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Dear Robyn

Consolidated Segmental Statements – revisions to regulatory framework

Thank you for providing the opportunity to comment on Ofgem's proposed changes to the Consolidated Segmented Statements (CSS). This is a non-confidential response on behalf of the Centrica Group, excluding Centrica Storage.

There are benefits to the CSS, for example in helping customers better understand the energy sector and the costs that make up their bill. The costs of the CSS are less clear however. We are also mindful of the concerns raised by Ofgem, the OFT and the CMA in the State of the Market report relating to transparency as a feature of the retail energy markets.

Notwithstanding this, we hold four concerns about the proposed approach:

- **Intermediate suppliers should be incorporated within the CSS.** Over the last 2 years, small suppliers have become a large and enduring feature of the retail energy market. By the end of 2015, at least four “intermediate” suppliers will have grown to the point they deliver government schemes such as the Energy Company Obligation (ECO). If Ofgem consider that the net effect of the CSS is positive, given the fact that smaller suppliers are now a large and enduring part of the market, we believe that the objectives of both the CSS and Supply Market Indicators (SMI) can only continue to be met if the larger of these suppliers are also included from 2015.
- **Transfer pricing requirements should cover all suppliers.** We believe there is a strong case for the proposed transfer pricing requirements to cover all suppliers and not just those captured by the CSS. All UK companies are subject to the same transfer pricing standards and Ofgem should be interested that all suppliers adhere to UK and international standards on transfer pricing. We note for instance that some smaller energy companies hold generation licences or are part of international groups.
- **Any changes to the CSS should be workable.** Some of the licence condition changes proposed by Ofgem may be unworkable, for example the requirement for CSS audits to “conform” with IFRS¹. Like all large firms, energy companies are obliged to produce an Annual Report and Accounts (ARA) prepared in accordance with IFRS. The ARA differs in some areas to the CSS guidelines, which requires the preparation of a full reconciliation between the CSS and ARA. Similarly, interest and exceptional items will be very specific to

¹ International Financial Reporting Standards

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each supplier and are ultimately incomparable. We are happy to work with Ofgem to address these issues.

- **Changes to allow internal auditing of transfer pricing policies requires time.** We support Ofgem's proposal for energy companies to hold a transfer pricing policy and for companies to notify Ofgem of any changes to that policy. This builds on the recent review by BDO, which demonstrated that energy companies act in line with British and international standards. We would like clarity on the scope of the internal (and external) audit requirements for transfer pricing policies and the proposed annual confirmation process. Furthermore, to codify a policy and incorporate this policy within the internal audit regime may require resources and time and we therefore recommend that Ofgem allows companies a sensible implementation period to make these changes.

Further information is provided in Appendix A, which sets out our response to the seven consultation questions. If you have any questions, please contact Thomas Lowe (07769 548 906).

Yours sincerely

Sharon Johnson
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Appendix A

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

We welcome the BDO report showing that suppliers use transfer pricing appropriately and in line with relevant legislation. Ofgem's proposals to require suppliers to hold a transfer pricing policy, keep it up-to-date and include within companies' internal audit process are sensible. However, we believe that companies may need time to codify transfer pricing practices into a single policy and may already have planned their internal audits for 2015. The codification of a policy may take more time because of implementation of other proposed CSS changes, the additional resource required to publish the CSS early and the management of data requests from the CMA. We would welcome a reasonable implementation period to incorporate this policy within the internal audit regime and suggest that the audit requirement be completed no later than four months after the end of the financial year. We would also welcome further clarity on the scope of the internal (and external) audit requirements and the proposed "annual confirmation" process.

As set out above, we believe there is a strong case for the proposed transfer pricing requirements to cover all suppliers and not just those captured by the CSS. All UK companies are subject to the same transfer pricing standards and some smaller energy companies hold generation licences or are part of international groups. It is therefore illogical for only the policies of the largest suppliers to be scrutinised.

While we agree that Ofgem should be aware of HMRC investigations into transfer pricing, we question whether a licence condition requiring suppliers to notify Ofgem of such an investigation is necessary. Ofgem could achieve the same objective by agreeing a Memorandum of Understanding with HMRC, ensuring Ofgem is kept informed of transfer pricing developments while avoiding additional regulation.

We note that the drafting of SLC 19A.8 may have unintended consequences. The current drafting requires suppliers to notify Ofgem of changes to the transfer pricing policy, which could lead to suppliers notifying Ofgem of very minor policy changes. To ensure that the proposed licence conditions are proportionate and do not place an unnecessary regulatory burden on energy companies, we recommend that SLC 19A.8 be amended so that Ofgem is only notified of "material" changes to the transfer pricing policy.

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

We welcome Ofgem's proposal to ensure that each CSS receives external scrutiny. However, Ofgem should ensure that any requirements placed on energy companies are consistent with accounting standards. For instance, Ofgem propose for audits of the CSS to "conform" with IFRS standards. However, audits can only conform with auditing standards (ISA), expressing a view on financial statements prepared under accounting standards (IFRS). Furthermore, preparing the CSS under IFRS is not strictly possible because the CSS includes breakdowns and adjustments that do not fully align with IFRS standards. The PWC audit opinion of Centrica's 2013 CSS noted that the basis of preparation is not the same as segmental reporting under IFRS.

We note that Ofgem's proposals are silent on the appropriate level of materiality for the audits. Materiality is important in this context because, if the materiality threshold differs across companies, this could reduce confidence in the CSS audit process. When PWC audited the 2013 Centrica CSS, the materiality threshold was set at £30 million. We suggest that Ofgem require the audit opinion disclose the materiality threshold.

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

Yes, we support this proposal.

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?

While we recognise the original policy intent of the CSS in 2009 was aimed at vertically integrated companies, the energy market has developed since the introduction of the CSS. For example, in recent years a number of energy companies have grown to a significant size and one now supplies more than one million accounts. Some of these suppliers also have vertical relationships with upstream generation partners. To the extent that an objective of the CSS is to enable Ofgem and others to monitor energy companies' costs and profits, it is in the public interest to ensure that these companies are subject to scrutiny and are transparent in this regard.

If Ofgem consider that the net effect of the CSS is positive, given the fact that smaller suppliers are now an enduring part of the market - representing over 8% of the retail market, we see no reason why the larger of these suppliers should not also be included within both the CSS obligations and SMI methodology from 2015.

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?

We are concerned by the proposed breakdown of interest and tax by gas and electricity supply, as well as generation. Interest is paid on Group borrowings rather than per segment and is linked to capital employed. Each energy company may have a different way of calculating intra-group interest, reducing comparability. It therefore makes little sense for Ofgem to defer a decision on Return on Capital Employed (ROCE) but pursue an interest breakdown. If Ofgem want to look at interest, they should review this question as part of their 2015 work on ROCE.

We would also note that tax is paid on a legal entity basis and therefore we do not currently have the sort of split or allocation between business segments that Ofgem propose. We could try to establish an appropriate allocation, as we did last year by presenting EBIT and EBIT after tax for the supply business, though note that the figure would involve judgement and would be somewhat meaningless if this tax allocation had to consider the tax deductibility of interest and exceptional items (as the current template in Annex 1 suggests).

Following on from that point, we note that Ofgem propose the inclusion of "exceptional items" in the Annex 1 template. Whilst we are supportive of disclosing these exceptional items, including them in EBIT could lead to significant variation in treatment by suppliers. Furthermore, we do not currently split some of these exceptional items down to a domestic/non-domestic and gas/electricity level (e.g. MTM adjustments). To do so would require a significant amount of extra work, which would seem unwarranted given the purpose of the CSS financial data is to report true business performance for that year of operation. To avoid these problems, we propose that exceptional items are included as a separate line item at the end of the Annex 1 template and are only disclosed in aggregate for both the Supply and Generation business.

We believe Ofgem's current view that all metering costs be included under indirect costs provides an inaccurate picture of how these costs are incurred. Meter rental costs are unavoidable and should be treated as a direct cost. Similarly, meter reading costs are often incurred because of legal obligations,

e.g. to check meter safety, and, as such, these legally obligated meter reading costs should be included as direct costs. This would better align with our ARA prepared in accordance with IFRS.

We would welcome clarification from Ofgem on the following elements of the guidance:

- The revised guidance suggests that the Warm Home Discount should be deducted from domestic supply revenues directly but that the administrative costs associated with the GER should be captured in “Other Direct Costs”. We take the guidance to mean that the costs of administering social schemes such as the Warm Home Discount should be treated in the same way as GER administrative costs, i.e. included under other “environmental and social” costs. Could Ofgem confirm whether this is the intention?
- We note that the guidance proposes that brokers’ costs and intermediaries’ sales commissions are to be included under “Other Direct Costs”. We intend to split sales commissions for the supply businesses between indirect and other direct costs on the basis of our accounting policy, which looks at the nature of the payment and whether it is paid as a consequence of direct generation of new sales. We will not split this necessarily according to whether the commission was paid to British Gas employees or TPIs. We would welcome discussions with Ofgem on this point.
- British Gas incurs non-regulatory social costs, such as the winter top-up and the costs associated with the British Gas Energy Trust. Do Ofgem propose that we treat the winter top-up and costs associated with the British Gas Energy Trust as social costs?

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

As above, there are benefits to the CSS, particularly in helping address customer misconceptions about the level of energy company profitability, and the drivers of rising retail prices. To the extent that providing a further breakdown of costs can be done without harming competition, we are happy to engage with Ofgem about how their policy may be implemented.

For example, data such as ECO delivery costs can be easily used to derive both delivery strategy and therefore future pricing considerations. Care therefore needs to be taken to ensure that any further transparency does not lead to commercially sensitive information such as this being released to the market.

Care also needs to be taken to ensure that costs are allocated to the correct category in order to realise the customer benefits of transparency. For example, in order to present a true picture of environmental obligations, the costs associated with the EU Emissions Trading Scheme (ETS) and the UK Carbon Price Floor should be included as environmental costs rather than wholesale costs. Again, we are happy to engage with Ofgem about how this policy might be implemented.

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?

There are benefits to the CSS, and as we have previously said, we support Ofgem’s view that the CSS can be helpful in addressing customer misconceptions about the level of energy company profitability, and the drivers of rising retail prices.

Whether there are costs to the CSS is less clear however, particularly in the context of the more recent historical data it presents. As noted above, the CMA’s ongoing investigation may consider the CSS and the benefits and costs of transparency. Before proceeding, it would be prudent for Ofgem to undertake an impact assessment to determine the effect of their proposed changes, including on competition.

If Ofgem consider that the net effect of the CSS is positive, and that the CSS is proportionate in achieving its objectives, given the fact that smaller suppliers are now an enduring part of the market - representing over 8% of the retail market - we see no reason why the larger of these suppliers should not also be included within both the CSS obligations and SMI methodology from 2015.

