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Dear Maureen,

### **Reviewing the Consolidated Segmental Statements – Our Initial Proposals**

Thank you for the opportunity to contribute to Ofgem's review of the Consolidated Segmental Statements (CSS). We welcome the review as timely in light of market developments over the last few years which we agree have brought into question the effectiveness of the CSS in their current form.

Our responses to the specific questions raised are set out in the annex to this letter. We would highlight the following points:

- **Vertical Integration** – we are pleased Ofgem has recognised that vertical integration has reduced and is no longer a significant feature of the GB energy market, but we are disappointed that Ofgem seems minded to continue the unnecessary reporting obligation on vertically integrated generators. None of the reasons Ofgem gives for retaining the obligation stands up to scrutiny. It is a principle of good regulation that obligations should be removed as soon as there is no longer a compelling case for them. Ofgem has done this for the Secure and Promote mandatory market making obligation and it should do the same for the generation CSS (ie adopt 'Option 3b').
- **Additional financial information requirements** – we agree in principle with the additional financial information that Ofgem is proposing to require in the CSS, notably revenues, costs and profits split by tariff type and customer segment. We disagree with Ofgem's suggestion that this information should be provided privately to Ofgem (and published in aggregate form) instead of being included in published CSS. Although suppliers may consider such information to be commercially sensitive, this should not preclude the information being made public, provided there is a level playing field for suppliers and a consumer benefit from doing so. In our experience the CSS can be of significant value to suppliers in benchmarking and identifying areas for efficiency gains, and we think the same could apply to the additional information.

- **Cost allocation and other accounting policies** – we appreciate that many smaller suppliers may not have relevant cost allocation policies in place. Furthermore, suppliers are likely to vary in their approach to cost categorisation and other policies such as capitalisation and amortisation. We think the best way to ensure consistency is for Ofgem to develop an optional standard method and guidance to cover these issues. Suppliers who do not have corporate accounting policies in place could adopt Ofgem’s standard method to produce the CSS and companies using their own policies should disclose what they are and where they differ from the standard method. We do not believe that a standard method should be mandated for all suppliers as this would unnecessarily complicate preparation of the CSS for suppliers who might therefore have to restate their costs.
- **Non-licensed activities** – Ofgem is consulting on whether revenue reported by suppliers as “Other Revenue” (ie non-licensed activities) should be separated into constituent categories. We believe it would be *ultra vires* for Ofgem to place a blanket requirement on suppliers to provide more granular information relating to non-licensed activities. If Ofgem wishes to request such information, it should do so only where there is clear evidence of need, and only on a targeted basis. For example, if a supplier has a high proportion of non-licensed revenue and shows signs of financial weakness, it may then be appropriate for Ofgem to request additional information on its non-licensed activities. It is not appropriate to request such information on a blanket basis from all suppliers preparing CSS.

Please do not hesitate to contact me or Haren Thillainathan(0141 614 2007, [hthillainathan@scottishpower.com](mailto:hthillainathan@scottishpower.com)) if you have any questions arising from our response.

Yours sincerely,



**Richard Sweet**  
Head of Regulatory Policy

**REVIEWING THE CONSOLIDATED SEGMENTAL STATEMENTS: OUR INITIAL PROPOSALS – SCOTTISHPOWER RESPONSE**

**Chapter 1: Introduction**

**Question: What are your views of 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 those suppliers who have not previously submitted a CSS?**

Our preference is that no transition period is allowed for any supplier, so that the revised CSS reporting requirements are implemented in full in 2021. If some suppliers are allowed a transition period, this will not enable Ofgem to receive the complete and consistent information required for deliverables such as the State of the Market Report in 2021. Therefore, we believe Ofgem has two options:

- Allow all suppliers a transition period by deferring the first reporting year of the revised CSS requirements to 2022; or
- Do not allow a transition period, so that the revised CSS requirements are reported by all suppliers in 2021.

We think the need for a transition period could be avoided if Ofgem adopts our preferences for the revised CSS arrangements, specifically:

- removing the requirement on vertically integrated suppliers to report on affiliated licensed generation businesses;
- removing the requirement for the CSS to be independently audited;
- confirming any new additional reporting requirements and associated guidance sufficiently far in advance, ie no later than 31 October 2020 for CSS submission from April 2021.
- introducing the requirement for prior year comparisons with effect from the second reporting year of the new requirements.

However, if a transition period is to be allowed, we think it would be fairest to allow it for all suppliers, since even those suppliers who are already obligated will need to adjust to a substantially different set of reporting requirements.

**Extended deadline for year 1**

Although we do not support a transition period, we believe it would be appropriate to allow suppliers an extended deadline in Year 1, given the additional time required to set up new processes and systems. At present obligated suppliers must publish CSS within 4 months of the year end. We would suggest 6 months in Year 1.

## **Chapter 2: Main aims of the CSS and this review**

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

We are broadly supportive of the stated aims of the CSS in Chapter 2.

Under the aim “Ensuring Consumers are Treated Fairly”, Ofgem suggests that a breakdown of “Other Income” (ie non-licensed activity) may be required. For example, Ofgem argues that it may need to monitor the performance of non-licensed activities as there is a risk that losses from these other activities could cause a business to fail, with SoLR costs being recovered from GB energy consumers. However, given the small number of suppliers where this is likely to be an issue, we consider it would be disproportionate to impose a blanket requirement on all suppliers. Indeed, as explained in response to Question 9 below, we believe it would be *ultra vires* for Ofgem to do so.

## **Chapter3: The retail market has changed**

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

We agree with Ofgem’s assessment that vertical integration is no longer a significant feature in the market, but we are disappointed that Ofgem seems minded to continue the unnecessary reporting obligation on affiliated licensed generation businesses. As explained below (response to Ch 4 Question 1), we do not believe any of the reasons Ofgem gives for retaining the obligation stand up to scrutiny. It is a principle of good regulation that obligations should be removed as soon as there is no longer a compelling case for them. Ofgem has done this for the Secure and Promote mandatory market making obligation and it should do the same for the generation CSS (ie adopt ‘Option 3b’).

We note that Ofgem intends to consider separately, and potentially consult on, the case for a new reporting obligation on all licensed generators (not just vertically integrated ones). If a case can be made, then it would be right for Ofgem to introduce a new obligation in future, but there is no reason to retain the existing obligation in the interim.

## **Chapter 4: Proposals for changes to the CSS licence requirement**

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

We agree that all suppliers who hold a supply licence (above a customer number threshold) should be required to publish a CSS for their supply business, not just suppliers who are vertically integrated.

We disagree that vertically integrated suppliers should continue to be required to submit CSS for their generation businesses (as per Ofgem’s preferred Option A). Instead we believe Ofgem should select Option B, in which vertically integrated suppliers are only required to report in respect of their supply business.

Ofgem justifies its preference for Option A on the basis that:<sup>1</sup>

- Separate from this review, it is considering whether it should consult on a new CSS requirement for [non-vertically integrated] generators.

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<sup>1</sup> Condoc para 4.9

- It wishes to collect information that will help identify and understand any emerging/re-emerging issues such as transfer pricing or cross-subsidisation
- It will be important to have continuity of data if a CSS is put in place for generation licensees.

It is an important feature of good regulation that regulators are swift to remove obligations as soon as there is no longer a need for them. The findings of the CMA Energy Market Investigation and recent industry restructuring have provided ample evidence that vertical integration is no longer an issue. Ofgem has already acted to remove the 'Secure and Promote' mandatory market making obligation, which was predicated on vertical integration. CSS reporting obligations on generators are less onerous than market making, but the same principle applies: obligations should be removed as soon as there is no longer a need for them. We note that Ofgem is separately considering the need for generation reporting, but until a case has been made (which we doubt it will), the obligation should be suspended.

Even if Ofgem's separate review were to conclude in favour of requiring generators to report CSS, we think Ofgem's arguments around continuity of data are weak. There will be no continuity of data for most of the generators who would be covered by a new obligation (who are not vertically integrated) and therefore no continuity for overall industry trends.

Finally, if Ofgem is genuinely concerned about cross-subsidy and transfer pricing, there are better ways of mitigating this risk than requiring publication of generation CSS. Over the period since the CSS were launched Ofgem has conducted various reviews of transfer pricing, and companies have responded with greater disclosure in the notes to their CSS as to their approach to setting internal transfer prices, which in turn should give greater comfort that there is no cross-subsidy. (Indeed, as noted below, ScottishPower has voluntarily disclosed information about its energy trading business, to contribute to increase transparency.) We are not aware of any evidence or suggestion that transfer pricing is still a concern, but if it were, Ofgem should look to tighten up disclosure around such pricing, not require publication of generation CSS.

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

Yes, we agree with Ofgem's assessment that lowering the threshold to suppliers with 50k customers ensures a sufficient percentage of the energy retail market (98.4%) will be covered by the CSS. This market coverage should ensure the CSS continues to achieve Ofgem's stated policy objectives. We also note the 50k threshold is consistent with other statutory obligations such as ECO and WHD and therefore aligning the CSS threshold to this supplier scale would be a proportionate reform.

**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?**

Ofgem's proposal to separate indirect operating costs into customer service, metering, sales and marketing, central services, bad debts and others seems reasonable.

It will be necessary for more detailed guidance on the precise nature of costs to be included in each category; both to ensure consistency of reporting but also to make sure the categories are broad enough to minimise the values in other costs. For example, guidance should include:

- i) what is to be included in central services?
- ii) what activities are covered by metering: is it just meter rental or does it include other items such as back-office and IT costs related to metering

In terms of more detailed cost allocation between customer types, we are well placed to do this so again would not disagree. Again, to reiterate the point above, if Ofgem is going to use this data for efficiency analysis and to look for cross subsidy between high cost to serve and low cost to serve customers then it is key that definitions of cost categories are clear and unambiguous to ensure consistent reporting across suppliers.

Overall, we are supportive of the more detailed reporting, and also would find it useful for this to be disclosed within the published CSS reports.

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

This is a split ScottishPower can produce using existing systems and, provided we could report on the same basis as we use internally, there would be no additional costs involved. To ensure consistency, Ofgem should develop a standard method for providing this split for suppliers who do not currently do this. Companies using their own approach, like ScottishPower, should be required to state where they deviate from the standard method and on what basis.

**Question 5: How feasible would it be to breakdown non-domestic cost, revenues and profits into microbusiness and other? What would be the one-off and ongoing costs of this?**

In ScottishPower's case we could provide this breakdown if we were allowed to broaden the definition of microbusiness to include SMEs - in which case, there would be no additional costs involved. If the requirement could not be relaxed in this way, we would be unable to provide this breakdown, since we do not hold sufficient data to distinguish reliably between microbusiness and SME customers. Obtaining such data would involve considerable time and effort – which we believe would be disproportionate.

As with other cases, we suggest Ofgem could specify a standard method for providing this split for suppliers who are able to. Companies like ScottishPower, who need to use a different approach, should be required to state where they deviate from the standard method and on what basis.

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

This is a split ScottishPower can produce using existing systems and, provided we could report on the same basis as we use internally, there would be no additional costs involved. To ensure consistency Ofgem should develop standard definitions for these indirect operating cost categories and the method for allocating between these categories. Companies using their own approach like ScottishPower should state where they deviate from the standard method and on what basis. If Ofgem wants companies to report indirect costs on a more granular basis e.g. by tariff type or customer segment Ofgem will have to extend the standard method to set out the how aggregate costs disaggregated to this more granular level.

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

We have previously raised with Ofgem our concern that large (former incumbent) suppliers face additional costs compared to other suppliers as a result of their mix of customers – a cost difference that is not reflected in the tariff cap. One of the main areas in which costs are sensitive to customer mix is bad debt write off, but cost relating to customer support (including but not limited to PSR services) may also vary. We have done some initial analysis internally to attempt to quantify this effect, but it is difficult to do this without data on other suppliers' customer mix. We would therefore welcome Ofgem doing further work in this area, but we believe it would be premature to move straight to including this in the CSS.

As a first step we believe Ofgem should undertake a one-off RFI exercise with a view to understanding where the main customer mix-related cost differences lie, and how this can best be monitored through information requests to suppliers. Without such preparatory work there is a risk that any metrics reported in the CSS would present a partial picture and be misleading. For example, the costs associated with providing PSR services are only a relatively small part of the difference (and may not be routinely recorded by suppliers), and the statistics may be distorted by the fact that different suppliers have different approaches to registering customers on the PSR.

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

We agree that a standard method for cost allocation should be developed to be used as a default by suppliers that do not have an established cost allocation methodology. However, we do not agree that all suppliers should be compelled to use this standard method; rather suppliers should be able to use their established methodology if applicable, and state where and on what basis it differs.

**Question 9: How feasible would it be to split Other Revenue into more specific revenue categories i.e. other than energy generation and energy supply? What would be the one-off and ongoing costs of this?**

For the purposes of the CSS we think it is sufficient to disclose cost allocation between "Other Revenue" (ie non-licensed activities) and licensed activities in aggregate; there is no need to separate other revenue into constituent categories.

Indeed, we believe it would be *ultra vires* for Ofgem to place a blanket requirement on suppliers to provide more granular information relating to non-licensed activities. Ofgem's information gathering powers (s47A(1) of Electricity Act and s34A(1) of Gas Act) are solely for the purpose of exercising its functions in respect of licensable activities. Ofgem argues that it may need to monitor the performance of non-licensed activities as there is a risk that losses from these other activities could cause a business to fail, with SoLR costs being recovered from GB energy consumers.<sup>2</sup> However, Ofgem gives no examples of where this has happened in practice, and we are aware of no suppliers where this would appear to be a risk.

If Ofgem wishes to stretch the limits of its statutory powers, it should do so only where there is clear evidence of need, and only on a targeted basis. For example, if a supplier has a high proportion of non-licensed revenue and shows signs of financial weakness, it may then be

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<sup>2</sup> Condoc para 4.29

appropriate for Ofgem to request additional information on its non-licensed activities. It is not appropriate to request such information on a blanket basis from all suppliers preparing CSS.

In recent CSS publications ScottishPower has chosen to provide additional information on its energy trading activities on a voluntary basis, in order to provide increased transparency and confidence over transfer pricing between retail and generation businesses. Although we were willing to do this on a voluntary basis, we would have objected in principle to being required to do so, given that Ofgem has no vires in this respect. Similarly, suppliers may choose to provide additional disclosure where there may be concern over cross-subsidy between licensed and non-licensed activities, but we do not believe Ofgem can compel them to do so.

**Question 10: What specific categories should Other Revenue be separated out into?**

As explained in our response to Question 9, we do not agree that suppliers should be required to provide this information.

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

There will be some one-off costs in year 1 to develop reports and make internal system changes, but we are not in a position to estimate these costs at the moment.

On an ongoing basis we would not at present expect the costs to be significantly higher, on the assumption that we are not required to get the revised CSS audited.

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

In relation to licensed supply costs, we think the splits by tariff type, customer segment and indirect operating cost categories are the most useful.

We believe this additional information should be included in the CSS that suppliers are required to publish, rather than being provided on a confidential basis to Ofgem. The CSS have come to be used by a range of different stakeholders for a variety of purposes and can be of significant value to suppliers in benchmarking and identifying areas for efficiency gains. We believe the additional information that Ofgem is proposing to require could be similarly useful and, provided that all suppliers are required to publish it, this should not create competitive distortions.

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

As noted above (response to Q12), the fact that suppliers would consider information to be commercially sensitive should not necessarily preclude its publication, if there are policy grounds for doing so and it is done on a level playing field. Suppliers would typically consider much of the information currently published in the CSS to be commercially sensitive (if it were not already in the public domain), but because the obligation applies to all large suppliers, the competitive distortions resulting from sharing this information are reduced.

On that basis, we would argue that most of the additional information suggested by Ofgem is likely to be considered commercially sensitive, but if it is required to be disclosed by all



suppliers, we do not think that suppliers would suffer any material commercial detriment as a result. A possible exception to this would be where the information relates to a deterioration in the financial robustness of a supplier, since such information could affect its ability to obtain credit. However, given the likely reporting time lag associated with CSS (in contrast to other Ofgem RFIs) we think this is unlikely to be a material issue.

**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?**

In relation to licensed supply activity, we do not expect to incur materially increased costs on an ongoing basis. However, we could potentially incur significant internal resource costs in revising our internal processes to accommodate the additional information requirements in the first year, and in carrying out associated checks and reviews.

In relation to licensed generation activity, we do not expect any increase in costs if the reporting obligation continues (unless there is a change in reporting year – see below). However, if, as we have argued for, the requirement is removed, we would expect to see a reduction in cost.

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

It currently costs ScottishPower around £25k to audit the CSS, as an add-on to the main audit.

If we were required to report on April-March year instead of January to December, and if new data items are added to the report which do not form part of our statutory reporting (eg balance sheet details), this would make the audit process significantly more complicated. Under these circumstances, if Ofgem still wished to require an audit, we would recommend that Ofgem engage with the main accountancy/audit firms to discuss what would be practicable in terms of the scope and nature of the audit report. This is effectively what Ofgem did when the audit requirement was first introduced and would be the best way of achieving a sensible balance between degree of assurance and cost of audit.

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

We agree with the proposal to remove audit requirement and for Ofgem to keep this as a reserved right of request. In terms of ensuring robustness this may be an area that can benefit from some of the new supply licensing review obligations for ongoing monitoring.

For example, there will be an obligation for suppliers to maintain robust systems and operational capability. Ofgem's CSS team could liaise with the Ofgem team monitoring this to understand which suppliers maybe at higher risk in terms of the robustness of their reporting and Ofgem could request audits accordingly.

**Question 17: Would removing the requirement to audit the CSS on a regular basis enable suppliers to submit the CSS earlier? How much earlier?**

If the CSS requirements were unchanged, removing the audit requirement might save a week or two of time, but it would not make a significant difference.

If Ofgem expands the reporting requirements and changes the reporting year, this will mean that it take us longer to prepare the CSS, even without an audit, and particularly in year 1.

If Ofgem expands the reporting requirements and requests an audit, this could introduce further delay, depending on the scope and nature of the audit report (see Question 15).

**Question 18: What is the average cost of preparing an RFI with detailed financial information?**

From an internal preparation and reporting basis, the costs would be much the same as producing an unaudited CSS.

**Question 19: What are the pros and cons of changing the reporting year to the year ending March instead of the company year end?**

From our perspective, the disadvantages are the time and potential cost involved in reconfiguring our financial reporting systems to report to a March year end on a reliable basis, instead of our December year end.

The proposed removal of the audit requirement significantly reduces the scale of this cost, but it is still material given that we will have to make changes to reporting for both supply and generation. It is not clear whether there is a sufficiently large majority of suppliers currently reporting to a March year end to justify this proposal.

**ScottishPower**  
August 2020