

Alban Asllani
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

12 August 2020

Dear Alban,

Reviewing the Consolidated Segmental Statement - Initial proposals

ESB welcomes the opportunity to respond to your consultation¹ on reviewing the Consolidated Segmental Statement (CSS) obligation. Our operations in Great Britain include 1.45GW of generation capacity and a small domestic supply business. We trade on the wholesale power markets to support both of these operations, making us a vertically integrated utility. Given the changes the market has seen in recent years, now is a good time to review the CSS. However, your initial proposals need a great deal of refinement in order for them to be effective, proportionate and well targeted. We've provided feedback below on the issues we consider most material.

Question: What are your views on the aims of the CSS?

Question: Do you agree with the considerations we have identified for reviewing the CSS? Have we missed anything in our analysis?

You've structured your consultation around a general preamble where the aims of the CSS are set out, followed by a list of data items you'd like to collect. However, you do not set out which data items will fulfil what aims of the CSS. For example, it is not clear what data items you think are needed for your Conditions of Effective Competition report and as opposed to what is required in order to provide clarity to potential investors. This limits our ability to provide useful feedback on your proposals.

Question 1: Do you agree with our proposal to require vertically integrated suppliers and suppliers who hold only a supply licence to submit a CSS?

Question 2: Do you agree with the proposal to lower the customer base threshold from 250k to 50k?

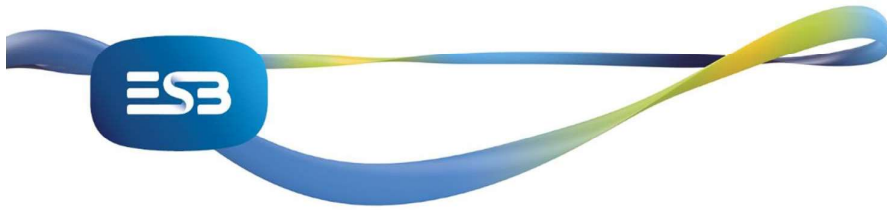
With regards to vertical integration, you assess two options, 3A and 3B. Under 3A, vertically integrated suppliers must provide accounts on the business of its affiliate generation licensee. Separate to this review, you are considering whether you should consult on a new CSS requirement for generators. If and when you put in place a new licence condition requiring generation licensees to provide a CSS, vertically integrated suppliers will no longer be required to submit accounts on their generation business under this CSS. Under 3B, vertically integrated suppliers will only be required to report in respect of their supply business.

Your preference is option 3A. You provide the following reasons as to why you believe this is the better option:

1. You wish to identify and understand any emerging or re-emerging issues in the market with regards to transfer pricing and cross-subsidisation.
2. You need transparency on suppliers' business activities as each activity affects overall profitability and consumer costs.
3. It is also important to have continuity in your data, particularly if you decide to put in place a CSS for generation licensees.

The CSS was introduced in 2009 in response to concerns that there was cross-subsidisation in the market owing to transfer pricing. Segmental reporting and increased transparency on transfer pricing were designed to provide better visibility to existing market participants and potential new entrants regarding margins in different parts of the value chain. Since it was introduced, the CSS has consistently shown that there is no evidence of cross-subsidisation through transfer pricing among obligated suppliers. In recent years, the retail market has evolved significantly. As you conclude in your consultation, vertical integration is no longer a

¹ https://www.ofgem.gov.uk/system/files/docs/2020/05/consultation_document_-_css_review_2020.pdf



significant feature of the market. Compared to when it was introduced in 2009, the case for having a vertically integrated aspect to the reporting has weakened dramatically.

You also propose lowering the threshold by which suppliers must provide accounts on the business of its affiliate generation licensee from 250k to 50k. This is imposing change instead of continuity. Vertically integrated suppliers that previously did not have to provide generation accounts will now have to provide that data. Compounding this issue is the prospect that the requirement will be temporary should you require generation licensees to provide a CSS. From an ESB perspective, you would impose setup costs on us now under option 3A and then impose further setup costs shortly afterwards under the generation CSS. You have stated at your Financial Accounting Workshop that this cost would be marginal. You are mistaken. Our estimate of the cost of providing this is in the confidential annex.

Thankfully, sensible steps can be taken to provide the continuity of reporting you want without incurring unnecessary costs. A modified version of option 3A could be pursued whereby the threshold for providing accounts on the business of a supplier's affiliate generation licensee remains at 250k. According to Table 1 of your consultation, you would still capture over 91% of the market with this higher threshold. In addition to this, all suppliers who are not currently mandated to provide affiliate generation licensee accounts could be given a temporary derogation from the obligation, pending your decision on whether to place an obligation on generators to provide a CSS. The derogation will ensure that suppliers do face double setup costs.

Question 3: Do you agree with the proposed cost categories, and the detailed allocation of cost items between these categories? Do you agree with the additional information to be disclosed?

Question 4: How feasible would it be to break down costs, revenues and profits by tariff type? How can we ensure consistency? What would be the one-off and ongoing costs of this?

Question 6: How feasible would it be to breakdown indirect operating costs into customer service, bad debts, metering, sales & marketing, central service and other?

Question 7: How feasible would it be to report costs associated with serving different types of customers, such as those on the PSR? What would be the one-off and ongoing costs of this?

Question 8: Should we put in place a standard method for allocating costs?

Question 9: How feasible would it be to split "other revenue" into more specific revenue categories (ie, beside income from energy generation and retail supply)? What would be the one-off and ongoing costs of this?

Question 10: What specific categories should the 'other revenue' item be separated out into?

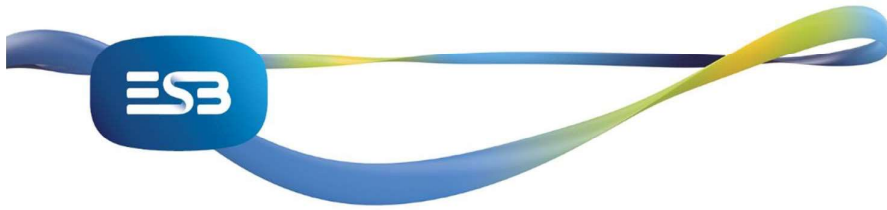
Question 11: What are your views on providing the additional information reporting requirements that we have listed? What would be the one-off and ongoing costs of this?

Thank you for inviting us to your workshop and sharing your draft CSS templates. We found this very useful in understanding the level of granularity of the data you're looking for.

We believe that we could provide the information at the level of granularity of the *current* CSS templates without incurring significant costs. However, the new templates which incorporate a split in costs according to what type of tariff or payment method each customer is on, will cause serious problems. These costs are managed on a portfolio and blended² basis as this is the most sensible approach to managing both the cost and customer experience for our business and our scale. What this means is that we do not have the level of granularity of data available to allocate the cost of, for example, our IT systems, across tariff or payment types. The only way to allocate these costs would be to make assumptions. Depending on the assumptions made, one could present dramatically different representations of the cost to serve and result in a significant risk of misinterpretation by any user of that information. An example of this is IT investments and costs. An investment in IT may provide improved customer experience, increase customer retention, improve billing accuracy amongst other benefits. The benefits of the investment may appear across a number cost categories. However how the investment is treated from supplier to supplier will vary as some may treat this as a capital investment depreciate the costs over a number of years, some may purchase this software as a service and others may fully expense the cost in any given year. This could present dramatically different representations of the cost to serve across different suppliers and different years.

We've identified four basic approaches to addressing the issue of a lack of primary cost allocation data.

² By 'blended' we mean that we allocate costs in a way that does not align with the traditional cost categorisations set out in the CSS template. For example, retention of customers is a discreet activity within our business. In order to align with the CSS template, we would have to decide whether retention should reside under 'Sales and Marketing' or 'Customer Service'.



Option 1: Allow suppliers to make assumptions on how to allocate costs where data otherwise isn't available. The suppliers CSS would include an explanation of how they have allocated costs. Suppliers know their business better than anyone else, so are best placed to make sensible and realistic allocations of cost. However, different suppliers will take dramatically different approaches to allocating costs, partially down to different suppliers having different structures and partially down to matters of judgement. This introduces the risk that CSS reports will not be comparable across suppliers.

Option 2: Ofgem clearly identifies assumptions on how suppliers should allocate their costs through detailed guidance. Given the diversity of businesses in the retail market, it's likely for some suppliers that in allocating costs according to Ofgem guidance, they would be presenting a misleading picture of their costs to the market. This could cause potential investors in energy to make poor decisions. In addition to this, when using this data to, for example, assess the state of competition in the market, Ofgem risks falling into a dangerous causal loop. Ofgem imposes assumptions about how suppliers should allocate costs under the CSS and then has those assumptions confirmed when they look at the reports. However, setting aside the issue of whether or not the reports are reflecting what is actually happening in the market, they will allow for easier comparison between suppliers.

Option 3: Require suppliers to make investments in their systems and manpower solely to generate granular, accurate CSS reports. This would involve costly and time-consuming IT upgrades for the sole aim of fulfilling regulatory reporting requirements. For many smaller scale suppliers, it would involve procuring an Enterprise Resource Planning (ERP) system at the very least, as well as a substantial overhaul of supporting systems, like the Customer Relationship Management (CRM) system. For example, it's not unrealistic to see it taking a year to procure and replace an entire CRM system (an exercise that brings with it the chance of bad consumer outcomes owing to IT migration issues, especially if it's rushed). Once a supplier's new IT systems are in place, then you must collect a full year's worth data before you're in the position to publish a CSS. For suppliers operating on a larger scale the changes involved are likely to be less dramatic – as you grow in scale it likely they will have already procured these systems. However, they're still likely to face costs in configuring these systems solely to meet the CSS reporting requirements.

Option 4: Differing requirements for differing sizes of supplier. All suppliers under a certain threshold could be required to deliver a CSS similar to the current format. When suppliers reach a certain scale, they're required to produce a more granular CSS report. Ofgem would need to engage with the supplier community to understand what level of cost reporting granularity is typical as suppliers grow in scale and then set requirements that minimise investments made solely for the purpose of generating the CSS report. It may be that no suppliers currently capture costs at the level of granularity you're looking for³. If this is the case, the level of granularity should be scaled back and alternative ways of meeting your objectives will need to be explored. We believe this option is the most common-sense approach to achieving your goals.

Question 12: Of the additional financial information requirements discussed, which ones should be given priority in submitting as part of the CSS?

Priority should be given to capturing data that suppliers already use to run their own businesses. Asking suppliers to generate data at a level of granularity in prescriptive cost categories they otherwise do not require is overly burdensome. Asking suppliers to arbitrarily allocate costs in a way they otherwise do not do risks painting a misleading picture of the market⁴. Ofgem should speak with suppliers to understand what data is currently collected at different scales of businesses and tailor their reporting requirements around what is already collected and used.

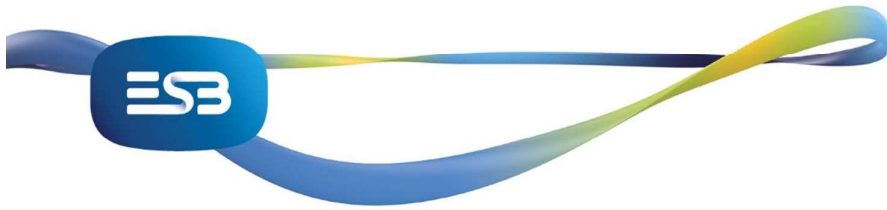
Question 13: Please state if any of the additional information reporting requirements we have listed are commercially sensitive and why.

It was suggested at your workshop that where information was considered commercially sensitive, it would be aggregated to present a market-wide view. If the information was to be aggregated then the information must be prepared in comparable fashion across each supplier, otherwise the aggregate data risks being misleading. However, as set out above, comparability brings its own drawbacks.

Question 14: How much would you expect it to cost in terms of FTE staff to meet new CSS reporting requirements based on our preferred options?

³ We've assumed that larger suppliers have an ERP but that assumption may not bear out.

⁴ Again, our example of allocating IT system costs, above, is relevant here.



Question: What are your views on how a transition period could work if and when revised CSS licence conditions come into effect? We would like to understand whether any transition period should apply to all obligated suppliers or only to those suppliers who have not previously submitted a CSS?

As set out above, the cost and implementation timescales are going to vary a great deal depending on how you intend to deliver the level of granularity you've set out in your preferred option.

If new systems are required to capture the data you need, the implementation period could be 24 months if not longer. One would assume that suppliers already mandated would be able to meet the new requirements more quickly. If the level of granularity was dialled back and greater flexibility was afforded to suppliers in how they allocate costs, reports could be more quickly and cost-effectively generated by all suppliers.

In terms of transition, a key goal should be to avoid imposing setup costs on newly vertically integrated suppliers, only to impose further setup costs a year later through a generation CSS.

Question 15: How much does it cost, or would cost, to audit the CSS? Please provide evidence.

See our confidential annex, below.

Question 16: Do you agree with the proposal to remove the audit requirement but for us to retain the right to request an audit when we have concerns? Do you have any views on how best to ensure that information provided to us via the statements are robust?

Yes, we agree that routine auditing should not be required. Our understanding is that data provided to Ofgem by suppliers cannot be false or misleading and we do not believe that suppliers would intentionally provide false data. In practise, submitted data is likely to be of a poor quality because the requirement wasn't phrased clearly and/or insufficient guidance was provided. The best way to ensure quality is to be consultative and collaborative in developing the requirements and associated guidance and then work with suppliers to identify and resolve any potential misunderstandings early in the reporting process.

Question 17: Would removing the requirement to audit the CSS on a regular basis enable suppliers to submit the CSS earlier? How much earlier?**Question 19:** What are the pros and cons of changing the reporting year to the year ending March instead of the company year end?

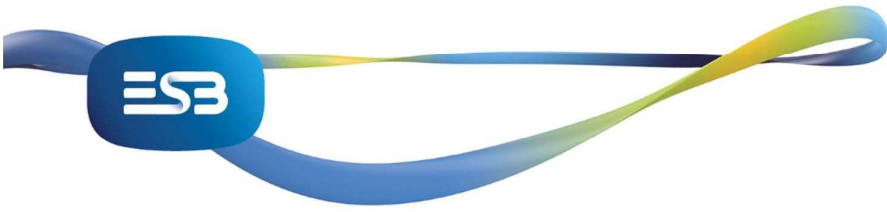
Allowing suppliers to report in line with company year-end brings benefits in terms of better quality information and substantial cost savings as a great deal of duplication of work can be avoided. An additional focus on quality of reporting takes place for a company's financial year end (in preparation for financial audits) rather than for monthly management accounts, leading to better quality CSS reporting. Avoidance of duplication of work is especially valuable to smaller, less well staffed suppliers.

Forcing suppliers to align to a March year end not only unnecessarily increases the workload and burden on suppliers for the sole reason of fulfilling regulatory reporting, it will also have the effect of reducing the accuracy and reliability of the information provided. If suppliers are allowed to report in line with company year end, then each supplier will still provide an annual summary of performance every 12 months. Ofgem's Data Exchange and Data Services team should be able to make the collation of CSS reports on a rolling basis a straightforward activity.

Mandating the reporting year to the year ending March does not appear to bring any benefits.

Removing the requirement to audit the CSS while allowing the supplier to submit information in line with the company year end would enable suppliers to submit the CSS earlier, approximately 4 months after the year end.

We hope you've found this feedback helpful. We're more than happy to engage and provide assistance on further developing your package of proposals in the next phase of your work. Please don't hesitate to get in touch.



Yours Sincerely,

Paul Fuller
Regulation Manager

