Appendix 10.3: Financial reporting remedy – further detail of proposals

Introduction

1. In paragraphs 10.234 to 10.297 of Section 10 we describe at a high level our proposed enhancements to the current reporting regime. In this appendix we set out further detail behind our proposals and other aspects of the current reporting obligations which we are not proposing to recommend that Ofgem changes.

Proposed enhancements to the current reporting regime

2. In this section we provide further detail about how we envisage each of the proposed enhancements to the current reporting regime would work.

A: Separation of the Six Large Energy Firms' activities along market rather than divisional lines

3. In paragraph 10.234 of Section 10 we set out our provisional decision that the Six Large Energy Firms should report along market lines. In this appendix we describe further what we mean by reporting on market lines and how we envisage this would be done in practice. We also set out principles for identifying the markets the Six Large Energy Firms are active in and which of these we recommend Ofgem should require the Six Large Energy Firms to report on. We also consider a number of issues raised by parties in response to the Remedies Notice.

Principles of reporting along market lines

Capturing all activities in a particular market

4. This is achieved by reporting all activities that relate to a particular market regardless of which part of the firm they are included in for statutory or internal reporting purposes.[1] This approach would result in firms reporting their actual costs, revenues, assets and liabilities in a particular market. For example firms would report the actual transactions the firm has made with external parties and, for transactions relating to internal supply across market boundaries, these should be accounted for as though they had in fact been made with external parties. Applying this principle would lead to the Six Large Energy Firms reporting on their activities in a particular market on a

[1] Section 10, paragraph 10.240*(a)*.

comparable basis. We give three examples of applying this principle in practice below.

- *Obligation to apply to firm rather than individual subsidiaries*

5. Ofgem's practice, historically (and in contrast to the proposed remedy), has been to impose licence obligations on particular subsidiaries of each of the Six Large Energy Firms, specifically the holder of the relevant licence. The reporting of generation and retail supply activities has therefore related solely to the individual licensed subsidiary. This practice however has meant that if another subsidiary within one of the Six Large Energy Firms' corporate group is also active in GB generation or retail supply markets, then this GB activity is not necessarily captured in the reporting of the licensed subsidiary in question. We have seen examples of assets that are owned partly by UK subsidiaries and partly by non-UK subsidiaries within the same corporate group that have not been fully included in the results for generation.[2] However, in terms of our proposed remedy, our provisional view is that this does not raise any practical issue requiring a change to the relevant standard licence conditions for financial reporting. This is because, under the relevant standard licence conditions, it is already the case that the relevant individual licensed subsidiary must, where applicable, prepare a segmental statement *in conjunction with* that subsidiary's holding company or any other subsidiary of that subsidiary's holding company.[3] This wording makes it clear in our view that the licensed entity would have to provide financial information relevant to our proposed remedy (ie along market lines) regardless of how (and by which entity within the group) this information is being recorded.

- *Reporting of wholesale energy costs incurred by the firm ('actual costs')*

6. Three of the Six Large Energy Firms (Centrica, Scottish Power and SSE) have told us that they reflected in their segmental statements the cost that the firm had actually incurred.[4] They achieved this by transfer charging across to their retail supply division the actual cost incurred by their trading division. Each of these three Six Large Energy Firms emphasised the importance of

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[2] Eg the holding company for the renewables division of EDF's GB generation unit, EDF Energy Renewables Holdings Limited, is a 50:50 joint venture with EDF Energy Nouvelles, a separate wholly owned subsidiary of EDF International, a legal entity which sits within the EDF corporate group but not within the EDF Energy plc intermediate corporate group

[3] Holding company and subsidiary of a holding company are defined in the relevant standard licence conditions as per within the meaning of sections 1159 and 1160 of the Companies Act 2006.

[4] Centrica has done this since at least 2009, Scottish Power since 2011 and SSE since 2014/15. See Appendix 10.5, Annex A.

being able to report their actual costs, not least to deliver transparency on the profits they had actually earned.[5]

7. For some of the Six Large Energy Firms (eg RWE and EDF Energy), however, their transfer charges reflect internal purchases made by the UK division from their trading division, all costed on the basis of standard wholesale products. This approach means that, if the firm had actually purchased energy in the wholesale markets through its trading division at some other date or procured some of its energy on some other (eg longer-term bespoke) basis, then its costs as reported in its segmental statements would not reflect the costs the firm had actually incurred.

8. Our provisional view is that, so long as RWE's and EDF Energy's use of standard wholesale products for transfer charging into retail supply is otherwise in line with paragraphs 3 to 16 of this appendix, this is likely to be an acceptable substitute for reporting the costs actually incurred by the firm for the following reasons:

(a) The costs transferred would reflect the independent purchase decisions of the UK management of the retail supply business.

(b) As explained in paragraph 10.270 in Section 10, these purchases are of simple wholesale energy products.

(c) These purchase decisions are costed using market products which are traded in a liquid market that we have provisionally found to be competitive. They are also verifiable prices.

(d) As we also propose that all of the Six Large Energy Firms should be required to identify their purchase opportunity cost on a standardised basis (see Section 10, paragraphs 10.249 to 10.276), this should ensure that there will in future be at least one common measurement basis for wholesale energy costs for retail supply across all of the Six Large Energy Firms.

- *Preparation of balance sheet to reflect external payment terms*

9. Some of the Six Large Energy Firms have pointed out that the segmental debtor and creditor balances they provided to us for the purposes of our ROCE profitability analysis did not reflect their external payment terms.[6] In line with the principle that costs and revenues should reflect those actually

[5] See Appendix 10.2, paragraphs 8 and 11.
[6] See Appendix 3.4, paragraph 84.

incurred by the firm, under our proposed remedy these balances should reflect the amounts due to, or owed by the firm, and not reflect settlement arrangements internal to the firm.

Adopting a standalone basis of preparation

10. This principle addresses the issue of how integrated firms should account for those goods and services the firm in one market provides to itself in another market.[7] The Six Large Energy Firms are all large, often international, businesses which are active in a number of different markets including the ones within our terms of reference (generation and retail supply). For integrated firms like the Six Large Energy Firms, for the purposes of our proposed broader package of remedies relating to the Governance AEC, this means that there needs to be some effective mechanism to identify their performance in each relevant market.

11. To achieve this, we employ the concept of the standalone firm operating in a single market. For each of the Six Large Energy Firms, the financial results of the firm would be divided up across the markets (as defined for the purpose of our proposed remedy) in which it is active. Appropriate transfer charges between the different markets, and 'grossing up' of any transactions and balances that have been netted off across markets, would ensure that the relevant revenues, costs, assets and liabilities are all attributed to the relevant markets for the purpose of our proposed remedy.

- *Only using goods or services sold into or out of the markets to levy transfer charges*

12. In order to isolate the profitability of each of the Six Large Energy Firms in a particular market, it is necessary to ensure that the goods and services internally supplied into, or sold out of, that market are outputs of, or inputs into, another market, and that these outputs or inputs are reported on the basis of market terms and conditions.[8]

13. Our proposed remedy therefore requires the use of goods and services transacted freely between an independent party active in one market and another independent party active in another market as the basis for calculating internal charging across market boundaries.[9]

[7] Section 10, paragraph 10.240*(b)*.
[8] See paragraph 9 of this appendix for an example of the relevance of terms and conditions.
[9] Section 10, paragraph 10.240*(c)*.

14. However, in the case of wholesale energy for some of the Six Large Energy Firms, some of the products they have historically transferred between their divisions (ie internally) have either been products that are not available as an output of another market or not available at the time of purchase/sale. For example, some of the Six Large Energy Firms have used non-market based tolling arrangements to transfer some of their generation activities into their trading division instead of reporting their generation activities on the market-based 'full-function generator' basis.[10] Another example is that one of the Six Large Energy Firms' (E.ON) transfer charges into its retail supply business have historically been based on shaped products that were not available for purchase on the wholesale market at the time of purchase.[11] In both cases, the use of such non-market based products for transfer charging has resulted in reporting along lines other than market lines.

- *Using (liquid and directly observable) market prices for such goods and services*

15. Our proposed remedy includes a principle that the pricing of any goods and services provided by one of the Six Large Energy Firms in one market to itself in another market (as per paragraphs 12 to 14) must be reported at the prevailing price in the market for that good or service at the time of sale/purchase.[12] We note that this principle is consistent with our proposed approach, which requires that for regulatory accounting purposes transfer charges be directly based on products that are inputs or outputs of another market.

16. The more liquid the market and more directly observable the market prices, the more confident stakeholders can be in the robustness and objectivity of any transfer charging. Auditors would also be in a position to give a higher level of assurance that such transfer charges are fairly stated. These are two of the reasons why elsewhere[13] we have included in our proposed remedy the use of standard wholesale products to cost wholesale energy for retail supply on a comparable basis across the Six Large Energy Firms.

17. In practice our concern about wholesale energy transfer charging has not been focused on the *pricing* of these products, rather the use by some of the Six Large Energy Firms of products that were not market products. This, in

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[10] See the provisional findings report, Appendix 11.1, paragraphs 28 & 29.
[11] See the provisional findings report, Appendix 11.1, paragraphs 32 & 33.
[12] Section 10, paragraph 10.240*(d)*.
[13] Section 10, paragraph 10.270.

turn, meant that the ‘market’ price of these non-market products had to be estimated using subjective adjustments to prices for actual transactions.

Principles relevant to identifying which markets should be reported on

18. Having established how the Six Large Energy Firms should, in our provisional view, be required to report on market lines as set out in Section 10 (paragraphs 10.236 to 10.243), there remains two further issues, namely identifying the individual markets potentially of relevance for the purpose of addressing the Governance AEC and then deciding which of these should be reported on. In our Remedies Notice we only referred to the markets (generation and retail supply) in general terms, as markets that fell within our terms of reference and in relation to which we have provisionally identified that there was a lack of relevant financial information available to Ofgem.

Principles for identifying markets/market segments

19. In our provisional findings report we provisionally defined a number of economic markets. These markets were:

(a) the wholesale electricity market in GB (including trading);

(b) the wholesale gas market in GB (including trading);

(c) the retail supply of electricity to domestic customers in GB;

(d) the retail supply of gas to domestic customers in GB;

(e) the retail supply of electricity to SMEs in GB, comprising, at least, a microbusinesses segment; and

(f) the retail supply of gas to SMEs in GB, comprising, at least, a microbusinesses segment.[14]

20. Currently Ofgem requires separate reporting (profit and loss account only) of the following:

(a) for the generation market (ie part of wholesale electricity market in GB):

(i) conventional (eg coal and gas-fired generation);[15] and

(ii) non-conventional (eg wind); and

[14] Provisional findings report, Section 3, paragraph 3.45.
[15] EDF Energy and Centrica voluntarily report nuclear separately.

(b) for the retail supply markets of electricity and gas (including supply to I&C customers), broken down between:

(i) domestic electricity;

(ii) domestic gas;

(iii) non-domestic electricity (ie SME and I&C combined); and

(iv) non-domestic electricity.

21. Through its specification of the existing financial reporting obligation, Ofgem indicated that it was more interested in monitoring outcomes in certain markets or market segments than others. This was also reflected in our formulation of the possible remedy in our Remedies Notice which proposed a financial reporting remedy concerning generation activities and retail supply activities.

- *Markets for financial reporting versus formally defined economic markets*

22. For the purposes of our proposed remedy, we consider a commercial approach to identifying markets is particularly relevant in that each reporting business must be unambiguously capable of operating in the relevant market on a standalone basis. The divisional structures adopted by firms in order to manage their business operations do not necessarily confirm that this is in fact the case.[16] We also consider that sales and purchases between markets should reflect commercial transactions actually entered into by businesses operating independently in these markets. In practice these two principles should ensure that integrated firms subject to such reporting obligations would be capable of objectively reporting their performance on a standalone basis in each of these markets by minimising the need to make subjective judgements when levying transfer charges.

Principles for identifying which markets should be routinely reported on

23. Ofgem is best place to assess precisely which markets it needs to monitor in order to do its job effectively in future. Some markets, based on an assessment of all the evidence including predictions for the future, will be seen as potentially more problematic than others regarding competitive outcomes. As set out in paragraph 20, Ofgem has already made such an assessment, at least at the point when it last revised its reporting

[16] For example, generation activities split between a 'generation' division (renting out the power station and operating in line with instructions received) and a trading division (all other generation activities) rather than on a full-function generator basis.

requirements on the Six Large Energy Firms.[17] Our proposed remedy is designed to give Ofgem the relevant information to assess the state of the markets (including generation and retail supply), and so where Ofgem decides to require financial reporting by the Six Large Energy Firms in a particular market, the approach specified in our recommendation should be applied.

24. We believe that for the purpose of addressing our Governance AEC Ofgem should have a better understanding of the profitability of firms active in both generation and retail markets. This is because there has been a past history of extensive intervention by government (both UK and EU) in the operation of the generation sector to achieve public policy outcomes, notably decarbonisation targets, and we expect these interventions to continue in the future. Such interventions not only tend to increase the competitive cost of supply but also result in windfall gains and losses to generators, the precise extent of which has tended to be a function of the generation technology adopted. For example, as a consequence of the introduction of the EU carbon trading scheme certain generators earned substantial windfall gains as a result of carbon allowances being gifted to them for free.[18] This led some stakeholders to call for these gains to be passed on in lower retail prices.[19] Financial reporting of generation activities would have helped identify the extent of the gain actually earned in each case, and in turn helped identify the impact of this policy initiative in the GB market on consumers.

- *Trading activities*

25. Commodity trading covers a number of wholesaling activities such as buying commodities in large quantities (eg the output of flexible generation plant or a long-term gas supply contract eg from Qatar, Gazprom or Statoil) and selling more granular products. In the case of purchasing the output of intermittent generation, trading activity would also cover managing the risks of non-delivery. Another example is acting as an intermediary between buyers and sellers who need to modify their previously contracted positions. A further example would be 'proprietary' trading where a firm would, effectively, take a position on future movements in commodity prices.

26. Ofgem has hitherto not formally sought to specify trading activities as one of the areas that the Six Large Energy Firms should report on. We note, in this

[17] The reporting licence conditions were last updated in late 2014/early 2015. See Ofgem (2014), *Statutory consultation on proposed licence modifications to improve the transparency of energy company profits*. The guidelines were last updated on 5 May 2015. See Ofgem (2015), *Guidelines for preparing Consolidated Segmental Statements*.
[18] See the provisional findings report, paragraph 2.81.
[19] For example by Energywatch in *Why British Energy markets in gas and electricity require a competition investigation*, an Energywatch discussion paper, section 2.1, published 16 July 2008.

regard, that trading activities are not a licensed activity under the GA86 or EA89. In this market investigation we have sought to understand how the trading market operates, primarily to aid our understanding of how the generation and retail supply markets work. We have not sought to analyse the outcomes of the trading market in terms of the Six Large Energy Firms' profitability.

27. In Section 10, paragraphs 10.236 to 10.243 and in paragraphs 4 to 17 above, we explain why in our view it is necessary that the Six Large Energy Firms report along market lines, and why internal transactions between different markets (such as generation and trading, and trading and retail supply respectively) should reflect market transactions. Adopting the approach in our proposed remedy will allow the Six Large Energy Firms to clearly delineate the markets that Ofgem indicated it wanted to actively monitor.

28. We therefore consider that the focus of the revised reporting regime for the purpose of our proposed reporting remedy should be on making sure that any internal transactions between the generation and retail supply markets (respectively) and the trading market are market based.

Principles for identifying which market segments should be routinely reported on by firms

29. Ofgem will need to assess which market segments require such reporting to take place in terms of the benefits it may provide to its decision making and wider stakeholder confidence in the financial information and trust in the markets, balanced against the incremental costs to the Six Large Energy Firms from providing such information.

30. An example of the further segmentation that may be relevant to Ofgem's monitoring work for retail supply could in future include:

(a) microbusinesses and other SMEs/I&Cs within non-domestic;

(b) SVTs, fixed tariffs and other tariffs within domestic; and

(c) payment methods (eg direct debit, standard credit, prepayment) within domestic.

31. However, the more granular the financial information that Ofgem might require, the greater the imposition and regulatory burden on the Six Large Energy Firms, and the greater the need would be to formalise regulatory

accounting principles such as cost causality[20] and objectivity.[21] Such regulatory accounting principles would be used to inform the selection of the most appropriate basis on which costs and revenues aggregated by the Six Large Energy Firms on a pan-segment basis (or even pan market basis) for internal and statutory reporting purposes would be attributed across individual market segments.

32. In addition, in order for Ofgem to be able to monitor the impact of policy choices on market outcomes[22] it may need to consider whether to require disaggregation of 'policy' costs for generation as it currently requires for retail supply.

B: Provision of balance sheet as well as profit and loss account

33. In paragraph 10.244 of Section 10 we set out why we propose to recommend to Ofgem that each of the Six Large Energy Firms also prepares a separate balance sheet for their generation and retail supply businesses. In this appendix we describe some detailed implications of this proposal for the financial reporting remedy as a whole.

Implication for the presentation of the profit and loss account

34. Pursuant to Ofgem's guidelines,[23] the Six Large Energy Firms currently exclude exceptional items from their segmental statements and show these items as reconciling items to their segmental profit and loss account in their statutory statements. However, in order for their profit and loss account to correspond with their balance sheet, these exceptional items need to be included, as individually reported items, in the profit and loss account.

35. The only exceptional item that would not be reported in the segmental statements would be commodity mark-to-market profits or losses and the associated derivatives balances. The Six Large Energy Firms emphasise their segmental profits in their annual reports on a historical cost accounting

[20] Costs (revenues/assets/liabilities) should be attributed to segments/markets in accordance with the activities which cause the costs (revenues/assets/liabilities) to be incurred (earned/acquired/incurred).
[21] The attribution of costs (revenues/assets/liabilities) should be objective and not intended to benefit the reporting of the performance of one particular segment/market.
[22] See Section 10, for example our proposed recommendation to Ofgem to publish annually a State of the Market Report including an assessment of (i) the evolution of energy prices and bills over time, (ii) the profitability of key players in the markets (eg the Six Large Energy Firms), (iii) the social costs and benefits of policies, (iv) the impact of initiatives relating to decarbonisation and security of supply, (v) the trilemma trade-offs, and (vi) the trends for the forthcoming year.,
[23] Guidelines for financial reporting, paragraph 1.6. (These guidelines relate to Standard Condition 19A of the Gas and Electricity Supply Licences and Standard Condition 16B of the Electricity Generation Licences (collectively referred to as 'the Conditions' for the purposes of these guidelines.)

basis in respect of their purchase and sale of wholesale energy sales.[24] To achieve this outcome, they exclude any mark-to-market profits or losses that they have recorded that relate to future delivery periods but include such profits and losses that relate to energy produced/delivered in the current period but which arose in prior accounting periods.[25] Ofgem reviewed this practice and concluded that reporting commodity costs and revenues on a historical cost basis to be more relevant than on a current cost basis.[26] In other words, it was important to match the costs of delivering energy in the period, no matter how far in advance the price of that wholesale energy was contracted for and no matter how much the market price for that energy had changed from the date at which it was contracted for, to the revenues earned in that period. This practice, therefore, allows the Six Large Energy Firms to report their 'actual' costs in line with their revenues for the period.

36. We agree with Ofgem that the Six Large Energy Firms should report their wholesale energy costs for retail supply on an 'actual' basis, but that should not be the only basis on which these costs, and therefore their retail profits, should be reported. As set out in paragraphs 10.249 to 10.274 of Section 10, we propose that, for retail supply, 'actual' wholesale energy purchase costs should be disaggregated between an opportunity cost (determined on a standardised basis for each of the Six Large Energy Firms) and a residual element being the remainder of their 'actual' cost. We consider the opportunity cost to be the most relevant measure of current cost, but as this measure can relate to the cost for transactions entered into in two or more adjacent accounting periods, then it would be more meaningful to disaggregate the historical cost than any other measure of wholesale energy costs.

Implication for debtor and creditor balances

37. As already explained in paragraph 9 some of the Six Large Energy Firms have pointed out that the segmental debtor and creditor balances they provided us for the purposes of our profitability analysis did not reflect their

[24] Note that such an approach is not fully IFRS (International Financial Reporting Standards) compliant, not least because IFRS requires wholesale energy purchases bought to hedge forecast transactions to be marked-to-market. As a result the Six Large Energy Firms' annual reports report the profit and loss account on two bases, once on an 'adjusted' basis, ie historical cost basis concerning wholesale energy transactions, and then again on a fully compliant IFRS basis, which include mark-to-market adjustments in respect of some wholesale energy transactions.
[25] Not all mark-to-market profits or losses are required under accounting standards to be reported within the profit and loss account. This happens where firms satisfy criteria which allows them to opt for hedge accounting. Hedge accounting allows the Six Large Energy Firms to report their wholesale energy costs on a historical cost accounting basis, ie incurred costs attributed to the period in which the energy is delivered.
[26] See 2012 BDO report (page 9) where Ofgem asked BDO, a firm of accountants which it had commissioned to analyse the Six Large Energy Firms' 2009 segmental statements, to describe the methodology used by the Six Large Energy Firms to account for long-term hedges and derivative contracts in these statements and to summarise any recommendations regarding hedge accounting. Ofgem adopted BDO's recommendation (as set out on page 22) that mark-to-market adjustments be excluded from the profit and loss account.

external payment terms. In line with the principle that costs and revenues should reflect those incurred by the firm,[27] under our proposed remedy these balances should reflect the amounts due to, or owed by the firm, and not reflect settlement arrangements internal to the firm.

Feasibility of implementation

38. Some of the Six Large Energy Firms told us that it would not be possible to report balance sheets on anything other than a pan-generation or pan-retail basis. In other words, they would be able to produce a balance sheet that covered all of their generation or retail supply activities respectively but would not be able to segment that balance sheet further across different generation or retail supply markets. Our provisional view is that it should be possible to disaggregate the balance sheet items that are material to each market/market segment, not least because they will be specific to each area. In any case, we propose to recommend to Ofgem that they mandate the provision of balance sheets on a pan-generation and pan-retail supply basis.

C: Disaggregation of wholesale energy costs for retail supply between standardised opportunity cost and residual elements

Introduction

39. In paragraphs 10.260 to 10.271 of Section 10 we set out the high-level principles by which the Six Large Energy Firms would estimate the opportunity cost for wholesale energy purchases on a standardised basis. In this section we discuss the mechanics of how we propose that this opportunity cost should be estimated under our proposed remedy.

Recap of the principle of the purchase opportunity cost

40. To minimise their exposure as retail suppliers to movements in input prices, prudent retail suppliers tend to purchase forward their wholesale energy requirements when taking on a commitment to supply their customers at a particular price. They do this by purchasing inputs forward to the extent permitted by the availability of the products in the wholesale market. As a result, prudent retail suppliers are largely able to fix at the outset their gross margins on the volumes they expect to supply for the agreed price. We describe the cost of purchasing in line with this approach as the 'purchase opportunity cost'.

[27] As set out in paragraph 5.

41. We propose that there should be a single approach to estimating the purchase opportunity cost across the Six Large Energy Firms by standardising the point ahead of delivery at which it is deemed that retail suppliers take on the commitment to supply. This would be the point at which the retail supplier is contractually committed to supply at a particular price the volumes that its customer demands. This approach to estimating the purchasing opportunity cost is broadly in line with the timing of established independent retail suppliers' purchase of wholesale energy.[28]

42. Were retail suppliers to purchase inputs ahead of taking on commitments to supply at a particular price, they would leave themselves exposed to falls in input prices which they could not expect to recover in a highly competitive market. Similarly if retail suppliers do not purchase at the point they take on the commitment to supply at a particular price, they expose themselves to the risk of incurring additional costs if input costs rise which they cannot pass on.

43. Inevitably a retail supplier's forecast of the volumes it expects to supply its customers at the point of taking on a commitment is unlikely to be fulfilled exactly.[29] The purchase opportunity cost would therefore be a combination of the estimated volume of wholesale energy costed using the prices prevailing at the time the retail supplier commits to supply its customers at a known price (ie the majority of the total purchase cost) together with the prices prevailing near, or at the point of, delivery which are used to cost the purchase of any additional volumes required or the sale of volumes excess to requirements.

44. We note that the remainder of the actual purchase cost that is not attributed to the purchase opportunity cost could turn out to be either an addition to cost (ie the incremental cost incurred as a result of each of the Six Large Energy Firms' actual purchasing strategy differing from the one assumed in this calculation) or a reduction in cost (ie the incremental profit earned by each of the Six Large Energy Firms from following its own purchasing strategy). The key point about interpreting this amount is that it is a cost (or profit) that the Six Large Energy Firms would not have expected to have incurred (where it turns out to be a cost) or earned (where it turns out to be a profit) had it consistently made its initial purchases at the point at which it contractually committed to supply its customers at a certain price.

[28] See the provisional findings report, Appendix 6.1, paragraph 125.
[29] Appendix 3.4, Annex A, paragraph 5*(c)*.

Our consideration of stakeholder comments on how wholesale energy purchases might be costed

45. SSE told us that the effectiveness of any purchasing strategy could not be judged simply based on what subsequently happened to wholesale prices between the point of purchase and the point of delivery,[30] stating that domestic customers on SSE's SVT had been completely protected under its price freeze commitment.[31] RWE told us that prices should be reported at the forward curve at the point of sale or purchase, and not use 'spot' prices at the point of delivery.[32] We note that our proposed approach involves both capturing the wholesale costs actually incurred by each of the Six Large Energy Firms following its own individual purchasing strategy (ie RWE's concern) and disaggregating these costs in such a way that is not simply based on what subsequently happened to wholesale prices between the point of actual purchase and the point of delivery (ie SSE's concern).

46. SSE cautioned against adopting a short-term universal method to benchmark the purchase cost of wholesale energy across all the retail tariffs under which the Six Large Energy Firms had supplied energy. In its view such an approach would in practice lead to there being a less diverse set of tariffs being offered in future and, as a result, there would be less competition on price.[33] We note that the extent to which firms take on commitments to supply at a given price ahead of the delivery period will vary according to the nature of the tariff being offered. Accordingly, the measure of the opportunity cost will vary with the nature of each tariff.

47. Therefore adopting an opportunity cost approach has the potential to address the concern identified by SSE, ie that a universal benchmark applied across all tariffs would not be appropriate. In consequence, however, it will be necessary for each of the Six Large Energy Firms to calculate and report purchase opportunity costs on a standardised basis by broad tariff type. It will be necessary to disaggregate these costs by broad tariff type, so that Ofgem and other stakeholders can identify and understand similarities in, and differences among, each of the Six Large Energy Firms' performance as retail suppliers. Six Large Energy Firms' financial performance would be expected to vary not least because of the extent to which they supply energy on different types of tariffs, for example the balance between variable rate and fixed-term tariffs.

[30] Appendix 10.2, paragraph 9.
[31] Appendix 10.2, paragraph 43.
[32] Appendix 10.2, paragraph 11.
[33] Appendix 10.2, paragraph 9.

Proposed methodology to estimate purchase opportunity cost on a standardised basis

48. In order to estimate the purchase opportunity cost on a standardised basis, we propose that retail suppliers cost the volumes they *expect* to deliver in line with paragraphs 40 and 41. There will be a second element to the calculation for two reasons. Firstly, as retail suppliers are generally not able to purchase the expected shape of their customer demand when they take on their commitment to supply, they will need to refine their initial purchases of seasonal blocks of wholesale energy by selling and purchasing more granular wholesale products as they become available in the wholesale market. Secondly, as retail suppliers inevitably cannot forecast accurately the quantity of energy their customers will consume in any half-hour period (electricity) or each day (gas), they will also need to purchase or sell quantities of energy close to the point of delivery to meet the actual demand of their customers.

49. For the purposes of calculating the purchase opportunity cost in our proposed remedy, we propose to simplify the calculation of the total purchase opportunity cost to two points in time: *(a)* the point at which the initial purchases would be made and *(b)* at the point of delivery (for those purchases made nearer or at the point of delivery). Our understanding is that the costs of shaping (ie combining different products so as to procure electricity in a manner that reflects the expected demand curve for any given day) are not material to the overall cost of wholesale energy[34] and therefore adopting such an approach is unlikely to distort the estimate materially of the purchase opportunity cost.

50. There would therefore be a two-stage calculation. First there would be the estimate of the cost of fulfilling expected demand when retail suppliers commit to supply their customers (ie addressing price risk). Second there would be the cost of tweaking these purchases (ie shaping, which as noted above, are not material) and addressing any volume shortfalls or excesses near or at the point of delivery (ie 'weather risk' and forecasting errors).

51. Given that retail suppliers commit to supply customers at an agreed price under a contract throughout the financial year, we propose that the calculation of the purchase opportunity cost under our proposed remedy should be estimated for each set of freshly contracting customers on a monthly basis.[35]

[34] See the provisional findings report, Appendix 10.5, Annex A, paragraph 83.
[35] For example, the retail supplier would calculate the purchase opportunity cost for customers taking out/renewing their fixed-rate fixed-term deal in January using the relevant forward prices averaged over January. Likewise for customers joining or renewing in February, the relevant forward prices averaged over February, and so on for each month of the financial year. We consider that a monthly calculation would strike a reasonable balance between the accuracy of the calculation (in principle this calculation should be done separately for each

In the case of fixed-term fixed-rate deals that extend beyond one financial year, a proportion of the costs will need to be attributed between the two accounting periods.

52. In Table 1 below we summarise the approach for example retail tariffs covering both domestic and non-domestic customers.

Treatment of the SVT and other variably priced tariffs

53. Compared to, for example, a one-year fixed-rate tariff, the SVT[36] is not as well defined a product in terms of the horizon over which prices are fixed. Under the SVT, retail suppliers are free to change the price for their variable rate tariffs as often as they like subject to giving 28 days' notice. Based on the historic frequency of price changes to the SVT, however, in our view it is unlikely that retail suppliers would choose to change SVT prices more than once a month.[37] For the purposes of our proposed remedy we, therefore, propose to characterise the SVT as a one-month fixed-rate product broadly in line with the minimum duration of the notice period within the contract between the retail supplier and its customer. Thus, we have assumed that retail suppliers would hedge the volumes they expect to supply one month ahead.[38]

54. Historically there has been a range of variable tariffs available to both domestic and non-domestic consumers other than the SVT tariff. For the purposes of our proposed remedy, we propose to treat these non-SVT variable tariffs in exactly the same way as the SVT, ie use the length of the notice period to determine the point at which we would assume that the retail supplier would make its initial energy purchases.[39]

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day's new/renewing customers before being aggregated across the financial year) and the need to keep the calculation tractable (12 sub-calculations rather than 365 sub-calculations).

[36] The SVT is the cheapest evergreen tariff available to domestic consumers. Evergreen in this context means the contract between the domestic consumer and the retail supplier contains terms and conditions that last indefinitely. In practice the retail supplier can change these terms, most notably the price, by giving notice of the change in line with the terms of the contract.

[37] Based on our review of the pricing strategies of the Six Large Energy Firms. See the provisional findings report, Appendix 7.3.

[38] So, if at the 3 January 2016 a retail supplier gives 28 days' notice to alter the price of its SVT effective 1 February 2016, it would then purchase on 3 January 2016 the volumes of energy it would expect the customers it has on 3 January 2016 to demand in February 2016.

[39] Note that microbusinesses are not supplied on a SVT type tariff in that there is no requirement for the retail supplier to put each customer on its *cheapest available* evergreen tariff when a non-variable contract has come to an end. The minimum notice period for microbusinesses is 30 days.

Table 1: proposed methodology to estimate purchase opportunity cost for wholesale energy by tariff type

Retail tariff type	*Methodology*
One year fixed-rate tariff: Retail suppliers commit to sell at a set price for the following 12 months	*Initial purchases at time when retail supplier commits to supply at the agreed price* The supplier would estimate the total cost using those standard wholesale traded products available for purchase in the forward markets at that time that best fit with the expected demand that the supplier forecasts for that customer group. *Actual subsequent net purchases closer to the point of delivery* This element of the cost would be approximated by multiplying the difference between initially purchased volumes (based on expectations) and actual volumes by the spot price.
Two-year fix: Retail suppliers commit to sell at a set price for the following 24 months	Same approach as above.
Fixed end date fixed-rate tariff: Retail suppliers commit to sell at a set price until a fixed end date stipulated in the contract	Same approach as above.
Three-year fix: Retail suppliers commit to sell at a set price for the following 36 months	For the initial purchases element, the supplier would be able to estimate an opportunity cost of the energy as soon as it is possible to purchase the relevant standard wholesale energy products in the forward markets.
Standard variable (SVT): Retail suppliers commit to sell at a set price for one month after giving 28 days' notice	There would need to be a similar calculation to one-year fix but for one month.
Tracker linked to firms' own SVT (ie a form of discounted SVT tariff)	As per SVT.
Tracker linked to a basket of firms' SVTs (ie a form of discounted SVT tariff)	As per SVT.
Tracker linked to market index of spot wholesale prices: Retail suppliers commit to sell at a price indexed to the prevailing half hour (electricity spot/daily (gas) price	'Spot' prices across the period of provision based on actual volumes consumed by customer. (We understand that this approach approximates the contractual basis on which many large industrial and commercial firms purchase energy.)
Non-standard variable tariffs: Retail suppliers commit to sell at a set price for a fixed period determined by the minimum notice period in the contract between the supplier and retail customer.	As per SVT but the length of the fixed period would be determined by the notice period in the contract.
Fixed term variable (ie a form of discounted SVT tariff)	As per SVT but no longer than the length of the fixed-term period.
Fixed term capped: Retail suppliers commit to sell at a particular price not to exceed X pence per kWh	As per fixed tariff of equivalent duration.
Any of the above but badged as 'green'	As per 'parent' tariff structure left All retail supply firms are required to procure a certain % of its supply in terms of renewable energy anyway (strictly speaking procure ROCs). Plus the cost of providing the additional environmental benefits claimed beyond that provided by the equivalent non-green tariffs.*

Source: CMA analysis.
*Ofgem published a consultation document on the principle of *additionality* in the connect of green and renewable tariffs on 27/06/2014 (Protecting Domestic Consumers in the Green and Renewable Tariffs Market – Final Proposals).

Estimating unexpected costs (or profits) arising from departures from seasonal weather norms

55. Retail suppliers can make unexpected gains or losses due to significant departures from seasonal weather norms (‘weather risks’). Such events can cause spikes or unexpected lows in demand by customers and the impact on firms will depend on the net impact of the incremental (or decremental) revenues and associated wholesale energy costs. Being able to isolate these impacts would further help Ofgem interpret profitability as such gains or losses are likely to significantly contribute to year-on-year volatility in outturn profitability, even after separately identifying that part of actual profitability that arises from the incremental impact of the retail supplier adopting its individual purchasing strategy rather than the one implicit within the standardised purchase opportunity cost approach.

56. Ofgem told us that it had in the past estimated the impact of unseasonal weather on each of the Six Large Energy Firms’ expected profit margins as part of its exercise to ‘reconcile’ the forecast profit levels implicit in its estimates for the SMI (in which the average customer bill and the associated wholesale energy costs are estimated on the basis of seasonally normal demand) and the outturn reported in the Six Large Energy Firms segmental statements.

57. Identifying the incremental (or decremental) profitability arising from material departures from seasonally expected weather norms is relevant to help correctly interpret outturn profitability for the purpose of evaluating trends in the strength of competition at the retail level over time. Otherwise there is a risk that peaks and troughs in reported profitability attributable in fact to exceptionally cold or warm weather might well be wrongly ascribed to the exercise/lack of exercise of pricing power on the part of the Six Large Energy Firms. Ofgem therefore may want to consider formalising an approach that could be used by the Six Large Energy Firms to estimate this quantum in any individual reporting period.

D: Prior period comparatives

58. In addition to the proposed enhancement as described in Section 10 (paragraphs 10.287 to 10.291), there are other aspects concerning comparability of financial information beyond comparability between one period and the next. We discuss some of these issues below.

***Comparability: a qualitative characteristic of financial information that enhances its usefulness*[40]**

59. If financial information is to be useful, it must be relevant and faithfully represent the economic phenomena that it purports to represent. The usefulness of such financial information is enhanced if it is also comparable.[41]

60. The enhancements we propose to recommend to Ofgem to implement would result in a greater comparability of the financial information prepared by the Six Large Energy Firms than is currently the case. Greater comparability of this financial information would help Ofgem and other stakeholders to better identify and understand similarities in, and differences among, each of the Six Large Energy Firms' financial performance.

61. Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a firm or in a single period across firms. Comparability is the goal; consistency helps to achieve that goal.

62. Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different. Comparability of financial information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different.

63. Some degree of comparability is likely to be attained by providing a faithful representation of relevant economic phenomena.[42] Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability.

64. In the context of our proposed remedy, there are several potential dimensions to the comparability of the resulting financial information including:

   (a) between one period and the next for each of the Six Large Energy Firms;

   (b) between the Six Large Energy Firms across a particular market;

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[40] This subsection draws heavily on the IASB (International Accounting Standards Board) 2010 text on the *Conceptual Framework for Financial Reporting*, Chapter 2, Qualitative Characteristics of Useful Financial Information.
[41] As well as being verifiable, timely and understandable.
[42] Financial statements provide information about a firm's economic resources, claims against the firm and the effects of transactions and other events and conditions that change those resources and claims. This information is referred to in the IASB's Conceptual Framework (see footnote 40) as information about economic phenomena. IASB (2015), *Conceptual Framework for Financial Reporting,* paragraph 2.2.

(c) between the Six Large Energy Firms across a particular market segment; and

(d) between the Six Large Energy Firms regarding the accounting period.

Comparability between one period and the next for each of the Six Large Energy Firms

65. We propose to directly address this by recommending that the Six Large Energy Firms report prior year comparatives (proposed enhancement D) as set out in paragraphs 10.287 to 10.291 in Section 10.

Comparability between the Six Large Energy Firms across a particular market

66. We propose to directly address this by recommending that the Six Large Energy Firms report along market lines as set out in paragraphs 10.236 to 10.243 in Section 10. This should help ensure that all the Six Large Energy Firms are working to report against common market definitions for regulatory financial reporting purposes.

Comparability between the Six Large Energy Firms across a particular market segment

67. As discussed in paragraphs 29 to 32, this would require the Six Large Energy Firms to report at a more granular level, perhaps at a level that does not have clearly defined market segment boundaries.

68. We have observed that for retail supply each of the Six Large Energy Firms take a different approach to segmenting their non-domestic customers between SME and I&C. Likewise in generation, where at the margins one of the Six Large Energy Firms classifies generation technologies as conventional or non-conventional differently from others of the Six Large Energy Firms.

69. Our current view here is that, so long as firms report their own segments consistently from one period to the next, a lack of consistent definitions across the Six Large Energy Firms may not frustrate Ofgem's ability to monitor market segment outcomes. What is likely to be more important is that, however specified, the individual segments are reported on along market lines as set out in paragraphs 10.236 to 10.243 of Section 10 and paragraphs 4 to 17 of this appendix, eg include all the activities for that segment, and that transactions between other levels of the value chain reflect market transactions.

70. For the purposes of our proposed remedy, we do not propose to be prescriptive as regards the treatment of segments. For instance, should Ofgem be minded in the future to require the Six Large Energy Firms to report on their microbusiness segment, then reporting meter profile classes 3 and 4 might provide an acceptable proxy measure.

Comparability between the Six Large Energy Firms regarding the accounting period

71. Five of the Six Large Energy Firms report with December year ends. SSE is the exception with a March year end. As explained in paragraph 55 unseasonal weather can lead to unexpected profits or losses being reported by a firm. Whilst this might be expected to impact all of the Six Large Energy Firms broadly equally, if one firm has a different reporting year end, then unexpected gains or losses can fall in another accounting period. This in turn hinders comparability across the firms across each period and Ofgem's ability to interpret profitability. Ofgem should therefore consider whether to require SSE to report, for the purposes of our proposed remedy, on a December year-end basis (ie separately to SSE's decision to account for statutory reporting purposes on a March year-end basis) or, alternatively, prepare an 'out-of-line' reconciliation between its actual (March) and an estimated year-end (December).

Other aspects of the design of the current reporting regime which we are not proposing to recommend Ofgem to change

Introduction

72. Above we provide details concerning how we envisage each of the proposed enhancements to the current reporting regime would work, including elaborating on closely related issues. The discussion below relates to other possible design changes we have considered but are not proposing to recommend to Ofgem to enact.

Scope of firms affected by the reporting obligation

73. In the Remedies Notice we asked whether this obligation should apply only to the Six Large Energy Firms. Most of the Six Large Energy Firms submitted that the current obligations should be extended to other retail suppliers and generators above a threshold size. These other suppliers and generators' view was that such a move would not be warranted.[43]

[43] See Appendix 10.2, paragraphs 17, 27 & 30.

74. The current reporting regime applies to the holders of a supply licence *(a)* it supplies, or it and any of its affiliates jointly supply: (i) electricity to more than 250,000 domestic customers; or (ii) gas to more than 250,000 domestic customers; or (iii) electricity to more than 250,000 non-domestic customers; or (iv) gas to more than 250,000 non-domestic customers, respectively; and (b) it or any of its affiliates is a holder of an electricity generation licence. In other words, it applies only to vertically integrated firms which exceed a certain materiality threshold. Our provisional view is that the current scope of the financial reporting obligation is appropriate. For the purpose of addressing the Governance AEC, the focus of this proposed remedy should be the understanding of the financial performance of large, vertically integrated firms such as the Six Large Energy Firms. Firstly this is because of the role and impact of these firms in the GB energy markets due, among other things, to their size and status as ex-incumbents in retail markets. Secondly, there is a need for additional transparency with respect to firms that are vertically integrated across a value chain which includes generation and retail supply.

75. In our view, extending the applicability of the reporting regime to energy firms that are not vertically integrated, or that fall below the current threshold would, in our view, impose a disproportionate burden on operators, including smaller integrated operators, at this stage of the evolution of energy markets. In due course, however, Ofgem may want to review the scope of the obligation in line with market developments and the need for it to be able to monitor policy impacts across the whole sector.

Exemption of certain generation activities

76. E.ON pointed out that an increasing amount of the output from some of the Six Large Energy Firms was exempted by Ofgem from segmental reporting requirements due to the fact that this generation related to local small-scale generation.[44] We are not proposing to recommend to Ofgem to amend the current exemption arrangements but note that, were such generation to become material to the GB energy supply, then Ofgem would need to consider whether it needed to dis-apply these exemptions in order to capture this source of generation's contribution to the cost and benefits of furthering government policy objectives.

[44] See Appendix 10.2, paragraph 81.

Reconciliation between reporting on market lines and firm's own segmental reporting

77. Some of the Six Large Energy Firms submitted that segmental reporting for regulatory purposes should fully coincide with their segmental reporting for statutory purposes.[45] Many stakeholders including Ofgem thought that it would be wrong to constrain the choices about how firms choose to organise themselves across the value chain. We, however, do not consider that the segmental reporting for regulatory purposes along market lines should necessarily fully coincide with the reporting for another purpose (eg statutory reporting).[46]

78. Some of the Six Large Energy Firms submitted that it was very important to stakeholders that the segmental statements could be straight forwardly reconciled to the segmental reporting in their statutory accounts. We consider a straight forward reconciliation to be a highly desirable feature of the segmental statements. The nature of this reconciliation, however, will depend on to what extent the Six Large Energy Firms already organise themselves along market lines in the first place. We note that both Scottish Power and SSE have recently moved in this direction of their own accord, and EDF Energy has through the period we have looked at consistently reported broadly along market lines for both generation and retail supply.

Audit and publication

79. In response to the Remedies Notice stakeholders made a number of suggestions, not least regarding the audit framework and publication, on which we had specifically set out questions. Our judgement is that at this stage of the process the focus should be on helping ensure that relevant financial information is prepared in the first instance. That is to say, reporting on market lines, the need also for balance sheets, disaggregation of wholesale energy costs for retail supply and the need for prior year comparatives. That said, it is important that wider stakeholders are able to gain confidence in the reporting regime both through audit and publication of financial statements, albeit not necessarily of all information to be produced. Ofgem will therefore need to examine these issues further in due course.

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[45] See Appendix 10.2, paragraphs 39 & 75.

[46] For example, in the telecoms regulatory reporting regime for BT plc is markets-based and therefore does not necessarily coincide with BT's organisational structure.