in £ per MW) for different generation technologies, perhaps based on a 'cost of new entry' approach, and for ROCEs to be calculated on that basis. It will be important that the methodology recognises the need for prices over time to meet long run marginal cost.

We agree that it would not be appropriate to calculate a ROCE for the supply businesses, given the difficulty in defining a meaningful measure. Intangible assets such as brands may be difficult to value objectively and the value of IT infrastructure is likely to fluctuate significantly over the investment cycle, leading to instability in the ROCE calculation. We think that return on sales is a more meaningful ratio in this context, though this itself could be distorted by decisions such as whether to lease or buy smart meters.

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 summary document

We think Ofgem's annual Summary Document provides a useful comparative overview of the segmental statements and is generally well presented. One area which might benefit from more explanation is the definition of profit and the relationship between different measures of profit. For example, the measure of profit used in the Statements is EBIT (referred to as 'operating profit'), and not all readers may understand that the cost of interest and tax must be subtracted to calculate the amount available for reinvestment (or payment of dividends to shareholders).

SMI reporting

Similar care needs to be taken in explaining the measure of 'profit' used in Ofgem's Supply Market Indicators (SMI) reports. Although the SMI reports are not intended to measure profitability in a way that is directly comparable to the segmental statements, this comparison is often made. We think it would be helpful for Ofgem to refine the methodology for the SMI reports so that it more closely matches the range of hedging strategies, including all associated costs and risks, and core tariffs offered by suppliers (the SMI are currently based only on standard evergreen tariffs).

We also think it would be helpful if the SMI could show the trends in average energy bills adjusted for changing energy consumption. We note that Ofgem intends to revise its typical domestic consumption values (TDCVs) on a periodic basis, but we think it would be helpful to show trends based on more smoothly varying consumption curves.

Segmental Statements

We think the presentation of Segmental Statements could potentially be improved by better use of plain English and simple flow charts to allow non-industry stakeholders to understand the businesses more readily, in particular for the description of transfer pricing policies. Ofgem could perhaps help facilitate stakeholder feedback on the accessibility and usefulness of the Statements.

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

One of the most important areas where energy companies and other stakeholders can work together to improve confidence is explaining the reasons behind price increases. The Statements have an important role to play, as an authoritative source of information on company profits, but recent experience has shown that greater transparency is also required around the various costs that make up the bill and how they have changed. Clearly a balance has to be struck between transparency and too much disclosure of cost information, which could be detrimental to competition, but we think that more can be done to improve the communication of information which is already in principle in the public domain.

ScottishPower
11 December 2013