

Appendix 11.1: Financial transparency

Introduction

1. Many firms including the Six Large Energy Firms operate in several different markets, often across a vertical or horizontal value chain. The Six Large Energy Firms themselves are in the best position to determine the basis for financial reporting that best enables them to run their businesses.
2. From the perspective of the public policy debate and wider regulation, it can be important to obtain market orientated financial information that reflects the financial performance of generation, trading and retail supply as stand-alone businesses, in particular for considering profitability.¹ This is particularly the case where firms operate internationally.
3. Both UK and European statutory financial reporting rules² require firms³ to report the financial performance for their activities as a whole.⁴ These rules also require firms to report a limited set of financial information for the key operational divisions (segmental information) through which senior management run the business as a whole. In addition, since 2009, Ofgem has required the Six Large Energy Firms to report to its specification a set of profit and loss information for generation and retail supply activities.
4. It is important that the regulatory framework for financial reporting makes available to regulators and policy-makers financial information (including balance sheet information) on market lines consistently delineated across firms and giving a sufficient degree of transparency over revenues, costs and profitability. In this regard, the financial information needs to be relevant and reliable as well as having a clear and accessible basis of preparation.
5. In this appendix we set out the status quo regarding financial transparency of the information available to help Ofgem in its regulatory and public-policy decision making role. This appendix is therefore structured as follows:
 - (a) Ofgem's initiatives to obtain further financial information (paragraphs 6 to 22); and
 - (b) Our diagnosis of the Six Large Energy Firms' accounting information (paragraphs 23 to 51).

¹ See Section 11, paragraphs 11.16 to 11.19 for some examples.

² These rules are a mix of company law reporting requirements and financial reporting rules as embodied in either UK or International accounting standards.

³ Here, incorporated firms such as the Six Large Energy Firms.

⁴ These rules focus on the information needs of investors.

Ofgem's initiatives to obtain further financial information

6. Ofgem has taken a number of initiatives in this area over the last past few years, as set out below. These range from obtaining further ex post 'accounting' information from the Six Large Energy Firms to developing its own financial information. The justification given for each initiative has varied.

Use of Ofgem's powers to require segmental accounting information

7. In the following paragraphs we set out the recent history leading up to the current position for the provision of segmental accounting information by the Six Large Energy Firms. This is relevant as it explains the starting point for the financial information provided to us in this market investigation.

Post-liberalisation

8. As discussed in paragraph 2.48, caps on retail prices for domestic consumers were imposed in the initial period after liberalisation. These were removed in 2002, and along with it the requirement on energy firms hitherto subject to price caps to provide financial information for their retail businesses beyond that required to be published for statutory reporting purposes. There was no requirement for generation businesses to provide financial information to the regulator pre liberalisation because all generation plant had been in public ownership and subsequent to that were considered to be a competitive part of the value chain.

Energy Supply Probe

9. The Energy Supply Probe in 2008/09 highlighted the need for more transparency with regard to the relationship between the generation and retail supply activities of the Six Large Energy Firms. Ofgem explained that, as not all of the Six Large Energy Firms produced separate segmental accounts at the time for gas supply, electricity supply and electricity generation, it was difficult for existing and potential market participants to assess the profitability of these different activities. In addition, Ofgem observed that there was little transparency regarding the transfer price used by the supply and generation businesses to exchange wholesale energy, which gave rise to concerns about cross subsidisation.⁵
10. Ofgem argued that segmental reporting and increased transparency on transfer pricing would provide better visibility to existing market participants

⁵ Ofgem (7 August 2009), [Energy Supply Probe – Proposed Retail Market Remedies](#), paragraph 6.1 (p33).

and potential new entrants regarding margins in different parts of the value chain.⁶

11. Ofgem put forward four options for consultation and decided to require the Six Large Energy Firms to publish separate profit and loss accounts for gas and electricity retail supply and generation and to reconcile such accounts to Great Britain (GB) group earnings before interest tax, depreciation and amortisation (EBITDA). All accounting policies would need to be consistent with and reconcilable to the policies that such firms had adopted in their statutory accounts.^{7 8}
12. After the publication of Ofgem's analysis of the first set of profit and loss information for 2009 in March 2011, Ofgem issued guidance in May 2011 that the 2010 information, amongst other things, should explain how the transfer pricing methodology related to open market prices and/or a cost plus methodology.⁹ These sets of profit and loss statements are described as the Consolidated Segmental Statements (CSS).

Retail market review

13. As part of this subsequent 2011 retail market review (RMR), Ofgem appointed the accountancy firm BDO to review the way the Six Large Energy Firms provided information about the profits of different parts of their vertically integrated (VI) businesses. BDO had found that the Six Large Energy Firms had allocated key functions to different parts of their business, but the transfer pricing methodologies each had employed had accounted for these differences.¹⁰ BDO concluded that that such firms transfer pricing policies were broadly 'fit for purpose and transparent'¹¹ and would likely meet the measure of best practice described in the OECD's transfer pricing guidelines.

Most recent developments

14. In the summer of 2014, Ofgem commissioned BDO to review the Six Large Energy Firms' latest transfer pricing methodologies as reflected in their 2013 profit and loss accounts for generation and retail supply of gas and electricity. BDO's key finding was that such firms' current transfer pricing rules reflected

⁶ Ofgem (7 August 2009), [Energy Supply Probe – Proposed Retail Market Remedies](#), paragraph 6.2 (p33).

⁷ Ofgem (7 August 2009), [Energy Supply Probe – Proposed Retail Market Remedies](#), paragraphs 6.2 and 6.11 (pp33 & 35).

⁸ See [Electricity generation SLC 16B and Electricity supply SLC 19A](#).

⁹ Ofgem (23 May 2011), [Financial Information Reporting: Amended Guidance](#), paragraph 1.9 (p4).

¹⁰ [Improving the Reporting Transparency of the Large Energy Suppliers](#), 1 May 2012, Footnote 4 to paragraph 3.20 (p13).

¹¹ Ofgem (31 October 2013) [Rebuilding Consumer Confidence: Improving the transparency of energy company profits](#), paragraph 3.16. The footnote cross refers to p56, Ofgem Segmental Statements Review, BDO LLP Final Report, 16 January 2012.

the arm's length standard. As a result, Ofgem concluded that it was even more confident that the profits the Six Large Energy Firms declared were the ones they actually made from their activities in generation and supply.¹²

Supply market indicator

15. Following the Probe, Ofgem committed in 2008 to continually monitor price changes to help stakeholders better understand the relationship between domestic retail prices and wholesale costs. This was in part in response to the concern that falls in wholesale energy costs had not been translating into lower retail prices as quickly as increases had been leading to higher retail prices. This initiative eventually became the supply market indicator (SMI).¹³ This information was updated and published regularly¹⁴ from 2009 to April 2015.
16. In its most recent form, the SMI, as calculated by Ofgem, inferred a measure of the retail margin for the Six Large Energy Firms as a whole by comparing annual energy charges for an average¹⁵ customer based on such firms' published tariffs at a particular point in time with the costs of supply determined on the following approaches:
 - (a) Wholesale energy costs – based on the average of forward prices for the forthcoming year that had prevailed over a period¹⁶ in the immediately preceding past.
 - (b) Network costs – a bottom-up estimate using the prevailing wholesale transmission and distribution charging tariffs inflated by forecast RPI.
 - (c) Indirect costs of supply – actual costs (ie historically incurred) of supply taken from the Six Large Energy Firms' CSS profit and loss statements inflated by forecast RPI.
 - (d) Environmental and social obligations – future cost estimates taken from DECC's published impact assessments.
17. This approach to comparing costs with charges therefore utilises the following perspectives to measure costs and charges over the forthcoming year:

¹² [The revenues, costs and profits of the large energy companies in 2013](#), paragraph 5.6 (p42).

¹³ [Supply Market Indicator Methodology](#), Ofgem, dated 30 October 2014, paragraphs 1.3 & 1.4.

¹⁴ The frequency of publication has varied: quarterly, weekly and monthly.

¹⁵ 'A dual fuel direct debit 'medium' typical consumption customer as per the definition prevailing at the time of publication.

¹⁶ This period over which the average forward wholesale price for the forthcoming year was determined varied between 190 to 365 trading days preceding the particular point in time.

- (a) Wholesale energy costs – a *forecast* of these costs for the forthcoming year using an average of already known *historical* forward prices covering the same year.
 - (b) Network costs – a *forecast* of costs to be incurred in the forthcoming year.
 - (c) Other indirect costs of supply – a forecast of costs to be incurred in the forthcoming year directly based on *reported actual* costs in the most recently available sets of CSS inflated by forecast RPI.
 - (d) Environmental and social obligations – a *forecast* of costs made by DECC; and
 - (e) Energy charges – a *forecast* of charges based on the assumption that tariffs would remain unchanged over the forthcoming year.
18. We note that the approach to measuring wholesale energy costs adopted in the SMI, ie one based on the prevailing market price for products traded on the open wholesale market is conceptually the same approach we have sought to adopt in our analysis of retail profitability. See paragraph 30.
19. On 22 May 2015, Ofgem announced that it had suspended the SMI as part of its review of the information it collected and published so that in future it could provide greater transparency about the market to inform the energy debate.

Profitability analysis undertaken

20. Both the CSS and SMI initiatives focused on obtaining a better understanding of profits and profit margins. In 2011, as part of its RMR work to promote trust and engagement, Ofgem also tried to assess retail profitability, rather than retail profits, of the Six Large Energy Firms. Ofgem sought, with the help of a firm of consultants specialising in the energy sector, Redpoint, to analyse these firms' retail supply profitability both as a VI firm and as a standalone retail supplier. In the absence of actual balance sheet information, Ofgem estimated on a bottom-up basis the operating capital employed of the Six Large Energy Firms including collateral requirements both as a VI firm and a standalone retail supplier.
21. To calculate profitability, Ofgem multiplied its estimate of capital employed by its estimate of the cost of capital and deducted this from operating profits, in principle the same approach we have used to present the results of our retail profitability analysis.¹⁷

¹⁷ See Section 10, paragraph 10.31 and Appendix 10.3, paragraph 21.

22. Ofgem did not publish this piece of analysis. We understand that this was in part because it was not confident that it had got to the bottom of the capital employed/collateral issue. Ofgem, however, did use it to inform its public assessment as to what operating margins should be. This analysis suggested that an operating margin of 3 to 4.5% of revenue for VI firms and up to 10.5% of revenue for a standalone supplier would allow firms to earn a reasonable return on capital employed.^{18 19}

Our diagnosis of the Six Large Energy Firms' accounting information

23. We now explain in what way, in our view, the accounting information that the Six Large Energy Firms initially supplied to us within the context of this market investigation did not provide a sufficiently robust basis for our analysis of profitability. In the course of our investigation we sought to address those issues surrounding the financial information that are material to our provisional conclusions. We did this by requiring parties to provide us with information that more closely reflected the financial performance of generation and retail supply as stand-alone businesses, and/or by making our own adjustments to the information initially supplied.²⁰ We illustrate below why the accounting information initially supplied to us differed from what we considered appropriate to conduct the profitability analysis for our market investigation. The inability of most of the Six Large Energy Firms to readily provide such market-orientated financial information²¹ may explain why some stakeholders consider the status quo regarding financial transparency in relation to Ofgem's regulatory and public-policy decision making role as inadequate.²²
24. We would like to emphasise that the following analysis is not a criticism of how the Six Large Energy Firms have chosen to organise their business or the set-up of their financial reporting systems. Firms design their financial reporting systems primarily to support the running of their business and enable them to fulfil their statutory reporting obligations, which are focused on the needs of investors. Inevitably, the information that the firms initially supplied to us were based on the financial information they were already routinely producing.

¹⁸ Ofgem (1 March 2011), RMR Profitability Analysis, paragraph 5.1.

¹⁹ See [RMR – Findings and initial proposals - Supplementary Appendices](#) (pp41–44) for how the output of this profitability analysis was used publicly. Ofgem (21 March 2011).

²⁰ We set out the detail of how we did this across appendices 10.1–10.3 and 4.2.

²¹ This is because, the existing divisional reporting lines of certain firms differs from the segmentation of the energy value chain on market lines. As a result these firms need to re-cut their financial information. Unless the firms' reporting systems have this flexibility already built in to their reporting systems, the information segmented on an alternative basis across the value chain cannot be easily and robustly produced in a timely fashion.

²² See Section 11, paragraphs 11.16–11.19 for examples.

25. Our analysis within the context of this market investigation was focused on establishing the profitability of the Six Large Energy Firms for generation and retail supply. There were two distinct but interrelated themes as to why the accounting information initially supplied to us by the Six Large Energy Firms in some respects differed from what but we considered we needed for our analysis.

Misalignment of the scope of the activities of the Six Large Energy Firms to the needs of our analysis

26. The first theme related to the scope of the activities undertaken, and therefore reported, within each of the Six Large Energy Firms' operating divisions. Their groupings of activities within divisions did not necessarily align with the way we wished to group their activities for our analysis.
27. In addition, each of the Six Large Energy Firms organised their activities across their generation, trading and retail supply divisions differently, so simply basing our analysis of what activities they included in each of their divisions would have seriously hindered cross-comparability.

Generation defined as a tolling business

28. In order to assess the profitability of the Six Large Energy Firms' generation activities we considered it relevant to include all the activities that a 'full-function' generator would undertake. See Appendix 4.2: Generation return on capital employed, paragraph 18. We considered this to be the concept of generation that fully aligned the risks and rewards for owning and operating generation plant. It was also the business model that had been adopted for generation assets in GB over the period of review.
29. The main issue we found here was that some of the Six Large Energy Firms had allocated their generation activities between their generation division and trading division. These firms had limited the scope of the activities of their generation division to selling to the trading division the right to use the plant to generate electricity.²³ Unadjusted,²⁴ this would also have meant a lack of comparability across the Six Large Energy Firms in terms of what activities were included within generation.

²³ Where some of the Six Large Energy Firms sold the right to use generation plant it was to their trading division, not to an independent third party.

²⁴ Five of the Six Large Energy Firms were able to provide us information either in line (EDF, Centrica and Scottish Power,) or approximately in line (RWE and E.ON) with the basis specified. The firm that could not was SSE (see Table 1 in Appendix 4.2).

Retail supply included some trading activity

30. In order to assess the profitability of retail supply, we considered it relevant not to include the profits or losses associated with purchasing any wholesale energy products apart from those that were traded on the open wholesale markets. We consider the relevant demarcation line between retail supply and trading to be, for our analysis, the products sold on the open wholesale markets.²⁵ Therefore, the purchase of any other energy products by retail supply would include the results of what we would consider a trading activity, namely buying (or selling) bespoke and selling (or buying) products on the open wholesale markets.
31. The main issue we found here was that some of the Six Large Energy Firms had included within their results for retail supply the costs of energy products other than products available on the open wholesale markets.²⁶ The divergence in costing practice for wholesale energy costs across the Six Large Energy Firms reflects differences in specifying the boundary between retail supply activities and trading/generation activities. This in turn makes making relevant comparisons across the Six Large Energy Firms highly challenging.
32. For example, we found that [redacted] retail supply division recorded that it had ordered certain shaped products before such products were available on the open wholesale markets for that delivery date,²⁷ and that [redacted] had purchased products so far ahead of the point of delivery that it was unlikely that these quantities would have been available on the open market.²⁸ Other of the Six Large Energy Firms reported purchases of energy on a bespoke basis, in [redacted] case mainly from third parties, and in [redacted] case mainly the result of internal trading.
33. The first two cases ([redacted] and [redacted]) are examples of purchasing products traded on the open wholesale markets but not available at the time of purchase. The last two cases ([redacted] and [redacted]) are examples of purchasing bespoke products, which often involves a commitment to purchase over a longer time frame than with traded products. Purchasing on either basis can lead, from the perspective of our analysis, to an element of trading profits or losses being reflected in retail supply.

²⁵ See Section 7, paragraph 7.20 (a).

²⁶ Two of the Six Large Energy Firms' approach to costing wholesale energy comprised exclusively of products sold on the open wholesale markets, namely [redacted] and [redacted]. See Appendix 10.5: Assessment of the competitive benchmark in retail energy supply, Annex A, 'review of wholesale energy costs'.

²⁷ See Appendix 10.5, Annex A, 'review of wholesale energy costs, paragraphs 32–35.

²⁸ See Appendix 10.5, Annex A, 'review of wholesale energy costs', paragraphs 64–66.

34. There will inevitably be a difference between the value of energy sales and purchases priced on the basis of products traded on the open wholesale markets and their value priced on some other (bespoke) basis. We found that this difference appeared to be inconsistently handled across the Six Large Energy Firms. For example, for [X], retail supply reflected the purchase of some [X] electricity sourced on a bespoke longer term basis, whereas for [X], retail supply reflected the purchase of all energy, including presumably some internally supplied energy, wholly on the basis of traded products. This implies that, for [X], any difference in the values between bespoke and traded products for this [X] electricity was reflected in retail supply, but elsewhere for [X].
35. Another example of the difference is the treatment of intermittent energy such as wind. Only [X] and [X] showed such purchases in retail supply, although all of the Six Large Energy Firms own GB wind generation plants. On account of its intermittency, no wind output is sold in the form of traded products which guarantee provision of a certain volume over a specified period of time; rather it is sold with reference to, but not at the same level as, the prices prevailing at the time of production/delivery.

Identifying internal sales and purchases

36. It can be important to stakeholders to appreciate the extent of internal trading that occurs within integrated firms such as the Six Large Energy Firms. In order, for example, to reflect the extent of supply of energy by generation to retail supply in the accounting information provided, it would be necessary for the generation and retail supply to be shown to have directly transacted with each other. In practice, the Six Large Energy Firms channelled these transactions via their trading divisions. For the purpose of our analysis, however, such transactions do not give rise to a trading activity; instead, the generation business sells energy to its retail supply business and the retail supply business buys energy from generation.
37. Five of the Six Large Energy Firms were unable to show in the accounting information supplied to us the extent of such self-supply. The exception was [X], which had tagged its transactions in such a way as to be able to distinguish between those sales and purchases that were external to the firm and those that were internal.

Standalone firm perspective in each relevant segment of the value chain

38. The second theme was that, even if the Six Large Firms had consistently grouped their activities across generation, trading and retail supply on the lines we considered relevant for our analysis, they did not always account for

these activities to reflect the costs and revenues that would have been incurred by a standalone firm. As explained in paragraph 32 in Appendix 10.1: Approach to profitability and financial analysis, in our profitability analysis, we used as the relevant benchmark the costs and revenues that would have been faced by a new entrant entering into a competitive market. This consideration is particularly relevant to assessing whether the basis of transfer charging into and out of the businesses analysed was appropriate.

Open wholesale markets energy purchases costed at market prices

39. As already explained in paragraphs 30 to 31, we consider that the demarcation line between retail supply and trading should be determined by reference to the open wholesale energy markets for electricity and gas. In other words, for the purposes of our analysis retail supply should only source energy from the wholesale markets in the form of products available on these markets. Furthermore, in order to reflect the costs that would be faced by a standalone firm, the costs for these open wholesale markets products should be at the prevailing market prices.
40. We found that where the Six Large Energy Firms had purchased product traded on the open wholesale markets, their approach to costing was to reflect the prevailing market prices for those products. However, four of the Six Large Energy Firms were not sourcing all these inputs exclusively in the form of products sold on the open wholesale markets. This in turn led these four firms not to cost all their wholesale energy inputs using the prevailing market prices for products sold on the open wholesale markets.
41. The approach to transfer pricing that is relevant for our analysis is different from that set out in the OECD transfer pricing guidelines.²⁹ These guidelines focus on the pricing of transfers between different legal entities, whereas we are concerned with the pricing of transfers between markets. In the case of analysing the profitability of retail supply, we wanted input costs to reflect transfers between the open wholesale energy market and retail supply, and for these transfers to be market-priced.

Absence of transfer charges for implicit guarantee

42. The Six Large Energy Firms told us that their retail supply businesses benefited from being part of a financially strong wider corporate group. This enabled them to maintain investment grade credit ratings, which allowed them, among other things, to enjoy preferential trading terms on commodity

²⁹ See paragraph 13 above where the OECD transfer pricing guidelines were used as the relevant benchmark.

markets. We have characterised this situation as firms benefiting from an implicit guarantee from the rest of the group. See Appendix 10.3: Analysis of retail supply profitability.

43. However the Six Large Energy Firms did not explicitly account for the cost of obtaining these benefits in their results for retail supply.³⁰ Our analysis set out in Appendix 10.3 shows that a standalone supplier would have to pay a third party to obtain benefits such as preferential trading terms on commodity markets. We therefore made an adjustment (a transfer charge) to account for the cost of obtaining this guarantee based on the level of the fee that one independent retail supplier paid over the period of review to obtain similar benefits from an intermediary.

Absence of grossing up

44. There are some benefits that arise within an integrated group. For example, such firms may be able to net off transactions made and balances held by different parts of the group with external parties eg when posting collateral.³¹ However, in order to reflect the costs that a standalone firm would face, it would be necessary for these transactions and balances to be grossed up. We found that some balance sheet items such as collateral reflected the net position across generation and retail supply, and therefore were not consistent with the perspective of what a standalone generator or retail supplier would have posted.³²

Other transparency issues

45. There were some other issues that did not stem directly from either the firms' divisional structures or the need to reflect the costs that would be faced by a standalone firm. We outline some of the most important of these issues below.

The need for balance sheets aligned with scope of our analysis

46. To assess profitability it is necessary to take into account the operating capital employed in the business.³³ However, some of the Six Large Energy Firms

³⁰ In principle, generation would also benefit from being part of a financially strong wider group too. The extent of this benefit is not as significant as it is for retail supply as only the generation gross margin, rather than the whole of wholesale energy costs, would be hedged.

³¹ For example, the retail division of a firm might need to post collateral of 100 with an external counterparty whereas this same counterparty might at the same time need to post collateral with the firm's generation division of 70. If, as is normal commercial practice, the firm and the external counterparty net off these balances between themselves, then the firm will only need to post collateral of 30 with the external counterparty.

³² See paragraph 38 above where we discuss the standalone firm principle.

³³ See paragraphs 25 & 29 of Appendix 10.1.

had difficulties providing us with a full balance sheet in line with the divisionally-based profit and loss accounts they had supplied us for retail supply and generation.³⁴ In particular, working capital (including any collateral posted) was not necessarily routinely disaggregated for reporting along divisional lines. This difficulty would then have been compounded where the scope of our analyses differed from the scope of their divisions (see paragraphs 26 to 35).

Granularity of reporting within generation and retail supply

47. Sometimes it can be important to analyse profitability at a more granular level than the business or market as a whole. For example, we attempted to analyse generation by technology and retail supply by the customer types set out in our terms of reference. However, as a result of the way some of the Six Large Energy Firms accounted for the sales by their generation business – once the energy had been initially sold it went into a general pot – they were not able to provide revenues by generation technology, and therefore not able to report generation profitability by technology. We therefore were unable to report generation profitability by technology across all the Six Large Energy Firms. See Appendix 4.2, paragraph 95.
48. In contrast, all of the Six Large Energy Firms were able to provide information which disaggregated retail supply between domestic and non-domestic customers to a certain degree. However, while the Six Large Energy Firms were generally also able to disaggregate non-domestic customers between SME and Industrial & Commercial (I&C), they were not able to provide granular information for microbusinesses. This may have been because these customers had been defined in such a way in our terms of reference that did not lend them to being systematically identified as microbusinesses.

Selective use of other accounting bases other than historical cost

49. To assess profitability on a comparable basis, it is necessary for the financial information to have been prepared adopting a consistent and relevant accounting convention. For the most part the Six Large Energy Firms adopted the historical cost accounting convention in the financial information they supplied. However, there were two instances where we came across the use of other accounting bases. While these other bases may more closely align with a measure of current costs, and therefore economic costs, the selective

³⁴ Ofgem required the Six Large Energy Firms to supply profit and loss accounts and not balance sheets, which may explain the difficulties some of the Six Large Energy Firms experienced in supplying us with that information.

use of other accounting conventions can lead to a lack of comparability both within and across the Six Large Energy Firms.

50. For example, [redacted] had revalued some of its gas contracts when it [redacted]. This meant that the cost of gas procured under these contracts did not reflect the historical cost, rather the historical cost plus an amortisation charge.³⁵
51. A further example was [redacted] which, for its I&C customers alone, transfer charged wholesale energy costs on the basis of the average market price on the day that a supply contract was agreed,³⁶ rather than its hedged (ie historical) costs. [redacted].

³⁵ See Appendix 10.5, Annex A, 'review of wholesale energy costs', paragraph 71.

³⁶ See Appendix 10.5, Annex A, 'review of wholesale energy costs', paragraph 55.