Appendix 19.1: Financial reporting remedy – further detail of proposals

Contents

Introduction

1. In Section 19 we describe at a high level the enhancements that we are recommending to the current ex post reporting regime. In this appendix we set out further detail behind our recommendations, as well as a discussion of other aspects of the current reporting obligations which we are not recommending that Ofgem changes.

2. In two annexes we summarise the responses we received on the financial reporting proposals set out in our provisional decision on remedies (Annex A) and the response to the previous set of proposals set out in the Remedies Notice (Annex B). We consider a number of issues raised by parties in response to the provisional decision on remedies and the Remedies Notice both here in this appendix and in Section 19.

Enhancements to the current reporting regime

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

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

4. In Section 19 we set out our recommendation 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.

Principles of reporting along market lines

Capturing all activities in a particular market

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

Obligation to apply to firm rather than individual subsidiaries

6. Ofgem's practice, historically (and in contrast to the remedy we are recommending), 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 obligation to report generation and retail supply activities has therefore been borne by 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 activities, 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 remedy, our 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

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[1] Section 19, paragraph 19.173*(a)*.
[2] For example, 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. EDF told us that it had adopted this treatment based on its interpretation of Ofgem's current reporting guidelines. See Annex A, paragraph 30
[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.

in our view that the licensed entity would have to provide financial information relevant to our 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')

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

8. 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.

9. Our 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 4 to 18 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 Section 19, 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 recommend that all of the Six Large Energy Firms should be required to identify their purchase opportunity cost on a standardised

[4] Centrica has done this since at least 2009, Scottish Power since 2011 and SSE since 2014/15. See Appendix 18.1, Annex A.
[5] See Annex B, paragraphs 8 and 11.

basis, 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.

10. EDF queried whether its approach to transfer charging would remain acceptable should it in future base some transfer charges on bespoke products.[6] As discussed in Section 19, we consider that transfer charges based on the costs actually incurred by the firm for market products, either in relation to bespoke or standard products, reflects the principle of reporting on market lines.

Preparation of balance sheet to reflect external payment terms

11. 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.[7] In line with the principle that costs and revenues should reflect those actually incurred by the firm, under our remedy these balances should reflect the amounts due to, or owed by the firm, and not reflect financial arrangements internal to the firm.

Adopting a standalone basis of preparation

12. 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.[8] 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 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.

13. 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

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[6] See Annex A, paragraph 31.
[7] See Appendix 9.9, paragraph 84.
[8] Section 19, paragraph 19.173*(b)*.

relevant revenues, costs, assets and liabilities are all attributed to the relevant markets for the purpose of our remedy.

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

14. 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.[9]

15. Our 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.[10]

16. 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.[11] 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.[12] 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

17. Our 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 14 to 16) must be reported at the prevailing price in the market for that good or service at the time of sale/purchase.[13] We note that this principle is consistent with our approach,

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[9] See paragraph 11 of this appendix for an example of the relevance of terms and conditions.
[10] Section 19, paragraph 19.173*(c)*.
[11] See Appendix 18.1, Financial Transparency, paragraphs 58 & 59.
[12] See Appendix 18.1, Financial Transparency, paragraphs 62.
[13] Section 19, paragraph 19.173*(d)*.

which requires that for regulatory accounting purposes transfer charges be directly based on products that are inputs or outputs of another market.

18. 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[14] we have included in our remedy the use of standard wholesale products to cost wholesale energy for retail supply on a comparable basis across the Six Large Energy Firms.

19. 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 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

20. Having established that the Six Large Energy Firms should be required to report on market lines, there remain 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 had identified that there was a lack of relevant financial information available to Ofgem.

21. We have defined a number of economic markets. These markets are:

(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

[14] Section 19, paragraph 19.203.

(f) the retail supply of gas to SMEs in GB, comprising, at least, a microbusinesses segment.[15]

22. 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);[16] and

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

(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 gas.

23. 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 and provisional decision on remedies which both proposed a financial reporting remedy concerning generation activities and retail supply activities.

Principles for identifying which markets should be routinely reported on

24. We consider that Ofgem is best placed to assess precisely which markets it needs to monitor in order to do its job effectively. However, in order to address the features giving rise to the Governance AEC, we believe that it is necessary for Ofgem to have a better understanding of the financial performance of energy firms' generation[17] and retail supply activities. As discussed in Section 18, in recent years there has been extensive intervention by both government (UK and EU) and Ofgem in the operation of wholesale and retail markets in order to achieve a range of public policy and competition outcomes. In order to both assess the need for future such interventions, and

[15] Section 3.
[16] EDF Energy and Centrica voluntarily report nuclear separately.
[17] As set out in paragraph 16, we consider that the requirement to report along market lines means that the reporting of generation activities should be on a full-function generator basis, rather than reflecting tolling arrangements. This is consistent with our definition of the wholesale electricity market.

the impact of previous interventions, we consider that it is necessary for Ofgem to have relevant financial information on these activities.

25. We considered whether to recommend that Ofgem also require financial reporting on the trading activities of the Six Large Energy Firms. We noted that Ofgem has hitherto not formally sought to specify trading activities as one of the areas that the Six Large Energy Firms should report on. In addition, trading activities are not a licensed activity under the GA86 or EA89.

26. Our remedy is designed to give Ofgem the relevant information to assess the financial performance of the generation and retail activities of the Six Large Energy Firms. In Section 19 and this appendix, 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 remedy will allow the Six Large Energy Firms to clearly delineate their financial performance within the markets that require further monitoring without the need for further reporting of firms' trading activities. On this basis, we have concluded that it is not necessary to recommend that Ofgem impose separate or additional financial reporting obligations on these activities beyond those already required for reporting along market lines.

Segmental reporting requirements

27. Ofgem will need to assess the extent to which it requires more disaggregated financial reporting, 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 for providing such information.

28. Examples of the further segmentation that may be relevant to Ofgem's monitoring work for retail supply include:

(a) By customer type, eg microbusinesses or SMEs, and 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.

29. However, the more granular the financial information that Ofgem might require, the greater may be the cost 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[18] and objectivity.[19] 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.

30. In addition, in order for Ofgem to be able to monitor the impact of policy choices on market outcomes[20] it may need to consider whether to require the 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

31. In Section 19 we set out our reasons for recommending 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

32. Pursuant to Ofgem's guidelines,[21] 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.

33. 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 basis

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[18] 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).
[19] 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.
[20] See Section 19, for example our 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.,
[21] 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.)

in respect of their purchase and sale of wholesale energy sales.[22] 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.[23] Ofgem reviewed this practice and concluded that reporting commodity costs and revenues on a historical cost basis was more relevant than on a current cost basis.[24] 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.

34. 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 Section 19, we recommend 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

35. As already explained in paragraph 11 above, 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

[22] 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.

[23] 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.

[24] 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,[25] under our 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

36. 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 activities. Our 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 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

37. In Section 19 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 remedy.

Summary of the principle of the purchase opportunity cost

38. To minimise their exposure 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. As a result, retail suppliers are broadly able to fix 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’.

39. We recommend 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

[25] As set out in paragraph 7.

suppliers take on the commitment to supply. This would be the point at which the retail supplier is contractually committed (or deemed to be contractually committed[26]) 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.[27]

40. 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 well-functioning 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.

41. 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.[28] 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.

42. 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 (or earned) had it consistently made its initial purchases at the point at which it contractually committed (or deemed to be contractually committed) to supply its customers at a certain price.

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

43. SSE told us that the effectiveness of any purchasing strategy could not be judged simply based on what subsequently happened to wholesale prices

[26] See Section 19 for a discussion of how evergreen contracts such as the SVT would be treated.
[27] Appendix 7.1, paragraph 125.
[28] Appendix 9.10, Annex A, paragraph 5*(c)*.

between the point of purchase and the point of delivery,[29] stating that domestic customers on SSE's SVT had been completely protected under its price freeze commitment.[30] 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.[31] We note that our approach involves both capturing the wholesale costs actually incurred by each of the Six Large Energy Firms following its own individual purchasing strategy (ie addressing 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 addressing SSE's concern).

44. 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.[32] 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.

45. 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.

Methodology to estimate purchase opportunity cost on a standardised basis

46. In order to estimate the purchase opportunity cost on a standardised basis, retail suppliers will need to cost the volumes they *expect* to deliver in line with paragraphs 38 and 39. There will be a second element to the calculation for

[29] Annex B, paragraph 9.
[30] Annex B, paragraph 43.
[31] Annex B, paragraph 11.
[32] Annex B, paragraph 9.

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 precisely the quantity of energy their customers will consume in any half-hour period (electricity) or each day (gas),[33] 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.

47. In the provisional decision on remedies, for the purposes of calculating the purchase opportunity cost in our proposed remedy, we set out how 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 was 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) were not material to the overall cost of wholesale energy[34] and therefore adopting such an approach was unlikely to distort the estimate materially of the purchase opportunity cost.

48. 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).

Our consideration of stakeholder comments on the proposed methodology

49. We received several comments on the detail of this calculation as set out in the provisional decision on remedies. RWE told us that we needed to take account of a variety of costs that were incurred closer to or at the point of delivery such as shape, weather and imbalance, costs which were managed at a portfolio level. Wholesale energy cost items not reflected in the costs of standard products should be incorporated into any standardised benchmark.[35]

50. RWE also highlighted that suppliers regularly re-forecasted and re-hedged positions throughout the term of the product, to reflect the most up to date

[33] For example, because actual weather conditions will differ from seasonal averages causing changes in customer demand.
[34] See Appendix 18.1, Annex A, paragraph 85.
[35] Annex A, paragraphs 77 and 78.

view of customer numbers, their expected energy demand and therefore costs. These forecasts would change over the life of the product depending on customer attrition rates. Our opportunity cost calculation however assumed that a prudent supplier would only reforecast its position once, just prior to delivery. RWE submitted that we should account for the costs of ongoing hedging activity undertaken to minimise the risk of forecasting error.[36] Scottish Power made similar points.[37]

51. Centrica told us no account had been taken of the strength of the balance sheet/credit rating of individual market participants which would affect the terms on which they were able to purchase in the market.[38]

52. Our view is that all the costs that a prudent retailer would need to incur should be included in the purchase opportunity cost, including those costs that are not reflected in standard products. Furthermore, the level of initial purchases should take account of expected customer attrition rates as a prudent retailer would not contract for demand that it did not expect to fulfil. As expected customer attrition rates will vary across tariffs and across individual suppliers, the application of the approach we are recommending will accordingly vary.[39] In the interests of simplifying the calculation we consider it desirable to retain a two-stage process but in principle it could involve further stages. What is important, however, is not precise accuracy, rather estimates that are sufficiently robust for their purpose.

53. Regarding Centrica's point, we acknowledge that different suppliers, especially the non-Six Large Energy Firms, may have to effectively pay more for standard wholesale products. In the first instance, this reporting requirement is limited to the Six Large Energy Firms, and so should not pose an issue. Should the obligation be extended to other suppliers in the future, then Ofgem would need to consider this point.

Granularity of calculation

54. Given that energy retail suppliers commit to supply customers at an agreed price under a contract throughout the financial year, we recommend that the calculation of the purchase opportunity cost under our remedy should be estimated for each set of freshly contracting customers on a monthly basis.[40]

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[36] Annex A, paragraphs 80 and 81.
[37] Annex A, paragraph 17.
[38] Annex A, paragraph 57.
[39] See paragraphs 62 to 67 for a discussion of comparability. Paragraph 65 in particular highlights that comparability is not enhanced by making unlike things look alike.
[40] 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

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.

Application of approach to determining purchase opportunity costs to different retail tariffs

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

Treatment of the SVT and other variably priced (ie evergreen) tariffs

56. Compared to, for example, a one-year fixed-rate tariff, the SVT[41] 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, we note that retail suppliers do not choose to change SVT prices frequently.[42] As set out in Section 19, for the purposes of our remedy we are recommending that the SVT be characterised as a six-month fixed-rate product broadly in line with how often suppliers seeking to supply a smoothed SVT product have adjusted prices. Thus, we have assumed that retail suppliers would hedge the volumes they expect to supply six months ahead.

57. 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 remedy, we treat these non-SVT variable tariffs in exactly the same way as the SVT.[43]

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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 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).

[41] 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.

[42] Based on our review of the pricing strategies of the Six Large Energy Firms. See Appendix 8.3.

[43] 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.

Table 1: Application of approach to determine 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 six months.
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 their 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 net cost (or profit) arising from departures from seasonal weather norms

58. 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.

59. 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.

60. 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

61. In addition to the proposed enhancement as described in Section 19, 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[44]

62. 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.[45]

63. The enhancements we are recommending to Ofgem to implement would result in 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.

64. 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.

65. 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.

66. Some degree of comparability is likely to be attained by providing a faithful representation of relevant economic phenomena.[46] Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability.

67. In the context of our 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;

[44] 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.
[45] As well as being verifiable, timely and understandable.
[46] 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 44) 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 particular accounting period.

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

68. We propose to directly address this by recommending that the Six Large Energy Firms report prior year comparatives (enhancement D) as set out in Section 19.

Comparability between the Six Large Energy Firms across a particular market

69. We propose to directly address this by recommending that the Six Large Energy Firms report along market lines as set out in Section 19. 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

70. As discussed in paragraphs 27 to 30, 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.

71. We have observed that for retail supply each of the Six Large Energy Firms takes 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 the others of the Six Large Energy Firms.

72. In coming to a view on appropriate segmental reporting requirements (see paragraphs 27 to 30), Ofgem should consider carefully the extent to which differences in firms' existing approaches to segmenting their customers may frustrate the aims of financial reporting as a means of market monitoring.

Comparability between the Six Large Energy Firms regarding the particular accounting period

73. 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 58 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. In the provisional decision on remedies, we stated that this in turn hindered 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 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).

74. In response to the provisional decision on remedies SSE told us that Ofgem had concluded in October 2013 that its March year end did not undermine comparability because for any comparisons to be meaningful the information needed to be based on periods covering several years. Ofgem had re-affirmed this position in October 2014 by placing emphasis on it being able to understanding trends from one year to the next (rather than across firms over the same period).[47]

75. In this regard we reemphasize the fact that there are many dimensions to comparability. The thrust of the ex post reporting remedy is to improve comparability across firms and from one year to the next, not least for retail supply through wholesale energy costs being disaggregated into a purchase opportunity cost on a standardised basis and a residual element. We therefore remain of the view that this issue is a relevant future consideration for Ofgem.

Aspects of the design of the current reporting regime which we are not recommending Ofgem to change

76. Above we provide details concerning how we envisage each of the proposed enhancements to the current ex post 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 recommending to Ofgem to enact.

Scope of firms affected by the reporting obligation

77. 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

[47] Annex A, paragraph 99.

generators above a threshold size. The view of these other suppliers and generators was that such a move would not be warranted.[48]

78. The current reporting regime applies to the holders of a supply licence if the following conditions are met: *(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 measured in terms of customers supplied. Our view is that the scope of the financial reporting obligation is currently appropriate. For the purpose of addressing the Governance AEC, the focus of this 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 both generation and retail supply.

79. In our view, extending the applicability of the reporting regime to energy firms that are not vertically integrated, or that fall below the current materiality threshold would impose a disproportionate burden on affected operators, including in particular 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

80. 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.[49] We are not recommending 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.

[48] See Annex B, paragraphs 17, 27 & 30.
[49] See Annex B, paragraph 81.

Reconciliation between reporting on market lines and firm-specific segmental reporting

81. Some of the Six Large Energy Firms submitted that segmental reporting for regulatory purposes should fully coincide with their segmental reporting for statutory purposes.[50] Many stakeholders including Ofgem thought that it would be wrong to constrain firms' ability to choose how to organise themselves across the value chain. We note that financial reporting requirements do not constrain firms' ability to choose how to organise themselves for the purposes of managing their business: they only seek to collect information on a particular basis. It is not, therefore, necessary that reporting for regulatory purposes along market lines fully coincides with the reporting for another purpose (eg statutory reporting).[51]

82. 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 straightforward reconciliation to be a highly desirable feature of the segmental statements. The nature of this reconciliation, however, will depend on the extent to which the Six Large Energy Firms already organise themselves along market lines. We note that both Scottish Power and SSE have recently moved in this direction of their own accord, and EDF Energy and Centrica have through the period we have looked at consistently reported broadly along market lines for both generation and retail supply.

Audit and publication

83. 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 the 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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[50] See Annex B, paragraphs 39 & 75.
[51] 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.

Annex A: Financial reporting remedy – views of stakeholders in response to the provisional decision on remedies

1. In our provisional decision on remedies we proposed to recommend that Ofgem require that the Six Large Energy Firms:

   (a) report their generation and retail supply activities along market lines;

   (b) prepare balance sheets to cover at least all generation markets in total and all retail supply markets in total separately;

   (c) disaggregate their actual wholesale energy purchase costs for their retail supply businesses between an opportunity cost calculated on a standardised basis and a residual amount. This would be achieved by standardising the point ahead of delivery at which it is deemed that the Six Large Energy Firms take on the commitment to supply – for the SVT this would be deemed to be one month ahead of delivery; and

   (d) include prior period comparatives in both the profit and loss account and balance sheet based on the same accounting rules as the current period.

2. We also proposed to recommend that Ofgem require the Six Large Energy Firms to also publish this accounting information.

3. In our Provisional Decision on Remedies we also considered some other possible design changes. Following consideration of these possible changes, we decided not to propose to recommend that Ofgem:

   (a) revise the scope of the firms affected by the reporting obligation – currently the Six Large Energy Firms; and

   (b) develop a revised tool to monitor the linkage between movements in wholesale prices and retail prices (although we encouraged Ofgem to consider the purchase opportunity cost approach for measuring wholesale energy costs were it minded to develop such a tool)

4. In this annex we provide a summary of comments on these proposals stakeholder-by-stakeholder.

Ofgem[52]

5. Ofgem told us that tracking trends in revenues, costs and profits was fundamental to its ability to understand how well the market is working for

[52] Ofgem's provisional decision on remedies response, page 16

consumers. It welcomed our proposed changes to improve the transparency, comparability and relevance of the information that the Six Large Energy Firms publish. It noted that this was a complex area, and that it would work closely with us to ensure that the remedy was both effective and proportionate in meeting its aims.

6. Ofgem agreed with us that evaluating the nature of the relationship between retail and wholesale energy prices was central to understanding the functioning of the retail energy markets. It noted, however, that assessing cost pass-through for wholesale energy was challenging, given the widespread price smoothing that took place in the market and the challenges associated with estimating wholesale costs for vertically integrated businesses. It supported our proposal to require the Six Large Energy Firms to provide standardised information about their wholesale costs.

7. Ofgem highlighted the risk of confusion from the Six Large Energy Firms publishing two measures for their wholesale energy costs. Firstly the costs they would have incurred in the absence of their long-term rolling hedging strategies and secondly their actual, realised costs. Greater transparency, particularly around suppliers' costs for individual product types, might also influence market dynamics in an unintended way. Ofgem suggested we might minimise these unintended consequences by keeping the former measure of wholesale energy from the published segmental statements. Instead the Six Large Energy Firms would provide this information directly to Ofgem to publish in an aggregated or anonymised form.

8. Ofgem also told us that it was, in its view, highly desirable that information on historical margins should be made available where possible – for example over the period 2008 to 2014 – to allow for future comparisons.

9. Ofgem expected that our proposals would affect both the licence conditions containing the current financial reporting obligation and the associated guidelines. Sufficient time would need to be allowed for the Six Large Energy Firms to implement the required changes

Citizens Advice[53]

10. Citizens Advice told us that the public lacked confidence that the prices they pay are fair. A major contributory factor was the lack of transparency on the underlying cost drivers that move retail prices, which had resulted in frequent

[53] Citizens Advice provisional decision on remedies response, pages 3, 7,64 & 65.

public disputes between industry, regulator and government. We needed to equip the public with the tools to break this cycle.

11. Citizens Advice noted that, although we had made comments on how Ofgem's Supply Market Indicators ('SMI') could be improved if they were to be re-introduced, we had stopped short of making a recommendation on whether they should be re-introduced. It told us that this would be an opportunity missed and encouraged us to go further and recommend the re-introduction of the SMI. In its view, this would fill a transparency gap that would otherwise exist concerning the contemporaneous trend of energy bills and costs. It stressed that a projection of price trends for the coming year contained within the proposed State of the Market would not, in its view, be an adequate substitute for the SMI.

12. Citizens Advice supported all four of our proposals to improve the segmental statements (summarised in paragraph 1 above, in three cases without reservation). Reporting on market, rather than divisional, lines should make the data more comparable from firm to firm, and help Ofgem to better assess the state of competition in the market. The introduction of balance sheet reporting was necessary in order to calculate the return on capital of these businesses, particularly in the case of generation which is extremely capital intensive. Reporting prior year figures on the same basis as current year figures should help in developing trend analysis. These measures should improve the value of the segmental statements.

13. Citizens Advice told us that, while it understood the logical basis of our recommendation to disaggregate wholesale energy costs between a standardised purchase opportunity cost and a residual element, it had not understood exactly how the opportunity cost would be calculated and communicated to users of the segmental statements. It contrasted our proposed approach of estimating purchase costs based on prices a month ahead of delivery for SVT customers (ie the majority) with its understanding that the Six Large Energy Firms hedge these customers over a very considerably longer timescale of several years. In fact, the latter was the most frequent justification heard to support claims that wholesale price falls could not be passed through to consumers. As a result, the residual element of wholesale energy costs could be substantial. Stakeholders must be able to understand these figures, something Ofgem would need to give thought to in the implementation process.

Scottish Power[54]

14. Scottish Power told us that it continued to support transparent and robust financial reporting for the industry. In particular, it supported remedies that would provide Ofgem and other stakeholders with additional information to support robust assessments and decision making in relation to the profitability and overall financial performance of the industry. There was, however, a risk that some of the information provided could be misinterpreted and therefore considerable thought needed to be given to how the information should be analysed, interpreted and presented.

Reporting on market lines

15. It did not oppose the proposal to report activities along market lines irrespective of where the relevant activities are undertaken within an organisation. The link from the segmental statements back to the statutory accounts of the subsidiaries might, however, become more complicated and necessarily less transparent. A clear and straightforward trail back to the statutory accounts would help build confidence that the figures in the segmental statements were robust and would mitigate audit costs. Accordingly, we should give Ofgem sufficient latitude that firms could provide a meaningful link back to the legal entities involved in a proportionate and efficient manner.

Providing balance sheets

16. Scottish Power told us that it saw no difficulty in providing balance sheets for generation and retail supply so long as these could be tied back closely to statutory accounts of the relevant legal entities. It noted, however, that it would be significantly more difficult to create balance sheets for entities that did not exist. It was also important for stakeholders to have clarity regarding the basis of any adjustments to balance sheet items that Ofgem might need occasionally to make in order to assess economic profitability.

Disaggregating wholesale energy costs

17. Scottish Power cautioned us against our proposal to disaggregate wholesale costs between a set of stylised opportunity and residual costs. It considered that a significant number of assumptions would need to be made to draw any conclusions regarding the strength of inter-firm rivalry from this disaggregation. Residual costs would not simply reflect the differences in

[54] Scotish Power’s provisional decision on remedies response, pages 51-52

market purchasing strategies across firms, but also differences due to system imbalance costs, demand forecasting, hedging costs etc, all of which would make comparing opportunity costs across firms potentially complicated.

18. Scottish Power also thought that the creation of such a regulatory benchmark would have the potential to influence the purchasing behaviours of the Six Large Energy Firms, for example encouraging them to follow closely the prescribed hedging policy. This might have unintended consequences, such as restricting the ability of competition to discover more efficient approaches, or drawing liquidity from forward markets towards spot markets and prejudicing the initiatives Ofgem had pursued over a number of years aimed at increasing forward market liquidity.

19. If we were to proceed with this aspect of the remedy, Scottish Power requested that we consider the appropriateness of the benchmarks. It was important that such benchmarks reflected as far as possible prudent purchasing strategies. It considered the proposal for standard fixed term products broadly achieved this balance, however it believed the proposed approach for SVTs was too “short” to represent a sustainable purchasing strategy. It suggested a more sustainable approach would be to make purchases over a longer duration, e.g. 18 months ahead of the point of supply, with the volume purchase spread evenly over this duration, e.g. monthly.

Prior year comparatives

20. Scottish Power told us that it would be content to include prior year comparatives, reported on the same basis as the current year though this would make the segmental statements longer and potentially less accessible to the reader. A side-by-side presentation of the comparatives (which had originally been suggested by Ofgem but not pursued) would be particularly complex, but other presentations might be feasible.

E.ON[55]

21. E.ON told us that it continued to support Ofgem in its work to continually improve and develop the efficacy of financial reporting through the segmental statements. Whilst there was scope for improvement, the existing reporting framework, in its view, currently provided a high degree of transparency and assurance around the profitability of the Six Large Energy Firms.

[55] EON’s response to provisional decision on remedies, page 14 and 56 and 58 to 59.

Reporting on market lines

22. It was important that the reporting regime did not constrain energy firms from operating the corporate structures that they believed gave them their best competitive position. E.ON believed that there would need to be a compromise between this consideration and Ofgem acquiring financial information that was relevant, complete, understandable and comparable. As a consequence E.ON supported our proposal that the reporting remedy be implemented via a recommendation to Ofgem. That approach would enable a thorough consultation process to take place before Ofgem modified the relevant licence conditions.

23. E.ON submitted that it did currently report along market rather than divisional lines and had previously supported the idea of reporting balance sheets. Without having the detail of precisely how balance sheets would be defined, however, it reserved its right to challenge this proposal.

Disaggregating wholesale energy costs

24. E.ON, however, did have concerns about our proposal to disaggregate wholesale energy costs for retail supply between standardised opportunity cost and residual elements. However we specified this standardised opportunity cost, we would be assuming that there was a valid single benchmark for wholesale energy costs. In E.ON's view, it was invalid to attempt to produce a single benchmark for all suppliers when each firm's purchases were influenced by a combination of factors, namely customer needs, market availability and company risk appetite /preferences. We ran the risk that these reporting requirements inappropriately driving commercial hedging behaviours and strategies.

Prior year comparatives

25. E.ON would, in principle, be able to provide prior year comparatives. However, it noted that any newly required information – for example as per paragraph 24 above – would not have been collected in the normal course of the firm's business. Such information might prove difficult to acquire retrospectively. It therefore suggested that prior year comparatives should only be required from the financial year following the year in which a new or amended reporting requirement had been implemented.

Scope of firms obligated to report

26. E.ON noted that we were not proposing to change the scope of firms caught under this obligation to report. Given the significant position that suppliers,

other than the Six Large Energy Firms, had established in the market place, particularly the mid-tiers such as Ovo, Co-Operative Energy, First Utility and Utility Warehouse, it could not see how their continued exclusion was consistent with our aim of ensuring that reporting was relevant, complete, understandable and comparable.

27. It reiterated its view that the requirement to produce and publish segmental statements should apply to all licensed suppliers (electricity and gas). The audit burden could be relaxed for suppliers with less than 250,000 customers to address any concern regarding costs. Without a consistent reporting requirement across all suppliers, Ofgem and other stakeholders would not be able to acquire a complete view of the market.

EDF Energy[56]

28. EDF Energy told us that it supported appropriate steps to improve the usefulness of the current regulatory framework for financial reporting. It did not support the proposal for the Six Large Energy Firms to disaggregate their wholesale energy costs for retail supply between a standardised purchase opportunity cost and a residual element. It was not clear to EDF that this would provide Ofgem (or the wider public) with any meaningful information and, if in the public domain, would provide scope for misinterpretation that would unjustifiably damage customer trust.

Reporting on market lines

29. EDF Energy supported our proposal to report generation and retail supply activities on market rather than divisional lines and for Ofgem to implement the remedy. It agreed that Ofgem should determine the market segments on the lines set out in Appendix 10.3 to the provisional decision on remedies. Sufficient time would need to be allowed to allow firms to make any systems changes.

30. EDF Energy explained that the reason why it had not fully consolidated the results of a subsidiary operating in GB of its parent group was based on its interpretation of Ofgem's current reporting guidelines. These required that only EDF Energy's share in this particular renewables business be reflected in its generation segmental statement. If we wanted this accounting treatment to change, then the guidelines would need to be changed.

[56] EDF response to provisional decision on remedies, pages 7 and 59 to 61 and 58.

31. EDF Energy sought clarity about the circumstances in which its approach to transfer charging would continue to be considered an acceptable substitute to reporting the wholesale energy costs actually incurred by the firm. Were it in the future to base some transfer charges on bespoke products (ie not market products which were traded in a liquid market), then this could mean it would have to track a separate cost base for segmental reporting purposes. This could create high implementation costs for future innovative products, thus reducing its ability to compete.

Balance sheet reporting

32. EDF Energy pointed out there were multiple difficulties in determining the appropriate accounting treatment on the balance sheet for certain elements of the supply business. It noted that we, the Six Large Energy Firms and independent experts had not been able to agree on a valid approach here. EDF therefore found it difficult to envisage a balance sheet approach for reporting on supply businesses that all parties would agree as useful and accurate. Were this proposal to be taken forward, EDF Energy would need to make significant and subjective changes to its current approach to reporting balance sheets in order for them to be used to understand profitability. Accordingly, it would be important that sufficient time was allowed before requiring balance sheets to be reported.

Disaggregating wholesale energy costs

33. EDF Energy told us that it did not support our proposal to separate wholesale energy costs between “opportunity” and “residual” costs for the retail supply business. We had not described the benefits of this reporting sufficiently to justify the implementation costs it would bring and the potential for misinterpretation / misunderstanding that would unjustifiably damage customer trust. EDF Energy’s objections fitted into three main categories as explained below.

Potential impact on hedging

34. Our proposal for the costs of purchasing to be in line with the contractual arrangements with customers (ie on a month ahead basis for SVT customers) would not be that which would be carried out by a “prudent retail supplier”. EDF Energy explained that it currently purchased its energy requirements in advance for SVT customers [✂] to smooth costs. This enabled it to implement infrequent tariff changes that it believed were valued by this group of customers. In the event that it only purchased energy for SVT customers on a month-ahead basis, this would require multiple tariff changes in a volatile

market and affect its customers' ability to budget. Current regulation mandated 30 days' advance notice of increases to the SVT. This entailed a direct cost and introduced a lag between changes in costs and the time when the price change became effective.

35. EDF Energy noted that, in mandating the proposed reporting, neither we nor Ofgem would be forcing suppliers to hedge any differently to how they do now. However, it would not be difficult to imagine a scenario in which wholesale prices had fallen and the "residual" cost element represented a significant additional cost. Its experience (e.g. of Ofgem's SMI) suggested that, in such a case, some commentators could misinterpret this as being the result of speculative activity, even though the reverse would, in its view, in fact be true. In a rising market, the "residual" cost would be negative and would bring benefits to customers. However, that would unlikely to be highlighted by the media or consumer groups.

36. It would therefore be possible that suppliers would begin to hedge their SVT customers in a similar way to the opportunity cost reporting, leading to much greater volatility for customers and further eroding trust in the market. Although most of the period of the CMA's analysis has been characterised by declining global energy prices, if the analysis had included 2007/2008, the "prudent supplier" in question would be likely to either have gone bankrupt, or to have subjected its customers to monthly price changes of up to 17% (from September/October 2007).

37. EDF Energy's proposed alternative was to model energy costs based on spot market prices (i.e. no forward hedging). Purchasing only in the spot market could not be characterised as a prudent hedging approach for a supplier as price volatility that could not be passed onto SVT customers could quickly lead to bankruptcy and because outturn wholesale prices would be very different if a supplier did try to hedge on this basis. This approach would however give Ofgem visibility of the difference between this benchmark and the costs generated by suppliers' actual hedging strategies.

Additional costs

38. EDF Energy told us that, if the "opportunity" cost were to be specified prescriptively (as seemed to be the case), this would effectively entail it maintaining parallel systems – one storing the hedges that it had actually carried out, and the other purely to maintain information for the segmental accounts. As well as significant up-front implementation costs, this would be likely to lead to a noticeable operational overhead (which could be as high as £0.5m-£1m per year for EDF Energy if a high level of precision was required).

This could be mitigated if Ofgem were to calculate this cost itself based on product and customer data from suppliers.

Impact on innovation

39. This proposal might also stifle innovation because reporting the opportunity costs would be a significant hurdle to overcome in any new product or hedging strategy. Although the specific issues with SVTs were larger than for fixed price products, even the reporting proposed for fixed price products was likely to be an approximation that suppliers would not wish to replicate precisely in their processes.[57] This would lead to increased overheads from running a parallel system. As and when the RMR four tariff rule was lifted, EDF Energy would expect to see far more innovation in the retail tariff market. It was concerned that any requirement to agree with Ofgem as to how such products should be reported may well slow down or stymie such innovation.

Prior year comparatives

40. EDF Energy agreed that prior period comparatives should be reported based on the same accounting rules to facilitate a comparison. However, to carry out historic accounting assessments would impose a costly regulatory burden on suppliers. Therefore, it proposed that this requirement operated going forward, but did not require firms to re-report on previous years where different reporting rules had applied.

Scope of firms obligated to report

41. EDF Energy told us it was concerned that the requirement for only the Six Large Energy Firms to report financial information would not provide a full view of the market and would exclude domestic suppliers with substantially more than one million customer accounts from providing this information, as well as non-domestic suppliers (a number of which have larger market shares in terms of volume supplied than some of the Six Large Energy Firms). It believed that a more useful and future-proof approach would be to specify the size of a supplier at the time of reporting that must provide the information, rather than defining the remedy based on historic market shares.

[57] EDF Energy explained that the proposed opportunity cost methodology for fixed price products, as outlined by us, seemed reasonable as an approximation of the hedging activities that a prudent supplier might carry out. However, in practice, there would be details of the actual hedging process which would be different, allowing suppliers to achieve a more precise hedge to fit the detail of the product. For example, as a fixed price product was essentially an option sold to the customer, suppliers might wish to hedge in the options market. This meant that, even for relatively straightforward fixed price products, suppliers would need to maintain separately a system to track the "opportunity cost" for any product that they offer.

Publication

42. EDF Energy advised us to consider whether it would be better for this information to be made available publicly or only to Ofgem. The benefits of this information being in the public domain would need to outweigh the risk of further erosion of trust that has been created in the past by misinterpretation and misreporting. If information were to be provided solely to Ofgem, and therefore confidentiality could be maintained, greater detail could be provided.

Supply Market Indicator (SMI)

43. EDF Energy told us that transparent and accessible information about retail price formation was central to the operation of a well-functioning market and is also an essential element in the democratic scrutiny of energy policy. In analysing the evolution of energy prices, the profitability of key players in the market and the social costs and benefit of policies, as well as the other issues identified, it was vital that lessons are learned from previous attempts to provide information to stakeholders. There was a risk that any analysis would be insufficiently robust, and could itself lead to a distortion of the market (particularly if energy providers, initiatives or trends are singled out as having a precise impact).

Centrica[58]

44. Centrica submitted that our proposals would create significant confusion and generate mistrust rather than promote transparency as intended. Given the granular nature of the existing segmental statements it was unclear what benefit our proposals could deliver. On the other hand, the costs and unintended consequences of the proposals were clear.

Reporting on market lines

45. Centrica told us that it had been an advocate of the segmental statements since their introduction. It noted 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.”[59] It submitted that it had being doing this since 2011 when it had chosen to adopt transfer charging practices that mirrored market pricing. Not only were its segmental statements already prepared on market lines but these statements

[58] Centrica’s response to provisional decision on remedies, pages 9 to 10 & 81 to 84
[59] Provisional decision on remedies appendix 10.3, paragraph 28.

could also be reconciled to its Annual Report and Accounts, thereby achieving a high level of transparency. As a result it was unclear to it what issue this remedy intended to address.

46. Centrica also noted that our proposals would require the Six Large Energy Firms to produce P&Ls for each individual “market”. There had also been the suggestion that this might be extended to product class. Assuming it was possible, such granular disaggregation would inevitably lead to disclosure of commercially sensitive material. Centrica gave several examples including provisions, their approach to hedging, and the potential for exceptional costs to be revealed in detail, especially once such analysis was split down to domestic/non-domestic and fuel type - and more so if split further (e.g. by product class and payment type).

Reporting on a standalone business basis

47. Centrica told us this requirement would damage transparency. It feared that this proposal would require artificial adjustments to profit and loss statements and balance sheets to take into account firms’ working capital and contingent capital requirements and to eliminate the synergies/efficiency benefits accruing to Centrica that would not be present in stand-alone businesses. Centrica believed that these adjustments could not be undertaken in a way that would be transparent and consistent across energy firms, thereby undermining confidence in any direct comparability between Six Large Energy Firms.

Balance sheet reporting / implications for the profit and loss account

48. In Centrica’s view, our proposals in this respect were also technically highly complex. Movements in the balance sheet would need to agree with the P&L. This was not straightforward as some balance sheet movements did not map across to the relevant P&L figure, and risked the “reported” balance sheet diverging from the “actual” balance sheet over time. For example, operating profit did not include exceptional items, tax or interest but these would clearly contribute to movements in the balance sheet. Another example would be cash flow hedges for foreign exchange that did not pass through the profit and loss until settled.[60] Centrica would expect the the latter to materially undermine comparability across the Six Large Energy Firms.

[60] Centrica explained that cash flow hedges on foreign currency transactions fixed forward exchange rates impacting the balance sheet alone until the hedged transaction settled. The profit and loss account would therefore only be affected when the hedged transaction occurred and the hedge settled.

49. Centrica also noted that we had proposed that exceptional items should be reported within the main profit and loss account. Such an approach would not be consistent with individual P&Ls and balance sheets aggregating back up to a consolidated view that would be consistent with statutory results (both Centrica Annual Report and Accounts and British Gas Trading Limited statutory accounts).

Disaggregating wholesale energy costs

Concerns regarding the rationale

50. Centrica told us it was particularly concerned by the proposal that a major part of the cost benchmark for wholesale energy costs be based on month-ahead costs. It strongly disagreed with any suggestion that energy purchasing over a longer period for Standard Variable tariff (SVT) customers would be speculative, or that month-ahead purchasing for SVT customers would be appropriate.

51. The requirement to split out purchase “opportunity cost” and “residual cost” would create a hypothetical construct which would fail to take into account the risk (existing at the time forward purchasing took place) that had been mitigated. This cost disaggregation, as proposed, would instead demonstrate – with the benefit of perfect hindsight – the impact of what would have been a highly speculative approach to energy purchasing for SVT customers.

52. Centrica observed that conclusions drawn from this analysis would be entirely dependent on the movement of commodity prices over the year in question, and the period leading up to it. Over periods when commodity prices rose, a strategy of buying well in advance would appear highly profitable. Over periods when commodity prices fell, such an approach would appear highly inefficient. Indeed, to the extent that hedging strategies evolved over time, the proposed split of commodity costs in any year would not reflect the current hedging strategy in isolation, thus limiting any insight about a supplier’s current or future approach to hedging.

53. Centrica provided us with analysis covering the period 2009-2015 that showed what the impact would have been on its reported domestic supply profits for each year assessed on a historical cost basis had it instead consistently followed either a 2-year rateable or a month ahead purchasing strategy. Pursuing a 2-year rateable purchasing strategy profits across this period would have been somewhat lower than reported profits [✂] but somewhat more variable from year to year. Pursuing a month ahead purchasing strategy profits would have been significantly higher than reported profits [✂] but much more volatile from year to year.

54. Centrica used this year-by-year analysis to explain how in any one period the ordering of profits prepared on the three different bases set out in paragraph 53 was determined by the trend in (either rising or falling) wholesale energy prices and the exposure to these trends implicit in the purchasing strategy adopted for that period. The trends in wholesale energy prices in turn were determined by world events such as the fall-out from the accident at Fukushima and rising oil prices.

55. Centrica also used this analysis to point out that reporting wholesale energy costs based on a one month ahead purchasing strategy would result in the level of profits not only varying significantly from one period to the next but also varying significantly from its reported profits. In Centrica's view this demonstrated the lack of suitability of this methodology for creating trust and transparency.

56. Reporting against this artificial construct would only serve to distract attention from actual profitability, and instead focus debate on hypothetical profits had firms known in advance what commodity markets were going to do. Such an approach would damage trust in the assessment of the profitability of vertically integrated energy firms, an outcome which would be particularly unfortunate given our provisional finding that vertical integration was likely to benefit consumers.

Concerns regarding practicality of implementation

57. Centrica told us that this proposal to disaggregate wholesale energy costs would also be highly complex to implement and operate on an ongoing basis. The calculation of the split at a disaggregated level by broad tariff type would be both onerous and open to considerable judgement, given the portfolio approach taken to hedging. Furthermore, no account has been taken of contingent capital, or how the strength of the balance sheet/credit rating of individual market participants would affect the terms on which they were able to purchase in the market. Both these factors would make the accuracy of this split of commodity costs uncertain and risk undermining the comparability between Six Large Energy Firms.

Prior year comparatives

58. Centrica told us that it had concerns regarding proposals for prior year comparatives. Prior year comparatives would drive a significant increase in disclosure notes compared to the current position to explain year-on-year movements. This would be further complicated by any prior year restatements (as it would have to explain why the prior year figures had changed, e.g., changes to accounting standards, as well as why they have moved year-on-

year). This was likely to result in far more complex and opaque – not clearer – financial statements.

Cost implications

59. Centrica told us that the requirements of this remedy would be onerous in terms of resource (headcount), time and incremental audit costs. It would require additional processes and controls to track the financial measures required by the remedy, including artificial adjustments to split out "stand-alone businesses". A high-level estimate suggested the remedy would lead to incremental operating costs of [✂] annually (payroll and external fees). The divergence of the reporting needed for the remedy from its core reporting requirements for statutory purposes would, in its view, add an unnecessary layer of complexity to the external audit process, replacing the well-established process for current segmental reporting, which was both transparent and efficient.

60. In particular, the calculations needed to split energy commodity costs between "purchase opportunity cost" and "residual cost" would depend on regular "snapshots" of the state of its customer base, i.e. the extraction and storage of large data sets at the individual customer level from its live billing system (or a derivative system linked to its live billing system). As well as the initial development cost of this additional functionality, regular updates would be required in the future to remain up-to-date with other changes to its systems as they evolved.

Scope of firms obligated to report

61. Centrica submitted that it would be a serious omission for these reporting requirements to apply only to the Six Large Energy Firms, given that similar gains to switching were available to mid-tier suppliers' customers, and particularly given that we had proposed to determine a competitive benchmark from the financial performance of a subset of the mid-tier supplier segment.

RWE[61]

62. RWE submitted that our proposed remedy was flawed because it

    (a) sought to facilitate the future measurement of profitability using a ROCE approach which, in its view, was inappropriate for retail suppliers;

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[61] RWE response to PDR, pages 78 to 86

(b) applied a wholesale cost benchmark for SVT tariffs which did not represent a prudent risk management approach; and

(c) gave rise to practical challenges of producing further segmented results/balance sheets which would provide an incomplete view of the market because the requirements would only apply to the Six Large Energy Firms.

Reporting on market lines

63. In response to our proposal set out in provisional findings that the boundary between markets be demarcated on the basis of standard wholesale products, RWE told us that it believed that all costs and revenues relating to generation and retail supply activities should be reported regardless of whether they relate to standard or non-standard products, illiquid fuels etc as these reflected the true costs incurred to operate the relevant business segment.[62]

64. RWE told us that segmenting reporting along market activities would necessitate the arbitrary allocations of profit, cost and balance sheet items, for example, splitting balance sheet items such as cash and the profitability by fuel type in our generation business. Consequently, the result would become less robust as levels of segmentation increased. We had failed to propose any allocation methodologies. RWE considered there would be significant challenges in their practical application.

65. RWE told us that the current disclosure requirements in segmental statements for policy costs related to the Generation segment, provided appropriate transparency of the impact of government regulation. Any further disclosure would be impossible due to the complexity of aspects such as, but not limited to, the impact on wholesale power prices of regulatory changes.

66. RWE pointed out what it saw as a contradiction in our proposals. We had proposed that the P&L include all items that were currently excluded to ensure consistency with the balance sheet. However, according to RWE, we had proposed to only include domestic and SME markets, and therefore exclude the I&C segment from the retail market profit and loss account. In order to achieve consistency between the P&L and balance sheet, I&C would need to be included.

[62] RWE PDR, paragraph 65.25.

Providing balance sheets

67. RWE questioned the relevance of providing a pan-generation and pan-supply balance sheet as a comparator across firms due to the significant potential differences in non-operational balances. These would include, but were not limited to, items such as goodwill, deferred tax and loan balances, some of which by their very nature (e.g. tax) only relate to a legal entity and not any business segment. We consider that an arbitrary allocation process would be likely to hinder the comparability of reporting between firms.

68. RWE noted that while a reconciliation to supply and generation segments within its group accounts (RWE AG) was possible for the profit and loss account, no such reconciliation would be possible for the balance sheet. Such balance sheet segmentation was neither required by IFRS for group accounts nor was there any requirement to produce locally consolidated accounts.

69. RWE told us that its generation segmental profit and loss account included costs and revenues for certain subsidiaries which it did not locally consolidate. Additional reporting work would be required to bring their assets and liabilities onto the balance sheet.

Disaggregating wholesale energy costs

Concerns regarding the rationale

70. RWE told us that it agreed with us that the reporting of wholesale costs should be comparable across suppliers. For RWE this meant all suppliers applying arm’s length transfer pricing and employing a common set of assumptions about what made up the transfer price. Adopting the same reporting period would further aid this comparability. RWE however rejected our hypothetical ‘opportunity cost’ approach because it was detached from reality, and therefore would be misleading. It could also lead to consumers being exposed to additional price risk.

71. RWE submitted that our application of our opportunity cost approach to SVT tariffs failed to represent the actions of a prudent supplier and at worst would influence the hedging actions of suppliers to the detriment of competition and customers. A supplier would introduce significant and unpredictable volatility into its wholesale costs (and its profitability) if it were to purchase all volumes at one month ahead. We had rejected the use of ‘spot’ pricing but the wholesale price volatility at one month ahead was large and similar in magnitude to spot market volatility. This was because weather drove short to medium term prices. RWE supplied a graph of historical wholesale energy

price volatility plotted against the time interval between purchase and delivery to demonstrate this point.

72. RWE told us that it would expect the frequency of SVT tariff price changes would increase dramatically. If a supplier truly believed that its contracted position was one month, then all commercial evaluation would occur at this tenor, including hedging and pricing. One would therefore observe seasonal fluctuations in SVT prices equivalent to launching successive one month fixed deals. This would result in a transfer of wholesale price risk from energy suppliers to consumers. RWE believed that energy suppliers were better placed than consumers to manage energy price risk.

73. RWE noted that we had recognised that some suppliers chose to smooth out commodity purchases by utilising a greater portion of the forward market, to allow them to offer SVT tariffs that did not change too regularly, for greater customer convenience. In these circumstances it would be misleading to assess performance relative to a volatile benchmark.

74. RWE also noted that liquidity in retail purchases at one month ahead would only be enabled by willing sellers (generation businesses) being active in the market. It observed that generation businesses currently sold their planned output up to three years in advance of delivery. At one month ahead there might be little volume available because output would already have been committed to other counterparties in earlier trades.

75. RWE concluded that a one month ahead strategy would neither be reflective of the behaviour that should or would be expected of a supplier hedging SVT nor welcomed by consumers. We, therefore, should not use a month ahead purchasing strategy as the basis for any benchmark.

76. RWE furthermore argued that, as the SVT product was not intended to follow shorter term fluctuations in market movements, one could misinterpret the higher cost base incurred in a falling market as inefficient. Conversely in a rising market, one could misinterpret the lower cost base incurred following a 12 month linear rather than a month ahead purchasing strategy as being grounds for a price cut, when in fact prices had never been raised.

Concerns regarding practicality / detail of implementation

77. RWE told us that estimating the opportunity cost for each type of product would require a number of significant assumptions to be made. These assumptions would include those needed to attribute costs incurred closer to

or at the point of delivery such as such as Shape[63], Weather and Imbalance, which were managed at a portfolio level. These assumptions might rightly differ between suppliers, or by product within each supplier, potentially reducing the intended comparability of the data.

78. RWE noted that we did not consider that the costs of shaping a customer's demand were material. RWE however had estimated that shaping a flat monthly commodity purchase into a half-hourly shape would add 5-7% to the commodity cost for Profile Class 1[64] and negative (2-4%) for Profile Class 2[65]. These were material amounts given that commodity costs represented half of total tariff costs and the low margins of retail supply. RWE submitted that wholesale energy cost items not reflected in the costs of standard products should be incorporated into any standardised wholesale cost benchmark.

79. RWE told us that the treatment of Fixed Term Contracts ('FTCs') was not as straightforward as we had made out. It was possible for customers to exit these in a variety of ways (with no exit fee, with exit fee, product transfer, moving home etc). Our assumption of 100% hedge to termination date might be misleading because customer attrition occurred over the life of the contract. The attrition rate was affected by a number of factors include wholesale prices, tariffs discounts, tariff types, industry churn rates and customer retention activity.

80. RWE told us that suppliers hedge products' wholesale price risk based on forecasts of customer numbers and their expected energy demand for each product. These forecasts would change over the life of the product depending on the attrition rates. The further from delivery, the more error one would be likely to observe between forecast and actual. By one month ahead of delivery, however, RWE had the target of its cost forecasts being within a couple of percentages of outturn.

81. In order to minimise this price risk, suppliers regularly re-forecasted and re-hedged positions throughout the term of the product, to reflect the most up to date view of volume and costs. Our opportunity cost calculation however assumed that a prudent supplier would only reforecast its position once, just prior to delivery. RWE submitted that we should account for the costs of ongoing hedging activity undertaken to minimise the risk of forecasting error.

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[63] Shape was the cost of transforming a block of seasonally or monthly purchased volume into the half-hourly consumption profile actually used by customers.
[64] Profile Class 1 describes 'domestic unrestricted' consumers, where the unit rate does not change by time of day and there is a clear peak in consumption at 6-7pm.
[65] Profile Class 2 describes Economy 7 customers, where day and night consumption is measured and priced separately. Economy 7 customers are traditionally those with storage heaters, consuming predominantly in the cheaper night period to charge the heaters.

Concerns regarding commercial confidentiality

82. RWE told us that specific supplier hedging strategies relating to individual tariffs or tariff groups should be kept confidential. Our proposal would reveal individual firms' hedging strategies, damaging their competitive responses to changes in the market. It would likely drive convergence in this regard, leading to a reduction in the overall level of competition on wholesale costs, and therefore distort competition more generally. That would contrary to the public interest. Market segment granularity would be sufficient to allow Ofgem to assess retail profitability. Anything more granular than that compiled in the current segmental statements should not be publicly available.

Concerns regarding the proportionality of providing this information

83. RWE told us that ex post disaggregation of hedges for the sole purpose of segmental reporting would not only be burdensome but also approximate as different suppliers would do this differently. In its view, as this additional granularity would provide very limited relevant information, it did not consider that the benefits of this proposal were sufficient to warrant the additional costs of providing it.

Prior year comparatives

84. RWE told us that our proposal to require that prior year figures to be in line current year reporting would incur significant further costs.

Scope of firms obligated to report

85. RWE submitted that, given that the purpose of financial reporting was to provide a transparent view of the energy marketplace, it considered that segmental reporting should be the standard requirement for all suppliers in the industry subject to a de minimis limit of 250,000 customers. We had provisionally found that vertical integration was not a feature of the market that gave rise to an AEC. Therefore retaining "vertical integration" as a criterion for publication had no justification.

SSE[66]

86. SSE told us that current segmental reporting had been able to establish a credible reputation by facilitating the reporting of financial information on a clear and consistent basis. Our continued focus on ROCE reporting would risk

[66] SSE's response to PDR, pages 11 to 12 and 55 to 62.

undermining third party confidence in the results produced. Our investigation had shown that ROCE was a relatively volatile measure of performance. SSE noted that our measure of excess profitability based on ROCE across all customer groups had moved from circa £900 million to £566 million per year based on methodological changes (rather than any material changes in the underlying data). In its view the estimations and assumptions required to undertake the analysis were liable to lead to extreme conclusions that were detached from market reality.

87. SSE told us that the proposed remedy carried a material risk to giving rise significant unintended adverse consequences in the market. Customers and investors would be confused because the highly theoretic outputs produced would not be able to be reconciled with published accounts.

Reporting on market lines

88. SSE told us that, as it had explained previously, it was critical that financial reporting should reflect the way that the market worked in practice. As we had noted in the provisional decision on remedies, the retail supply segmental statements of Centrica, Scottish Power and SSE now reflected the costs actually incurred in procuring energy. SSE told us that in its case these costs would include those arising from its external legacy power purchase agreements (PPA) with Seabank and Marchwood.

89. Although we did not consider that "the segmental reporting for regulatory purposes along market lines should necessarily fully coincide with the reporting for another purposes (e.g., statutory reporting)" SSE submitted that we had provided no explanation, let alone any evidence, to support this position. In SSE's view the opposite was true. In order to achieve our stated objectives (i.e., to provide information that is "relevant, complete, understandable and comparable"), it was imperative that segmental reporting for regulatory purposes should be consistent with statutory accounts.

90. SSE submitted that, to the extent we considered that the existing reporting system would benefit from increased transparency, it would be far more effective and transparent to mandate the inclusion of trading activities as an additional area for segmental reporting. This would have the key benefit of reflecting firms' actual costs, thereby avoiding the drawbacks of a theoretic reporting regime (see SSE's comments on disaggregation of wholesale energy costs in paragraphs 93 to 96).

Providing balance sheets

91. SSE told us that it thought the precise scope of this obligation remained unclear. In some places we had indicated that these should be provided on a pan-generation and pan-retail supply basis whereas elsewhere we had suggested that balance sheets should be provided for "all generation markets and all retail supply markets separately."

92. SSE told us it was able to provide a balance sheet at total generation and total supply level. Providing more granular information separately for all generation markets and all retail markets would, however, require a number of significant estimates and assumptions to be made. The application of these estimates and assumptions would inevitably reduce the weight that could be placed on the outputs that they produced.

Disaggregating wholesale energy costs

Concerns regarding the rationale

93. SSE noted that we had observed that Centrica's, Scottish Power's and SSE's segmental reporting for retail supply now reflected the costs actually incurred in procuring energy. However, on the basis of our, in its view, unsubstantiated, assumption that reporting energy costs on the basis of incurred cost did not "reflect competitive market dynamics", we had proposed that, in the interests of delivering "transparency", the six large energy firms should report their energy costs on a highly theoretic standardised basis.

94. In addition, the specific methodology proposed for reporting by the CMA risked causing particularly unhelpful market outcomes. In particular, the provisional decision on remedies indicated that the opportunity cost of wholesale energy purchases would be fixed at the "point ahead of which would be deemed that the Six Large Energy Firms take on the commitment to supply." We had suggested that this would be roughly one month ahead of delivery for an SVT.

95. SSE told us that it was wholly unrealistic for a prudent supplier to purchase roughly one month ahead of delivery for an SVT. We had apparently assumed in particular that suppliers would be able to change their prices on a monthly basis. SSE noted that all suppliers who had pursued such a policy in 2008, would likely have gone out of business due to the significant increase in the wholesale markets pushing their costs significantly higher than the competitive level of prices from suppliers following a more prudent strategy.

96. SSE criticised our proposal to base the estimate of the purchase opportunity cost calculated on a standardised basis on the basis of standard products traded on open wholesale markets. To suggest that any differential between its external legacy power purchase agreements (PPA) and such standard products at any given point in time would be somehow a "residual" was manifestly misleading.

Concerns regarding practicality / detail of implementation

97. SSE told us that disaggregating actually incurred wholesale energy costs in this way would not be effective. There would be little stakeholder confidence in profits based on these numbers, if they could not be reconciled to statutory accounts. This was also needed to facilitate a proper audit.

Concerns regarding dampening of competition

98. SSE submitted that adopting a standardised method to measure wholesale energy costs also risked dampening competition in energy supply. In practice, the use of a prescribed method to benchmark energy costs would provide a strong incentive for suppliers to realign their energy procurement activities in that way. This would, in turn, reduce the diversity of business models in the market (which would, in turn, reduce the diversity of tariffs offered available to customers). This would reduce innovation and customer choice and, in particular, undermine the effectiveness of our proposal to withdraw the simpler choices component of the RMR rules.

Comparability between the Six Large Energy Firms regarding the accounting period

99. SSE submitted that requiring it to provide information on a calendar year basis, rather than on its current March year end basis, would be misleading and confusing. The provisional decision on remedies had suggested that Ofgem should consider whether SSE should be required to report, for the purposes of the proposed remedy, on a December year-end basis or to prepare an “out-of-line” reconciliation. However, Ofgem had concluded in October 2013 that this did not undermine comparability because for any comparisons to be meaningful the information needed to be based on periods covering several years. Ofgem had re-affirmed this position in October 2014 by placing emphasis on it being able to understanding trends from one year to the next (rather than across firms over the same period).

100. SSE told us that the adjustments that would have to be applied would likely undermine the clarity and reliability of the results produced. Producing a

second set of results would also risk causing confusion for customers and investors.

Assurance

101. SSE told us that in May 2012 Ofgem had stated that segmental statements should be based on the same profit measures as those presented to the investor community and the risk of different messages being presented to different audiences should be avoided. Ofgem had therefore emphasised the need for a simple reconciliation between the segmental statements and publicly available profit figures. More recently in February 2014 Ofgem had indicated that confidence in the segmental statements would be best delivered by having external auditors scrutinise them. In October 2014 Ofgem had indicated that it would mandate a full financial audit in line with recommendations from the Energy and Climate Change Select Committee and BDO's review of the Six Large Energy Firms transfer charging practices..

102. SSE submitted that the combination of the proposed changes would make the results reported impossible to reconcile with firms' statutory accounts and undermine the ability to audit the results produced. As the auditors would not be able to rely on the reconciliation to group accounts or to the actual wholesale energy trading purchase book, they might not be able to issue a "fairly presented" audit opinion. At best, external auditors would likely be forced to issue an opinion based upon "agreed upon procedures" (AUPs), which would not provide the same third party confidence in the results produced.

Proportionality / cost implications

103. SSE told us that it believed our remedy to be disproportionate. The claimed benefits of the remedy were marginal (in particular because the information reported would not be robust). On the other hand, the costs that the remedy would entail (in terms of unnecessary investment in internal system and additional auditing) were significant. These costs would ultimately fall on customers and tax payers.

104. SSE would need to make significant changes to its internal systems (affecting the energy risk trading management system, the customer billing system and other settlement systems). As SSE had previously explained to us these changes would likely cost between [✄] and take around 12 to 18 months to implement. In addition, the outputs were likely to be more difficult to audit (see paragraphs 101 to 102). The external audit process would therefore likely be materially more expensive (and also take longer to execute, which could risk delaying the timely publication of the results in practice).

Scope of firms obligated to report

105. SSE noted that we had articulated the objective of the proposed remedy in terms of enabling Ofgem to undertake and interpret a robust profitability analysis across the generation and retail supply markets. SSE also noted that we had found it instructive in the provisional decision on remedies to analyse the performance of independent suppliers for the purpose of market-wide comparisons. SSE submitted, that on this basis, we should apply the proposed remedy to all firms active in generation and supply subject to a suitable de minimis thresholds. Limiting the scope of the proposed remedy to the Six Large Energy Firms undermined the relevance and comparability of the proposed remedy.

106. SSE told us that it though it inconsistent for us to suggest that the proposed reporting regime was critical to facilitating trust in the energy sector, but then to entirely exempt suppliers and generators that account for a material proportion of the market

107. SSE submitted that, as it believed the proposed remedy would impose a disproportionate burden on all operators large or small, the grounds that we had given for not wanting the remedy to apply to smaller operators had no basis.

Commercial confidentiality

108. SSE told us that, as it had already previously explained, the proposed remedy appeared to envisage the publication of certain granular information that was competitively sensitive (e.g., in relation to commercial arrangements for the delivery of Energy Company Obligation (ECO) costs). We had provided no indication to how these risks would be addressed.

Annex B: Financial reporting remedy – views of stakeholders in response to the Remedies Notice

Introduction

1. In our Remedies Notice we set out that this proposed remedy would comprise a recommendation that Ofgem develop a comprehensive 'market-orientated' regulatory accounting framework under which the large domestic and SME energy generators and retail suppliers should report.[67]

2. In that notice we asked the following consultation questions:[68]

   (a) Should the scope of the individual areas reported on align with the scope of the markets as set out for generation and retail supply in our provisional findings? For example, should a requirement to report wholesale energy costs on the basis of standard products traded on the open wholesale markets be imposed? ('reporting on market lines'/'reporting of wholesale energy costs')

   (b) What regulatory reporting principles would be particularly relevant to the preparation of regulatory financial information in this sector?

   (c) Would summary profit and loss account and balance sheet information for each area be sufficient to enable the effective regulation of the sector and the development of appropriate policies? Or should the large domestic and SME energy suppliers be required to collect and submit additional, more granular financial information?

   (d) Should Ofgem require that the summary profit and loss and balance sheet information be audited in accordance with the regulatory reporting framework?

   (e) Should this remedy apply to the firms that are currently under an obligation to provide Ofgem with Consolidated Segmental Statements (CSS)? Or should it apply to a larger or narrower set of firms? ('Scope of coverage')

   (f) What would be the costs of imposing such a remedy? We note that some firms' reporting systems are not currently capable of providing information on such a 'market-orientated' basis and that our remedy could require significant additional system requirements.

[67] Remedies Notice, paragraph 108.
[68] ibid, paragraph 109.

(g) Should the CMA implement this remedy by way of licence modifications or by way of a recommendation to Ofgem?

(h) To what extent should this financial information on performance be published?

3. The views of stakeholders relate not just to the formal responses to the Remedies Notice but also any comments relevant to the development of the remedy in hearings we held with the Six Large Energy Firms and Ofgem after we published our provisional findings. We also requested information from two of the Six Large Energy Firms (SSE and E.ON) and the relevant points are also summarised here.

4. In this appendix we first provide both a high-level summary of these views and then a detailed summary of the views of each party, stakeholder-by-stakeholder.

5. We demonstrate how these views have influenced or not the development of our remedy in Section 19 and in this appendix.

High level summary

6. We first summarise the views of stakeholders at a high level grouped by type of stakeholder (Six Large Energy Firms, Ofgem, independent suppliers, independent generators and consumer advocates and academics). For the Six Large Energy Firms we have also summarised their views thematically.

Six Large Energy Firms

Reporting on market lines

7. Regarding the proposal to report on market lines rather than on divisional lines, Six Large Energy Firms were of the view that either they already reported on this basis in any case or that it was more important that any financial information produced directly reconciled to their statutory financial information. In their view it was particularly important that any measure did not constrain how firms chose how to organise their own businesses across the energy value chain.

Reporting of wholesale energy costs

8. Many of the Six Large Energy Firms strongly objected to the proposal that wholesale energy within retail supply should be costed exclusively on the basis of wholesale standard products. This approach ignored commercial

reality and would not allow them to report the costs that they had actually incurred, a measure, as Centrica pointed out, that would lead to confusion and less trust in the sector.[69]

9. 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. SSE cautioned against any short term universal benchmark as that would result in less differentiation and less competition on price.[70]

10. Centrica cautioned against us imposing a common notional purchasing strategy for retail supply such as buying at spot prices. It highlighted that there was a strong link between the products that firms supply (eg fixed-term products and SVT) and their purchasing strategies for each of these products. It would be difficult to focus on wholesale energy costs without also looking at product structure and pricing at the same time.[71]

11. RWE advised that commodity transfer pricing should be audited at the forward curve vector at the point of sale or purchase, and not using 'spot' prices at the point of delivery. This approach reflected the way firms managed commodity risks and would result in firms reporting the costs they had incurred.[72]

12. Regarding the differential impact of individual Six Large Energy Firms' purchasing strategies on their retail supply wholesale energy costs, RWE told us that it was very risky for retail suppliers to come into the market and adopt a short strategy. Although it had been the case that spot prices had turned out to have been consistently lower for a period than the corresponding forward prices, this might not have been the case. When markets had previously turned, some small suppliers had gone bust because they had adopted a short-term strategy and not purchased in the forward energy markets the commitments to supply they had taken on.[73]

13. Scottish Power suggested two ways in which we could improve transparency and trust in the market. First it said in relation to segmental reporting that commodity purchases and sales should reflect the actual transactions entered into by the firm rather than transfer charges based on notional pricing. Scottish Power pointed out that unless firms like itself accounted for the

[69] Paragraph 53.
[70] Paragraph 43.
[71] Paragraph 54.
[72] Paragraph 61.
[73] Paragraph 62.

transactions at actual market prices, they wouldn't know whether or not they had actually made money on the products they had sold.[74]

14. The other suggestion that Scottish Power had to improve transparency and trust in the market was designed to forestall the question that constantly arose regarding why retail prices did not reflect wholesale prices more quickly. Were we minded to accept Scottish Power's proposal to replace the default tariff with a fixed rate one-year fixed-term (SVT) tariff, then this would lead to firms setting a new price for this tariff every month. This in turn would lead to retail prices faster reflecting what was happening to wholesale energy prices in the wholesale market. This dynamic in turn would affect what the segmental accounts reported.[75]

Provision of balance sheets

15. Most of the Six Large Energy Firms were content to provide a balance sheet as well as profit and loss account for both generation and retail supply as a whole. This was the case even though many of them doubted the value of a balance sheet when analysing the performance of retail supply. Furthermore some of the Six Large Energy Firms (RWE[76] and EDF Energy[77]) doubted the value of routine production of balance sheets without also routinely updating asset carrying values onto a current basis.

16. However to provide balance sheets further segmented eg by customer type would, in the view of many of the Six Large Energy Firms, be a step too far, potentially involving subjective attributions of costs that were unlikely to add value.

Scope of coverage

17. The Six Large Energy Firms all believed that there was a strong case for extending the coverage of reporting obligations beyond themselves. Some of the Six Large Energy Firms saw this in terms of the public and Ofgem being able to compare the performance of the Six Large Energy Firms to other independent players, whereas others saw no justification of the obligations being centred on them given that we had provisionally found no issue with vertical integration.

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[74] Paragraph 71.
[75] Paragraph 72.
[76] Paragraph 63.
[77] Paragraph 94.

Cost/feasibility of implementation

18. Many of the Six Large Energy Firms pointed out that our proposals were not sufficiently well specified for them to cost their implementation in other than general terms. Some of the Six Large Energy Firms pointed out that we needed to consider the ability of audit firms to issue audit opinions on some aspects of our proposals and there would inevitably be additional costs if the extent of the audit increased.

Audit, publication and implementation mechanism

19. The Six Large Energy Firms understood the importance of audit and publication of this financial information to fostering understanding and trust in the sector. They were broadly happy with the current publication arrangements but wanted us to consider the tension between extra publication on the one hand and commercial confidentiality and any potential impact on competition, including to facilitate tacit coordination on the other.

20. All but one of the Six Large Energy Firms favoured that we implemented this by way of a recommendation to Ofgem rather than by an order.[78] They pointed out that these changes were being grafted onto an existing remedy for which there was already a proper consultation process.

Ofgem

21. Ofgem explained to us that it had sought to level the playing field in terms of the requirements for segmental financial reporting of GB activities between the Six Large Energy Firms which were UK-quoted and those that weren't. Ofgem had been pressed by the Energy and Climate Change Select Committee in particular to go much further than this, largely because it suspected that there was a black hole into which the money was going and that consumers were being overcharged as a result. Ofgem had not accepted this argument at the time.[79]

22. Ofgem was unsure about whether it would be appropriate to require reporting on market lines given that it didn't regulate the prices of either generators or retailers. Furthermore BDO, the accountancy firm it had commissioned to review the Six Large Energy Firms' transfer pricing practices, had stated that an arm's length standard had been applied. Ofgem, like the Six Large Energy

[78] Only EDF Energy was neutral on this point. See paragraph 99.
[79] Paragraph 102.

Firms, emphasised the importance of firms being able to report their actual wholesale energy costs.

23. On the question of balance sheets, Ofgem saw value in having them only if they replicated the customer type segmentation it mandated for retail supply.

24. Ofgem told us that it had actively considered the issue of whether the Six Large Energy Firms' activities as trading intermediaries[80] should also be reported alongside generation and retail supply. This would be problematic to implement not least because Ofgem did not have general powers to compel production of information on this trading activity for regulatory purposes. In addition, some of the Six Large Energy Firms' trading divisions (which carried out this trading activity) are located outside GB and, in any case, it might be difficult for some of the Six Large Energy Firms to distinguish intermediary trading activities from proprietary trading activities.

25. Ofgem advised us, were we minded to require the reporting of intermediary trading activities, our order powers might need to be utilised to mandate this. It therefore advised us to consider whether an order on our part might be a more appropriate mechanism to implement this remedy than a recommendation to it.

26. Ofgem noted that many stakeholders were dissatisfied with the financial information currently published and that more information might help hold the industry to account. Ofgem, however, was keenly aware of the tension between ever more publication and the impact further disclosure might have on firms' ability and incentive to compete vigorously with one another.

Independent suppliers

27. Views were mixed on whether the possible remedy should also apply to independent suppliers. Ovo Energy thought that it would be valuable for Ofgem to be able to compare its efficiency with that of the Six Large Energy Firms. Utility Warehouse, a multi-utility provider, however thought that there was little value to be gained from requiring firms with innovative business models like itself to also report, not least because it would require it to arbitrarily attribute costs across the quite different retail services it provided to its customers. Good Energy however pointed out that in the eyes of the public the performance of retail suppliers as a whole was being conflated with that of the Six Large Energy Firms.

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[80] This is where a Six Large Energy Firm acts as an intermediary between buyers of commodities (eg retail suppliers) and sellers (eg generators). See Appendix 10.3, paragraphs 25–28 for further discussion.

28. A couple of independent suppliers, Ecotricity and the Co-operative Energy pointed out what they saw as similarities between our proposal that wholesale energy should be costed on the basis of standard wholesale products and the reporting requirements under EU energy market integrity and transparency regulations.

29. Most of the independent suppliers emphasised the importance of comparability across the firms to which the obligation would be applied. The Co-operative Energy went so far as advocating a common reporting year end for the Six Large Energy Firms for regulatory reporting purposes and suggesting a single audit firm to ensure consistency of audit approach across the Six Large Energy Firms.

Independent generators

30. Drax pointed out that it already separated out generation and retail supply (Haven Power) using well-established transfer pricing rules in its annual report and saw no reason why any reporting obligation should apply to it. It also pointed out that Haven Power did not have legacy customers to give it an incumbency advantage.

31. The three other independent generators that submitted responses on this remedy, Engie (formerly GDF SUEZ), Eggborough Power and ESB, all called for greater standardisation of, and comparability in, the reporting of the Six Large Energy Firms to provide a clear separation between the various segments of their businesses.

Consumer advocates and academics

32. Citizens Advice thought we had identified a major deficiency in the way some of the Six Large Energy Firms didn't report on market lines, not least by not reflecting the way stand-alone generators and retail suppliers would buy and sell in the marketplace.

33. Citizens Advice thought that the reporting obligations should remain focused on the Six Large Energy Firms. The debate about the profitability and energy prices was closely linked to the extent which the Six Large Energy Firms used their incumbency in retail markets and vertical integration to their advantage.

34. Citizens Advice advocated that there should be a presumption towards full publication of the financial information to be produced under the obligation. It pointed out that this market investigation was prompted in large part by a breakdown in trust in the energy sector and a lack of confidence by the public

that the prices they pay were fair. Resolving this issue would need to involve communicating where firms were making their money.

35. Citizens Advice told us that we should not focus exclusively on ex post financial reporting and there was also a need for current analysis/forward looking projection of the costs of supply which would help consumers understand the drivers between a contemporaneous price rise or price cut. This had been provided by Ofgem's Supply Market Indicator (SMI) but which was currently suspended. In the view of Citizens Advice the SMI had provided insight about the direction of energy bills and had incentivised retail suppliers to try and better justify their pricing decisions. Citizens Advice was concerned if this suspension became protracted or was replaced with a less detailed or less frequently produced product.

36. Which?, National Energy Action and the Energy Policy Group at the University of Exeter welcomed our financial reporting proposals.

Summary of the views of each party/stakeholder

37. In contrast to the high-level summary, we now set out the views of each set of stakeholders (Six Large Energy Firms, Ofgem, independent suppliers, independent generators and consumer advocates and academics) stakeholder by stakeholder.

Six Large Energy Firms

SSE

38. SSE told us that it believed the overall transparency of generators' and retail suppliers' revenues, costs and profits was currently fit for purpose and advanced against other comparable[81] markets.[82] SSE would, however, have no objection to the inclusion of the trading function on the face of the segmental statements.[83]

39. SSE argued that reporting for generation and retail supply must substantially align with the energy firms' published accounts. To impose any other requirement would be unreasonable and disproportionate.[84] SSE also noted that the ability to fully reconcile back to group accounts was important for

[81] Such as international energy markets and other competitive markets, particularly where there is an element of vertical integration.
[82] SSE response to provisional findings and Remedies Notice, paragraph 3.20.1.
[83] SSE response to Remedies Notice, paragraph 3.20.4.
[84] SSE response to Remedies Notice, paragraph 3.20.4.

transparency for all Six Large Energy Firms, both those UK based and those not UK based and which operated central trading desks.

40. SSE also emphasised the importance of reporting actual numbers, not theoretical numbers. SSE wanted us to be clear whether the policy intention was to deliver *transparency* of profits actually earned by firms or *comparability* of profits based on a stylised assessment of a notional stand-alone business.[85]

41. SSE criticised the proposals as seeking to mandate comparability across the firms on the basis of a theoretical stand-alone firm.[86] It pointed out that both BDO and Ofgem had found that the current reporting regime including the transfer pricing arrangements to be broadly fit for purpose and transparent, presenting an accurate picture of generation and supply profitability.[87]

42. SSE thought the proposal to cost wholesale energy for retail supply exclusively on the basis of standard wholesale energy products ignored commercial reality. Some purchases related to non-standard products including power purchase agreements. In addition, the proposal to standardise cost in this way would not improve transparency because it would involve a highly complex and contrived reconciliation to its actual numbers.[88]

43. 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. For example, SSE's domestic customers would have been completely protected under its price freeze commitment had wholesale prices in fact gone up. A realistic benchmark purchasing strategy would also take into account each firm's risk appetite and the volatility of the market. SSE cautioned against any short term universal benchmark as that would result in less differentiation and less competition on price.

44. SSE told us that the current (CSS) requirement to prepare segmental profit and loss accounts was a proportionate response to the issue of transparency but that the provision of balance sheets as well, other than for generation and retail supply as a whole, would be difficult to achieve and of uncertain benefit.[89] SSE submitted that ROCE was not an appropriate profitability

[85] SSE response to Remedies Notice, paragraph 3.20.3.
[86] SSE response to Remedies Notice, paragraph 3.20.7.
[87] SSE response to Remedies Notice, paragraph 3.20.9.
[88] SSE response to Remedies Notice, paragraph 3.20.5 & 3.20.6.
[89] SSE response to Remedies Notice, paragraph 3.20.10, 3.20.13 & 3.20.15.

measure for retail supply. It noted that we had had to make several adjustments to reported balance sheet values in any case.[90]

45. SSE also advised us (or Ofgem) to engage with audit firms experienced in the energy sector to establish the basis on which they would issue an audit opinion, should the reporting regime significantly change.[91] SSE noted that more onerous audit processes would result in increased costs.

46. SSE argued that extending the scope of the reporting obligation to stand-alone suppliers and generators and to vertically integrated firms operating in the large end of the non-domestic market would provide results against which the Six Large Energy Firms could be benchmarked, thereby enhancing public understanding of the energy market.[92]

47. SSE noted that during 2014/15 it had revised its transfer pricing arrangements onto a more market orientated pricing basis. This change had been enabled by its investment in an energy trading risk management system.[93] [✂].[94]

48. SSE told us that the investment in its energy trading risk management system had been prompted by its desire to improve its purchasing and selling decisions across generation and retail supply and the associated financial reporting. [✂]. For its 2014/15 segmental statements SSE had been able to report its generation and retail supply activities on the basis of how they had interacted with the external market rather than on the basis of tolling agreements within an integrated group. For example, generation was now reported on a full function rather than on a toll-generator basis. [✂].

49. SSE believed it would be more appropriate to implement this remedy by way of recommendation to Ofgem. That way Ofgem would be able to consider the reporting modifications it was planning in tandem.[95]

50. SSE warned against more detailed publication of segmental financial information beyond the current arrangements to avoid the risk of publishing commercially sensitive information. There was a balance to be struck between transparency and confidentiality.[96]

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[90] SSE response to Remedies Notice, paragraph 3.20.14.
[91] SSE response to Remedies Notice, paragraph 3.20.17.
[92] SSE response to Remedies Notice, paragraph 3.20.19.
[93] SSE response to Remedies Notice, paragraph 3.20.21.
[94] SSE response to Remedies Notice, paragraph 3.20.23.
[95] SSE response to Remedies Notice, paragraph 3.20.24.
[96] SSE response to Remedies Notice, paragraph 3.20.25 & 20.20.26.

Centrica

51. Centrica believed that the current segmental statements provided a transparent and audited view of its generation and retail supply businesses, which gave stakeholders assurance that the stated profits earned upstream and downstream were accurate.[97]

52. Centrica noted that regulatory financial reporting was usually only applied to markets where prices were set by regulators (in order to enable over/under recovery of costs) rather than as the outcome of a market process.[98] Centrica noted it was important to understand what problem was being solved when considering/assessing regulatory reporting.

53. Centrica emphasised the importance of firms being able to report their actual wholesale energy costs for retail supply rather than on a theoretical basis which assumed that all firms procured their wholesale energy exclusively in the form of standard wholesale products.[99] The latter approach, based on past experience, would lead to confusion and less trust in the sector.

54. Centrica cautioned against us imposing a common notional purchasing strategy for retail supply such as buying at spot prices. It highlighted that there was a strong link between the products that firms supply (eg fixed-term products and SVT) and their purchasing strategies for each of these products. It would be difficult to focus on wholesale energy costs without also looking at product structure and pricing at the same time.

55. Centrica believed that a summary balance sheet alongside the profit and loss account would be sufficient for effective regulation provided that they reconciled to group annual accounts and were subject to a full financial audit.[100] Centrica pointed out that the existing reporting requirements already imposed a significant cost burden on licensees. This would increase materially were we to require firms to recalculate their wholesale energy purchases.[101]

56. Centrica proposed that enhanced reporting requirements be focused on the default tariff it had proposed, rather than on generation and retail supply, and be introduced by way of a recommendation to Ofgem.[102]

[97] Centrica response to Remedies Notice (redacted version), paragraph 224.
[98] Centrica response to Remedies Notice, paragraph 398 b).
[99] Centrica response to Remedies Notice, paragraph 400 a).
[100] Centrica response to Remedies Notice, paragraph 398 c).
[101] Centrica response to Remedies Notice, paragraph 398 f).
[102] Centrica response to Remedies Notice, paragraph 398 f).

57. Centrica told us that it saw publication of financial information as serving a wider transparency purpose. Confidence in the sector could, however, also be achieved by Ofgem assessing the submitted financial information and then issuing a statement stating whether it had confidence in that information.[103]

RWE

58. RWE told us that it supported the clear segmentation of retail supply and generation performance and transparency of profitability in these business areas.[104]

59. RWE told us that all commodity purchases and sales within both generation and retail supply should be reported on the basis on which the firms actually buy and sell regardless of whether this was in the form of standard wholesale products or not. It cautioned against any approach that might discourage the use of innovative products to manage risk that in turn would reduce cost efficiency to customers.[105] With respect to generation, RWE also cautioned that, as many commodity costs such as illiquid coal and weather hedges did not relate to traded standard wholesale products, there was a risk of losing transparency about how the real business was being managed thereby removing an important competitive element of the market.

60. RWE noted that it reported its retail supply activities on a market basis in that it transferred wholesale energy into retail supply almost entirely using standard wholesale products priced at market prices.[106] It also reported generation on a market basis in that all profits related to its generation business ended up in the generation profit and loss account.[107] RWE also told us that any netting of power between its generation and retail supply business related to very small amounts, which were then recorded for internal reporting purposes. All these netting deals were done at market prices. RWE believed that such an approach to ring-fencing should be required across the marketplace but it understood that not all Six Large Energy Firms did this.

61. RWE advised that commodity transfer pricing should be audited at the forward curve vector at the point of sale or purchase, and not using 'spot' prices at the point of delivery. This approach reflected the way firms managed commodity risks and would result in firms reporting the costs they had incurred.[108]

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[103] Centrica response to Remedies Notice, paragraph 398 h).
[104] RWE response to Remedies Notice, remedy 14, paragraph 2.1.
[105] RWE response to Remedies Notice, remedy 14, paragraph 2.2.
[106] RWE response to Remedies Notice, remedy 14, paragraph 2.3.
[107] RWE response to Remedies Notice, remedy 14, paragraph 2.4.
[108] RWE response to Remedies Notice, remedy 14, paragraph 2.7.

62. Regarding the impact of the Six Large Energy Firms' individual purchasing strategies on retail supply wholesale energy costs, RWE told us that it was very risky for retail suppliers to come into the market and adopt a short strategy. Although it had been the case that spot prices had turned out to have been consistently lower over the recent past than the corresponding forward prices, this might not have been the case. When markets had previously turned, some small suppliers had gone bust because they had adopted a short-term strategy and not purchased in the forward energy markets the commitments to supply they had taken on.

63. RWE saw the existing publication requirements as sufficiently granular to provide transparency of business performance.[109] RWE cautioned against imposing a requirement to disaggregate the retail supply balance sheet. It would only be possible to compare profitability across retail segments if the carrying values for assets were to be restated onto an economic basis.[110]

64. RWE thought that the reporting obligation should be extended to smaller retail suppliers because consumers might want to factor in their financial performance when contemplating switching.[111] It also noted that for retail supply the existing requirements were already at the point of revealing strategic and competition sensitive information and that further transparency of granular information would put competition at risk, particularly where only some suppliers needed to report the information.[112]

65. Regarding costs of implementation, RWE noted that our proposals were not sufficiently detailed for it to specifically cost them out. However, RWE did indicate that such a remedy would result in increased costs which would be proportionally greater for larger firms. The cost stack would typically comprise system development costs, potentially further employees in accounting and regulatory departments and increased audit fees.[113]

66. RWE advocated that we implement this remedy by way of recommendation to Ofgem.[114] Any reporting changes should be taken up within the existing regulatory reporting framework of the CSS.[115]

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[109] RWE response to Remedies Notice, remedy 14, paragraph 2.11.
[110] RWE response to Remedies Notice, remedy 14, paragraph 2.12.
[111] RWE response to Remedies Notice, remedy 14, paragraph 2.18.
[112] RWE response to Remedies Notice, remedy 14, paragraph 2.19.
[113] RWE response to Remedies Notice, remedy 14, paragraph 2.20.
[114] RWE response to Remedies Notice, remedy 14, paragraph 2.22.
[115] RWE response to Remedies Notice, remedy 14, paragraph 2.17.

Scottish Power

67. Scottish Power told us that it supported transparent and robust financial reporting of the industry and it itself had reported its profit and loss account across the value chain of generation, trading and retail supply.[116]

68. Scottish Power noted that the purpose of the regulatory financial information was to facilitate regulatory policy making, principally monitoring competition in GB energy markets. It emphasised the importance of full capture of all of a firm's activities in each relevant market, the need for transfers to be at market prices and the desirability of alignment with statutory reporting at the group level.[117]

69. Scottish Power stated that individual areas within the financial statements should broadly align with the economic markets we had provisionally formally determined. However it did not believe they should be identical. For example I&C, which was outside the scope of the reference, was in its view appropriately included in the non-domestic segment for retail supply.[118]

70. Scottish Power noted that it already prepared its generation and retail supply activities on a market basis in that internal trades were at the prevailing market prices for the tenor of the trade at the time that it was agreed. It argued that the financial statements would not reflect commercial reality if they reflected an approach to purchasing other than the one that had been actually employed.[119]

71. Scottish Power suggested two ways in which we could improve transparency and trust in the market. Firstly it said that in relation to segmental reporting, commodity purchases and sales should reflect the actual transactions entered into by the firm rather than transfer charges based on notional pricing. Scottish Power contrasted its situation with some of the Six Large Energy Firms where all the money it made in GB from energy markets was in the segmental results. For these Six Large Energy Firms the segmental accounts reflected transfer charges from their trading division, which meant that these accounts did not necessarily fully reflect the external transactions the firms had entered into. This was a point that it had previously made to Ofgem. Scottish Power pointed out that unless firms like itself accounted for the transactions at actual market prices, they wouldn't know whether they had actually made money on the products they had sold or not.

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[116] Scottish Power response to Remedies Notice, remedy 14, paragraph 14.1.
[117] Scottish Power response to Remedies Notice, remedy 14, paragraph 14.7.
[118] Scottish Power response to Remedies Notice, remedy 14, paragraph 14.3 & 14.4.
[119] Scottish Power response to Remedies Notice, remedy 14, paragraph 14.6.

72. The other suggestion that Scottish Power had to improve transparency and trust in the market was designed to forestall the question that constantly arose regarding why retail prices do not reflect wholesale prices more quickly. Were we minded to accept Scottish Power's proposal to replace the default tariff with a fixed rate one-year fixed term (SVT) tariff, then this would lead to firms setting a new price for this tariff every month. This in turn would lead to retail prices faster reflecting what was happening to wholesale energy prices in the wholesale market. This dynamic in turn would affect what the segmental accounts reported.

73. With regard to wider transparency considerations Scottish Power pointed out that it had been first among the Six Large Energy Firms to voluntarily publish the profit and loss account for its trading activities.[120]

74. Scottish Power wanted to better understand our thinking about the proposal to require a balance sheet. Producing a balance sheet at a more granular level than generation and retail supply as a whole was likely to require at least some judgemental allocations.[121] Scottish Power noted that during the course of our investigation it had supplied us with granular balance sheet information, much of which it had sourced and developed specifically for our requests.[122]

75. Scottish Power told us that stakeholders gained confidence in the financial information from the fact that it was reconciled to firms' statutory accounts and that stakeholders valued the audit mainly because it verified the reconciliation to statutory accounts.[123]

76. Scottish Power pointed out that any increase in the scope of the audit would entail extra cost and recommended that we consider the views of leading audit firms on what they would be able to audit appropriately.[124]

77. Given that we had provisionally found that no AECs arose out of vertical integration between generation and retail supply, Scottish Power saw no reason for the obligations to be targeted only at VI firms.[125]

78. Scottish Power considered a recommendation to Ofgem rather than an order by ourselves to be the better approach. Alongside, Ofgem might want to implement other changes and strike a balance between timeliness of production of the accounts (now down to four months after the year-end) and

[120] Scottish Power response to Remedies Notice, paragraph 14.5.
[121] Scottish Power response to Remedies Notice, paragraph 14.8.
[122] Scottish Power response to Remedies Notice, paragraph 14.9.
[123] Scottish Power response to Remedies Notice, paragraph 14.11.
[124] Scottish Power response to Remedies Notice, paragraph 14.12.
[125] Scottish Power response to Remedies Notice, paragraph 14.14.

the extent of any new reporting requirements.[126] Scottish Power also advised that extending the current reporting requirements could well lead to commercially sensitive information being included that was not appropriate for publication.[127]

E.ON

79. E.ON told us that it supported Ofgem's efforts to continuously improve the segmental reporting for generation and retail supply. It thought, however, that the current reporting regime already gave a high degree of transparency and assurance around the profitability of the Six Large Energy Firms.[128]

80. E.ON told us that it believed its current reporting was on a 'market-orientated' basis and that BDO in its 2012 review of the Six Large Energy Firms transfer pricing practices had endorsed its approach.[129]

81. E.ON told us that current reporting for generation excluded small scale[130] and local supply[131] generation and for retail supply some very small scale supply associated with local generation. These activities had been exempted by Ofgem. E.ON, however, pointed out that, because of the increasing importance of these generation and retail supply activities, this was leading to an incomplete picture of financial performance in these markets. E.ON, therefore, suggested that all generation and retail supply activities, including exempted activities, undertaken by a firm be reported.[132]

82. E.ON thought that requiring firms to report wholesale energy costs on the basis of standard wholesale products might risk limiting firms to purchasing only these products and in any case would not reflect the commercial decisions firms had made to manage their business risks.[133]

83. E.ON emphasised the importance that transfer charges reflecting the price that a corresponding external trade would have taken place.[134] This reporting measure would support other regulatory measures it was advocating elsewhere, namely to prohibit cross-subsidy between the different businesses

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[126] Scottish Power response to Remedies Notice, paragraph 14.16 and 14.17.
[127] Scottish Power response to Remedies Notice, paragraph 14.18.
[128] E.ON response to Remedies Notice, paragraph 376.
[129] E.ON response to Remedies Notice, paragraph 362.
[130] Supply that is authorised by exemption through either the Electricity (Class Exemption from the Requirement for a Licence) Order 2001 No. 3270 Schedule 4 Class A: Small suppliers, or the Electricity (Class Exemption from the Requirement for a Licence) Order 2001 No. 3270 Schedule 4 Class B: Resale.
[131] Supply that is authorised by exemption through the Electricity (Class Exemption from the Requirement for a Licence) Order 2001 No. 3270 Schedule 4 Class C: On-site supply.
[132] E.ON response to Remedies Notice, paragraph 362.
[133] E.ON response to Remedies Notice, paragraph 363.
[134] E.ON response to Remedies Notice, paragraphs 368.

of a licensee and to prohibit discrimination in the trading of gas or electricity.[135]

84. E.ON advocated balance sheet information only in relation to generation. It also recommended that firms should also report their investment in generation over the previous 12 month period.[136]

85. E.ON noted that the current audit opinion related to whether the relevant licensee had prepared the (CSS) profit and loss account in accordance with the licence condition and Ofgem's reporting guidelines. E.ON believed that this opinion provided adequate assurance over the validity of this information.[137]

86. In the interests of wider transparency E.ON suggested that all retail suppliers (both electricity and gas) should produce and publish a profit and loss account to Ofgem's specification with suppliers with less than 250,000 accounts being exempt from the audit requirement.[138] For generation, however, E.ON suggested that for the moment at least the reporting requirements should be limited to operators vertically integrated across retail supply and generation.[139]

87. E.ON strongly supported that any changes to reporting requirements be effected by way of a recommendation to Ofgem. E.ON pointed to the 'due-process' governance arrangements that surrounded any licence modification. If we were to effect any changes by an order it removed Ofgem's ability to input into the process and the licensees' ability to appeal against any decision to the CMA.[140]

88. In the interests of transparency E.ON believed that all the financial information prepared should be published.[141]

89. Regarding its plans to split E.ON into two, E.ON told us that this would not happen until its shareholders had voted to approve the split intended to take place in June 2016, with the spin-off most likely becoming effective in the second half of 2016. [✂]. E.ON told us that the intention was that the two businesses would be working towards full commercial independence and that in the fullness of time E.ON would fully divest its remaining minority share in

[135] E.ON response to Remedies Notice, paragraphs 364 & 365.
[136] E.ON response to Remedies Notice, paragraphs 362.
[137] E.ON response to Remedies Notice, paragraphs 370 & 371.
[138] E.ON response to Remedies Notice, paragraphs 373.
[139] E.ON response to Remedies Notice, paragraphs 374.
[140] E.ON response to Remedies Notice, paragraph 377.
[141] E.ON response to Remedies Notice, paragraph 378.

what had been its conventional generation and commodity trading house businesses. E.ON [✂].

EDF Energy

90. EDF Energy said that we had rightly identified the difficulty in obtaining comparable market-based information for generation and retail supply across firms, in particular in terms of how firms treat the optimisation of their generation fleets and the divide between selling and purchasing for generation and retail supply on the one hand and acting as trading intermediary on the other.[142] EDF Energy said that it already organised itself on the market lines we envisaged but felt that other firms should not be forced to change their legal or organisation structure to comply with any new requirements.[143]

91. EDF Energy told us that there could be no real trust in the sector without both transparency in the financial reporting and credibility in the narrative that accompanied that reporting.

92. EDF Energy told us that it would not object to reporting SME customers as a separate segment using a workable definition that would be common across all suppliers. As this change would likely entail system changes for EDF Energy it would be important to allow sufficient time to implement it properly.[144]

93. EDF Energy recommended an approach to regulatory reporting that was in line with the financial reporting standards that applied to all large firms for external reporting purposes. Adhering to such an approach would reduce the potential for users to misinterpret financial information and avoid the maintaining of multiple sets of books.[145]

94. EDF Energy told us that it did not consider balance sheet information to be necessary for the market to understand profitability as profits in the supply industry were not driven by capitalised assets. EDF Energy pointed out that significant and subjective alterations needed to be made to the balance sheet for balance sheet information to be used to assess profitability. Some of these had been made by the CMA during this investigation. The degree of

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[142] EDF Energy response to Remedies Notice, paragraph 14.4.
[143] EDF Energy response to Remedies Notice, paragraph 14.6.
[144] EDF Energy response to Remedies Notice, paragraph 14.7 & 14.8.
[145] EDF Energy response to Remedies Notice, paragraph 14.10.

subjectivity surrounding these alterations, particularly if done individually by each firm, would inevitably lead to a lack of comparability across firms.[146]

95. EDF Energy thought that the current audit requirement was appropriate to help increase stakeholder confidence in the statements.[147]

96. EDF Energy considered it counterintuitive that the current reporting requirements only applied to the Six Large Energy Firms. Subject to some de minimis thresholds, it thought that the requirements should apply to all generation and supply firms. Current coverage of the generation market was only two-thirds. Were smaller suppliers, many of whom have different business models, to provide statements, then this would facilitate further new entry.[148]

97. EDF Energy viewed the additional cost to it of preparing the current statements (profit and loss account only) as relatively small compared to the wider public interest. EDF Energy also noted that an independent supplier had voluntarily published an equivalent profit and loss account.[149]

98. EDF Energy commented that it had only been able to cost each of the outlined enhancements outlined in the Remedies Notice at a very high level but had attempted to provide estimates for each enhancement including any associated increase in audit fees.[150]

99. EDF Energy considered any changes should be implemented through licence conditions but was neutral regarding whether this should be initiated by the CMA (ie an order) or by Ofgem (ie a recommendation).[151]

100. Regarding publication EDF Energy's view was that care should be taken to ensure that the presentation remained clear and concise. It was also important to consider the appropriate balance between transparency (ie publication) and commercial confidentiality and any potential impact on competition, including to facilitate tacit coordination.[152]

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[146] EDF Energy response to Remedies Notice, paragraph 14.12.
[147] EDF Energy response to Remedies Notice, paragraph 14.16 & 14.17.
[148] EDF Energy response to Remedies Notice, paragraph 14.16 & 14.17.
[149] EDF Energy response to Remedies Notice, paragraph 14.19.
[150] EDF Energy response to Remedies Notice, paragraph 14.20.
[151] EDF Energy response to Remedies Notice, paragraph 14.21.
[152] EDF Energy response to Remedies Notice, paragraph 14.22 & 14.14.

Regulators (Ofgem)

101. Ofgem told us that it saw improving financial transparency as an important objective. It had itself done a lot of work to understand cost drivers and profits both through its SMI and the segmental statements (CSS).[153]

102. Ofgem explained to us that it had sought to level the playing field in terms of the requirements for segmental financial reporting of GB activities between the Six Large Energy Firms which were UK-quoted and those that weren't. Ofgem had been pressed by the Energy and Climate Change Select Committee in particular to go much further than this, largely because it suspected that there was a black hole into which the money was going and that consumers were being overcharged as a result. Ofgem had not accepted this argument at the time.

103. Ofgem was not sure whether reporting on market lines would be appropriate given that it did not price regulate either generators or suppliers.[154] Ofgem saw some value in the firm reporting their activities in line with the way they ran their business, not least because to do otherwise might impose constraints on their structure. It also believed that the statements should reflect the cost of wholesale energy based on each firm's sourcing decisions.[155]

104. Ofgem was also unsure whether there was an issue with the Six Large Energy Firms' transfer pricing given that it had commissioned three independent reviews by accountancy firms to improve the transparency and comparability of the segmental statements, the most recent of which (by BDO in 2014) was on transfer pricing and had found that the Six Large Energy Firms had used the arm's length standard.[156]

105. Ofgem pointed to the reporting principles it had developed for the distribution and transmission businesses that it price regulated as possibly relevant to regulatory financial information in the energy sector.[157]

106. Ofgem saw value in having balance sheet information for retail supply only if it could replicate the granularity it mandated for the profit and loss account ie split by gas and electricity and domestic/non-domestic.[158] Naturally any

[153] Ofgem response to Remedies Notice, remedy 14, paragraph 1.1.
[154] Ofgem response to Remedies Notice, remedy 14, paragraph 1.6.
[155] Ofgem response to Remedies Notice, paragraph 109 a).
[156] Ofgem response to Remedies Notice, paragraph 1.3.
[157] Ofgem response to Remedies Notice, paragraph 109 b).
[158] Ofgem response to Remedies Notice, paragraph 109 c).

balance sheet information provided should be audited in line with the current requirements for the profit and loss account in order to increase confidence.[159]

107. Ofgem believed that if our concern was the transparency of the vertically integrated players then the reporting requirements should focus on them, at least for the time being.[160]

108. Ofgem felt that the firms affected would be best able to comment on the additional costs but noted that there might be additional costs for it, for example in employing a team of accountants to implement and monitor the obligation.[161]

109. Ofgem told us that it had considered whether the activities undertaken by the Six Large Energy Firms in their role as intermediaries between buyers of commodities (eg retail suppliers) and sellers (eg generators) ought also to be reported in its own right by the Six Large Energy Firms. This activity fell into the trading market, in relation to which, unlike for generation and retail supply, it did not have general powers to compel the production of information for regulatory purposes.[162]

110. Ofgem explained that this intermediary activity, although relating to the trading of commodities (to be) produced by generators or upstream gas producers in GB or delivered to customers in GB, might be transacted and then reported on outside the UK depending on where firms had chosen to locate their trading function. In addition, some of the Six Large Energy Firms might have difficulty isolating this type of (intermediary) trading activity from any proprietary trading activity they undertook on their own account.[163]

111. Ofgem advised us that were we minded to require Six Large Energy Firms to report intermediary trading activities, our legal powers[164] would be more effective in achieving this outcome than its own.[165] Therefore an order on our part rather than a recommendation to it might be the appropriate implementation mechanism.[166]

112. Ofgem noted that many stakeholders were dissatisfied with the financial information currently published and that more information might help hold the

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[159] Ofgem response to Remedies Notice, paragraph 109 d).
[160] Ofgem response to Remedies Notice, paragraph 109 e).
[161] Ofgem response to Remedies Notice, paragraph 109 f).
[162] Ofgem response to Remedies Notice, remedy 14 paragraph 1.5.
[163] Ofgem response to Remedies Notice, remedy 14 paragraph 1.5.
[164] For example, under part 4 of the Enterprise Act 2002 the CMA can make orders or accept binding undertakings on non-licensed entities, eg another subsidiary or the parent company of the corporate group. A licence can only require the licence holder to do something.
[165] Ofgem response to Remedies Notice, remedy 14 paragraph 1.5.
[166] Ofgem response to Remedies Notice, paragraph 109 g).

industry to account. Ofgem, however, was keenly aware of the tension between ever more publication and the impact further disclosure might have on firms' ability and incentive to compete vigorously with one another.[167]

Other retail suppliers

Ovo Energy[168]

113. Ovo Energy advised that we use the current reporting framework as our starting point and that there would be merit in extending the scope of retail reporting to cover all domestic suppliers with excess of 250,000 accounts. It itself had voluntarily produced and published a profit and loss account for its (supply) business modelled on the existing requirements.

114. Ovo Energy saw value in independent retail suppliers being able to demonstrate to Ofgem, their customers and investors, that their businesses were better managed than the Six Large Energy Firms in terms of the level of their indirect costs. Ofgem would also gain insight from comparing the margins of the independent retail supplier margins with the Six Large Energy Firms.

115. Ovo Energy also advocated that suppliers should report their domestic customer numbers on each of their tariff types on a quarterly basis.

Utility Warehouse[169]

116. Utility Warehouse pointed out that the original justification of the current reporting obligations was grounded in the hypothesis that vertical integration was leading to negative consequences for retail customers. As we had provisionally concluded that no competitive harm arose from vertical integration, Utility Warehouse argued that the reasons for these obligations had now disappeared.

117. As a multi-service utility provider Utility Warehouse would have real problems in reporting its performance in retail supply on a stand-alone basis given that it had completely integrated many of its business functions across its energy, mobile and phone & broadband services. New entrants with innovative business models would also likely face similar cost allocation issues to isolate their performance in retail supply.

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[167] Ofgem response to Remedies Notice, paragraph 109 h).
[168] Ovo Energy response to Remedies Notice, remedy 14.
[169] Utility Warehouse response to Remedies Notice, remedy 14, p15.

118. Utility Warehouse argued that there would be very little value in extending the reporting obligations to suppliers like it. The (non-financial) reporting burden on all retail suppliers was already bordering excessive and any additional costs placed on smaller retail suppliers would make it more difficult for them to provide good value to their customers.

***First Utility*[170]**

119. First Utility told us that it had not focused on this possible remedy at this point in time but reserved the right to do so later.

***Ecotricity*[171]**

120. Ecotricity told us that we should prioritise improving the transparency of cross-border wholesale energy transfer charges. It was concerned that our proposal to mandate the use of standard wholesale traded products for transfer charging purposes would not achieve this aim as, in its view, internal trades would not be captured. Ecotricity pointed out that under REMIT, the EU regulation on energy market integrity and transparency, firms were already required to report all (external) gas and electricity trades to the Agency for the Cooperation of Energy (ACER) as standard wholesale products even if the trade had been structured on a bespoke basis.

121. Ecotricity urged us to maximise comparability across the Six Large Energy Firms through standardising what is reported, particularly in relation to wholesale energy. It acknowledged that flexibility might be required for certain contracts.

122. Ecotricity thought that reporting obligations should apply to the Six Large Energy Firms alone. It justified this through a combination of these firms' market dominance, their vertical integration and their operation across multiple jurisdictions. Little could be gained from extending the requirements to smaller market participants.

123. Ecotricity advocated that we should implement this remedy by way of recommendation to Ofgem so that it could go through its normal consultation process.

[170] First Utility response to Remedies Notice, remedy 14, p52.
[171] Ecotricity response to Remedies Notice, remedy 14.

The Co-operative Energy

124. The Co-operative Energy pointed out that the reporting requirements under REMIT paralleled the requirements to report on a market basis. It believed that the reporting systems of the Six Large Energy Firms should already be capable of reporting on a market basis.[172]

125. The Co-operative Energy advocated that, in the interests of clarity and transparency, all Six Large Energy Firms should report to the same year end.[173]

126. The Co-operative Energy put forward two suggestions for us to consider, firstly the use of a single audit firm to ensure consistency in audit approach across the Six Large Energy Firms and secondly that guidance might be issued regarding the conduct of the audit.

127. The Co-operative Energy believed that this remedy should be implemented by way of a change to licence obligations and that the information produced under it should be published.

Haven Power

128. Haven Power, a subsidiary of Drax (an independent generator) which specialises in providing power to business customers, doubted whether retail suppliers would be able to satisfactorily separately identify the financial performance of SMEs beyond the level of gross margins.[174]

Gazprom

129. Gazprom had no comments to make on this possible remedy beyond pointing out that smaller challenger retail suppliers like itself should not be burdened with such a reporting requirement.[175]

Good Energy

130. Good Energy highlighted the use in the media of Six Large Energy Firm financial performance to proxy that of the industry as a whole. If all suppliers were also required to report, then Ofgem would be able to compare and

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[172] Co-operative Energy response to Remedies Notice, remedy 14, p24, a) and f).
[173] Co-operative Energy response to Remedies Notice, remedy 14, p24, b).
[174] Haven Power response to Remedies Notice, remedy 14.
[175] Gazprom response to Remedies Notice, remedy 14.

contrast the profit margins of the Six Large Energy Firms with the independent retail suppliers.[176]

Generators

Drax[177]

131. Drax, which owns both a generation and a retail supply business (Haven Power), pointed out that in its group accounts it already separately reported the financial performance (profit and loss account only) of these two businesses in line with international accounting standards and well-established arm's length transfer pricing rules. This allowed its competitors, both current and potential, as well as commentators, Ofgem and other stakeholders as well as its own investors, to assess the profits of its electricity generation and retail supply business separately.

132. Drax observed that, unlike all of its Six Large Energy Firm competitors, its retail supply business did not have any inactive legacy customers. Instead it had won all these customers on its own merits. Therefore, it saw no justification for extending the reporting obligation to itself.

133. Drax also pointed out that any regulatory reporting obligations on it could lead to differences between its group and regulatory accounts. This might well cause confusion for some users. Drax would then need to devote resources explaining these differences.

Engie

134. Engie (formerly GDF SUEZ) advocated the standardisation of the reporting for firms subject to the reporting obligation but noted that a regulatory reporting requirement should not drive how firms organise themselves internally.[178] The obligation should remain focused on the Six Large Energy Firms, not least because for smaller businesses this would duplicate the financial information they would report externally anyway.[179]

135. Engie suggested that we implement the remedy by way of recommendation to Ofgem, which could then draft the necessary licence changes. If the rationale

[176] Good Energy response to Remedies Notice, remedy 14, p10.
[177] Drax response to Remedies Notice, remedy 14.
[178] Engie response to Remedies Notice, remedy 14, p13.
[179] Engie response to Remedies Notice, remedy 14, p14.

of the remedy was to improve transparency, then the information should be published in line with the current (CSS) practice.[180]

Eggborough Power

136. Eggborough Power agreed that we should make improvements to standardise the segmental reporting for the larger vertically integrated business to improve transparency in the wholesale and retail markets.[181]

ESB

137. ESB, an Irish utility also operating in the GB generation market, supported a more transparent and consistent regime for financial reporting, which should ensure a clear separation between the various segments of a business. It believed that it should only apply to the Six Large Energy Firms given the relevant provisional findings (lack of clear and relevant information ultimately leading to an AEC) and our articulated aim for the remedy (improving robustness and transparency of regulatory decision making).[182]

Consumer advocates

Citizens Advice

138. Citizens Advice thought that we had identified a major deficiency in current reporting where financial information was segmented on internal divisional lines rather than based on the way stand-alone generators and retail suppliers (‘notional market actors’) would buy and sell in the marketplace. It supported our proposed approach to resolve this issue.[183]

139. Citizens Advice, however, was unclear whether this meant that the Six Large Energy Firms’ transfer pricing policies could now be considered ‘fit for purpose and transparent’ as BDO, the accounting firm that Ofgem had commissioned to conduct a review, had concluded. In its review BDO had used the OECD transfer pricing guidelines as the relevant benchmark. These guidelines governed transfer pricing between different legal entities, rather than between notional market actors.[184]

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[180] Engie response to Remedies Notice, remedy 14, p14.
[181] Eggborough response to Remedies Notice, remedy 14, p5.
[182] ESB views on specific remedies, Accounting Framework for energy generators and retail suppliers. ESB response to provisional findings and Remedies Notice.
[183] Citizens Advice response to Remedies Notice, remedy 14, 14a).
[184] Citizens Advice response to Remedies Notice, remedy 14, 14a).

140. Citizens Advice saw no reason for changing the coverage of the existing reporting obligation. The debate about the profitability and energy prices was closely linked to the extent which the Six Large Energy Firms used their incumbency in retail markets and vertical integration to their advantage.[185]

141. Citizens Advice believed that the Six Large Energy Firms should continue to be required to report financial information on a reasonably granular basis. Citizens Advice emphasised the importance of consumers being able to understand what was driving the make-up of their bills, foremost environmental and social policy costs as well as network costs. Any reduction in the granularity of publication here would lead to a less informed public debate.[186]

142. Given the low level of trust in the Six Large Energy Firms, Citizens Advice advocated that all the financial information should be audited in line with the trend to more extensive external verification. Ofgem had recently enhanced the level of independent scrutiny of the existing financial reporting in response to previous calls from stakeholders.[187]

143. Furthermore Citizens Advice advocated that there should be a presumption towards full publication of the financial information to be produced under the obligation. It pointed out that this market investigation had been prompted in large part by a breakdown in trust in the energy sector and a lack of confidence by the public that the prices they pay were fair. Resolving this issue would need to involve communicating where firms were making their money.[188]

144. In relation to environmental and social policy costs, Citizens Advice advocated that there should be sufficient granularity in publication to allow analysts such as Policy Exchange to be able to investigate the linkage to customer bills.[189]

145. Citizens Advice pointed out that we should not focus exclusively on ex post financial reporting as this approach inevitably looked backwards with the information published sometime after. Citizens Advice told us that there also needed to be a current analysis/forward looking projection of the costs of supply, which would help consumers understand the drivers between a contemporaneous price rise or price cut. This had been provided by Ofgem’s SMI but which was currently suspended. In the view of Citizens Advice the SMI had provided insight about the direction of energy bills and had

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[185] Citizens Advice response to Remedies Notice, remedy 14, 14e).
[186] Citizens Advice response to Remedies Notice, remedy 14, 14c).
[187] Citizens Advice response to Remedies Notice, remedy 14, 14d).
[188] Citizens Advice response to Remedies Notice, remedy 14, 14h).
[189] Citizens Advice response to Remedies Notice, remedy 14, 14h).

incentivised retail suppliers to try and better justify their pricing decisions. Citizens Advice would be concerned if this suspension became protracted or was replaced with a less detailed or less frequently produced product.[190]

146. Citizens Advice pointed to two potential interactions with other remedies we had put forward in the Remedies Notice. Regarding the 'cost plus approach' to a safeguard transitional price cap for certain domestic and microbusiness customers (remedy 11), there would be a need for close to real-time financial performance information, possibly monthly and no less than quarterly. Otherwise there would be a real risk of a price cap being locked in to an unreasonably high or low level for too long.[191]

147. The other remedy Citizens Advice highlighted was remedy 15 regarding the trade-offs between policy objectives and communication of the impact of policies on prices and bills. A new independent body or an existing body through an expansion of its role would need access to the financial information collected under this remedy.[192]

Which?

148. Which? welcomed the financial reporting remedy as outlined if it could deliver greater transparency of the profitability across energy suppliers. However, it thought that we should ensure that the cost to firms of implementing the remedy would not be significant, otherwise the measure would have a negative impact on consumers' bills.[193]

National Energy Action

149. National Energy Action told us it was important that Ofgem and therefore customers had confidence in the Six Large Energy Firms' financial reporting but it had no comment on the precise way it should be done.[194]

Academics

Energy Policy Group

150. Energy Policy Group, the Energy Policy Group at the University of Exeter which provides an academic hub for the interdisciplinary study of energy policy, told us that it strongly supported this remedy but that it did not have the

[190] Citizens Advice response to Remedies Notice, remedy 14, 14h).
[191] Citizens Advice response to Remedies Notice, remedy 14, 14h).
[192] Citizens Advice response to Remedies Notice, remedy 14, 14h).
[193] Which? response to provisional findings/response to Remedies Notice, p8.
[194] National Energy Action response to provisional findings/response to Remedies Notice, p11.

expertise to make detailed suggestions to us. Energy Policy Group felt that it should be possible for both other interested stakeholders like itself and Ofgem to keep track of the profits of the energy firms in all areas of their business.[195]

[195] Energy Policy Group response to provisional findings/response to Remedies Notice, paragraph 53.