



Making a positive difference  
**for energy consumers**

Gwneud gwahaniaeth gwirioneddol  
**i ddefnyddwyr ynni**

Direct Dial: 020 7901 3877  
Email: [CSS@ofgem.gov.uk](mailto:CSS@ofgem.gov.uk)

Date: 14 November 2014

Dear colleague

### **Statutory consultation on proposed licence modifications to improve the transparency of energy company profits**

We are proposing to modify Standard Licence Condition (SLC) 19A of the gas and electricity supply licences and SLC 16B of the electricity generation licence and the guidelines prepared under these conditions. We are proposing to make these modifications to provide greater transparency of energy company profitability and we are keen for these to be applied by companies for the 2014 Consolidated Segmental Statements. Attached to this letter are the notices proposing these modifications.

#### **Background**

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

Since 2009 we have required the large vertically-integrated energy companies to disclose annually the revenues, costs and profits of their electricity generation activities and their electricity and gas supply activities. They have to do so separately for each activity through the Consolidated Segmental Statements (CSS).

The 2013 CSS provided greater transparency on companies' profitability than in the past, and we are more confident that they present an accurate picture of generation and supply profitability. We intend to embed and enhance these improvements in the licences.

In February 2014, we published a decision letter outlining a plan, with our and the companies' actions, to further improve transparency in this area. We consulted on our proposals in October 2014.<sup>1</sup> A summary of stakeholders' responses to the consultation can be found in Appendix I.

---

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

## Proposal

After consideration of the responses received, we have decided to proceed with the principles of our original proposal, subject to a few minor changes to make the original proposals as effective as possible.

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.<sup>2</sup>
- **More accessible** – companies will have to break down their costs further, and report them consistently in more meaningful categories. This will shed light on certain costs, like environmental obligations and network costs.

We are also proposing to modify the definition of 'Relevant Licensee' in the electricity and gas supply licences to clarify that the licence conditions only capture holders of supply licences that are part of a vertically-integrated group of companies. This is consistent with the original policy intention but is without prejudice to reconsidering the scope of application of the obligation in the future. We consider that such an assessment should await the findings of the CMA investigation.

We asked respondents for their views on our proposal to require further breakdown of environmental and social obligation costs from the 2015 statements onwards. On further consideration of responses, we will look to explore the options with industry and government next year for including more detailed information in this cost category.

We also asked respondents for their views on whether there is a potential tension between transparency and competition. Taking into consideration consultation responses, we consider that the proposed modifications will improve the level of transparency of energy company revenues, costs and profits in the 2014 CSS and will not have an adverse effect on competition. We will continue to be mindful of this potential tension in considering any further changes to the CSS in the future, beyond the changes proposed here.

We would like to draw your attention to a proposed change in the guidelines that was not raised in the October consultation. This is the addition of a line in Appendix 1 of the guidelines that requires relevant licensees to include the supply volume as purchased from the wholesale market (ie without adjusting for losses). This seeks to address the issue that the WACO E/G calculation currently assumes losses within the numerator but not within the denominator.

## Next steps

Representation to the proposed licence modifications should be made in writing on or before 12 December 2014 to: Robyn Daniell, Office of Gas and Electricity Markets, 9 Millbank, London, SW1P 3GE or by email to [CSS@ofgem.gov.uk](mailto:CSS@ofgem.gov.uk).

All responses will normally be published on Ofgem's website. However, if respondents do not wish their response to be made public then they should clearly mark their response as not for publication. Ofgem prefers to receive responses in an electronic form so they can be

---

<sup>2</sup> We appreciate that the licence modification is due to come into effect in February, after the end of most of the companies' financial years. We do however expect all companies to comply with the four month deadline as they have had ample time to consider the effect of the changes to the licence condition during policy development and the consultation process. If a company feels that it does have a legitimate reason for an extension of the deadline we will consider any application made.

placed easily on the Ofgem website.

If you have any queries regarding the information contained within this letter please contact Robyn Daniell on 0207 901 3877 or by email to [CSS@ofgem.gov.uk](mailto:CSS@ofgem.gov.uk)

Yours faithfully

**Neil Barnes**  
**Associate Partner, Retail Markets**  
**For and on behalf of the Gas and Electricity Markets Authority**

## **Appendix 1: Rebuilding consumer confidence: Actions to improve the transparency of energy company profits – summary of consultation responses**

We received 16 responses to our October 2014 consultation.

- Six from large energy suppliers
- Five from smaller domestic/non-domestic energy suppliers
- three from consumer groups and trade associations
- one from a power generator
- one intermediary

We have published non-confidential responses on our website.

### *Tightening the scrutiny of companies' transfer pricing policies*

Most respondents broadly agreed with our proposal to tighten the scrutiny of companies' transfer pricing policies. The majority of suppliers supported efforts to increase reassurance in this area, albeit some questioned specific details of our proposals. A handful of other suppliers were not supportive. One supplier thought the proposed requirements were disproportionate; another considered that market forces already provide sufficient protection to consumers. Consumer groups and trade associations supported further work in this area; a consumer group thought that our proposals should go further by requiring the results of companies' trading functions to be incorporated in the CSS.

**Conclusion:** We propose to go ahead with our proposals as set out in the consultation to require companies to keep appropriate and up-to-date transfer pricing policies. As stated in the October consultation, we will consider what constitutes a proportionate approach to the disclosure of trading information in light of the CMA findings.

### *Proposed audit requirement*

Most respondents agreed with our proposed audit requirement, although there were a few notable opponents. Two suppliers thought that it would add onerous and unnecessary regulatory obligations. A consumer group considered that the audit should be undertaken by an independent auditor, rather than allowing companies to commission the same auditor they use for their statutory audit.

**Conclusion:** Based on the broad support for this requirement, we confirm that the CSS must include a report from an Appropriate Auditor that gives an audited opinion on whether the statements have been appropriately prepared. We consider that this will deliver assurance that the companies have prepared their statements appropriately in a cost-effective way.

### *Proposed change to the reconciliation requirement*

Respondents were divided on this point. A number of suppliers and a consumer groups agreed with our proposed change. One supplier was supportive but said it would not be able to publish a reconciled statement within the four month deadline. On the other hand, a few suppliers (not based in the UK) disagreed due to the prospect of incurring extra costs; one supplier argued that requirements to provide both an audit opinion and reconciliations to statutory accounts were duplicative. A consumer group thought that the CSS did not provide a contemporaneous view of profitability and, consequently, it considered there should be a tighter deadline.

**Conclusion:** We consider that the new drafting of the requirement allows sufficient flexibility for the companies to reconcile to Group accounts where UK accounts are not

available. We consider that the proposal to reduce the timing for preparing the CSS from six to four months after the end of the Relevant Licensee's financial year is appropriate and proportionate.

#### *The obligation to produce Consolidated Segmental Statements*

All of the large energy suppliers thought that the obligation should be extended to other parties, apart from one who thought that we should wait for the outcome of the CMA's market investigation before making a decision. Of the other large suppliers, the consensus was that the extension should apply to suppliers of a certain size and, for some, other areas of the energy value chain as well. One supplier argued that, for a new entrant, information on smaller suppliers was more relevant than information on the large suppliers. The majority of other respondents supported continuing to target large vertically integrated companies. Whilst some thought that it would be more appropriate to delay the decision until after the CMA had completed its investigation, the rest highlighted that the additional costs would be burdensome and would outweigh any consumer benefit.

**Conclusion:** We note the views of all respondents and will consider the scope of application of the obligation pending the findings of the CMA investigation.

#### *Proposed cost categories and the detailed allocation of cost items*

Whilst the large suppliers were generally supportive of increasing transparency in this way, they had a number of reservations with our proposals. Every supplier disagreed with our proposal to require companies to disclose interest and tax on a segmental basis. The consensus was that this would not be meaningful and would not allow for a comparison across groups. Other concerns centred on the categorisation of costs into Direct Fuel Costs and Other Direct Costs and disagreements over the treatment of specific cost items. Of the other respondents, a trade association warned that, as this data provides details on firms' business practices, Ofgem should ensure that is collected and published appropriately. It also thought that consideration should be given to whether this data is needed without disrupting the market.

**Conclusion:** We considered all responses to the proposed cost categories and can confirm that we will proceed with the greater breakdown of cost categories including specific categories for network and environmental and social obligation costs and the inclusion of additional non-financial information including customer numbers. Based on feedback from respondents, we have decided not to proceed with our proposal to separate out some costs currently in 'direct fuel costs' to 'other direct costs'. We may revisit this proposal next year. We also decided not to proceed with the proposed inclusion of tax, interest and net profit lines given the challenges raised by respondents in estimating and allocating tax and interest across the business segments.

#### *Proposed breakdown of environmental and social obligation costs*

All respondents agreed with our proposal to require further breakdowns of environmental and social obligation costs. Some respondents encouraged us to bring forward the requirement earlier than for the 2015 statements. Others, although supportive, argued that care needs to be taken to ensure that commercially sensitive information is not provided to the market. A supplier warned about the risk of increased granularity leading to extra delivery costs. Another supplier disagreed with our proposal, because it considered ECO costs would still not be comparable and this could cause confusion for consumers. This concern was echoed by a trade association who suggested that, as a solution, caveats and explanations should be included in the report.

**Conclusion:** On considering responses, we will look to explore the options with industry and government next year for including more detailed information on this cost category in 2015. It is not possible to consider this in time to make it a requirement for the 2014 CSS.

*Tension between transparency and competition*

Respondents broadly agreed that there was a potential tension in theory between transparency and competition but did not comment on whether they considered that the benefits in improved transparency outweighed the risks of an adverse impact on competition. Instead, a number of suppliers suggested that it would be appropriate to await the outcome of the CMA investigation. Some suppliers suggested that Ofgem should undertake an impact assessment to determine the effect of the proposed changes. A trade association suggested that some information may be better withheld than published in the public domain. One supplier summarised its position by stating that while it agreed there was a tension, we should not progress with our proposals as they will increase the regulatory burden and lead to higher bills for consumers.

**Conclusion:** We consider that the proposed modifications will improve the level of transparency of energy company revenues, costs and profits in the 2014 CSS and will not have an adverse effect on competition. We will continue to be mindful of this potential tension for any further changes to the CSS in the future, beyond the changes proposed here.