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

EDF Energy remains committed to rebuilding trust in energy markets. Recognising that energy company profits are a key thread of the trust debate, it is important that stakeholders have faith in the consolidated segmental statements (CSS) and see them as the source of authoritative profitability information.

We believe that the CSS provide robust information as to the size and source of energy company profits and we note that Ofgem has recently confirmed that it confidently believes the 2013 statements are by far the most transparent since the statements were introduced, presenting an accurate picture of generation and supply profitability. In particular, we also welcome the findings of BDO's recent review of transfer pricing policies which, while recognising that not all methodologies are identical, finds no material issues with the transfer pricing arrangements underpinning the CSS.

However, in the interests of making the CSS as transparent and accessible as possible to reassure consumers and dispel any myths over profiteering, we are committed to working with Ofgem and other stakeholders on possible measures to improve the CSS.

We agree with Ofgem's approach of pressing ahead with improvement measures as the Competition and Markets Authority (CMA) conducts its energy market investigation, while recognising that there are certain areas where it would be better to wait until the CMA has completed its work before bringing forward new proposals. We note in particular that Ofgem is minded to return to the question of developing a common methodology for estimating and disclosing a measure of return on capital employed (ROCE) in generation in the CSS after the CMA investigation. In the meantime, we trust that Ofgem will make it very clear to stakeholders that profits in generation can only be interpreted in view of the size of investments made.

One further measure Ofgem may wish to consider as it works to improve the CSS is the inclusion of upstream gas and gas storage in the statements. This would achieve a better balance across gas and electricity, while also ensuring that the CSS reflect all areas of value chain.

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In the context of rebuilding consumer confidence, it is important that Ofgem's Supply Market Indicator (SMI) works and its forward looking estimates of costs and margins are reliable and accurate, as well as ensuring that any limitations in the analysis are fully explained to stakeholders. While we acknowledge that improvements to the SMI methodology have been made, we remain concerned that it significantly overstates supplier margins and that as a result stakeholders are being misled. For example, EDF Energy believes that the SMI overstates revenues by failing to recognise that consumers tend to select cheaper fixed price products within a supplier's range of offers. We note that between 2009 and 2013 the CSS indicate a 1% to 4% pre-tax profit margin on energy supply for a typical dual fuel customer. However, the revised SMI shows forecast margins of between 6% and 8% for 2014/15 (based on estimates across the two year period). This discrepancy between actual and forecast margin is not justifiably credible, suggesting that the SMI continues to overstate margins, and notably at the detriment of improving customer trust that we, and other stakeholders, are working hard to achieve.

Our detailed comments on Ofgem's proposals on the CSS are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact me on 0207 752 2187.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

Paul Delamare

Paul Delamare
Head of Customers Policy and Regulation

Attachment

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

EDF Energy's response

Q1: Do you agree with the proposal to tighten the scrutiny of companies' transfer pricing policies?

We note that BDO's recent review of transfer pricing policies, while recognising that not all methodologies are identical, finds no material issues with the transfer pricing arrangements underpinning the CSS. We are pleased that the review has provided assurance to Ofgem that the CSS present an accurate picture of generation and supply profitability, as we hope it will to customers and other stakeholders. We also hope that the findings of the review will feed into the ongoing investigation being conducted by the CMA.

While BDO's review points to the fact that there does not appear to be any significant deficiency in the CSS in respect of transfer pricing, we recognise the importance of continued efforts to reassure stakeholders that profits are not being hidden outside of the statements. On this basis, we support Ofgem's proposals to enhance scrutiny of transfer pricing policies.

Regarding the proposal to require licensees to undertake an internal audit of transfer pricing policies and procedures, it would be useful to clarify the required frequency of such a review. Additionally, we suggest that licensees have the flexibility to carry out such a review through their internal audit process or their external audit process. We have proposed an amendment to the proposed draft licence condition changes in Annex A.

Q2: Do you agree with the proposed audit requirement? Do you have any views on the detail of the requirement?

We believe that the introduction of a requirement for the statements to be audited by the individual companies' statutory auditors prior to their publication should provide greater reassurance on the robustness of the statements. We welcome the possibility of using the same external auditors who perform our statutory audit (rather than requiring a re-audit of statements by an independent firm) so as to avoid unnecessary duplication and additional costs.

We will need to work with our statutory auditors to develop our audit process accordingly, including working through the practicalities of providing an auditor opinion in the CSS.

Q3: Do you agree with the proposed change to the reconciliation requirement?

Broadly speaking, EDF Energy welcomes the reduced deadline for publishing the CSS. In order to increase the transparency of EDF Energy's performance, we have produced consolidated accounts for EDF Energy Holding Limited since 2011 and prepared reconciliations for our segmental statement to these accounts.

In order to meet the four month reconciliation requirement, we will likely publish a statement reconciled with audited figures from the EDF Group accounts. However, we will subsequently republish our statement with an additional, audited reconciliation back to our UK statutory accounts as soon as the latter become available (which will be after the four month deadline). We understand this approach to be in line with Ofgem's proposed reconciliation requirement, as set out in the draft proposed changes to the licence conditions (19A.3 and 19A.4).

Q4: 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?

Given the recognised public interest of providing information on profits in energy, it is perhaps counter-intuitive to only include the large vertically integrated companies in the CSS exercise. EDF Energy believes that the obligation to prepare CSS should, in the very least, be applied to suppliers of a certain size (to be determined), irrespective of whether they have a generation business. An appropriate threshold for this obligation might be 250,000 customers in line with the current licence condition. Whatever the chosen customer threshold, the licence condition should be amended to make it clear at what point within a financial year the threshold is measured in order to determine whether a licence holder falls within the definition of a "Relevant Licensee" and become subject to the requirement to produce CSS.

We would also urge Ofgem to consider whether it would be appropriate for the obligation to prepare CSS to be applied further still. There are many players in the GB energy market with multiple models of conducting business in different segments of the market, including independent suppliers and generators, smaller suppliers in the residential supply market with renewable generation assets, market players integrated across generation and non-domestic energy supply, and so on. In order to provide a more accurate view of profits in energy, we believe it would be better to apply the CSS obligation to businesses present in one or more areas of the energy value chain.

EDF Energy sees the additional cost of preparing a statement as small compared to the public interest and we note that an independent supplier has voluntarily published statements, which is arguably evidence of the costs not being excessive. Additionally, we believe that applying the CSS obligation to other players would act as a facilitative measure in encouraging new entrants to the market, many of whom may struggle to see their business models reflected in those of the large vertically integrated companies.

Q5: 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?

EDF Energy has concerns around the proposed requirement to disclose interest and tax on a segmental basis. Both interest and tax are allocated across legal entities, yet the business segments disclosed in the CSS transcend these entity parameters. The financing of EDF Energy is managed centrally and although certain parts of the business have clearly defined financing, it is not meaningful to split financing costs between domestic and non-domestic gas and electricity segments for example. Likewise, tax is only administered on legal entities with regard to both the profits and the balance sheets of those entities. While interest and tax could always be notionally attributed across the business segments using a number of assumptions, EDF Energy does not believe that this additional information would provide any more clarity on profits by segment due to the level of judgement required. The number of assumptions required in deriving any allocation could also impact on the scope and cost of any audit opinion which is provided on the statements.

EDF Energy acknowledges that while disclosure of tax and interest as a whole could increase transparency about overall profitability, disclosure on a segmental basis would not provide any meaningful insight. An alternative solution could be to include a reconciliation of EBIT in the CSS and net income in the statutory accounts to increase the visibility of the interest and tax costs borne by EDF Energy. This information would be provided in our republished statement once our UK statutory accounts become available (see our response to Question 3), since the level of disclosure about EDF Energy in the EDF Group accounts would not permit this reconciliation.

A separate concern we have is with regard to the proposal to remove losses from direct fuel costs and report them under other direct costs. Losses are intrinsic to the delivery of energy, and it is therefore not immediately apparent how they could be valued. Any attempt to do so would require various assumptions, and is unlikely to provide any additional transparency or insight into profitability. We assume that Ofgem has put forward this proposal due to a lack of comparability between weighted average cost figures for electricity and gas in supply businesses and wholesale prices. However, it is worth noting that this differential is primarily due to the fact that volumes for supply are shown at meter point ('CT'), whereas power is purchased at NBP. Assuming this to be the rationale behind Ofgem's proposal, one solution may be to quote everything at NBP across supply and generation segments, whereby we note that generation volumes are already shown at NBP so that fuel cost and volume are comparable.

Additionally, we note that Ofgem proposes to move the costs of imbalance and the energy element of RbD costs from direct fuel costs to other direct costs. We are uncertain about the rationale behind this proposal since together these costs are effectively another source of volume, so stripping them out of direct fuel costs would mean that the volumes quoted do not match up with the fuel costs. We would welcome further clarity from Ofgem on this proposal.

A final comment is with regard to Ofgem's proposal to include average customer numbers for both non-domestic and residential supply. EDF Energy recommends that there is agreement across the industry as well as clear guidelines on the appropriate definition of a "customer", especially for the non-domestic segment where definitions can vary significantly between suppliers. For instance, many non-domestic customers may be attached to a single contract, a single non-domestic customer may have multiple contracts and sites, and each site many have more than one MPAN. In this way, a clear definition of "customer" is essential to ensure comparability of reported figures across suppliers.

Notwithstanding the concerns detailed above, we have not identified any further significant issues in relation to this question.

Q6: Do you agree with our proposal to require further breakdown of environmental and social obligation costs from the 2015 statements onwards?

Given the understandable concern from customers over the size of their bills, we welcome any measures designed to better inform consumers about the drivers of energy costs. This should help to reassure customers that they are getting fair and competitive prices, and contribute to rebuilding customer trust. To this end, we support Ofgem's proposals to provide greater transparency over the cost of environmental and social obligations, especially since these obligations are becoming an increasingly important driver in customer bills. We would also urge Ofgem to consider bringing forward this requirement earlier than for the 2015 statements.

EDF Energy welcomes any opportunities to make the reporting of environmental and social obligations comparable across suppliers where it is feasible to do so, and we are prepared to work with Ofgem, Government and the wider industry to achieve this.

Q7: 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?

The tension between transparency and competition is well established. As a non-discretionary purchase, there is a great desire for transparency in energy, and transparency will be important in restoring trust in energy markets. Of course, increased transparency also has the potential to give rise to concerns over coordination, which in turn could have a damaging impact on trust.

We support Ofgem's decision to ask the Competition and Markets Authority (CMA) to look at competition in the market, and we trust that during the course of its investigation the CMA will consider the dynamic between additional transparency and competition.

Whatever the appropriate balance to be struck between transparency and competition, it is essential that the information provided in the CCS can be relied upon to provide 'apples-to-apples' comparisons, including in the public domain.

EDF Energy
November 2014

Annex A – Proposed amendment to draft licence condition changes

We suggest the following amendment (in red) to the draft licence condition changes:

"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 or external audit process."