

# Rebuilding consumer confidence: Actions to improve the transparency of energy company profits

## Consultation

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### Overview

Promoting transparency of energy company profitability is an important aspect of our efforts to rebuild consumer confidence in the energy market.

We currently require the large vertically-integrated energy companies to publish annual statements showing the revenues, costs and profits of their electricity generation and electricity and gas supply activities.

We are proposing changes to the rules that underpin these statements. This document sets out our proposals. We would like responses to this consultation from interested parties by 6 November.

## Context

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Ofgem's principal objective is to protect the interests of present and future consumers. In accordance with this objective, we want to ensure that there is transparency of energy company profitability. This is important for consumer confidence, and for new firms thinking to enter the energy market. Robust data also helps us to monitor and assess how well the market is working for consumers.

This consultation is the latest phase of our work to improve transparency of energy company profitability. It follows a consultation late in 2013, and a package of actions that we and the companies have been working on throughout 2014. We now intend to embed these improvements in licence conditions.

Since we started this work, we have finished implementing our Retail Market Review reforms, and we have referred the energy market to the Competition and Markets Authority (CMA). Their investigation should identify and address any potential barriers to competition. Our retail market reforms facilitate consumers to shop around for a better energy deal while the CMA investigation takes place. Both complement our work to improve transparency of energy company profitability. They all aim to rebuild consumer confidence in the energy market.

## Associated documents

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- [The revenues, costs and profits of the large energy companies in 2013](#) (10 October 2014)
  - [Review of Big Six transfer pricing policies](#) (10 October 2014)
  - [Energy companies' Consolidated Segmental Statements for 2013](#) (1 August 2014)
  - [Actions to improve the transparency of energy company profits](#) (26 February 2014)
  - [The revenues, costs and profits of the large energy companies in 2012](#) (25 November 2013)
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# Contents

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<b>Executive Summary</b>	<b>1</b>
<b>1. Introduction</b>	<b>3</b>
<b>2. The state of transparency today</b>	<b>5</b>
<b>3. Actions to improve transparency</b>	<b>9</b>
Improving robustness	10
Improving usefulness	17
Improving accessibility	21
<b>4. Next steps</b>	<b>25</b>
<b>Appendices</b>	<b>26</b>
<b>Appendix 1 - Consultation Response and Questions</b>	<b>27</b>
<b>Appendix 2 - Draft of proposed licence condition changes</b>	<b>29</b>
<b>Appendix 3 - Draft of proposed amended guidelines</b>	<b>33</b>
<b>Appendix 4 - Feedback Questionnaire</b>	<b>41</b>



## Executive Summary

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Transparency of energy company profits matters. It is important for consumer confidence, and for new firms thinking to enter the energy market. Robust data also helps us to monitor and assess how well the market is working for consumers.

### **Our role in improving transparency**

Large energy companies' profits continue to attract significant public interest. Rising domestic supply prices and profits over the last five years have resulted in concerns about the effectiveness of competition. This has been coupled with distrust over the profits that the large companies have reported for their generation and supply businesses.

We referred the market to the CMA earlier this year for a comprehensive investigation. Profit information is only one of many indicators to assess how well the market is working for consumers. The CMA is likely to conduct a detailed analysis of profitability. The investigation should identify and address any potential barriers to competition. It should also help rebuild consumer confidence in the energy market.

While their investigation takes its course, it is important to push forward to improve the robustness, usefulness and accessibility of cost, revenue and profit information.

Since 2009 we have required the large vertically-integrated energy companies to disclose annually the revenues, costs and profits of their electricity generation and electricity and gas supply activities. They have to do so separately for each activity through the Consolidated Segmental Statements (the statements). This is something that only one of the six large energy companies did previously. We also publish a Supply Market Indicator (SMI), which complements the statements by providing a forward look at costs trends in the domestic supply market.

### **The state of transparency today**

As a result, there is more transparency of energy company profitability today than at any point since the introduction of competition in our energy market. Transparency of profits in the British energy market is among the highest in Europe.

In February 2014, we published a decision letter outlining a plan with our and the companies' actions to further improve transparency in this area. Since then, we have already jointly delivered improvements. For example, the companies have increased auditor scrutiny of their 2013 statements, and we concluded an independent, in-depth review of transfer pricing. The main finding is that the companies' transfer pricing methodologies are appropriate. We have published the review findings as an associated document to this consultation.

As a result, the 2013 statements provide greater transparency on company's profitability than in the past, and we are more confident that they present an accurate picture of generation and supply profitability. But our work continues.



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

## **Actions to improve transparency**

We now intend to embed these improvements in licences. Our intention is that from next year, the statements will be:

- More robust – companies will have to get a full external audit of their statements. This will include tighter scrutiny of transfer pricing practices
- More useful – companies will have to publish them earlier, within four months of the end of companies' financial year
- More accessible – companies will have to break down their costs further, and report them consistently in more meaningful categories. This will shed light into certain costs, like environmental obligations or network costs.

The CMA investigation is a development we must consider in our work programme. We think it is necessary to wait until the conclusion of the investigation before considering whether it is appropriate to require companies to disclose specific information about their trading activities. We consider, to do otherwise, at this time would be disproportionate. We commit to revisit this issue, and our wider financial disclosure requirements in the light of the CMA's findings and any potential remedies that may result. In the meantime, we strongly encourage the companies to provide further insights into their trading activities, where the additional information is robust, useful and accessible.

We want the requirement to produce statements to remain effective as the market evolves. We therefore ask for stakeholder views on whether from the 2016 statements onwards, the obligation should apply to companies other than just the large, vertically-integrated ones.

## **Next steps**

The deadline for consultation responses is 6 November. In the light of responses to this consultation, we intend to publish the statutory consultation in mid-November, and the licence modification decision in December 2014. Our aim is that companies prepare the 2014 statements under the updated rules.

In the first half of 2015, and depending on the responses to this consultation and approval by the Authority, we will work to develop an approach that enables consistent reporting of certain individual government policy costs that suppliers incur. Any changes to the guidelines would happen by close 2015, to allow companies time to implement in their 2015 statements.

In the first half of 2016 we will revisit our financial disclosure obligations in the light of the CMA findings. We plan to assess whether our requirements strike an appropriate balance between providing transparency and not facilitating coordination, what is a proportionate approach to the disclosure of trading information, decide on whether to extend the obligation to other companies, and revisit the option of developing a consistent methodology to calculate return on capital employed (ROCE).

# 1. Introduction

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## Chapter summary

This consultation is the latest phase of our work to improve transparency of energy company profitability. This chapter discusses the relevance of transparent information on company profitability, our role in ensuring this information is available, and our approach to transparency.

## The relevance of transparency on energy company profitability

- 1.1. Transparency of energy company profitability matters. It is important for consumer confidence, and for new firms thinking to enter the energy market. We recognise that transparency offers a route to strengthened accountability and provides important regulatory benefits.
- 1.2. Robust data on company profitability also helps us and others to monitor and assess how well the market is working for consumers. Profit levels are one of a number of useful indicators of the state of a market. They should be assessed alongside broader analysis of how the market is working. Consequently, profitability is only one of the many indicators we track as part of our monitoring of the market.
- 1.3. Large energy companies' profits continue to attract significant public interest. They are a source of confusion and lack of consumer confidence in the market. The tendency of rising domestic supply prices and profits over the last five years has resulted in concern about the effectiveness of competition. This has been coupled with distrust over the profits that the large companies report for their generation and supply businesses.

## Our role

- 1.4. We referred the market to the CMA earlier this year for a comprehensive investigation. We expect this to include a detailed analysis of profitability. The investigation should identify and address any potential barriers to competition. This should also help rebuild consumer confidence.
- 1.5. While the investigation takes its course, it is important for us to continue to play our role to improve the robustness, usefulness and accessibility of the information on company profitability, while being mindful of what may happen as a result of the investigation.
- 1.6. When we consider action in the area of transparency, we have to be mindful of the public policy framework that governs our energy markets. This establishes that end-user gas and electricity prices should be set – and kept in check – through

competitive markets. This recognises the additional benefits that competition can bring, such as providing customer choice and driving innovation.

1.7. We take regulatory intervention very seriously, and intervene where we can make a positive difference to consumers. In other words, we intervene where we are confident that the benefits of intervention outweigh the costs to consumers, and the risk of unintended consequences is minimised. We are required by law to ensure that our interventions are both necessary and proportionate.

1.8. In this context, this consultation is the latest phase of our work to improve transparency of energy company profitability. It follows a consultation in late 2013, and a package of actions we announced in February this year<sup>1</sup>. We and the companies have been working on implementing these actions throughout 2014.

1.9. We now intend to secure and enhance these improvements through licence conditions.

### **Our approach to transparency**

1.10. For transparency of energy company profitability to be effective, the information made available by the companies and Ofgem needs to be:

- **Robust.** The information should represent an accurate picture of the companies' revenues, costs and profits and how these are allocated across their generation and supply businesses.
- **Useful.** The information should be relevant, meaningful and timely for stakeholders and commentators, without revealing commercially-sensitive information that could harm competition.
- **Accessible.** The information should be presented in a way that can be understood by interested parties, for example by providing for effective comparison across companies and over time.

1.11. Significantly, therefore, improving transparency is not about publishing ever more information. It is about providing meaningful and robust information in a way that can be clearly understood.

1.12. This consultation presents our proposals to improve the transparency of information on energy company profitability. We welcome responses by 6 November.

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<sup>1</sup> <https://www.ofgem.gov.uk/publications-and-updates/improving-transparency-energy-company-profits>

## 2. The state of transparency today

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### Chapter summary

We have played a central role in improving transparency of energy company profitability. In this chapter we outline the main ways in which we do so, including the Consolidated Segmental Statements, the Supply Market Indicator and aspects of our wider work. As a result, there is more transparency of energy company profitability today than at any point since the introduction of competition.

2.1. There is more transparency of energy company profitability today than at any point since the introduction of competition in our energy market. Profit transparency in the British energy market is among the highest in Europe.

2.2. We have played a central role in delivering this. We outline the main ways in which we have done so below.

### Consolidated Segmental Statements

2.3. We require the six largest energy companies to publish Consolidated Segmental Statements (statements) annually. These show the revenues, costs and profits of their generation and supply arms separately. The statements are based on companies' audited accounts and so provide a backward-looking picture of whole company profitability split across supply and generation activities.

2.4. This is one of our most important initiatives for promoting transparency of energy company profitability. Through the statements, data is available on the companies' generation and supply profits separately. This is something that only one of the six large energy companies did previously. This level of transparency therefore did not exist before we introduced this obligation in 2009.

2.5. Since the introduction of the statements, we have worked to improve their transparency, in particular their comparability. As part of this work, we have in the past commissioned three independent reviews from a specialised accounting firm. This is in addition to this summer's in depth, independent transfer pricing review, the findings of which we have published alongside this consultation.

2.6. The findings of these reviews have helped us improve the statements. In February 2014, we published a letter outlining our and the companies' actions to improve transparency. Since then, we and the companies have been working to implement this plan throughout 2014. Compared to previous years, most of the six companies published their statements earlier, subjected them to greater external auditor scrutiny (indeed, Centrica and Scottish Power got a full audit), broke down their costs into more meaningful categories, and provided more insight into their trading activities.



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

2.7. As a result, we are more confident that the statements present an accurate picture of generation and supply profitability.

2.8. But our work continues. The next chapter outlines our proposals to embed these and other improvements in licence conditions.

2.9. The format of the statements is primarily aimed at market participants, particularly smaller suppliers, and potential new entrants. However, the information they contain is important for all of our stakeholders. As a result, every year, following the publication of the statements, we produce an annual Summary Document. This document brings together the information contained in the six statements, summarising the results and comparing them to previous years to help identify trends over time.

2.10. We have published the Summary Document for the 2013 statements alongside this consultation<sup>2</sup>. Company's efforts to publish earlier allowed us to accelerate our publication by around two months. We want to do it earlier still next year.

2.11. In addition, following stakeholder feedback, we have included an assessment of our Supply Market Indicator (SMI) against actual data published by companies in their 2013 statements.

2.12. As last year, we are keen to receive views from stakeholders on the content and accessibility of the information in this document. In particular, we would appreciate any feedback that could improve the document in future years.

### **Supply Market Indicator**

2.13. The SMI complements the statements, which are necessarily backward looking. It provides estimates of the costs and profit margin (proxy for EBIT margin) that a large energy supplier would make for an average gas, electricity and dual fuel customer over the following 12 months, if average revenues (proxy for bills) remained unchanged. The SMI is used by a wide range of stakeholders.

2.14. We introduced the SMI in 2009 as a tool for assessing trends in average energy supply costs and pre-tax margins of the six large energy companies' domestic retail supply businesses. An important aim is to help stakeholders to better understand the relationship between wholesale costs and retail prices. The SMI was originally published on a quarterly basis, then we published it weekly from March 2012.

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<sup>2</sup> <https://www.ofgem.gov.uk/publications-and-updates/revenues-costs-and-profits-large-energy-companies-2013>



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

2.15. As part of our actions to improve transparency of energy company profitability, in 2013 we committed to reviewing the SMI's methodology, recognising a need to improve it. We have done so and relaunched it in March. We tested the performance of the updated methodology. As explained in our Summary Document of the 2013 statements, and in the next chapter, our assessment suggests that the updated methodology performed significantly better than the old one. We now publish it on a monthly basis.

2.16. As a result, we are more confident of our SMI estimates. Nevertheless, the SMI is only an estimate and can only ever be as good as the data inputs available at the time of publication. Some of the data is necessarily lagged, and we have to estimate other components. For example, we don't try to forecast changes in retail prices, and we assume seasonally normal weather. This means that SMI estimates will rarely be the same as reported, after-the-fact actuals. This does not detract from the usefulness of the SMI as an indicator of normal trends. Our annual assessment of SMI estimates and actuals will show the drivers for any differences, and suggest possible improvements.

### **Our wider actions to promote transparency**

#### *Liquidity*

2.17. We have implemented our proposals to improve liquidity and transparency in the electricity wholesale market with the special licence condition 'Secure and Promote' that came into effect on 31 March 2014.

2.18. We now require the six large vertically-integrated energy companies to post the prices at which they are willing to buy or sell electricity - in a range of forward market products, ie to be "market makers" for those products. These measures should allow independent suppliers and generators to access the range of wholesale market products they need to compete effectively with the established companies. We also require the eight largest generators to comply with the Supplier Market Access rules, which ensure that small suppliers can get access the wholesale products that meet their hedging needs.

2.19. We are now monitoring the effectiveness of our liquidity reforms through monitoring of liquidity as seen in several market-level indicators, as well as through the quarterly compliance statements sent to us by the obligated parties. The early indication is that liquidity continues to follow the improving trend observed since at least 2013. We have seen an overall positive movement since Secure and Promote, however it is too early to draw any conclusions about the specific contribution of our intervention.

#### *Price benchmarks*

2.20. Wholesale market price benchmarks are an essential component of the way in which gas and electricity is traded in the over-the-counter (OTC) market.



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

2.21. We issued a call for evidence on benchmark prices and the role and processes of Price Reporting Agencies in June 2013. This sought views from market participants about how they both contributed to and used price assessments and indices, and sought views more broadly on whether current arrangements are fit for purpose. In July 2014 we set out our position that Price Reporting Agencies should voluntarily extend the IOSCO principles for Oil Price Reporting (to which they are already subject) to their gas and electricity products. We also noted that the European Union may bring forward legislation in this area through its proposed Benchmarks Regulation.

*REMIT*

2.22. The Regulation on wholesale Energy Market Integrity and Transparency (REMIT) came into force in December 2011. Its main contribution to transparency is the requirement it places on market participants to publically disclose inside information. This should ensure that price formation is based on market fundamentals and that individual market participants are not able to trade on information that the rest of the market is not aware of.

2.23. REMIT also allows for the Agency for the Cooperation of Energy Regulators to publish parts of the information which it will collect under REMIT (including, for example, trading data) provided that commercially sensitive information on individual transactions, market places or market participants are not disclosed and cannot be inferred from the data. The publication of such information may provide further transparency of prices.

2.24. The projects above demonstrate the work Ofgem is doing to improve transparency and market confidence in a broad range of areas. In the next chapter, we outline our proposals to amend the rules to prepare and publish the statements, aimed at improving the transparency of information on energy company profitability.

## 3. Actions to improve transparency

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### Chapter summary

In this chapter, we outline our proposals to secure and enhance the improvements in transparency we and the companies have worked on over the last year. We propose to amend the relevant licence conditions and guidelines.

### Question Box

**Question 1: Do you agree with the proposal to tighten the scrutiny of companies' transfer pricing policies?**

**Question 2: Do you agree with the proposed audit requirement? Do you have any views on the detail of the requirement?**

**Question 3: Do you agree that the proposed change to the reconciliation requirement?**

**Question 4: Do you think the obligation to produce Consolidated Segmental Statements should continue to be targeted to large vertically integrated companies? If not, who do you think the obligation should apply to and why?**

**Question 5: Do you agree with the proposed cost categories, and the detailed allocation of cost items between these categories? Do you agree with the additional financial and non-financial information to be disclosed?**

**Question 6: Do you agree with our proposal to require further breakdown of environmental and social obligation costs from the 2015 statements onwards?**

**Question 7: There is a potential tension between transparency and competition. Do the benefits in improved transparency this package aims to deliver outweigh the risks of an adverse impact on competition?**

3.1. This chapter outlines our proposals to secure and enhance the improvements in transparency we and the companies have worked on over the last year. We propose to do so by embedding them in the relevant licence conditions and guidelines.

3.2. The table below outlines our work plan to improve profits transparency, which we published in February 2014. Our aim is that the 2014 Consolidated Segmental Statements will be published in the first half of 2015 and will reflect the new requirements. We will continue refining the SMI.

Rebuilding consumer confidence:  
 Actions to improve the transparency of energy company profits

3.3. In this chapter, we set out our work and proposals under each of the elements of transparency, notably the robustness, usefulness and accessibility of the information.

<b>Action / Timing</b>	<b>Immediate</b>	<b>Through 2014</b>	<b>By end 2014</b>
<b>Robustness</b>			
Increase auditor scrutiny	Auditors scrutinising 2013 statements	2013 statements published	Enduring audit requirement in place
Transfer pricing (TP) review	Ofgem kicks-off TP review	Report findings	Any additional TP requirement in place
Give more insight into trading activities	Companies working to deliver	2013 statements contain more insight	Any additional trading requirement in place
<b>Usefulness</b>			
Faster publication	Companies working to deliver	Full set of 2013 statements published two months earlier	Enduring (shorter) publication deadline in place
Develop ROCE methodology	Ofgem kicks off work	Finalise new methodology	Enduring ROCE requirement in place
<b>Accessibility</b>			
Greater cost breakdown	Implement in improved SMI	2013 statements present further cost breakdown	Updated guidance published
Improved SMI	Re-launch shortly	Continuous refinement	Continuous refinement

## Improving robustness

3.4. Information on the profitability of supply and generation activities is one of the measures we and others use to monitor the evolution of competition in the energy market. Therefore, it is important that this information is robust, so it provides confidence that the reported figures are derived correctly. The aim of the statements is to provide accurate information, both to Ofgem and other interested parties.

### Review of energy companies' transfer pricing policies

3.5. The large energy companies use transfer prices to allocate revenues, costs and profits between their generation, trading and supply business segments. There are several approaches to transfer pricing. Companies' choices on structure and operation can result in different transfer pricing policies, for example, to reflect different choices on allocating risks between segments. The transfer pricing policy on its own does not directly affect whether consumers get a fair deal. What it does mean is that segmental revenues, costs and profits will not necessarily be directly and fully comparable between companies if transfer pricing policies differ, or over time if they change.

3.6. Transfer pricing rules seek to prevent the misallocation of profit to lower tax territories, and to enable management to get a more reliable view of the performance of each part of the business.

3.7. They do this by requiring the application of a third party price. This 'arm's length standard dictates that the allocation of income and costs from transactions between connected parties should correspond to one that would result if unconnected

parties were doing these transactions instead. Therefore, by applying a third party price at each stage of the value chain, transfer pricing rewards each segment for its activity and the value it adds, rather than allowing the business to manipulate where its profit falls.

#### *Reasons for the review*

3.8. This spring, we launched an in-depth, independent assessment of the transfer pricing policies that the companies use. We commissioned a specialised accounting firm to do it (BDO). This built on their previous 2012 review, which also covered transfer pricing, among other things.

3.9. The review was a response to public concern that, even after successive rounds of improvements to the statements, the companies could use their transfer pricing policies to unduly influence the profit figures they report for their supply and generation businesses. Our aim was, and remains, to address this concern, and in doing so, increase the public's confidence on the reported profitability information.

3.10. The review assessed whether, from a transfer pricing perspective, the policies that companies use are appropriate. This included an assessment of the business models used (the economic angle), the adherence to the arm's length standard (the legal angle), and whether the financial data reflect the transfer pricing policy (the accounting angle).

3.11. We have published the consultant's report alongside this consultation<sup>3</sup>.

#### *Findings of the review*

3.12. The review found the large energy companies' transfer pricing policies to be appropriate. This gives us even greater assurance that the statements present an accurate picture of generation and supply profitability.

3.13. It confirmed that the large energy companies, like any other business with internal transactions at different segments of the value chain, are constrained by transfer pricing rules. The use of transfer pricing is widespread in the economy, and is governed by an established set of legislation, guidelines and best practice.

3.14. Different jurisdictions implement and give force to transfer pricing rules through tax legislation. In the UK, the relevant legislation is the Taxation (International and Other Provisions) Act 2010, and HM Revenue & Customs is the tax authority responsible for enforcing it.

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<sup>3</sup> <https://www.ofgem.gov.uk/publications-and-updates/actions-improve-transparency-energy-company-profits-1>



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

3.15. The key finding is that the business models used by the large energy companies, and their current transfer pricing policies, reflect the arm's length standard. This means that they adhere to the key requirement of transfer pricing rules.

3.16. Furthermore, there appears to be no material tax, commercial or managerial incentive to shift profit from reported to unreported segments through transfer pricing.

3.17. Therefore, we are more confident that the profits companies declare are the ones they actually make, from their activities in generation and supply, and there is no undue allocation of profits into companies' trading arms. As a result, the statements present an accurate picture of segmental profitability.

3.18. The review noted one area that should be looked again in the light of the findings of the CMA investigation currently underway. Namely, basing transfer prices on market prices, as the latter are influenced by the dynamics of competition, which is the focus of the investigation.

3.19. The review highlighted the importance of keeping transfer pricing policies under review as the market, and businesses themselves, change. It also noted that in some companies, there are no transfer pricing-specific internal audit procedures.

*Proposal: tighten scrutiny of companies' transfer pricing policies*

3.20. We propose to require companies to keep, appropriate and effective transfer pricing policies for their specific individual circumstances, like business models. This must be done by, among other appropriate actions:

- keeping transfer pricing policies under review as the market changes, for example by ensuring that supporting comparable data underpinning their transfer prices remains appropriate, and
- ensuring that transfer pricing policies and procedures are subject to internal audit.

3.21. We also propose that companies must notify Ofgem of changes to their transfer pricing policy. They must also explain it in their annual Consolidated Segmental Statement.

3.22. Finally, companies must annually confirm to Ofgem the status of any HM Revenue & Customs inquiry into their transfer pricing practices.

***Question 1: Do you agree with the proposal to tighten the scrutiny of companies' transfer pricing policies?***

### **Increasing auditor scrutiny**

3.23. Since the introduction of the statements in 2009, we have worked to improve their transparency. As part of this work, we have in the past commissioned three independent reviews, in addition to the most recent transfer pricing review. The findings of these reviews have helped us improve the statements.

3.24. Nevertheless, it became clear from these exercises and the feedback we received, including from the Energy and Climate Change (ECC) Select Committee, that the statements were not fully delivering the confidence some stakeholders expected.

3.25. This led us to consult in late 2013 on whether a full financial external audit completed before publication of the statements would deliver the desired level of confidence. This measure received broad support, and we concluded that it would deliver the assurance required.

3.26. For the 2013 statements, we asked each company to get their external auditors to perform a detailed series of checks to their statements (formally known as Agreed Upon Procedures, or AUPs). They performed these checks, and two companies – Centrica and Scottish Power – went further, and delivered audited opinions from external auditors. The key difference is that an audited opinion delivers more assurance that the statements are properly prepared.

3.27. These checks improve confidence that the companies have prepared their 2013 statements appropriately. They also laid the groundwork to allow the companies and their auditors to develop the frameworks and processes they will need to provide a full audit from the 2014 statements onwards.

3.28. We considered and discarded requiring AUPs as the enduring requirement. This is based on the evidence obtained from the four companies that did them for their 2013 statements. We consider that AUPs do not give the assurance required in the current environment, and the outcome is not easily accessible, nor visible to the public.

3.29. Based on the evidence we have, an audit opinion costs the companies between £30,000 and £150,000 per company per year, depending on individual company circumstances. The direct benefits are measured in greater assurance that the statements are properly prepared and that the reported figures are derived correctly. The wider benefits are greater consumer and stakeholder confidence in the market. We consider that the benefits to consumers likely outweigh the costs, even if costs were fully passed through to consumer bills.

3.30. We therefore confirm our previously consulted-on proposal to require audits on the statements.

Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

*Proposal: require companies to get the Consolidated Segmental Statements audited*

3.31. We propose to make external audits of the statements compulsory by including this requirement in the licence condition.

3.32. Companies will need to commission an external auditor to provide an audit opinion that the statements have been prepared, in all material respects, in accordance with the licence condition and associated guidelines (we have published drafts of the proposed amended licence condition and guidelines in the appendices). The audits must conform to International Financial Reporting Standards (IFRS).

3.33. They will have to publish this opinion alongside their statement.

3.34. The external auditor can be the same one as the one companies commission for their statutory audit.

3.35. The companies should have started (or soon start) planning the audit work for their 2014 statements. We envisage that they will do this audit work alongside the statutory audit, to minimise costs. This should also enable them to deliver the audit and publish their statement within four months after the financial year closes.

***Question 2: Do you agree with the proposed audit requirement? Do you have any views on the detail of the requirement?***

We are also proposing to tweak the reconciliation requirement in the licence condition. The proposed change aims make the UK the main jurisdiction for the reconciliation, where possible. Non-UK Group accounts would be a fall-back option.

We propose that the Consolidated Segmental Statements are reconciled to UK statutory accounts. Only if UK statutory accounts are not prepared, then the companies should reconcile to audited figures (prepared under International Financial Reporting Standards) published in Group accounts.

***Question 3: Do you agree that the proposed change to the reconciliation requirement?***

### **Greater insights into trading activities**

3.36. There has been significant and concern in the role of the large energy companies' trading operations, and its relationship to reported generation and supply profits and consumer bills. One key concern expressed was that companies could use the transfer prices between generation, trading and supply activities to unduly influence reported profits. Another concern was that consumers could end up paying for trading losses, eg resulting from irresponsible behaviour.

Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

3.37. One manifestation of these concerns was the ECC Select Committee's July 2013 call on us to require companies to disclose their trading arm results<sup>4</sup>.

3.38. We understand these concerns and agree we must play our role in addressing them. We think that greater transparency in this area should help stakeholders' understanding and this, in turn, should help rebuild confidence in the market.

3.39. Our response was to launch the transfer pricing review to give greater confidence in reported profitability information, and inform any additional requirements. That is because transfer prices and trading results are interdependent. An appropriate transfer price should be sufficient to attribute the relevant trading function results (ie those associated with hedging activities, not speculative ones) between generation, supply and trading.

3.40. The other action we took was to call on companies to provide more insight into their trading activities in their 2013 statements.

*Insights into trading activities in 2013 statements*

3.41. Companies' response to our challenge ranged from full disclosure of trading results to enhanced descriptions of trading activities.

3.42. Two companies fully disclosed their financial results together with enhanced descriptions of the role of their trading arms:

- Centrica (called Midstream): £111m revenue and £29m profit. Trading profits were around 3% of generation and supply profits. This includes proprietary trading.
- Scottish Power (called Energy Management): £6.4bn revenue and £13m profit. Trading profits were around 6% of generation and supply profits. This includes proprietary trading.

3.43. SSE partially disclosed the results of its trading arm results (called Energy Portfolio Management), including revenue and profit information: £24.7bn revenue and £14m profit. Trading profits were around 2% of generation and supply profits. SSE did not specify whether it performs proprietary trading.

3.44. The remaining three companies (E.ON, RWE and EDF) provided enhanced descriptions of the role of their trading arms but did not provide financial results for their GB-related activities. These three companies' trading arms operate at an EU-wide (or global) level. In their responses to last year's transparency consultation<sup>5</sup>,

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<sup>4</sup> <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmenergy/108/108.pdf>

<sup>5</sup> <https://www.ofgem.gov.uk/publications-and-updates/improving-transparency-energy->



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

they noted that it would be difficult, unduly costly, or even impossible to isolate the trading data relevant to the GB power and gas market. Financial information on the performance of the overall activities of these companies' trading arms can be found in their groups' annual reports and accounts.

3.45. This trading information provides greater context to the operations of these companies, and gives a sense of how trading profits compare to those earned in generation and supply (ie they tend to be small, between 2% and 6%).

3.46. However, this additional information sheds limited light (if any) on the profitability of the generation and supply arms, and on the relationship between wholesale and retail prices and profits. This is mainly because:

- We are increasingly confident that the companies' transfer pricing policies are appropriate
- These trading results at least partly reflect speculative trading activity, which is not central to the energy supply chain.

3.47. In addition, some of the information disclosed is irrelevant to the GB market. For example, some figures include elements of overseas generation activities.

*Transfer pricing review – implications for trading transparency*

3.48. The transfer pricing review was our other response to concerns about insufficient transparency on energy company profitability.

3.49. The key finding of the review is that the large energy companies price internal transactions between generation, trading and supply at arm's length. This implies that the performance of trading arms has no bearing on the prices that generation receives from trading, or those that supply pays to trading.

3.50. Therefore, trading arm activity and results do not appear to materially affect generation/supply profits or consumer bills. This is because transfer pricing adheres to the arm's length standard. This gives us more confidence that consumers are not paying for things they shouldn't.

3.51. This situation needs to be kept under review to ensure the arm's length standard is met in the future, while market structure and operation remains the same. As explained above, we propose to do so by tightening the scrutiny of

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[company-profits](#)



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

companies' transfer pricing practices. We intend to place the onus on companies to keep appropriate transfer pricing policies and report on any material changes, and on auditors – both internal and external – to annually confirm that they are satisfied that company management has done so.

*The significance of the CMA investigation*

3.52. There remains a question on what further steps, if any, should be taken to increase transparency in this area.

3.53. The ongoing CMA investigation is a significant development that we must factor into any decision on whether and how to intervene any further. We expect that the CMA's conclusions could have a bearing on some or all of the following:

- Our view of whether further transparency is appropriate – several submissions to the CMA have pointed to the tensions between transparency and competition
- The level of any continued concern over company profits and the role that transparency plays in building trust and public confidence
- The appropriate form of any prescription – for example, depending on whether any CMA remedies involve structural reforms such as ownership unbundling or regulatory ring-fencing.

3.54. In addition, prescribed reporting in this area could impose significant costs for some companies – particularly those with central European trading arms. A step in this direction also poses some legal difficulties given that these activities are not licensed, and our jurisdiction does not stretch beyond GB.

3.55. For these reasons, we think it is not appropriate to take a substantive decision now. To do otherwise would be disproportionate. Instead, we commit to reassessing our financial disclosure requirements in the light of CMA findings, and any potential remedies that may result.

## **Improving usefulness**

### **Accelerate publication of the statements**

3.56. The companies currently have six months following the end of their financial year to publish their statements. We chose this deadline to give companies time after completing their annual report to produce the statements. We also recognised that for the first few years, the companies may need more time to develop their processes.



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

3.57. Having had the experience of five years' worth of statements, we consider that companies can, and should, publish their statements sooner. Most of the consultation respondents agreed that this would make the information more timely and relevant.

3.58. For the 2013 statements, we asked the companies to use their best endeavours to bring forward publication as much as they could. The involvement of external auditors added some time into the process. However, most of them published before the six months deadline. Centrica led the way, publishing less than two months after the end of their financial year.

3.59. Companies' efforts to publish sooner also allowed us to publish our annual Summary Document of the statements more quickly. We have published this document today, alongside this consultation, and welcome feedback on how to improve it.

3.60. We therefore confirm our previously consulted-on proposal to require earlier publication.

*Proposal: require companies to publish as soon as possible, and no later than four months after their financial year end.*

### **Develop a ROCE methodology to present profitability of generation**

3.61. In our February 2014 letter we proposed to work with stakeholders to develop a common approach for estimating and disclosing capital employed values. This would allow the calculation of a return on capital employed (ROCE).

3.62. ROCE is regarded as an appropriate measure of profitability in many markets. This is especially the case in capital-intensive industries, such as electricity generation. The nature of the wholesale energy market, in particular the potential for profits caused by comparatively low-cost generation and the long lead times for building new power plants, means that ROCE may not be a relevant indicator in determining whether profits are high or excessive. Nevertheless, we considered that the publication of ROCE figures for generation would provide a more meaningful picture of the level of profits over time.

3.63. A key factor in calculating ROCE is the asset values used to derive estimates of capital employed. There is a range of approaches used for valuing assets (eg book value, market value or modern equivalent value). These can result in very different ROCE results.

Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

3.64. The joint Ofgem/CMA State of the Market Assessment<sup>6</sup> confirmed the difficulties in deriving robust and comparable capital employed figures: "*the high degree of variability in these results and the obvious issues around comparability of data mean we would place very limited reliance on these results. We would need to conduct a fuller study of the composition of the capital employed figures to ensure they are stated on an appropriate basis to be able to form a view on ROCE for the supply business...[For generation], as for supply ROCE we are unable to place any more than limited weight on this result as we have not established the reliability of the EBIT and capital employed figures underlying these calculations.*"

3.65. This highlights the risk of inconsistent results, and therefore the importance of a common methodology to derive capital employed figures. We expect that the CMA investigation will conduct a fuller study of profitability, including ROCE.

3.66. We think it is appropriate that the development of a common methodology incorporates any findings and lessons from the CMA's exercise. In order to avoid the risk of having inconsistent and potentially confusing ROCE estimates in the public domain, our proposal is to revisit this action in the light of the CMA findings.

### **Obligation to publish Consolidated Segmental Statements – scope of application**

3.67. The requirement to publish statements is targeted at large energy companies that are vertically integrated (ie active in generation and supply). That was the original policy intent and has remained unchanged to today.

3.68. In the interest of clarity, we are amending the current drafting that defines the relevant licensees in the licence conditions (electricity generation licence and electricity and gas supply licenses), to align it with the original policy intent. As it stands, a supplier that passes the threshold in terms of customer accounts would technically be a relevant licensee regardless of it being active in electricity generation or not.

3.69. We do not propose to change the policy intent before the CMA concludes its investigation. However, we would like to solicit views now on whether the requirement to produce statements should be widened. Any potential changes would take place from the 2016 statements (published in 2017).

#### *Scope of application of the requirement to publish statements*

3.70. We introduced the statements in 2009 to address a competition concern. This was that vertical integration led to opacity with regard to the profitability of different segments of the value chain, resulting in a potential barrier to entry; and concerns around cross-subsidisation between generation and supply.

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<sup>6</sup> <https://www.ofgem.gov.uk/ofgem-publications/86804/assessmentdocumentpublished.pdf>



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

3.71. The statements have proved largely effective at addressing our original aim, although we continue to refine them. By adding transparency around company profitability, the statements have also proved a valuable tool to help rebuild confidence in the energy industry.

3.72. More recently, with the growth of small suppliers, there have been some calls to widen the scope of the obligation to cover other companies. For example, Ovo has voluntarily published statements for 2012 and 2013, and has argued that all energy companies should do so to help rebuild trust in the industry<sup>7</sup>.

3.73. We want the requirement to produce statements to remain effective as the market evolves. At the same time, we must act in a proportionate, consistent and targeted manner in order to adhere to the principles of good regulation.

3.74. We consider that now is not the time to introduce changes to the scope of application of the obligation. We think such an assessment should await the findings of the CMA investigation, especially on the tensions between transparency and competition, and any potential structural remedies that could follow.

3.75. Nevertheless, we see merit in using this opportunity to consult stakeholders on their views on potentially expanding the scope of application of the obligation to other companies. The dimensions to consider are company size and nature of vertical integration.

3.76. The potential benefits we consider most relevant for this assessment include:

- enhancing transparency on the profitability of different energy companies
- facilitating potential new entrants assessing opportunities to enter the market
- helping increase assurance of the information that vertically-integrated companies publish by providing comparator data
- helping government gather a broader evidence base on the impact of its policies on company costs
- exerting downward pressure on the cost of capital by reducing information risk<sup>8</sup>.

3.77. The potential costs include:

- imposing costs on companies to produce and audit the statements, which would likely be passed through to consumer bills to some degree. The

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<sup>7</sup> <http://www.ovoenergy.com/segmental-reporting/>

<sup>8</sup> Economic literature has found empirical evidence of an association between financial reporting transparency and the cost of capital. This supports theoretical findings that suggest that reporting transparency can reduce the cost of capital.  
<http://jaf.sagepub.com/content/23/2/173.short>



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

- evidence we have suggests that an audit can cost between £30,000 and £150,000 for a large energy company.
- adversely impacting competition by facilitating coordination between the companies, especially around wholesale costs hedging strategies.

3.78. To avoid doubts, we will continue to welcome voluntary production, provision to Ofgem and/or publication of statements from non-vertically integrated companies, as long as they are robust, useful and accessible (ie adhere to the licence condition and guidelines).

3.79. We will assess our financial disclosure obligations in the first half of 2016, in the light of the CMA investigation findings. The views expressed in response to this consultation regarding the scope of application of the obligation will inform our thinking at that later stage.

***Question 3: Do you think the obligation to produce Consolidated Segmental Statements should continue to be targeted to large vertically-integrated companies? If not, who do you think the obligation should apply to and why?***

## **Improving accessibility**

### **Greater cost breakdown and additional financial and non-financial information**

3.80. It is important that the highly public debate about the costs of energy is based on robust evidence and that consumers have an accurate understanding of the cost drivers behind their bills. This is harder to achieve when companies and opinion-formers calculate and present cost information differently.

3.81. Addressing this issue requires coordination. We have worked with the companies to agree a common set of cost categories for the statements and to present bill breakdown information. The focus is on showing network costs and environmental and social obligations costs separately. We sought to strike a balance between, on the one hand, having enough categories to allow people to understand the main cost drivers, while, on the other hand, keeping the breakdown simple and ensuring the greater detail does not undermine competition.

3.82. Companies already published their 2013 statements using this more detailed cost breakdown. We think this is an improvement from the past. However, we have identified some inconsistencies in how different companies allocated certain costs between the categories.

3.83. We anticipated this would be likely as we left some flexibility around the exact allocation of every single cost item between the agreed cost categories. We did this because we needed time to work with industry to settle this. This is the opportunity to do so.



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

3.84. We have included proposed draft guidelines in appendix 3. These detail how we propose to allocate costs between the categories. We also propose to include additional financial and non-financial information that we consider helps to improve transparency on company profitability and operation.

3.85. Important proposed changes to note include:

- **Direct fuel costs:** for suppliers, we intend these costs to be as comparable as possible (ie after hedging is factored in) with observed wholesale gas and electricity prices. We therefore propose that losses, balancing costs and the energy element of reconciliation by difference (RBD) costs are no longer included in this cost category.
- **Other direct costs:** we propose this category contains those costs that can be described as market participation costs, and which do not fit naturally in the other categories. For example, Elexon/Xoserve admin costs, losses, balancing costs, the energy element of RBD costs and Data Communications Company-related costs.
- **Additional financial information:** we propose to include a line for "exceptional items" as defined in the guidelines. As a result, we have included two additional lines, one for "adjusted EBITDA" and another for "adjusted EBIT", both of which exclude "exceptional items". In addition, we propose a line for "interest", one for "tax" and one for "net profit" (ie profit after tax and interest costs).
- **Additional non-financial information:** we propose that companies disclose the average number of "customer accounts" for their supply businesses, to be calculated as specified in the guidelines. This will complement the "volume" information they already disclose. This will enable the calculation of revenues, costs and profit information on a per-customer basis, where appropriate.

***Question 4: Do you agree with the proposed cost categories, and the detailed allocation of cost items between these categories? Do you agree with the additional financial and non-financial information to be disclosed?***

3.86. There are a number of government policies aimed to achieve different environmental and social goals. However, most of them also impose costs on companies, who in turn pass them through to consumers, to a greater or lesser extent. This has been a hotly debated topic in the past year.

3.87. The design of individual policies varies, which means that their impact on companies and consumers will vary. For example, the Carbon Price Floor, by increasing the cost of carbon emissions, impacts the profitability of electricity generators. This will tend to increase wholesale electricity prices, which suppliers further down the value chain face. On the other hand, the Energy Company



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

Obligation, by requiring suppliers to deliver energy efficiency measures to households, imposes direct costs on obligated suppliers.

3.88. We consider that there is a good case for greater transparency of the real costs that individual policies impose on suppliers and, ultimately, consumers each year. This should inform the public debate, and also allow government to evaluate the impact of its policies with robust data.

3.89. Therefore, we are minded to require policy-by-policy disclosure of environmental and social obligations costs. Subject to responses from this consultation, we envisage working with industry and government to develop an approach that enables consistent reporting from the 2015 statements (for publication in 2016) onwards.

***Question 5: Do you agree with our proposal to require further breakdown of environmental and social obligation costs from the 2015 statements onwards?***

### **Improving the methodology of our Supply Market Indicator**

3.90. The SMI adds value by providing a regular, forward-looking view of trends in costs and revenues. This complements the statements, which provide a historic view of realised revenues, costs and margins.

3.91. In October 2013, we undertook an extensive review of the methodology. We relaunched the SMI in March 2014, having made some substantial changes to the methodology to improve the robustness of our estimates and their comparability with the statements' data. For example, we made our revenue estimates more representative of the types of tariffs customers are on and we further aligned the cost categories with the way companies report costs in their statements.

3.92. We tested the revised SMI estimates against actual data from the statements. The revised methodology performed significantly better than the old one, with cost and revenue estimates for calendar year 2013 all being within 5% of actuals. Our EBIT margin estimates were 2.2% and 4.5%, depending on which of our two measures was used, while the actual margin was 3.9%. This analysis is presented in our Summary Document of the 2013 statements.

3.93. Understanding how well the SMI has performed provides useful evidence to help us continue refining the methodology.

3.94. Some responses to our 2013 transparency consultation suggested that the SMI should be reviewed each year and tested against outturn data from the



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

statements<sup>9</sup>. We agree. We plan to make a review of the SMI a regular feature of the annual summary document of the statements.

## Conclusion

3.95. Transparency of energy company profits matters. It is important for consumer confidence, and for new firms thinking to enter the energy market. Robust data also helps us and others to monitor and assess how well the market is working for consumers.

3.96. The market investigation reference to the CMA is a significant, complementary development that we have factored into the work plan we outlined in February. We have taken into account the potential impact of the CMA investigation on our proposals.

3.97. While the CMA investigation takes its course, we consider that it is important to push forward to improve the robustness, usefulness and accessibility of cost, revenue and profit information.

3.98. However, transparency over certain aspects of companies' operations, like pricing and strategy, has the potential to have adverse effects on competition.

3.99. We consider that our proposals strike an appropriate balance. But we note that some submissions to the CMA have pointed to the tensions between transparency and competition.

3.100. Therefore, we welcome stakeholder views on whether the level of transparency this package aims to deliver is appropriate.

***Question 6: There is a potential tension between transparency and competition. Do the benefits in improved transparency this package aims to deliver outweigh the risks of an adverse impact on competition?***

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<sup>9</sup> [Rebuilding consumer confidence: Improving the transparency of energy company profits](#), Ofgem, December 2013.

## 4. Next steps

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4.1. We ask stakeholders to respond to this consultation by 6 November. Appendix 1 provides details on how to respond.

4.2. In the light of responses to this consultation, we intend to publish the statutory consultation in mid-November, and the licence modification decision in December 2014. Our aim is that companies prepare their 2014 statements under the updated rules.

4.3. In the first half of 2015, and depending on the responses to this consultation and approval by the Authority, we would work to develop an approach that enables consistent reporting of individual government policy costs that suppliers incur. Any changes to the guidelines would happen by the end of 2015, to allow companies time to implement in their 2015 statements.

4.4. In the first half of 2016 we will revisit our financial disclosure obligations in the light of the CMA findings. We will assess the following:

- Whether our requirements strike an appropriate balance between providing transparency and not adversely affecting competition.
- The scope of application of the obligation to publish the statements.
- What is a proportionate approach to the disclosure of trading information
- The option of developing a common methodology for deriving capital employed values to calculate a return on capital employed (ROCE).

## Appendices

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### Index

<b>Appendix</b>	<b>Name of Appendix</b>	<b>Page Number</b>
1	Consultation Response and Questions	27
2	Draft of proposed licence condition changes	29
3	Draft of proposed amended guidelines	33
4	Feedback questionnaire	41

## Appendix 1 - Consultation Response and Questions

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1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from energy companies, consumer representatives and other users of information on energy company profitability. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated overleaf.

1.2. Responses should be received by 6 November and should be sent to:

**Diego Villalobos**  
Retail Market Analysis  
Ofgem  
9 Millbank  
London  
SW1P 3GE  
020 7901 1846  
[css@ofgem.gov.uk](mailto:css@ofgem.gov.uk)

1.3. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.4. Respondents who wish to have their responses remain confidential should clearly mark the document(s) to that effect and include the reasons for confidentiality. Respondents are asked to put any confidential material in the appendices to their responses.

1.5. Any questions on this document should, in the first instance, be directed to the contact above.

**Question 1: Do you agree with the proposal to tighten the scrutiny of companies' transfer pricing policies?**

**Question 2: Do you agree with the proposed audit requirement? Do you have any views on the detail of the requirement?**

**Question 3: Do you agree that the proposed change to the reconciliation requirement?**



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

**Question 4: Do you think the obligation to produce Consolidated Segmental Statements should continue to be targeted to large vertically integrated companies? If not, who do you think the obligation should apply to and why?**

**Question 5: Do you agree with the proposed cost categories, and the detailed allocation of cost items between these categories? Do you agree with the additional financial and non-financial information to be disclosed?**

**Question 6: Do you agree with our proposal to require further breakdown of environmental and social obligation costs from the 2015 statements onwards?**

**Question 7: There is a potential tension between transparency and competition. Do the benefits in improved transparency this package aims to deliver outweigh the risks of an adverse impact on competition?**

## Appendix 2 - Draft of proposed licence condition changes

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1.1. We include below the proposed drafting of the Standard Condition 19A of the Electricity Supply Licence and the Gas Supply Licence. This would apply to Standard Condition 16B of the Electricity Generation Licence, except for the definition of "Relevant Licensee", which would remain unchanged.

### **Condition 19A. Financial information reporting**

- 19A.1. The Relevant Licensee must prepare and publish on its Website a Consolidated Segmental Statement in respect of information relating to the revenues, costs and profits of its activities in the generation and supply of electricity and the supply of gas to any premises taking account of the Guidelines.
- 19A.2. Where applicable, the Relevant Licensee must prepare and publish the Consolidated Segmental Statement referred to in paragraph 19A.1 in conjunction with any Affiliates.
- 19A.3. The Relevant Licensee must, in conjunction with any Affiliates, prepare and publish a Consolidated Segmental Statement:
- (a) **as soon as reasonably practicable and** no later than **four** months after the end of the Relevant Licensee's financial year; or
  - (b) no later than a date specified by the Authority, which can be no earlier than **four** months after the end of the Relevant Licensee's financial year.
- 19A.4. Subject to complying with this paragraph the Relevant Licensee may, for the purpose of preparing the statement pursuant to paragraph 19A.3, prepare and compile the information according to the licensee's annual accounting procedures. The Relevant Licensee must include in every such statement an explanation of:
- (c) how it defines the terms revenues, costs and profits;
  - (d) **how the revenues and profits can be reconciled with its UK statutory accounts;**
  - (e) **or, if UK statutory accounts are not prepared or published, how the revenues and profits can be reconciled with audited figures (prepared**

Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

under International Financial Reporting Standards) published in Group accounts;

- (f) its transfer pricing methodology and how this relates to the revenues, costs and profits information published; and
  - (g) where individual business functions are captured in the Consolidated Segmental Statement, as specified by Appendix 2 of the Guidelines.
- 19A.5. The Relevant Licensee must ensure that the information prepared and made public pursuant to paragraph 3 includes the cost of fuel used to generate electricity and its share of revenues, costs, profits and volumes of Joint Ventures and Associates.
- 19A.6. Subject to complying with Paragraph 19A.5 the Relevant Licensee must ensure that all the information prepared and made public pursuant to paragraph 19A.3 is in all material respects consistent with the information prepared pursuant to paragraph 19A.4 and the information is presented with a clear and full explanation.
- 19A.7. The Relevant Licensee must, for the purposes of ensuring the transfer pricing methodology is appropriate and up to date:
- (a) keep transfer pricing policies under review;
  - (b) ensure that the supporting information that supports the transfer pricing policies remains appropriate and up to date; and
  - (c) include transfer pricing policies and procedures in the Relevant Licensee's internal audit process.
- 19A.8. The Relevant Licensee must notify the Authority as soon as reasonably practicable:
- (a) of any changes to transfer pricing policies; and
  - (b) if the Relevant Licensee's transfer pricing is the subject of an inquiry by HM Revenue & Customs.
- 19A.9. (a) The Authority shall prepare Guidelines in relation to the requirements of this condition and may modify, in whole or in part, the Guidelines following consultation with the Relevant Licensees.

Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

(b) The Authority shall modify the definition of Consolidated Segmental Statement as described in Appendices 1 and 2 of the Guidelines in accordance with section 11A of the Act.

19A.10. Except and to the extent that the Authority otherwise consents, the Relevant Licensee must include in the Consolidated Segmental Statement a report from an Appropriate Auditor that gives an audited opinion as to the extent to which the Relevant Licensee has properly prepared the Consolidated Segmental Statement in accordance with this licence condition and the Guidelines.

19A.11. The audited opinion prepared pursuant to paragraph 19A.10 must conform to International Financial Reporting Standards (IFRS).

19A.12. For the purposes of this condition:

**“Affiliate”** means any holding company or subsidiary of a holding company of the Relevant Licensee, in each case within the meaning of sections 1159 and 1160 of the Companies Act 2006.

**“ Appropriate Auditors”** means

- (a) in the case of a licensee which is a company within the meaning of section 1 of the Companies Act 2006, a person appointed as auditor under Chapter 2 of Part 16 of that Act;
- (b) in the case of any other licensee which is required by the law of a country or territory within the European Economic Area to appoint an auditor under provisions analogous to Chapter 2 of Part 16 of the Companies Act 2006, a person so appointed;
- (c) in any other case, a person who is eligible for appointment as a company auditor under sections 1212 and 1216 of the Companies Act 2006, or in relation to auditors appointed for financial years beginning before 6 April 2008, a person who is eligible for appointment as a company auditor under sections 25 and 26 of the Companies Act 1989.

**“Associate”** means an entity, including an unincorporated entity such as a partnership, over which the Relevant Licensee has significant influence and that is neither a subsidiary nor an interest in a joint venture.

**“Consolidated Segmental Statement”** means a statement as described in Appendices 1 and 2 of the Guidelines.



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

**“Joint Venture”** means a contractual arrangement whereby the Relevant Licensees and one or more parties undertake an economic activity that is subject to joint control.

**“Relevant Licensee”** means the holder of an [electricity/gas] supply licence granted or treated as granted under section 6(1)(d) of the Act if:

(a) it or any of its Affiliates:

- i. jointly supply electricity to more than 250,000 domestic customers; or
- ii. jointly supply gas to more than 250,000 domestic customers; or
- iii. jointly supply electricity to more than 250,000 non-domestic customers; or
- iv. jointly supply gas to more than 250,000 non-domestic customers, respectively; and

(b) it or any of its Affiliates is a holder of an electricity generation licence granted or treated as granted under section 6(1)(a) of the Act.

**“Website”** means a website controlled and used by the Relevant Licensee or an Affiliate for the purposes of providing information and communication.

## Appendix 3 - Draft of proposed amended guidelines

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1.1 These guidelines relate to Standard Condition 19A of the Gas and Electricity Supply Licences and Standard Condition 16B of the Electricity Generation Licences (collectively referred to as 'the Conditions' for the purposes of these guidelines).

1.2. The guidelines have been prepared by the Office of Gas and Electricity Markets ('Ofgem') pursuant to paragraph 7/19A.9 of the Conditions (throughout this document the first paragraph number relates to the generation licence and the second relates to the supply licences).

### **Scope and Application of the Licence Condition**

1.3. The Conditions only apply to those companies that are "Relevant Licensees" as defined in the Conditions. Where information required under the Conditions is held by an Affiliate the Relevant Licensee is required to obtain and publish the information. Annex 1 provides further information on the scope of information required.

### **Financial Year**

1.4. Under paragraph 3/19A.3 of the Condition, the financial year should be taken to mean the Relevant Licensee's current financial reporting year. For the avoidance of doubt this may differ between companies.

### **Interpreting the Financial Information**

1.5. Under paragraph 4(a)/19A.4(a) of the Conditions a clear and full explanation of how the Relevant Licensee defines the terms revenues, costs and profits should be set out, so as to enable understanding of what the information published pursuant to paragraph 1/19A.1 does and does not represent. The licensee should

- describe how it defines domestic and non-domestic supply business segments;
- describe the methodology or methodologies used to allocate marketing, shared and corporate costs across generation, supply and other activities;
- report all the material individual cost items included in each of the cost categories in the template in annex 1 and describe how each of these costs, such as Feed in Tariff costs and Renewable Obligation costs, are allocated across the segments.

Where issues pertaining to the data are unexpected or unusually complex these issues should be set out in full.

1.6 *Exceptional items*: we only expect the revenues, costs and profits to reflect company activities relating to that year of operations. Examples of financial items we



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

would not expect to be included are, but are not limited to, mark to market adjustments, profit or losses on disposal, restructuring costs that have been identified as such in the Group's annual report and impairment charges. Where the Relevant Licensee has included any such items for the purpose of reconciliation, or otherwise, a clear and full explanation must be provided.

1.7. *Reconciliation*: under paragraphs 4(b) & (c)/19A.4(b) & (c) and 6/19A.6 of the Conditions a clear and full explanation of the reconciliation should be provided, so as to enable an individual to understand as much as can be reasonably expected as to how revenues and profits reconcile to the Relevant Licensee's audited figures. If a licensee separately identifies a column which it attributes to trading or portfolio optimisation, the explanatory notes should contain a detailed description of its significant component parts. An explanation of any reconciliation would be expected to take the form of a numerical table and a written statement.

1.8. Paragraph 6/19A.6 of the Conditions provide for the information required pursuant to paragraph 1/19A.1 to be presented with a clear and full explanation. This clear and full explanation should be sufficient to inform an industry stakeholder of the financial data's proper interpretation and context (eg any structural constraints the business operates within, such as tolling agreements).

#### **Transfer Pricing Methodology**

1.9. Under paragraph 4(d)/19A.4(d) of the Conditions a clear and full explanation of the Relevant Licensee's and Affiliates' transfer pricing methodology should be provided, so as to enable an industry stakeholder to understand as much as can be reasonably expected about the transfer pricing methodology adopted.

The transfer pricing methodology used to calculate weighted average cost of electricity (WACOE) and weighted average cost of gas (WACOG) should reflect how each licensee actually acquires energy. This explanation should include:

- the allocation of financial risk between group companies and / or business segments (eg treatment of internal tolling agreements or capability/capacity payments);
- how the methodology relates to an arm's length measure, for example open market prices and/or comparable third party costs such as broker fees; and
- the treatment of allocated costs and corporate charges (eg head office charges).

#### **Treatment of Joint Ventures and Associates**

1.10. Under paragraph 5 of the Conditions the Relevant Licensee must ensure that the information provided in the CSS includes its share of revenues, costs, profits and volumes of any Joint Venture and Associates. In preparing the CSS, the Relevant Licensee should account for Joint Ventures and Associates (which hold a generation or supply licence relating to the generation or supply of gas or electricity in the UK) as follows:

- the share of revenues of Joint Ventures and Associates to be included within revenue;
- the share of the profit before tax of Joint Ventures and Associates to be included with Earnings Before Interest and Taxes (EBIT) and Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA); and



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

- the share of the generation volumes of Joint Ventures and Associates to be included within the generation volumes.

1.11. For each of the items, the Relevant Licensee's share of the income and expenses of a Joint Venture or Associate should be combined line by line with similar items in the Relevant Licensee's CSS or reported as separate line items in the Relevant Licensee's CSS.

1.12. The remainder of the guidelines consist of Annex 1 and 2.

Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

**Annex 1**

	Unit <sup>1</sup>	Electricity generation		Aggregate generation business <sup>13</sup>	Electricity supply		Gas supply		Aggregate supply business <sup>13</sup>
		Conventional	Renewable		Domestic	Non-domestic	Domestic	Non-domestic	
		20xx	20xx		20xx	20xx	20xx	20xx	
<b>Total revenue</b>	£M	£0	£0	£0	£0	£0	£0	£0	£0
Revenue from sales of electricity and gas <sup>2</sup>	£M	£0	£0	£0	£0	£0	£0	£0	£0
Other revenue <sup>3</sup>	£M	£0	£0	£0	£0	£0	£0	£0	£0
<b>Total operating costs</b>	£M	£0	£0	£0	£0	£0	£0	£0	£0
Direct fuel costs <sup>4</sup>	£M	£0	£0	£0	£0	£0	£0	£0	£0
Transportation costs <sup>5</sup>	£M	£0	£0	£0	£0	£0	£0	£0	£0
Env. & social obligation costs <sup>6</sup>	£M	£0	£0	£0	£0	£0	£0	£0	£0
Other direct costs <sup>7</sup>		£0	£0	£0					
Indirect costs <sup>8</sup>	£M	£0	£0	£0	£0	£0	£0	£0	£0
WACO F/E/G <sup>9</sup>	£/MWh, p/th	0	0	0	0	0	0	0	NA
Adjusted EBITDA <sup>10</sup>	£M	£0	£0	£0	£0	£0	£0	£0	£0
DA	£M	£0	£0	£0	£0	£0	£0	£0	£0
Adjusted EBIT	£M	£0	£0	£0	£0	£0	£0	£0	£0
Exceptional items	£M	£0	£0	£0	£0	£0	£0	£0	£0
EBIT	£M	£0	£0	£0	£0	£0	£0	£0	£0
Interest	£M	£0	£0	£0	£0	£0	£0	£0	£0
Tax	£M	£0	£0	£0	£0	£0	£0	£0	£0
Net profit	£M	£0	£0	£0	£0	£0	£0	£0	£0
Volume <sup>11</sup>	TWh, therms	-	-	-	-	-	-	-	NA
Customer accounts <sup>12</sup>	Thousands of accounts	NA	NA	NA	'000	'000	'000	'000	'000

## Notes

### Presentation of information

1. The financial data should be provided to the nearest £million to one decimal place, WACOE and WACOF to the nearest pence in £/MWh, WACOG in p/therms to one decimal place, volumes to 1 decimal place in TWh, and customer accounts rounded to the nearest 1,000 accounts. The grey shadings denote summations that can be calculated by using other information within the statement, eg adjusted EBITDA can be calculated using the total revenue and total operating cost lines in the statement.

### Revenue

2. For the generation business segment this means revenue from sales of electricity output generated; or if the business operates in a tolling-agreements structure, the revenues received from the capability or capacity payments including any account of associated fuel costs (an explanation/clarification of the latter type of revenues should be provided).

For the respective supply segments this means electricity and gas sales. Revenue for domestic supply should be less dual fuel discounts where applicable; that is these discounts should be deducted from revenue, with the discount split evenly between electricity and gas. Government-mandated social tariffs and discounts, such as the Warm Home Discount (WHD), should also be deducted from domestic supply revenues directly. For the avoidance of doubt, the Government Electricity Rebate (GER) should be neutral on revenues.

3. Other revenues not covered in Note 2, eg in the generation segment may include capacity payments, other physical options and ancillary services.

### Direct fuel costs

4. Generation should include the delivered input cost for fuel, irrespective of the business model of the Relevant Licensee or its Affiliate. If the business operates in a tolling-agreements structure the direct fuel costs for generation may be presented in the form of a footnote to the template. The footnote should include a description of the volume, total cost, and average cost.

Supply should include aggregate electricity and gas costs, including the wholesale energy cost and shaping costs. Relevant Licensees should not make any adjustments for the costs associated with emissions (eg EU Emissions Trading System (EU ETS) and Carbon Price Floor (CPF)). It is assumed that these costs are reflected in the wholesale price of electricity.

### Transportation costs

5. Transportation costs for generation should include all network costs and Balancing Services Use of System (BSUoS) charges. Supply should in addition include the transport element of Reconciliation-by-Difference (RBD) costs.

### Environmental and social obligation costs

6. Generation should include all emission costs (eg EU ETS and CPF). The licensee should specify in a footnote the volume of any granted free carbon allowances.

Supply should include the costs associated with:

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Actions to improve the transparency of energy company profits

- Renewable Obligation Certificates (ROCs);
- Feed-in Tariffs (FITs);
- Contracts for Difference (CfD);
- Capacity Market (CM);
- Energy Company Obligation (ECO);
- Administering the GER;
- Levy Exemption Certificates (LECs);
- Assistance for Areas with High Electricity Distribution Costs (AAHEDC).

### **Other direct costs**

7. Other direct costs for generation should include market participation costs, including losses, imbalance (ie cash out) costs, Elexon/Xoserve admin costs. Supply should in addition include, brokers' costs and intermediaries' sales commissions, the energy element of RBD costs, and any 'wider' smart programme costs (eg Data Communications Company (DCC)-related costs).

### **Indirect costs**

8. Indirect costs should be defined as licensees' own internal operating costs including sales and marketing costs, bad debt, costs to serve, IT, staffing costs, billing and all meter costs, including smart meter costs (eg linked to rollout or asset rental, not DCC).

### **Weighted average cost of fuel/electricity/gas (WACO F/E/G)**

9. For both generation and supply, WACO F/E/G means the "Direct fuel costs" line divided by the "Volume" line, shown as £/MWh or p/th. For generation, the costs of emissions (eg EU ETS and CPF) should be added to "Direct fuel costs" before dividing by "Volume".

### **Adjusted EBITDA**

10. EBIT means earnings before interest and tax; and EBITDA means earnings before interest, tax, depreciation and amortisation. Adjusted EBIT and EBITDA exclude exceptional items, which are defined in paragraph 1.6 of these guidelines.

### **Volumes**

11. Volumes should be supplier volumes at the meter point (ie net of losses). Generation volumes should be the volume of power that can actually be sold in the wholesale market, ie generation volumes after the losses up to the point where power is received under the Balancing and Settlement Code but before subsequent losses.

### Customer accounts

12. Customer accounts should be the average number of electricity and gas, domestic and non-domestic customer accounts during the reporting year. This should be calculated by adding monthly customer numbers and dividing by 12. For the avoidance of doubt, dual fuel customer accounts should be included in both the relevant electricity and gas columns.

### Aggregate supply business

13. The generation and supply aggregation columns (aggregation of conventional and renewable generation, and domestic and non-domestic electricity and gas supply businesses) sums the horizontal supply figures and thereby helps facilitate reconciliation to group accounts.

### Annex 2

Business function	Generation	Supply	Not included in CSS
Operates and maintains generation assets			
Responsible for scheduling decisions			
Responsible for interactions with the Balancing Market			
Responsible for determining hedging policy			
Responsible for implementing hedging policy / makes decisions to buy/sell energy			
Interacts with wider market participants to buy/sell energy			
Holds unhedged positions (either short or long)			
Procures fuel for generation			
Procures allowances for generation			
Holds volume risk on positions sold (either internal or external)			
Matches own generation with own supply			
Forecasts total system demand			
Forecasts wholesale price			
Forecasts customer demand			
Determines retail pricing and marketing strategies			



Rebuilding consumer confidence:  
Actions to improve the transparency of energy company profits

Bears shape risk after initial hedge until market allows full hedge			
Bears short term risk for variance between demand and forecast			

**Notes**

1. Companies should indicate where functions reside by way of a tick in the appropriate cell of the table. If profits or losses are not recorded in the same area, then an “F” should be used to indicate where the function resides and a “P/L” should be used to indicate where the profits or losses are recorded. If a payment is made or received by either generation or supply in lieu of a profit or loss this should be referenced by way of a footnote.

“Not included in CSS” should include entries if neither the Generation nor Supply Segments as reported in the CSS are responsible for a particular function, but that

## Appendix 4 - Feedback Questionnaire

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1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case, we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process that was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand? Could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Do you have any further comments?

1.2. Please send your comments to:

**Andrew MacFaul**  
Consultation Co-ordinator  
Ofgem  
9 Millbank  
London  
SW1P 3GE  
[andrew.macfaul@ofgem.gov.uk](mailto:andrew.macfaul@ofgem.gov.uk)