REVIEWS OF PUBLIC ELECTRICITY SUPPLIERS 1998 to 2000

REGULATORY ACCOUNTS CONSULTATION PAPER

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FOREWORD

In February 1998, I published a consultation paper, "Reviews of Public Electricity Suppliers 1998 to 2000". This outlined issues that will need to be considered as part of the programme of work and reviews envisaged for the 14 public electricity suppliers (PESs) over the next two years. The programme of work has the following eight main components, which have significant inter-relationships between them:

- distribution price control;
- quality of supply standards;
- competition in supply;
- separation of activities;
- metering and meter reading;
- regulatory accounts;
- prepayment meter customers; and
- Scotland.

In May, I issued a consultation paper on the separation of PES businesses. This set out my initial thinking on future arrangements for separating the present PES activities of distribution, metering and meter reading, and supply; and in Scotland, transmission. In July I issued a further consultation paper that set out my proposed approach to price controls and competition.

The present consultation paper deals with regulatory accounting requirements for all licensees in the electricity industry. It reflects the views of respondents to the February consultation paper as well as relevant proposals arising from the Government's Review of Utility Regulation, and the EU Directive on the internal market in electricity. It takes account of discussions which OFFER has had with various interested bodies including the Accounting Standards Board and the Centre for the Study of Regulated Industries, though the proposals it contains are OFFER's alone. Its purpose is to seek views on framing future regulatory accounting arrangements in the electricity industry. I expect to issue detailed proposals on regulatory accounting matters in the first part of 1999 following the results of this consultation.

I should like to hear from all those with an interest in regulatory accounts, including customers, their representatives and other interested groups as well as the companies themselves. Views are invited by 18 December 1998 and should be sent to:

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Responses will be published by placing them in the OFFER Library.

PROFESSOR S C LITTLECHILD
Director General of Electricity Supply

October 1998

1 INTRODUCTION

1.1 Electricity licensees are required to produce financial and operating information to meet a variety of external requirements. For example, as incorporated companies they are all required to produce and file annual statutory accounts. These are required to show a true and fair view of both the state of affairs of the company and of its profit or loss for the financial year. Further information is included as required by statute or applicable accounting standards. Most of the information relates to the company as a whole, although there may be statutory and accounting requirements for disclosure of segmental information in respect of different classes of business and geographical markets.

1.2 Under the terms of electricity generation, transmission and supply licences, the Director General of Electricity Supply (DGES) has the power to call for any information he requires from electricity licensees for the purpose of carrying out his duties. Many of the licences also contain specific provisions concerning the production of annual regulatory accounts for DGES, which show the results of the separate electricity businesses (supply, distribution, etc) within the ownership interest of the licensee. The licences also prohibit cross-subsidy between the separate businesses. These separate accounts for the separate electricity businesses, and certain accompanying information, are commonly known as "regulatory accounts". The licence conditions relating to regulatory accounts are set out in more detail in the next Chapter.

1.3 The present paper invites views on whether regulatory accounting arrangements in the electricity industry should be changed, for example, as regards the businesses for which regulatory accounts are required, the form of these accounts and of the information that might accompany them, and the extent of publication. The DGES will need to consider these matters against the background of his statutory duties. These include duties to exercise his functions so as to promote competition, to secure that licence holders are able to finance the carrying on of their licensed activities, and to protect the interests of consumers with respect to prices.

1.4 The paper deals with the issues as follows:

- Chapter 2 describes the present regulatory accounting arrangements in the electricity industry and which electricity licensees they apply to;

- Chapter 3 considers relevant developments in the industry and in Government and regulatory policy since Vesting, and the arguments that have been advanced for changing the regulatory accounting arrangements;

- Chapter 4 discusses possible changes to present arrangements, including which licensees should be required to prepare regulatory accounts and for which businesses; possible additional information requirements which

might improve transparency and make the accounts more useful; and what information should be published;

- Chapter 5 considers options for the treatment of cost attribution and for charging between businesses;

- Chapter 6 examines alternatives to the present current cost accounting (CCA) basis used for regulatory accounts, including the use of historical cost accounting (HCA), and how the regulatory accounts might suitably include information concerning the basis on which price controls are set;

- Chapter 7 describes the requirements relating to separate accounts for separate businesses in the EU Directive on the internal market in electricity and how these might be applied to electricity licensees;

- Annex 1 sets out views on regulatory accounts made by respondents to OFFER's February 1998 consultation paper, including a summary of a report on regulatory accounts which the Electricity Consumers' Committees' Chairmen's Group commissioned from the Centre for the Study of Regulated Industries;

- Annex 2 sets out extracts from two recent reports of the MMC which refer to regulatory accounting matters;

- Annex 3 summarises regulatory accounting practice in the water, telecommunications, gas and railway industries;

- Annex 4 contains the present format for a typical set of regulatory accounts in the electricity industry.

2 PRESENT REGULATORY ACCOUNTING ARRANGEMENTS

Separate Businesses

2.1 Table 1 below shows the electricity licensees currently required to prepare regulatory accounts and the separate businesses applicable to each.

COMPANIES	BUSINESSES
Regional Electricity Companies	Supply Second Tier Supply Distribution Generation
ScottishPower, Scottish Hydro-Electric	Transmission Generation Distribution Supply Second Tier Supply Wholesaling
National Power, PowerGen and First Hydro	Generation Second Tier Supply
Nuclear Electric, Scottish Nuclear, Magnox Electric	Nuclear Generation Non Nuclear Generation Second Tier Supply
National Grid Company	Transmission Settlements Interconnectors Ancillary Services

Licence Requirements

2.2 The separate accounting requirements are essentially the same for all licensees. The main provisions are:

- the accounting year must run from 1 April to 31 March. (For some licensees, this has been amended to permit a different accounting year for statutory purposes. In such cases the licensee must continue to produce regulatory accounts for the accounting year to 31 March and consolidated accounts for the same period having the same form and content as statutory accounts);

- the licensee must keep separate accounting records for each separate business, in the form that would be required by the Companies Act 1985 if the separate businesses were separate companies[1];

- the licensee must prepare for each separate business annual accounts comprising profit and loss, balance sheet and cash-flow statements, and statements of charges from other businesses and of amounts allocated or apportioned between businesses, together with a description of the basis of allocation and apportionment;

- the licensee must prepare interim profit and loss statements for the first six months of each accounting year;

- the separate accounts must be audited;

- they must be submitted in full to the DGES;

- the licensee must not change bases of charging or apportionment or allocation without the consent of DGES;

- separate business accounting statements must conform to best commercial accounting practices, and state the accounting policies adopted;

- the licensee must publish the separate business accounts with its annual accounts, except for the statements of amounts charged, allocated or apportioned between businesses, and the statement of the bases of charges and apportionment and allocation, and except for the accounts for the second tier supply business and the wholesale business in Scotland, which need only be made available to DGES;

- the accounts must be prepared on a CCA basis, or if they are not, they must be accompanied by additional CCA accounting statements.

2.3 These requirements were supplemented by a paper from OFFER in September 1991 on the format for the regulatory accounts to be submitted to the regulator. The main points were:

- a single accounting entity referred to as group capital employed[2] should be created for items such as financing, deferred tax and dividend

[1] The Companies Act 1985 (as amended by the Companies Act 1989) requires every company or group to prepare a balance sheet and profit and loss account giving a true and fair view respectively of the state of affairs of the company (or group) at the end of the financial year and of the profit or loss of the company (or group) for that financial year. This requirement is generally understood to require also compliance with UK accounting standards [which inter alia call for the presentation of a cash flow statement for the financial year].
[2] "Group" here means the company of which the various separate businesses are part.

liabilities, which are not specifically identifiable to the separate businesses;

- the profit and loss account for each separate business will only be taken to the level of operating profit;

- the separate business accounts should be reconciled to group statements; and

- notes to the accounts need not be duplicated and certain items required under the Companies Act are omitted.

2.4 Guidance on the auditors' responsibilities and duties in relation to regulatory accounts was issued by OFFER in July 1991. This laid out OFFER's requirements as to the audit work that should be carried out, and the form of the auditor's opinion, which makes it clear that the auditors are responsible for reporting to the DGES that the accounts for each separate business are properly prepared and give a true and fair view. The guidance specifies that auditors were expected to conduct their audit so that they can identify and report material cross-subsidy from one business to another; test to ensure completeness of the separate business accounts; review the accounting policies used to determine that the amounts apportioned or allocated between the separate businesses are reasonable and do not give rise to cross-subsidy; and review the amounts charged from one business to another to ensure that they are fair and do not give rise to cross-subsidy.

2.5 For the RECs in England and Wales guidelines known as CSC.194 and 195 were put in place prior at Vesting. (There are no equivalent formal guidelines in Scotland.) With one minor change, they remain applicable. They outline the methods to be used for allocation of shared costs and assets in the regulatory accounts. Chapter 5 contains a fuller description of the guidelines. As noted above, consent of the DGES is required if licensees wish to alter the basis on which any charges and allocations are carried out for the purposes of the regulatory accounts.

2.6 In 1995, OFFER agreed with PESs and generators that they would provide additional information to show how the results of any CHP schemes in which they have an interest are divided between the generation, supply and other businesses.

2.7 Annex 4 contains the format of a typical set of regulatory accounts and shows which parts are published, which parts are unpublished but required by the licence and which parts are not specifically required by the licence but are disclosed to OFFER in accordance with the September 1991 paper.

3 DEVELOPMENTS SINCE VESTING AND THE ARGUMENTS FOR CHANGE

3.1 This Chapter considers arguments for changes in the regulatory accounts requirements described in the previous Chapter. It is relevant to consider these against the background of changes in the industry since Vesting, and of developments in Government and regulatory policy.

Changes in the Industry

3.2 Since Vesting, there have been important changes in the way that many electricity licensees organise and manage their businesses. There is greater diversity in management structures of electricity companies today than there was at Vesting. The main implications of these changes for regulatory accounts concern the relationships between different electricity businesses, and between these businesses and affiliated companies to which the electricity businesses contract an increasing range of services. This is discussed more fully in Chapter 5. Since Vesting, electricity companies have changed the basis of their statutory accounts from CCA to HCA, bringing them into line with general practice in other industries. The implications of this change for regulatory accounts are discussed in Chapter 6.

3.3 There have also been significant changes in ownership. Take-overs of electricity companies have led to a reduction in publicly available financial information about them. Chapter 4 discusses some possible ways of remedying this. Take-overs have in many cases also led to changes in financial structure, typically through the creation of holding companies with high levels of gearing (which implies a requirement for high levels of dividends from the acquired company), or through increased gearing of the acquired electricity company. This has led to concern about the ability of electricity licensees to continue to finance their activities. The DGES has put in place amendments to the licences of PESs which have been taken over to protect customers, by ring-fencing the resources of the PES. These amendments, among other things, restrict the activities in which the PES may engage, and prevent it from dealing with affiliates other than at arms length and on a normal commercial basis. Chapter 5 discusses the accounting treatment of transactions between businesses and affiliates.

3.4 A third important change has been the development of competition in generation and supply. As regards the PESs, this had led OFFER to re-assess which activities should be regarded as part of the competitive supply business, and which should be part of the distribution business, as well as to make proposals for greater separation between these businesses. This has important implications for the existing guidelines relating to the attribution and allocation of costs between businesses, which are considered further in Chapter 5.

Government Review of Utility Regulation

3.5 The Government has recently completed a Review of Utility Regulation. On regulatory accounting matters, the Government concluded that regulators should use their existing powers to require price-regulated companies in each sector to publish regulatory accounts and other financial information in a more standardised format which facilitates customer understanding and benchmark comparisons. The Government also concluded that there was no compelling case for a standardised regulatory accounts format covering all sectors. However, they urged regulators to align the bases of regulatory reporting with formal accounting standards wherever possible, provided this did not conflict with the regulatory framework and regulatory objectives set for the individual sectors. They asked that regulators should work closely together to ensure that they achieve a broad measure of consistency in financial reporting in order to regulate multi-utility groups effectively. They suggested that there might be merit in developing formal accounting standards for the utilities sector in discussion with the Accounting Standards Board and other professional bodies.

3.6 The Government's review also laid emphasis on the need for regulators to be free to publish information. It said that the Government intended that records and information on the utility companies held by the regulators might be published at the latter's discretion, where it was in the interests of consumers and potential consumers. Such publication would be subject to tests relating to substantial harm and public interest in line with the principles set out in the Freedom of Information White Paper.

3.7 The Government also confirmed that it intended to align and integrate the gas and electricity regulatory regimes. It said that it would introduce legislation to provide for the separate licensing of electricity supply and distribution (which are at present covered by a single PES licence). It will be necessary to decide what provisions these new licences should contain as regards regulatory accounts.

Developments in Regulatory Policy

3.8 OFFER has made proposals for the full separation of the organisation and management of distribution and supply, in order to facilitate regulation and promote competition by minimising the scope for cross-subsidy, discrimination and anti-competitive flows of information. The extent of separation of distribution and supply will have implications for the separate accounts for these businesses.

3.9 OFFER has also proposed the separation of metering from distribution, and in a recent consultation paper has raised the possibility of a separate price control on PES metering services. It is therefore necessary to consider whether to require separate accounts for metering.

3.10 OFFER has proposed to Government that the legislation to provide for separate supply and distribution licensing should also end the present distinction between first and second tier supply. This has implications for regulatory accounting arrangements, which at present require PESs to prepare separate regulatory accounts for each of their first and second tier supply businesses.

3.11 Separate licensing of supply and distribution would make it possible for these two businesses to be held in separate companies, either in common ownership or in different ownership. This is not possible at present. This development would make possible take-overs or mergers involving one of these businesses, but not the other. It would be for consideration, following any such mergers, whether the regulatory accounts of the businesses concerned should also be merged, or should remain separate.

3.12 In July 1998, OFFER published the conclusions of the Review of Electricity Trading Arrangements in England and Wales. These propose substantial changes in present arrangements, including for the System Operator whose functions are presently carried out by NGC. Consideration will need to be given to possible financial reporting requirements, including the preparation of regulatory accounts, for the system operator, and possibly for other participants in the new arrangements.

Arguments for Change

3.13 The present regulatory accounting requirements for electricity were set up at Vesting. In the light of eight years' experience it is appropriate to review how well the accounting requirements are meeting their purposes. It may also be an appropriate time to review regulatory accounting requirements so that any new arrangements established following this review, can take effect in the year 2000 at the same time as new price controls.

3.14 Responses to the February consultation paper, as set out in Annex 1, indicate some areas where regulatory accounts might be made more useful. Recent reports by CRI[3] and the Consumers' Association[4] make further comment from a consumer's perspective. Proposals in the Government's review of utility regulation are noted above. Account also needs to be taken of observations in certain recent MMC statements (see Annex 2). These comments and reports, together with OFFER's own experience, suggest that the present arrangements have the following main shortcomings:

- it is not clear how the information in regulatory accounts of price-controlled businesses relates to the assumptions made by OFFER in

[3] Research Report 9 *Accounting Requirements for Regulated Industries* by M Board, P Boulding, C Hicks and P Vass, Centre for the Study of Regulated Industries, published by CIPFA, London, May 1998
[4] Policy Report *Utilities in transition - a consumer perspective* by the Consumers' Association, 1997

setting the prevailing price control, and what relevance it has to future price control reviews;

- the accounts lack detailed information, for example, on costs, and narrative explanation helpful for a proper understanding;

- present requirements relating to cost attribution and charging between businesses may not deal adequately with the consequences of changes in the industry, and may be incompatible with OFFER's proposals for separation of PES activities in order to promote supply competition. It has been argued that more guidance is needed in these areas, comparable to that issued by OFWAT for the water industry;

- there is a lack of clarity in the published regulatory accounts about how they relate to the statutory accounts;

- important information necessary for the understanding of the accounts, including information about bases of allocation and about transactions with affiliates, are provided to DGES but not published;

- each licensee was originally separately listed and, aside from regulatory requirements, was required to publish full financial statements complying with Stock Exchange requirements. This provided a significant level of explanatory detail accompanying the bare financial results. With 11 of the 14 PESs now taken over, such additional detail is generally no longer published;

- the current cost basis of accounting may not in practice be the most useful basis for information on the performance of the separate businesses; and

- there may be scope for changes which make it easier to compare the results of different electricity businesses, and which bring regulatory accounting requirements for electricity more into line with those of other regulated industries, or with accounting standards more generally.

Comments Invited

3.15 The rest of this paper considers possible changes which might meet these shortcomings, discusses their possible advantages and disadvantages, and seeks comments on them.

3.16 Comments are invited on the general arguments for change in regulatory accounting requirements for the electricity industry set out in this Chapter.

4 POSSIBLE CHANGES TO PRESENT ARRANGEMENTS

Purpose of Regulatory Accounts

4.1 In order to consider which businesses should in future prepare regulatory accounts, and whether changes should be made to the forms and content of the accounts, it is relevant to discuss the main purposes which regulatory accounts are intended to serve.

4.2 A major part of the revenue of some of the separate businesses, such as distribution, is subject to price control, reflecting the absence of a competitive market to determine prices. Regulatory accounts are part of the information which tracks the performance of price controlled businesses. Apart from the Regulator, a range of other parties including customers may wish to be able to monitor the companies' performance, for example to identify issues for consideration at the next price control review. Of potential interest to them and the Regulator are matters such as operational and capital expenditure, profits, return on assets and cash flow. These need to be presented in terms which can be related back to the bases on which the price control was set. This sort of information has been published by OFFER in the consultation papers and proposals which are part of the price control review process. Nonetheless, there is advantage in being able to track the performance of price controlled businesses on a continuing basis during a price control period through information in the regulatory accounts. An important issue is the level of detail on these and other matters to be included in the published regulatory accounts. This is discussed in paragraphs 4.13 to 4.26 below.

4.3 The regulator is concerned to enforce licence prohibitions on cross-subsidy between businesses, discrimination and anti-competitive behaviour. The requirement in many electricity licences to maintain separate accounting records for the individual businesses, and to prepare and publish regulatory accounts, is intended in part to assist in enforcement of these prohibitions. OFFER's guidance to auditors (July 1991) makes it clear that an important purpose of the audit is to ensure that the regulatory accounts do not give rise to cross-subsidy between businesses. The pre-amble to EU Directive 96/92/EC, which is discussed in Chapter 7, says that the provisions of the Directive that relate to regulatory accounts are intended to provide for maximum transparency, in particular to identify possible abuses of a dominant position, consisting for example, in abnormally high or low tariffs or in discriminatory practices relating to equivalent transactions.

4.4 Regulatory accounts are unlikely to be sufficient for the purpose of investigating an allegation of cross-subsidy or discrimination. This will require not only information in detail on how the companies have arrived at the particular price or prices complained of, but also on wider aspects of companies' market behaviour. However, the separate financial records for separate businesses which the companies are required to maintain will provide information about the way the company has viewed its costs and revenues. This may be a useful starting point for

further investigation, particularly if the regulatory accounts make clear the principles on which, for example, costs common to more than one business or activity have been allocated between them.

4.5 The DGES has a duty to exercise his functions in a manner to secure that licensees can finance their authorised activities. An important source of information on the ability of electricity companies to finance their activities is their statutory accounts. In addition, OFFER has put in place conditions in the licences of PESs that have been taken over requiring Directors to submit annual certifications of the availability (or otherwise) of adequate financial resources to the licensee as a whole for the following twelve-month period.

4.6 Regulatory accounts can usefully supplement the information in the statutory accounts. For example, information relating to the source and application of financial resources consumed during the year by the separate business will make it clear the extent to which individual businesses generate or consume cash. This may be an important factor for the regulator in considering new price controls or other action.

For which Businesses should Regulatory Accounts be Required?

4.7 Chapter 2 explained which licensees are at present required to keep separate financial records and prepare regulatory accounts, and for which separate businesses. The requirement is placed on licensees who succeeded the former nationalised undertakings at Vesting (and in a few cases, such as British Energy, Magnox Electric and First Hydro, on the successors to these licensees), in respect of all the electricity businesses in which they engage. New entrants in generation and supply are not required to keep separate financial records or prepare regulatory accounts for their electricity businesses.

4.8 Most of the substance of the concept of a "separate business" lies in the requirement to keep separate financial records and prepare accounts for it. Removing or reducing the present requirement on licensees would imply that the DGES no longer considers that effective regulation requires the financial separation of the activities which comprise the businesses concerned. Adding to the present requirements would imply that financial separation has now become necessary, while it has not been so in the past.

4.9 The earlier discussion in this Chapter suggested that regulatory accounts serve a number of purposes including enabling tracking of the performance of price-controlled businesses, assisting the enforcement of the prohibition on cross-subsidy between businesses, and assisting the regulator to assess the ability of licensees to finance their different licensed activities. These purposes remain relevant to all or nearly all the licensees who are at present required to prepare regulatory accounts for their separate businesses. For example, regulatory accounts will continue to be

required for transmission and distribution in order to facilitate tracking of the effects of price controls. PES supply businesses are likely to continue to enjoy a significant market power in their own areas for some time and continuing supply price restraints may be needed for some customer groups. There are, in addition, concerns about the possibility for abuse including cross-subsidy arising from the present close association of PES distribution and supply businesses; and also about market power in generation and the consequences of vertical integration between generation and supply; and about the vertical integration of generation, transmission, distribution and supply in Scotland and the limited development of competition in generation and supply in Scotland compared to England and Wales. Continuing take-overs and mergers in the electricity industry may produce new issues relating to competition, regulatory effectiveness and the financial stability of licensees.

4.10 As regards the possible need to extend regulatory accounting requirements to other licensees, it is relevant that new generators (that is, generators who do not have to prepare regulatory accounts) at present hold only 16 per cent of the market in England and Wales, and that the largest of these accounts for only 4.3 per cent of the market. Furthermore, those independent generators with PES ownership interests in independent generators are consolidated in the separate accounts of the PES generation businesses. In supply, suppliers other than PESs and generators (that is, suppliers who do not have to prepare regulatory accounts) account for only 2 per cent of the market in England and Wales. It is not clear, therefore, that there is a case at present for extending the regulatory accounting requirements to new entrants in generation or supply. It would, however, be appropriate for DGES to keep this under review in the light of developments in the regulation of the industry, competition and industry structure.

4.11 It is for consideration whether a number of detailed changes might be made. These include:

- whether there continues to be a case for requiring separate accounts for the nuclear and non-nuclear generating businesses of British Energy and Magnox Electric; and for separate accounts for First Hydro (who inherited the requirement from NGC through purchase of the pumped storage business);

- whether the requirement on the Scottish companies to account separately for their wholesaling businesses adds to transparency in relations between these companies' generation and supply businesses (and if it does, whether the same considerations might apply to other companies with significant vertical integration between generation and supply);

- whether the Scottish companies should be required to prepare separate accounts for their interconnector businesses, as is NGC.

Form and Content of Regulatory Accounts

4.12 A number of possibilities discussed below could make the published regulatory accounts more informative, and increase transparency and comparability. It will be for consideration, in each case, whether the additional requirements should apply to all businesses of electricity licensees, or just to some (for example, businesses subject to price controls).

Classification of Revenues

4.13 Neither the licences nor the Directive require any breakdown of revenue within each separate business. In particular, the element that is subject to price control is not required to be disclosed. It is therefore difficult from regulatory accounting information to identify the effect of any price control on reported results. It would be useful if the profit and loss account for each separate business were to identify separately price-controlled and non price-controlled revenue, including the effect of over- and under-recoveries.

Classification of Costs

4.14 The format of regulatory accounts follows that of statutory accounts as far as possible.

4.15 Preparation of information on statutory accounts is governed by the provision of the Companies Act 1985 and 1989. Information relating to costs may be presented in the profit and loss account classified according to either the type of the purpose of the related expenditure; for example, 'raw materials', 'wages and salaries', rent and rates' etc, or alternatively, 'cost of sales', 'distribution', 'administration' etc. In either case, the data may be aggregated at the level of the reporting entity (company or group). Regardless of the format selected, certain additional disclosure is required by way of footnote, again aggregated at the level of the reporting entity. This includes payroll costs, depreciation, hire of equipment and auditor's remuneration. Statement of Standard Accounting Practice No.25 (SSAP25) requires disclosure of certain information classified according to each significant class of business and geographical segment in which the reporting entity is active. The required information in this case is attributable turnover, operating profit and net assets. The criteria for determining whether a 'class of business' is separate for the purposes of SSAP25 do not necessarily accord with the definition of a 'separate business' for the purposes of electricity licences.

4.16 For the regulatory accounts, there are presently no guidelines as to an appropriate division of costs into categories, other than statutory disclosure, either as regards the split between cost of sales and operating costs in published statements or as to appropriate cost headings. As a result there is presently some inconsistency in

classification of costs between licensees and insufficient published cost analysis to inform customers and others about the levels and trends of costs. Although the unpublished information which is given to the DGES includes an analysis of cost types, the classifications adopted so far have varied between licensees and are not generally capable of comparison between them.

4.17 With a view to bringing further transparency to the regulated accounts, it might be helpful for them to include more detailed classification of costs. In order for this to be consistent and comparable across licensees, it would be necessary to define an appropriate cost classification that reflects activities that are common across particular categories of licensees, regardless of how they are organised. Classification of costs by activity (for example, network maintenance) may be of more use, and better able to be compared between licensees, than classification of costs by type (for example, payroll), provided that these activities can be clearly defined. It would also be useful for such a classification to be in a form which would be useful in comparing actual costs with previous estimates, forecasts or assumptions (for example, for price-controlled businesses, those made in the preceding price control review).

Explanatory Narrative

4.18 The licences do not at present require explanatory narrative other than formal notes as required for statutory accounts. The lack of explanatory material makes it difficult to interpret the regulatory accounting results. Whilst the additional unpublished information provided to DGES does now incorporate some narrative, it does not form part of the published report.

4.19 It would be of assistance for narrative to accompany the regulatory accounts, including as a minimum such information as:

- a comparison of the actual results against any forecast information published by the company or any assumption made by OFFER (as part of the price control consultation process);
- a commentary on the profit and loss and cashflow in the regulatory accounts for the year, including any one-off items;
- an explanation of why turnover has changed from the previous year, including comparative data such as GWh delivered and customer numbers as compared (where appropriate) with price control assumptions, and perhaps the expected levels of each in the forthcoming year;

- the change, if any, in electricity prices, describing how the terms of the price control have been followed during the year, including the effect of any correction factor, comparing the year with the previous year;
- an explanation of any significant changes in the level of each reported category of cost and perhaps an indication of expected cost levels in the forthcoming year;
- a summary of works represented by capital expenditure, and the reasons for any significant difference between actual capital expenditure and published plans for the year and perhaps an indication of expected expenditure in future years. (Some information of this kind already appears in the annual quality of supply reports); and
- any recent or prospective changes in the organisation of the businesses.

4.20 In addition, where PESs have been taken over, they no longer publish full annual statutory and interim reports, as required for quoted companies, which include significant accompanying narrative. It might be useful to require PESs to continue to publish reports in conjunction with their statutory accounts. Among other things, these might comment on the licensee's financial position and ability to finance the business, including the dividends paid to the holding company, and any changes in financing and the level of gearing. This would increase the information available to the Regulator and others about the licensee's ability to finance its licensed activities.

Allocation Statement

4.21 The licence requires that the regulatory accounts presented to the DGES include a statement of intra-group charges, apportionments and allocations together with a statement describing the basis on which this has been prepared. The statement is not at present required to be included in the published regulatory accounts.

4.22 In practice, these statements are prepared to varying degrees of detail, both in the figures and the narrative. Greater consistency between companies might be helpful. In particular, the statements might be based on the same classification of costs as outlined above, so that there would be a clear relationship between the summary profit and loss account, a specified classification of costs, and the intra-group charges and allocations included within them.

4.23 In addition, the explanatory statements of bases are not always linked clearly to specific figures in the allocation statement. As a result, it is not always possible to determine the basis of any given figure. It would be a considerable aid to review of these statements if this link were to be made for all significant numbers and if the statement were to be sufficiently detailed to facilitate a full understanding of the

underlying methodology and the sources of the various charges. The principles underlying cost attribution and charges between businesses are discussed in Chapter 5.

Reconciliation to Statutory Accounts

4.24 OFFER presently receives a reconciliation between PES' regulatory and statutory accounts. However, there is no licence requirement for this to be prepared or published. The EU Directive, discussed in Chapter 7, appears to envisage publication of such a reconciliation in its requirements for publication of accounts of the different electricity businesses and of consolidated accounts for non-electricity businesses. It would be of assistance for such a reconciliation to be published, so as to enable readers to understand clearly the relationship between these two sources of financial information.

Balance Sheet Information

4.25 At present, regulatory accounts are required to include a balance sheet showing the assets and liabilities relating to each separate business. They are not, however, required to relate the details of financing to each of the licensee's separate businesses. Separate licensing of supply and distribution would enable these businesses to be placed in separate companies (in the same or different ownership) and this might make clearer the separate financing of the two businesses. However, the financing structure of individual companies within a group is generally subject to wider group considerations and may not reflect the structure that would be put in place for an independent company.

Stand-Alone Basis of Presentation

4.26 The definition of separate businesses in the licences implies a requirement on licensees to consolidate activities which are part of that business, but which are carried on by affiliates and subsidiaries, with the results of the business. In such a consolidation, charges from other businesses or affiliates to the separate business concerned disappear, and are replaced by the costs incurred by the other business or affiliate. In the context of regulatory accounts, this has significant disadvantages. It treats services procured by the separate business concerned differently depending upon whether they are purchased from an affiliate or from a third party. The regulatory accounts for an individual licensed business might instead be made up on the basis that it stands alone, regardless of whether the licensee's statutory accounts are on a company or consolidated basis.

Publication of Regulatory Accounts

4.27 As noted in Chapter 2, the present licence conditions require that licensees publish their regulatory accounts with the annual (statutory) accounts, except for the statements of the amounts charged, allocated or apportioned between businesses, and the statement of the bases of charges and apportionment and allocation, and except for the accounts for the second tier supply business.

4.28 It is for consideration whether the material which is provided but not at present published should in future be published; and whether the additional information discussed earlier in this Chapter should be published also.

4.29 The desirability of improving transparency and accountability might argue for publishing all regulatory accounts in full. The Government's review of utility regulation attached importance to improved transparency. It concluded that it intended that records and information on the utility companies held by the regulators may be published at their discretion, where it is in the interests of consumers and potential consumers. Information about monopoly businesses would generally be disclosable. Publication would be subject to vigorous Freedom of Information tests relating to substantial harm and the public interest. It is clear that the Government intend that the "substantial harm" test should be a rigorous one, and that its application would result in significantly more information becoming publicly available than is the case at present.

4.30 Arguments that full publication of regulatory accounts would unnecessarily damage the interests of companies operating in competitive sectors need to be considered against this wider policy background. The possibility that publication would result in commercial damage might be reduced if published regulatory accounts were required from all competing businesses. This might, however, be unnecessarily burdensome to some companies, particularly smaller new entrants in generation or supply.

4.31 At present, all PESs except one publish regulatory accounts for their first and second tier supply businesses combined, though the licence requires publication only of first tier supply accounts. These PESs appear not to regard the publication of at least some accounting information relating to competitive and potentially competitive activities as damaging to their commercial interests. This suggests that it may be possible to deal with commercial sensitivities by allowing competitive businesses to omit certain specified information from the published regulatory accounts, rather than by allowing them not to publish accounts at all.

4.32 The present exemptions from publication include the statement of the amounts charged between businesses, and the statement of the bases of allocation and apportionment. It is not obvious that these exemptions are justified by reference to commercial sensitivities, or that any such considerations outweigh other considerations such as the desirability of greater transparency.

4.33 OFFER considers that licensees should be required to publish in full the regulatory accounts for their separate businesses, except for specific items of information where the DGES has agreed that substantial harm to the interests of the licensee or another person would result from publication.

Timing of Publication of Regulatory Accounts

4.34 The licences require full year regulatory accounts be provided to the DGES by 30 September each year, and published with the Licensee's statutory accounts. This is six months after the financial year-end of 31 March. Half-year accounts are to be produced by 31 December. This is three months after the half-year point of 30 September.

4.35 The EU Directive, discussed in Chapter 7, envisages publication of regulatory accounts with the statutory accounts. The present requirement on companies is to lodge statutory accounts within nine months of the end of the financial year.

4.36 By September, the information in the full year accounts is six months old and therefore becoming of decreasing immediate significance. The time-scales for producing regulatory accounts are longer than, for example, a public company would take to report to shareholders, which would typically be around three months. The latest Stock Exchange listing rules regard reporting within 60 days of the end of the relevant period as good practice. It is not clear that an extended timescale for the publication of regulatory accounts is necessary. For example, some auditors certify the full regulatory accounts in the first week of May, to the same timescale as the published shareholder accounts. It is for consideration whether it would be helpful to users, and reasonable for the companies, to provide and publish regulatory accounts more quickly than they are at present required to do, for example within three months of the end of the financial year.

Comments Invited

4.37 Comments are invited on:

- whether the present requirement as regards which licensees should prepare regulatory accounts, and in respect of which businesses, should remain broadly unchanged for the time being;

- the specific suggestions for additional information outlined in this Chapter;

- whether these additional requirements should apply to the regulatory accounts of all the separate businesses of electricity licensees, or just to some of them;

- whether licensees should be required to publish their regulatory accounts in full, except for specific items of information where the DGES has agreed that substantial harm to the interests of the licensee or another person would result from publication.

5 COST ATTRIBUTION AND INTER-BUSINESS CHARGING

Introduction

5.1 As with all businesses, regulated businesses incur some costs which can be attributed to specific activities, and others which cannot be so attributed but which must be covered if the company is to survive. Also, constituent businesses may be serviced by outside suppliers or by another constituent business. These characteristics necessitate principles to govern the method of cost attribution, the recovery of non-attributable costs, and the basis of inter-business charging.

5.2 A key function of regulatory accounts is to show how these principles are being applied. This facilitates comparison between different companies and elucidates relationships between costs and types and levels of activity. Such information is important to the whole range of regulatory duties, including the comparison of out-turns with the expectations that have informed the price controls and assessing competitive behaviour.

5.3 At Vesting these needs were tackled by CSC.194 and 195. As explained earlier, experience and changing circumstances since 1990 suggest that they should be replaced. This is discussed below. A major point for consideration is how specific the application of principles needs to be. Companies normally have wide discretion in, for example, their methods of cost-recovery and inter-business charging. It is arguable that regulation should be prescriptive only to the extent necessary to deal with monopoly power, actual or potential.

Guidelines on Cost Allocation

5.4 The PES licence conditions require separate accounting of each business, and disclosure of bases of allocation and apportionment in the regulatory accounts, with a requirement for DGES consent to any change in such bases. Guidelines known as CSC.194 and 195 were established at the time of Vesting, and remain largely unchanged.

5.5 CSC.194 defines which activities comprise distribution and supply and what may be charged as between the businesses. It is also concerned with the allocation of costs between the distribution, supply and unregulated businesses. It principally covers:

- distribution costs, including rates, which are to be treated as part of the distribution business;

- consumer service under several headings, for example, customer records which are to be charged equally between distribution and supply;

- meter reading, billing and collection: meter reading is to be treated as distribution; billing as distribution except for producing and mailing bills; collection is to be charged to supply;

- administration, training and welfare under several headings, for example, corporate overheads are to be charged as to 50 per cent on a CCA net assets basis and 50 per cent on a salaries basis;

- debtors, which relates to a notional debt repayment period and a quarterly unbilled adjustment for the use of system charge; and

- trading businesses (such as contracting and appliance retailing), any charges between businesses should be made on the basis of an arm's length relationship.

5.6 CSC.195 gives brief guidance regarding the allocation of assets and liabilities. In general, operational assets are to be allocated to the relevant separate business. Non-operational fixed assets are to be allocated on the basis of use or, where the asset is held predominantly for the use of a single business unit, or where, for purposes of operational accountability, it forms part of a single profit-centre, wholly to the relevant business unit. Current assets and liabilities are to be allocated wherever possible directly to each business unit. Funds in hand and borrowings are to be allocated according to the purpose for which they are required. Provisions for taxation are not required to be allocated.

Revising the Guidelines

5.7 At the time of Vesting some initial guidance was put in place to achieve a reasonable level of comparability between licensees. In that regard, CSC.194 and 195 have been useful. They have the merit of setting out some relatively straightforward rules for allocation of costs. However, they were drawn up without the benefit of experience of the way PES distribution and supply businesses would operate and develop in practice; and before it had become apparent that further separation of PES activities was necessary for effective competition in supply.

5.8 The disaggregation of separate business and service functions, driven by competition and the development of the non-franchise market, and supported by the introduction of new management information systems, has opened up possibilities for different methods for charging for resources, often based more clearly on usage. CSC.194 provides no guidance for such charging. In addition, flatter management structures have in some cases reduced corporate costs, facilitating the task of identifying and attributing management costs to the separate businesses without relying on the CSC.194 and 195 guidelines.

5.9 More important, CSC.194 and 195 influence the definition of what activities comprise each business. They do this in a way that allows PESs to charge to distribution certain costs which competing supply businesses might need to carry themselves. This may hinder the development of competition in supply. Examples of aspects of the guidelines which might be inappropriate to the competitive supply market include allowing PESs to charge a significant proportion of customer records and billing costs to distribution, the allocation of corporate overhead by a formula which weights these significantly towards distribution, the allocation of meter reading costs to distribution and the allocation of certain advertising costs to distribution. OFFER has issued a consultation paper on separation of PES activities, and plans to issue a further paper shortly. Any arrangements to replace CSC.194 and 195 will need to be fully consistent with proposals for the separation of PES businesses and the promotion of competition in supply.

Options for Future Regulation

5.10 Options for future policy in regulatory accounts might aim at one or more of a number of desirable objectives. Some of these objectives relate primarily to transparency and consistency - for example:

- the transparent disclosure of transfer pricing and allocation policies;
- consistency between charges actually passing to or from the regulated business and those reported in regulatory accounts;
- consistency between regulatory accounts and licence requirements, for example the requirement in the licences of RECs which have been taken over to deal with affiliates only at arm's length and on normal commercial terms;
- consistency between regulatory accounts and assumptions made for price control purposes;
- consistency between regulatory accounts of comparable companies in the industry (here primarily the PES distribution businesses);
- where relevant, consistency between regulatory accounts prepared for electricity businesses and those prepared within the same group for other regulators (primarily water); and
- consistency between regulatory accounts across different utility industries (primarily electricity and gas).

5.11 It is also desirable that any policy should not constrain the companies in developing organisational and management arrangements which meet their circumstances, and help to reduce costs.

5.12 As discussed above, it is also necessary for any new policy to be capable of being applied to a wide range of business structures. As will become apparent, it may not be possible to achieve all these objectives simultaneously. The following sections discuss three broad policy options for alternatives to the present arrangements based on CSC.194 and 195. The first involves the full explanation by each company of the bases on which it had attributed and allocated costs; the second would involve the establishment of detailed rules on attribution and allocation, applicable to all companies; the third would involve the establishment of general principles, within which companies could develop their own policies and procedures.

Explanation of Bases

5.13 One possibility would be to require licensees to explain fully the basis on which they had derived and applied their own rules for attributing and allocation of costs and for charging between businesses. This would give companies freedom to develop rules which they consider best suited to their circumstances. The chosen rules might differ between companies, possibly to a significant extent. However, full disclosure of the rules would enable differences between companies to be identified, and perhaps in some cases the effect of alternative possible rules and procedures to be tested.

Detailed Rules

5.14 A second possibility might be to establish detailed allocation and transfer pricing rules with which all licensees would be required to comply for purposes of regulatory accounts. Such rules might be related to each type of cost in accordance with a prescribed classification. The aim of such rules might be to establish bases of attribution and allocation suitable both for price control information and for regulatory accounts, and to secure a high degree of consistency between licensees.

5.15 Defining such detailed rules would present considerable practical difficulties. First, the rules would need to be extensive to deal with the wide range of business structures that companies have adopted, and might have the effect of constraining the way in which licensee groups organise themselves. Second, the rules may not match either the inter-business charges that companies actually make or the way that they are otherwise presented internally or externally. Third, companies would have incentives to circumvent those rules which caused them difficulties, and detecting this and enforcing the rules might cause difficulties.

A Framework of Principles

5.16 A third possibility might be for the licence to specify a framework of principles within which licensees would be required to develop policies and procedures for their specific circumstances. Such a framework might apply solely to transactions involving monopoly businesses and include some or all of the following.

5.16.1 All charges by affiliates ("service units") to a licensee (or within a licensee to a separate business), whether by way of cost allocation or transfer pricing, should as far as practicable be based on costs that are directly attributable to the licensed business.

5.16.2 The service unit must have adequate accounting systems for identifying such attributable costs at the level of individual activities.

5.16.3 Where charges include a mark-up on attributable costs to cover non-attributable costs, this should be identified to the licensee and disclosed in the regulatory accounts, and accompanied by a statement of the policy by which the mark-up is determined.

5.16.4 Where the mark-up is such as to relate the charges to external market prices, this should be disclosed in the regulatory accounts together with evidence of the price marker used.

5.16.5 Where a licensee accepts charges of whatever nature from a service unit, the licensee should have full access to the service unit's financial and other records.

5.16.6 These principles should apply equally to charges for all categories of cost including capital costs. Similar principles would also apply to charges out by regulated businesses to affiliates.

5.16.7 Where the basis of any charge recognised in the regulatory accounts of a separate business is inconsistent with an explicit assumption made by the DGES for the purposes of the prevailing price control, this should be disclosed, together with a statement of the relevant assumptions.

5.17 An approach of this nature could be applied whatever business structure a licensee chooses to adopt. It would not secure standardisation in the detailed policies and practices adopted by differing licensees, but it may secure as much comparability as is realistically possible in an industry comprising increasingly different organisational structures and combinations of businesses.

Comments Invited

5.18 Comments are invited on issues discussed in this Chapter, and particularly on:

- the implications of the development of competition in supply, and actual and potential changes in business structures for charges and cost attribution;

- the extent to which these factors indicate that CSC.194 and 195 require to be revised or replaced;

- the extent to which each of the approaches outlined above, or other possible approaches, would be practical and reasonable.

6 THE BASIS OF ACCOUNTING

6.1 Regulatory accounts are presently required to be prepared on a current cost accounting (CCA) basis. This followed the practice of the industry at Vesting. CCA accounts are intended to take account of the effects of changing prices in establishing asset values and measuring depreciation. They were regarded as having value both for continuity with previous practice in the industry, and in indicating whether operating capital was being maintained.

6.2 Since then, industry practice has changed. Licensees no longer produce CCA accounts for statutory purposes. CCA regulatory accounts are difficult to relate to companies' historic cost accounting (HCA) statutory accounts. Moreover, five out of 12 sets of REC regulatory accounts for the year ended 31 March 1997 were qualified by the auditors on the basis that the net current replacement cost of fixed assets exceeded the recoverable amount. HCA regulatory accounts would facilitate comparison with statutory accounts of electricity licensees.

6.3 Annex 3 describes the regulatory accounts requirements in other utilities. In gas, regulatory accounts are presented on the same basis as statutory accounts, that is, HCA regulatory accounts for water and telecomms are presented both on an HCA and a CCA basis.

Valuation of Assets

6.4 A central issue is the different ways in which different bases of accounting present the value of assets. Under HCA, fixed assets are recognised in the balance sheet at their acquisition cost (less depreciation), unless their value is deemed to have been impaired, in which case they must be written down to their estimated recoverable amount, being the higher of value in use and net realisable value. Under CCA, assets may be estimated on the basis of current prices for the same or a modern equivalent asset, or by the application of an appropriate index to the historical acquisition cost. Regardless of the method of estimation, a ceiling test is applied so that the asset may not be recognised at more than its recoverable amount. Under modified HCA, fixed assets may be periodically revalued to reflect their current value, based on the evidence of market prices or appropriate indices, subject to a similar ceiling test.

6.5 It has been suggested that regulatory accounts of businesses which are subject to price controls should value assets in a way which is directly comparable to the way in which the regulator valued those assets in the most recent price control review - in other words, that they should reflect what some commentators have called "regulatory asset values". Annex 2 contains an extract from the report of the MMC on BG plc in 1997, which records the Commission's view that there would be clear merit in regulatory accounts being established on a basis consistent with that used by the Director General of Gas Supply (DGGS) and the Commission in the price

control review. Regulators have adopted a variety of approaches to valuing assets and dealing with depreciation for the purpose of price control reviews. Neither they nor the MMC have in general been content simply to use the value (either CCA or HCA) in the companies' accounts[5]. In calculating the present distribution price controls on the PESs, for example, the DGES used the value derived from that which investors placed on the companies at Vesting, plus an uprating of 15 per cent; plus net investment (investment less depreciation) since Vesting; and an adjustment for inflation[6]. From a knowledge of the way the regulator set the price control, it would be possible to calculate an updated "regulatory value" for each year during the price control, taking account of investment and depreciation over the period since the price control was set.

6.6 This approach may well not imply asset valuation in accordance with standard accounting practice. It may therefore make the regulatory accounts difficult to compare with the statutory accounts. Moreover, it may carry implications for valuing assets for long term regulatory purposes which go beyond the intentions of the DGES (for example, implications about the way he will view asset valuation at the next price control review).

6.7 There may be merit in clarifying the relationship between the regulatory accounts and applicable price control mechanisms, particularly in relation to asset values, revenues and costs. This would be in line with the MMC's conclusions on Transco's accounts. It would facilitate certain assessments of how the price control is working in practice, and in particular calculations of what rate of return the price controlled business is earning compared with the cost of capital assumed by DGES at the last review.

6.8 A possibility would be to require the regulatory accounts of price-controlled businesses to be on an HCA basis with additional disclosure by means of a note to the accounts of the regulatory assumptions applied in the prevailing price control, and in particular the asset value and the depreciation thereon implied by the way the price control was set. NGC already publishes a note to its accounts reconciling their interpretation of the regulatory asset base with the CCA values in its accounts.

Comments Invited

6.9 Comments are particularly invited as to:

- whether there would be value in continuing to require regulatory accounts to be prepared on a CCA basis; or whether it would be

[5] OFTEL use CCA information not only for the presentation of regulatory accounts but also for the cost base used in calculating long-run incremental costs

[6] The distribution price control is described more fully in OFFER's Consultation Paper on Price Controls and Competition dated July 1998

preferable for them to be prepared on an HCA basis as the statutory accounts are;

- whether there would be value, for price-controlled businesses, in an additional requirement to disclose the asset value and depreciation thereon implied by the way the most recent price control was set.

7 THE EU DIRECTIVE

7.1 Article 14 of EU Directive 96/92EC on the internal market for electricity required certain undertakings to prepare separate accounts for their generation, transmission and distribution activities; the basis of those accounts; and what should be published. The Directive is required to be implemented in the UK by 19 February 1999, and it is therefore necessary to consider how it will be implemented. The Department of Trade and Industry issued a consultation paper on this in July 1998.

7.2 The DGES will need to consider how far his statutory duties indicate that he should implement the accounts requirements of the Directive for example by proposing amendments to licences. To the extent that he concludes that implementation of these requirements is not required by his statutory duties, other possibilities are available to the Government, such as an Order under the European Communities Act.

7.3 It is open to the DGES, in the light of his statutory functions and duties, to specify accounting requirements which go beyond those in the Directive, provided that they do not conflict with it.

Accounting Provisions of the Directive

7.4 The relevant provisions of the Directive can be summarised as follows:

a) electricity undertakings, whatever their system of ownership or legal form, shall draw up, submit to audit and publish their annual accounts in accordance with the rules of national law relating to accounts of limited liability companies. The effect of this provision appears to be to ensure that undertakings that would not otherwise be required to produce and publish annual accounts (for example, some types of joint ventures) are required to meet the same standards of published accounts as incorporated companies;

b) integrated electricity undertakings shall, in their internal accounting, keep separate accounts for their generation, transmission and distribution activities, and where appropriate consolidated accounts for other non-electricity activities. ("Integrated electricity undertaking" is defined in the Directive as meaning an undertaking performing two or more of the functions of generation, transmission and distribution; or an undertaking performing one of these, and another non-electricity activity). The separate accounts shall be accounts which would be required to be kept if the activities in question (that is, the separate businesses in our terminology) were carried on by separate undertakings, with a view to avoiding discrimination, cross-subsidy and distortion of competition. This provision refers to undertakings' internal accounting and provides for separate

accounting records for the separate businesses in a similar way to, for example, PES licence condition 2.3(a);

c) integrated electricity undertakings shall include a balance sheet and a profit and loss account for each activity (separate business) in notes to their accounts (that is, their published accounts). The effect of this is that integrated electricity undertakings should include separate financial results for the separate businesses of generation, transmission and distribution in their annual published accounts;

d) undertakings shall specify in notes to the annual accounts the rules for the allocation of assets and liabilities and expenditure and income, which they follow in drawing up separate accounts. These rules may be amended only in exceptional cases. Such amendments must be mentioned in the notes and must be duly substantiated; and

e) the annual accounts shall indicate in notes any transaction of a certain size conducted with affiliates, or associates, or undertakings belonging to the same shareholders.

Implications of the Directive

7.5 In many respects, arrangements under the Electricity Act have anticipated the requirements of the Directive. They have gone further than the Directive in requiring the accounting separation of supply and certain other electricity businesses. They also require the preparation of cash-flow statements, in addition to the balance sheet and profit and loss statements required by the Directive. However, there are some respects in which the Directive will require an enlargement of the scope of regulatory accounts. These include:

- independent generators who at present are not required to keep separate financial records and prepare accounts for separate businesses, will in future need to do so, unless they carry on only generation, and no other electricity or non-electricity business;

- the provisions of the Directive, including separate accounting provisions, apply to certain private distribution systems which are not at present licensed under the Electricity Act. The Government's consultation document on implementation of the Directive discussed, among other things, how it might be applied to such distribution systems.

7.6 In other respects, the Directive anticipates developments discussed in this consultation paper. For example:-

- it requires licensees to publish certain information which they are not at present required to publish, including their rules for the allocation of assets and liabilities and expenditure and income, and information about transactions with affiliates etc;

- it envisages that the separate accounts will be published as notes to licensees' statutory accounts, rather than as separate documents. This has implications for the timing of publication and consistency of the two sets of information.

Comments Invited

7.7 Comments are invited on the ways in which the regulatory accounts requirements of the Directive might be implemented, and on the extent to which they affect issues discussed in this paper, including areas where possible conflicts might arise.

ANNEX 1

RESPONSES TO THE FEBRUARY CONSULTATION PAPER

Respondents to OFFER's February 1998 consultation paper on Reviews of Public Electricity Suppliers commented on issues relating to regulatory accounts. The points made were:

- a review of regulatory accounting requirements is welcome (Yorkshire ECC, South West ECC);

- information on PES' performance should be transparent (South West ECC, Southern Electric). More regulatory accounting information is needed; it should be user friendly and include a plain English guide (Yorkshire ECC);

- there is a need to facilitate comparisons on matters such as how spending is related to improvements in supply reliability (South West ECC). The regulatory accounts should include a range of additional comparative statistics (Southern Electric). Real comparisons would be possible if there is consistency across the accounts (South Wales ECC); the regulator could produce for customers a composite report of all the companies' accounts (Yorkshire ECC);

- information requirements increase enormously during price control reviews. Increased reporting requirements on a routine basis between reviews simply add to costs for both companies and regulator, and thereby for the end customer (London Electricity);

- the regulatory accounts should be published earlier than they are currently (Southern Electric). Companies should report every six months (South Wales ECC);

- there should be clear definition of the businesses required to have separate regulatory accounts (Southern Electric). Consideration should be given to restricting the regulatory accounts to the monopoly distribution businesses of the PES as regulatory accounts can provide valuable commercial and financial information. It may not be appropriate for such information to be published by PESs in relation to competitive markets (SWALEC);

- it is right that publication of regulatory accounts has a limited role in the regulatory process. Clearly some general rules are required with regard to cost allocation, but otherwise the separate accounts should reflect the way in which costs arise. The incentive effects of RPI-X regulation are bound to give rise to different actions by companies, including organisational, in order to achieve efficiency gains and service improvements. It would not be

in anyone's best interests to specify accounting rules that imposed a constraint on beneficial organisational change (London Electricity). Regulatory accounts should include transfer pricing based on market/actual contract price, not at cost (Southern Electric); and

- accounts should not be prepared on a CCA basis, they should reflect the Regulatory Asset Base approach actually used (Southern Electric). It is important to establish a consistent regulatory approach to asset valuation (Scottish Hydro).

Report by the Centre for the Study of Regulated Industries

As part of their response to the February consultation paper, the ECCCG commissioned a research report from the Centre for the Study of Regulated Industries entitled "Accounting Requirements for Regulated Industries". This report focussed upon regulatory accounting for price-controlled businesses. It argued that a comprehensive financial and accounting system was necessary to underpin the price control process, and reflecting the objectives of incentive regulation. It argued that historical cost accounting could not adequately take account of the effects of inflation, or other factors, and that current value systems of accounting were therefore required. However, the value of assets which regulators used in setting price controls did not in general equate to a value of assets as they might be shown in CCA accounts prepared in accordance with recognised accounting practice. In order for regulatory accounts to reflect the basis on which price controls had been set, and to be useful as measures of the performance of companies' against these price controls, it was necessary to define a "regulatory book value" of assets, and to show how it related to the current cost net book value. The report discussed examples of how this might be done. It drew a distinction between "regulators' regulatory accounts" (which would reflect the basis on which the price controls had been set), and "companies' regulatory accounts" (which might differ from the "regulator's regulatory accounts" in, for example, treatment of costs, asset values or depreciation). It argued that accounting for regulated industries required both of these sets of accounts, and reconciliation between them, though it acknowledged that in practice regulators and regulated companies might agree a common model for both purposes. The "regulators' regulatory accounts" should enable actual outturns to be compared with past forecasts, and should permit analysis of the differences by causes.

The CRI report contained some specific comments on the present regulatory accounting arrangements for electricity. Little comparative detail on the performance of the separate businesses was published by OFFER as regards operating efficiency and capital expenditure. OFFER did not issue prescriptive guidelines in areas such as asset valuation for the current cost accounts, definitions of terms in the operating costs, or arm's length trading arrangements. It was possible that transfer prices disadvantageous to the regulated business would be one means by which cash could be transferred out of the regulated business, despite the financial ring-fence. There were problems also of different accounting bases and reconciliation between the statutory accounts of the group and its subsidiaries and the regulatory accounts for the separate businesses.

ANNEX 2

EXTRACTS FROM MMC REPORTS

In two recent cases the Monopolies and Mergers Commission (MMC) has commented directly on issues related to regulatory accounts.

Paragraph 2.129 of the MMC report on BG plc in May 1997 stated:

> "2.129 How the company accounts in its statutory accounts for asset values where it operates under a regulatory system that adjusts regulatory values by reference to the RPI is a matter for the company and its auditors. In respect of Transco's regulatory accounts, we see clear merit in these being established on a basis consistent with the approach used by the Director General and ourselves in this review. Should BG decide to continue to present Transco's figures on a CCA basis in its statutory accounts, it may be desirable for its annual accounts to contain a note explaining the regulatory principles applied and how the regulatory values can be reconciled with book values of assets in order to assist shareholders in understanding the basis on which Transco is regulated".

Subsequently, BG plc determined to change the accounting convention under which its published statutory accounts are prepared from CCA to modified HCA. In both its statutory and regulatory accounts for the year to 31 December 1997, BG plc adjusted the carrying value of its transportation and storage assets by passing an impairment charge, in accordance with the provisions of Financial Reporting Standard No.3, of £4,919 billion, "such that the carrying value in the financial statements based upon the net present value of these fixed assets, on a pre-tax basis, more closely reflects the regulatory value" (Source: Operating and Financial Review, BG plc Annual Report and Accounts 1997).

Paragraphs 2.28 and 2.29 of the MMC report on the proposed acquisition by PacifiCorp of The Energy Group plc in December 1997 stated:

> "2.28 Among other matters raised with us was that acquisitions, if accompanied by fair value adjustments in the accounts of the acquiring company or revaluations in the accounts of the acquired company, led to a discontinuity of asset valuation. It would, however, be open to any company to revalue assets, irrespective of any merger, subject to adequate evidence of changes in value. There was also concern about the use of CCA, rather than HCA, in the preparation of regulatory accounting statements. But the basis for the regulatory accounts is a matter for the DGES and is not directly connected with the proposed merger. The regulatory value which the DGES adopts for the purposes of price regulation will not necessarily be directly linked to either CCA or HCA book values. We noted that although the DGES has described in general terms the method used by him to determine regulatory values for the

RECs, no detailed information is currently published. The DGES told us that he is now minded to publish such information on regulatory values in future, though without making a formal commitment to do so. There was concern too about the treatment in the published regulatory accounts of intra-business and inter-company transactions, particularly those between the distribution and supply businesses: this would also seem to be a matter for the DGES which is not significantly affected by the merger.

2.29 We recognize that it may be legitimate for the public to obtain more information on monopoly utilities than is currently provided, and the adequacy of information available to the public is therefore an issue which could usefully be addressed by the DGES or in the inter-departmental review of utilities regulation currently being undertaken. The public availability of information is not, however, affected by this merger".

ANNEX 3

REGULATORY ACCOUNTING REQUIREMENTS IN OTHER INDUSTRIES

Gas Industry - BG and Centrica

At Vesting in 1986 there was one separate business defined in the gas licence - gas supply. Following an MMC enquiry and its subsequent findings in 1993, the regulatory accounting requirements changed in order to accommodate the separation of British Gas transportation and storage business from its trading businesses. De-merger activity continued in 1997 with the transfer of gas sales, gas trading, services and retail businesses of British Gas, together with some gas production business, to a new company, Centrica. Detailed regulatory accounts are now required from Transco and BG Storage (BG plc), to cover the separate businesses of Transco, other transportation and storage businesses and common services. Regulatory accounts for British Gas Trading (Centrica), cover the gas shipping and supply business.

Before demerger, the separation of Transco from British Gas Trading was achieved by requiring Transco to operate within a "chinese wall", monitored by a compliance officer. Transco was responsible for its own financial resources; it had to maintain its own set of accounts; have its own premises; ensure its Board of Directors acted independently of the main Board; restrict the flow of information between itself and other British Gas activities; operate a quarantine system for staff transferring; and strictly monitor meter reading services by British Gas on its behalf. At the end of each year, Transco was required to confirm to the DGGS that adequate arrangements had been made or were likely to be made to enable it to comply with its statutory duty; and furnish the DGGS with a comprehensive report on the activities of the compliance officer throughout the year.

The form of the licence conditions on the separate accounts for BG (Transco) and Centrica is similar to that in the electricity licences - detailed annual accounts in addition to a half yearly profit and loss account. The basis of accounts follows that of the statutory accounts and is therefore HCA. In the case of Transco the HCA basis is modified to value regulatory assets at depreciated replacement cost or, where lower, the estimated value in use. As a result, Transco's tangible fixed assets have been reduced to reflect regulatory asset values, following the 1997 MMC report on prices for gas transportation and storage services.

The licence requires the accounting statements from the separate businesses to include a description of the bases of charges and apportionments between the businesses and the amounts involved. At present there is no guidance on the bases of allocation or intra-group charging, other than a restriction on the provision of common services to Transco by other BG activities. Common services must be offered to all BG activities on the same terms, and only be used by Transco when no better value alternatives are available.

Any change to a basis of charge or apportionment requires prior approval. For Centrica's businesses of gas supply and shipping, (but not for Transco's businesses), this is deemed to have been granted unless refused within two months of receipt of the application.

Extracts from the separate accounts are required to be published but these exclude details of storage and common services, and bases of apportionment and recharges between the separate businesses.

Water Companies

Two separate businesses are defined in the licences:

- Water; and
- Sewerage.

The water regime is more proactive and prescriptive in determining how the water companies should account for their separate businesses. Licence Condition F, which covers accounts and accounting information, is extensive. Water companies must analyse their accounts between the appointed (that is, regulated) business and the non-appointed business. The Director General of Water Services (DGWS) has the power to issue accounting guidelines under licence Condition F. The regulatory accounting guidelines (RAGS) essentially interpret the licence requirements. There are presently five RAGS which deal with accounting for current costs; infrastructure accounting; contents of regulatory accounts; analysis of operating costs and assets and transfer pricing.

Infrastructure renewals accounting is used to account for expenditure on certain fixed assets, that is, underground assets. An infrastructure renewals charge is made to the profit and loss account which reflects the average costs of maintaining these assets over a suitable time period.

Water companies are required to prepare their regulatory accounts on both a historic and current cost accounting basis. The DGWS is primarily concerned with current value accounts. The basis of the current accounts is a modified form of financial capital maintenance. The RPI index is used to re-value shareholders funds. Profit is measured in real terms but initial assets are valued at replacement cost which is greater than their economic value.

A standard format of accounts and some bases of detailed allocation and apportionment were imposed on the companies at Vesting. This should aim to ensure that accounts are submitted on a consistent basis and inter-company comparisons can be made. In practice, guidelines are monitored and interpretation differences are minimised. Guidelines are amended where necessary to conform to statutory requirements.

The DGWS has given specific guidance on the treatment of certain costs. For example, operating costs have to be analysed by both function (for example, water resources, water

distribution and treatment) and category (for example, manpower costs, hired and contracted services, charges for bad and doubtful debts).

In paragraph 6 of Condition F, companies are required to ensure that all transactions between regulated and non-regulated businesses are made at arms' length. Companies have to disclose details of all transactions in excess of a specified materiality figure, 0.5 per cent of turnover of the appointee business or £100,000 whichever is the greater.

At Vesting there was no clause in the licences of the water companies which prohibited cross-subsidies between the regulated and non-regulated businesses. Following the Competition and Services Utilities Act 1992 a duty was placed on companies to trade at arm's length from associates which was reflected in amendments to Condition F of companies' licences in March 1993. Most water and sewerage companies have now set up unregulated businesses that provide services to the regulated businesses. The transfer pricing guidelines require that:

- cross-subsidy is prohibited between the appointed and non-appointed parts of the Licensee, and between appointed and associated companies;

- activity-based costing to be used to allocate amounts across the appointed and non-appointed business;

- subject to materiality limits and exceptional circumstances, all supplies, works and services provided to the Appointee by associates should be market tested. Where no market exists and related undertakings offer this service it should be at cost. Where revenue within the Appointee represents the majority of the income of the related undertaking, a reduction in "market price" is to be introduced to reflect the low risk of the business of the related undertaking; and

- OFWAT undertake investigations and reviews of Appointees methods, in addition to the review made on receipt of the regulatory returns to establish that companies are complying with RAG 5.02. The investigations will be more frequent in the earlier period of operation of the guideline.

With regard to ring-fencing, OFWAT have reflected in the licences of Hyder, ScottishPower, United Utilities and Wessex Water clauses to ensure that:

- the regulated water business has a separate board independent of its parent company;

- prices paid by the regulated water business to any associate company should be based on market prices or an agreed sharing of costs of the service provided to both utilities; and

- the regulated business cannot transfer assets or provide guarantees or loans to other companies without the Director's permission. Dividend payments to the parent company must be in accordance with a policy sanctioned by the Director.

Water companies are required to prepare their regulatory accounts on both a historic and current cost accounting basis. Each year after the regulatory accounting returns have been received and reviewed, OFWAT publishes a report of the companies' performance and highlights the common problems or issues that have arisen. The companies reporting date has been brought forward to 15 July to assist with this review. The regulatory accounts are in the public domain apart from details of transactions between the appointed company and any associated companies, and details of the allocation and apportionment of costs (but the publication of these is being considered for 1998/99 onwards).

British Telecommunications

At present there are six defined businesses in the British Telecom (BT) licence:

- Access;
- Network;
- Retail systems;
- Apparatus supply;
- Supplemental services; and
- Residual.

BT is required under Condition 20B to publish annual statements that fairly present the revenues, costs, assets and liabilities of each business, including the disaggregated activities of each of the above six defined businesses. The Director General has the power to ask for supplemental information under Condition 52, and Condition 20B.18 in certain circumstances. The financial statements have to be prepared in accordance with the Accounting Documents that have been agreed by OFTEL and BT under Condition 20B, and with the Detailed Attribution Methodology Document, the Detailed Valuation Methodology Document and the Long Run Incremental Cost: Relationships and Parameters Document.

Accounts are produced on both a HCA and CCA basis and reconciled with the annual financial statutory statements, with a "fairly presents in accordance with" audit opinion. The current cost statements for the group are prepared under the financial capital maintenance convention in accordance with the principles set out in the handbook "Accounting for the effects of changing prices", published in 1986 by the Accounting Standards Committee. Assets are stated in the balance sheet at their value to the business, usually equivalent to their Net Current Replacement Cost. This is generally derived from the asset's Gross Replacement Cost and is the current purchase price of an identical new asset or the cost of a modern equivalent asset with the same service potential.

The Accounting Documents agreed by OFTEL and BT under Condition 20B consist of:

- the Regulatory Accounting Principles, which set out the general principles by which the statements should be prepared;
- Attribution Methods, which explain how revenue, costs including transfer charges, assets and liabilities are attributed to the businesses;
- Transfer Charges, which explain how such charges are raised;
- Accounting Policies, which detail the accounting policies (HCA and CCA) adopted in preparing the underlying financial information; and
- Long Run Incremental Cost Methodology.

The accounting policies document acts as a catch all to ensure that UK GAAP and Companies Act legislation applies to anything not covered by the first three accounting documents.

The transfer-charging document principally explains how charges for services from the network to the retail business are raised. The price of each service should broadly lie between an incremental cost floor and a standalone cost ceiling. These prices, between network and retail, are subject to price control.

One of the purposes of the licence condition requiring separate accounts is to ensure BT does not unfairly subsidise or unfairly cross-subsidise or show undue preference to exercise undue discrimination. Condition 20B.15 enables the Director General to take steps to remedy a situation where an unfair cross-subsidy exists between any business (except residual) or part of a business of the licensee.

Railway Industry

Railtrack is the main focus of regulatory concern. Railtrack's licence allows the regulator to define accounting policies in respect of accounting records maintained for regulatory purposes. Accounting notices can be issued by the regulator requiring Railtrack to maintain accounting records which comply with the accounting policies as set out by the regulator. Two accounting notices have been issued so far and the most recent requires Railtrack to establish, and obtain the regulator's consent to, procedures for allocating expenditure on fixed assets for the following:

- maintenance and renewal of the existing infrastructure;
- enhancement expenditure subject to agreement with the Franchising Director under Section 54 of the Railways Act 1993;
- enhancement expenditure subject to other specific funding agreements; and
- other enhancement expenditure.

It also requires Railtrack to produce current cost information on a modified financial capital maintenance basis within its annual accounts in a format specified by the regulator. It includes current cost profit and loss account and balance sheet. At present the group current cost accounts are not materially different from the regulated company accounts, therefore Railtrack only publishes the current cost group accounts. However, if this situation changes then the regulator reserves the right to demand separate accounting information for the regulated company. ORR also monitors Railtrack on a more regular basis through the four weekly submission of management account summaries.

Railtrack Group as yet undertakes very little business outside the regulated company, although the regulator has made it clear that, were this position to change, he would want to review the adequacy of ring-fencing arrangements. Condition 10 of the licence sets out the requirements for ring-fencing, as well as accounting records. On ring-fencing there are restrictions on the type of business to be conducted by the licence holder; the issue of guarantees; the creation of encumbrances; and dealings with relevant assets.

Train operators have conditions in their licences requiring separate accounting information for stations and light maintenance depot activities. Formal accounting notice has been issued for depots along with cost allocation guidelines.

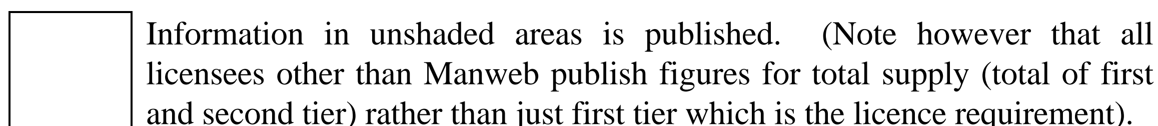
The regulator does not prescribe the basis of allocation of individual costs between different activities. However, ORR set out a statement of the general principles which light maintenance depot operators should bear in mind when developing their cost allocation policies. The guidelines stress consistency of approach. The overriding principle is that costs should be recorded by the activity that incurred or consumed them. The guidelines do not discuss the merits of the different methods of allocating common costs, but whichever methodology is adopted should be reasonable, fair, clearly determined and supported by rational argument. A comprehensive statement is required from operators which sets out the basis of cost allocation in preparing the separate accounts.

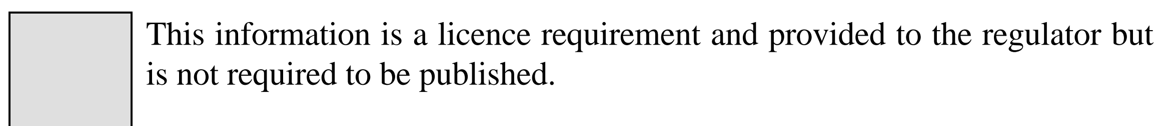
ANNEX 4

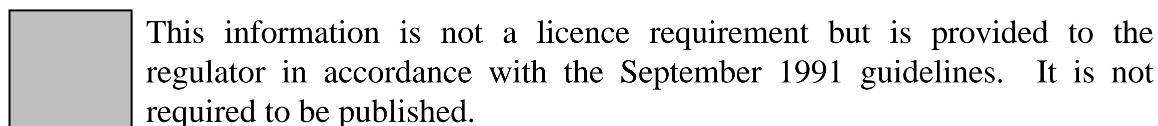
REGULATORY FINANCIAL STATEMENTS

This Annex contains the format of the regulatory accounts submitted by East Midlands Electricity. The broad scope and form of the regulatory accounts is specified in licence conditions (including the requirement that they have the same form and content as the licensees statutory accounts, and conform to the best commercial accounting practice) and in the September 1991 guidelines, and is common to all licensees who are required to produce such accounts. There are some difference of detail in the way that individual licensees present the information in individual tables.

KEY TO UNSHADED/SHADED AREAS







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STATEMENT [BY EAST MIDLANDS ELECTRICITY] OF RESPONSIBILITIES IN RESPECT OF REGULATORY FINANCIAL STATEMENTS

Condition 2 of the company's public electricity supply licence requires it to prepare for each financial year regulatory financial statements under the current cost convention which, so far as reasonably practicable, have the same content and format as annual accounts prepared under the Companies Act 1985. The regulatory financial statements are required to give, under the current cost convention, a true and fair view of the assets, liabilities, reserves and provisions of, or reasonably attributable to, the separate businesses, as defined for that purpose in the licence, and of the revenues, costs and cash flows of, or reasonably attributable to, those businesses for the year then ended.

In preparing the regulatory financial statements suitable accounting policies, supported by reasonable and prudent judgements and estimates, have to be used and applied consistently. Applicable accounting standards also have to be followed. The licensee is required to prepare the regulatory financial statements on a going concern basis unless it is inappropriate to presume that the group or a separate business will continue in business. Suitable bases of charges, apportionment and allocation have to be selected and applied consistently. The licensee is also responsible for maintaining adequate accounting records for each of the separate businesses, so as to ensure the regulatory accounts comply with the requirements of the licence. The licensee is responsible for safeguarding the assets of the group, certain of which may for regulatory accounting purposes be allocated or apportioned to the separate businesses, and for taking reasonable steps to prevent and detect fraud and other irregularities.

The directors confirm the licensee's compliance with these requirements.

By order of the board.

AUDITORS' REPORT TO THE DIRECTOR GENERAL OF ELECTRICITY SUPPLY

We have audited the regulatory financial statements set out on pages **[ ]** to **[ ]** which have been prepared under the current cost convention and the accounting policies set out in note 1 on pages **[ ]** and **[ ]**. The regulatory financial statements have been prepared by **[licensee]** for submission to the Director General of Electricity Supply as required by condition 2 of the public electricity supply licence issued to **[licensee]** on **[date]**.

Respective Responsibilities of Licensee and Auditors

As described on page 1, the licensee is responsible for the preparation of regulatory financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

Basis of Opinion

We conducted our audit in accordance with auditing standards issued by the Auditing Practice Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the regulatory financial statements. It also includes an assessment of the significant estimates and judgements made by the licensee in the preparation of the regulatory financial statements, and of whether the accounting policies are appropriate to the circumstances of the separate businesses as defined in the licence, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the regulatory financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the regulatory financial statements.

In our opinion the regulatory financial statements have been properly prepared in accordance with Condition 2 of the licence and give a true and fair view of the assets, liabilities, reserves and provisions of, or reasonably attributable to, the separate businesses, as defined for that purpose in the licence, at **[date]** and of the revenues, costs and cash flows of, or reasonably attributable to, those businesses for the year then ended.

Current cost profit and loss accounts
Year ended 31 March 1997

		Distribution		Supply		Second Tier Supply		Generation		Other Activities		Corporate		Adjustments Arising on Consolidation		Group	
	Note	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
TURNOVER																	
Continuing operations																	
- internal																	
- external																	
- exceptional rebate																	
Discontinued operations																	
TOTAL TURNOVER																	
COST OF SALES																	
Cost of sales before exceptional item																	
Exception levy adjustment																	
TOTAL COST OF SALES																	
GROSS PROFIT (LOSS)																	
INDIRECT OPERATING CHARGES																	
Indirect operating charges before exceptional items																	
Exceptional operating costs																	
Exceptional items, i.e. NGG																	
Release of fundamental restructuring provision																	
TOTAL INDIRECT OPERATING CHARGES																	
OPERATING PROFIT 9LOSS) BEFORE MONETARY WORKING CAPITAL ADJUSTMENT																	
Monetary working capital adjustment																	
OPERATING PROFIT (LOSS)																	
Continuing operations excluding exceptionals																	
Exceptional items, re NGG																	
Exceptional operating costs																	
Continuing operations																	
Discontinued operations																	
Release of fundamental restructuring provision																	
TOTAL OPERATING PROFIT (LOSS)																	
EXCEPTIONAL ITEMS																	
Release of fundamental restructuring provision																	
Surplus on disposal of discontinued operations																	
TOTAL EXCEPTIONAL ITEMS																	
Share of profits (losses) of associated undertakings																	
Other income from fixed asset investments																	
Transfer in respect of net rebate																	
PROFIT (LOSS) ON ORDINARY ACTIVITIES BEFORE INTEREST AND TAXATION																	
Gearing adjustment																	
Net interest receivable (payable)																	
PROFIT (LOSS) ON ORDINARY ACTIVITIES BEFORE TAXATION																	
Tax on profit (loss) on ordinary activities																	
PROFIT (LOSS) FOR THE FINANCIAL YEAR																	
Dividends																	
RETAINED PROFIT (LOSS) FOR THE FINANCIAL YEAR																	

Current cost balance sheets
As at 31 March 1997

	Note	Distribution		Supply		Second Tier Supply		Generation		Other Activities		Corporate		Adjustments Arising on Consolidation		Group	
		1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
FIXED ASSETS																	
Tangible assets																	
Investments																	
CURRENT ASSETS																	
Stocks																	
Debtors - due within one year																	
- due after more than one year																	
Investments																	
Cast at bank and in hand																	
CREDITORS (amounts falling due within one year																	
NET CURRENT ASSETS (LIABILITIES)																	
TOTAL ASSETS LESS CURRENT LIABILITIES																	
CREDITORS (amounts falling due after more than one year																	
PROVISIONS FOR LIABILITIES AND CHARGES																	
CORPORATE CAPITAL EMPLOYED IN SEPARATE BUSINESSES																	
SHARE CAPITAL AND RESERVES																	
Called up share capital																	
Share premium account																	
Capital redemption reserve																	
Current cost reserve																	
Realised																	
Unrealised																	
Profit and loss account																	
EQUITY SHAREHOLDERS' FUNDS																	

Current cost recognised gains and losses
Year ended 31 March 1997

	Note	Distribution		Supply		Second Tier Supply		Generation		Other Activities		Corporate		Adjustments Arising on Consolidation		Group	
		1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
Operating profit (loss)																	
Net non-operating credits (charges)																	
Profit (loss) for the financial year																	
Current cost revaluations in the year																	
Net tangible fixed assets																	
Investment in NGG																	
Stocks																	
Other current cost reserve adjustments																	
Capital gains tax																	
TOTAL RECOGNISED GAINS AND LOSSES																	

RECONCILIATION OF MOVEMENTS IN CORPORATE CAPITAL EMPLOYED AND GROUP EQUITY SHAREHOLDERS' FUNDS

Year ended 31 March 1997

	Note	Distribution		Supply		Second Tier Supply		Generation		Other Activities		Corporate		Adjustments Arising on Consolidation		Group	
		1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
Balance at 1 April 1996																	
Operating profit (loss)																	
Net non-operating charges																	
Tax adjustments reflected in Generation balance sheet																	
Movement in net adjustments relating to investments in subsidiaries																	
Group relief and ACT transfers relating to Other Activities																	
Dividends																	
Add unrealised gain arising from current cost																	
Net tangible fixed assets																	
Investment in NGG																	
Stocks																	
Other current cost reserve adjustments																	
Capital gains tax																	
Shares issued during the year																	
Internal transfers of fixed assets																	
Net amount transferred (to) from corporate funds																	
Balance at 31 March 1997																	

Current cost recognised gains and losses Year ended 31 March 1997		**Distribution**		**Supply**		**Second Tier Supply**		**Generation**		**Other Activities**		**Corporate**		**Adjustments Arising on Consolidation**		**Group**	
	Note	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
Operating profit (loss) Net non-operating credits (charges)																	
Profit (loss) for the financial year Current cost revaluations in the year Net tangible fixed assets Investment in NGG Stocks Other current cost reserve adjustments Capital gains tax																	
TOTAL RECOGNISED GAINS AND LOSSES																	

Cash flow statements Year ended 31 March 1997		**Distribution**		**Supply**		**Second Tier Supply**		**Generation**		**Other Activities**		**Corporate**		**Adjustments Arising on Consolidation**		**Group**	
	Note	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
NET CASH INFLOW (OUTFLOW) FROM OPERATING ACTIVITIES RETURNS ON INVESTMENTS AND SERVICING OF FINANCE TAXATION CAPITAL EXPENDITURE ACQUISITIONS AND DISPOSALS EQUITY DIVIDENDS PAID																	
CASH INFLOW (OUTFLOW) BEFORE USE OF LIQUID RESOURCES AND FINANCING MANAGEMENT OF LIQUID RESOURCES Net sale (purchase) of current asset investments FINANCING Proceeds from shares during the year Issue of Eurobonds Net cash inflows (outflows) from bank and other loans																	
NET CASH INFLOW (OUTFLOW) FROM FINANCING TRANSFER IN RESPECT OF NGG REBATE OTHER MOVEMENTS IN CORPORATE FUNDING																	
INCREASE (DECREASE) IN CASH IN THE YEAR																	

Current cost recognised gains and losses
Year ended 31 March 1997

		Distribution		Supply		Second Tier Supply		Generation		Other Activities		Corporate		Adjustments Arising on Consolidation		Group	
	Note	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
Operating profit (loss)																	
Net non-operating credits (charges)																	
Profit (loss) for the financial year																	
Current cost revaluations in the year																	
Net tangible fixed assets																	
Investment in NGG																	
Stocks																	
Other current cost reserve adjustments																	
Capital gains tax																	
TOTAL RECOGNISED GAINS AND LOSSES																	

Reconciliation of net cash flow to movement in net debt

OPENING NET CASH (DEBT)																	
(Decrease) increase in cash																	
Cash (inflow) outflow form change in liquid resources																	
Cash outflow from repayment of other borrowings																	
INCREASE IN NET DEBT																	
CLOSING NET CASH (DEBT)																	

Notes to the current cost accounts
Year ended 31 March 1997

1 Accounting policies

These financial statements have been prepared in accordance with applicable accounting standards. The particular accounting policies adopted are described below.

Basis of preparation

The financial statements have been prepared using cost accounting principles and conform, so far as reasonably practicable, with the Companies Act 1985. A revised presentation of cash flow information for the current and prior periods has been adopted following the issue of FRS1 (Revised 1996) - Cash Flow statements by the Accounting Standards Board in October 1996.

Current cost accounts allow for the impact of price changes specific to the business on the funds needed to maintain net operating assets and also take into account the way in which these assets are financed. The impact of price changes on the results for the year is reflected as follows:

(i) Depreciation is calculated on the basis of the current cost of tangible fixed assets as distinct from their original historical cost. Profit or loss on disposals is calculated by reference to their current cost carrying values;

(ii) A cost of sales adjustment is made to allow for the impact of price changes on stock consumed in the year;

(iii) A monetary working capital adjustment is made to represent the additional finance needed to maintain monetary working capital as a result of changes in the input prices of goods and services;

(iv) A gearing adjustment reduces the effect of the other current cost adjustments in the profit and loss account to allow for the benefit to shareholders of financing the business partly by borrowings.

The cost of sales adjustment and monetary working capital adjustment are calculated principally by applying appropriate indices to historical cost. These indices may be subject to continuing revision as more information becomes available. The component parts of indices are periodically reviews.

Changes, allocations and apportionments

In preparing these statements, categories of revenues, costs, assets, liabilities and provisions have been charged or allocated specifically to a business, wherever appropriate.

Because of the integrated nature of activities it is necessary to apportion certain elements of these categories to determine those amounts reasonably attributable to each of the businesses as an individual activity. Elements not attributable to an individual activity, such as capital liabilities, dividends and taxation, have been included in the corporate entry.

Accounting for disposals and goodwill

A business which is sold or closed is classified as discontinued if its sale or closure has a material effect on the nature and focus of the group's operations, represents a material reduction in the group's operating facilities and is completed prior to the date of approval of the financial statements. Goodwill which relates to a discontinued business is reinstated in the balance sheet from reserves and then written off through the profit and loss account.

Turnover

Electricity turnover represents the value of electricity supplied and charges for electricity distributed during the year, exclusive of value added tax., including estimates of the sales value of units supplied and charges for electricity distributed to consumers between the date of the last meter reading and the year end.

Where there is an over recovery of Distribution or Supply business revenues against the regulated maximum allowable amount, revenues are deferred equivalent to the over recovered amount. The deferred amount is deducted from turnover and included in creditors within accruals and deferred income. Where there is an under recover, no anticipation of any future recovery is made.

Other turnover represents the sales value of contract work performed in the year, and the invoice value of other goods sold and services provided, exclusive of value added tax.

Contributions to pension funds

Pension costs are calculated as a substantially level percentage of pensionable salary and are charged to the profit and loss account so as to spread the cost of pensions over employees' working lives with the company.

Tangible fixed assets

Tangible fixed assets other than investment properties are stated at current replacement cost less depreciation and customers' contributions. The gross current replacement cost of tangible fixed assets is calculated principally by applying appropriate indices to historical cost figures, which include attributable labour and overheads. Customers' contributions are indexed in line with the related assets. Certain land and buildings have been valued to

existing use value by external charted surveyors.

The charge for depreciation is calculated to write off assets over their estimated useful lives. Provision is made for permanent diminution in value where such diminution occurs. The lives of each major class of depreciable asset are as follows:

	Years
Distribution Network Assets	40
Depreciation is charged at 3% for the first 20 years, followed by 2% for the remaining 20 years.	
Customers' contributions are credited to the profit and loss account over a 40 year period at a rate of 3 per cent for the first 20 years, followed by 2 per cent for the remaining 20 years.	
Other assets	
Buildings - freehold	Up to 60
- leasehold	Lower of lease period or 60
Plant, machinery, fixtures and equipment	Up to 10
Vehicles and mobile plant	Up to 10

No depreciation is charged on freehold land or assets in the course of construction.

Property clawback

HM Government is entitled to a proportion of any gain realised by the company on certain property disposals made up to 31 March 2000. Full provision for clawback liabilities is made as soon as any disposal decision is taken.

Investment properties

In accordance with Statement of Standard Accounting Practice No 19, investment properties are revalued annually and the aggregate surplus or deficit is transferred to revaluation reserve.

The Companies Act requires all properties to be depreciated. However, this requirement conflicts with the generally accepted accounting principle set out in SSAP19. By the adoption of SSAP19 the investment properties have not been depreciated, but in the opinion of the directors this is not material to the financial statements and therefore does not have any effect on the true and fair view.

Fixed asset investments

In the consolidated accounts, shares in associated undertakings are accounted for using the equity method of accounting. The consolidated profit and loss account includes the group share of the pre-tax results and attributable taxation of the associated undertakings. In the consolidated balance sheet, the shares in associated undertakings are shown as the group's share of their net assets, less provisions.

Other fixed investments are stated at current cost less provisions for permanent diminution in value. Current asset investments are stated at the lower of current cost and net realisable value.

Stocks

Stocks are valued at the lower of net current replacement cost and net realisable value. The valuation of work in progress is based on the current cost of labour plus appropriate production overheads and the current replacement cost of materials.

Deferred taxation

Deferred taxation arises in respect of times where there is a timing difference between their treatment for accounting purposes and their treatment for taxation purposes. Provision for deferred taxation, using the liability method, is made to the extent that it is probable that the liability or asset will crystallise in the foreseeable future.

Restructuring

Provision is made when the group becomes demonstrably committed to a restructuring programme.

Notes to the current cost accounts Year ended 31 March 1997	**Distribution**		**Supply**		**Second Tier Supply**		**Generation**		**Other Activities**		**Corporate**		**Adjustments Arising on Consolidation**		**Group**	
	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
2 Regulatory correction factors																
Cumulative under (over) recoveries of maximum allowable regulated charges																
3 Exceptional items																
Exceptional items, other than those relating to the distribution of the company's interest in NGG in December 1995, were as follows:																
Operating																
[ ]																
[ ]																
Other exceptional operating costs																
Non operating																
Release of provisions no longer required																
Surplus on disposals																
Movement in fundamental restructuring provisions:																
Operating losses charges																
Utilisation of provisions in connection with discontinued activities																
Release of provisions no longer required																
Total movement in fundamental restructuring provisions																
4 Indirect operating charges																
Indirect operating charges comprise:																
Charges related to NGG distribution																
Exceptional costs																
Indirect employee costs (Note 5)																
Depreciation excluding exceptional depreciation																
Materials and purchase of services																
Materials and purchase of services includes:																
Auditors' remuneration																
Fees paid to group auditors for other services																
5 Employees																
Total employee costs during the year amounted to:																
Salaries																
Social security costs																
Other pension costs																
Charged to the profit and loss account																
Allocated to:																
Cost of sales																
Indirect operating charges																
Capitalised within fixed assets																

	Distribution		Supply		Second Tier Supply		Generation		Other Activities		Corporate		Adjustments Arising on Consolidation		Group	
	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
6 Income from other fixed asset investments																
Income from fixed asset investments																
Internal dividends																
7 Tangible fixed assets																
Cost																
At 1 April 1996																
Transfer																
Additions																
Disposals																
Revaluation during the year																
At 31 March 1997																
Depreciation																
At 1 April 1996																
Transfers																
Provision for the year																
Disposals																
Revaluation during the year																
At 31 March 1997																
Net book value																
At 31 March 1997																
At 31 March 1997																
The net book value comprises:																
Distribution network																
Land and buildings																
Plant, machinery, fixtures and equipment																
Vehicles and mobile plant																
Less: customers' contributions																
Land and buildings, which excludes those forming part of the distribution network, principally comprises freehold properties																
Tangible fixed assets include the following, which are not depreciated:																
Assets in the course of construction																
Land																
Investment properties																
The investment properties and certain land and buildings were valued at open market value by [ ], chartered surveyors, as at 31 March 1997																
Fixed asset expenditure commitments																
In respect of contracts placed																
8 Investments																
The XXXXXXXXXXXXXX																
At 1 April 1996																

Additions Revaluation Distribution to shareholders Special dividend received on shares held by ESOP																
At 31 March 1997																
Associated undertakings *Cost* At 1 April 1996 Additions Disposals																
At 31 March 1997																
Group share of undisturbed profits At 1 April 1996 Profit for the year after tax Disposals																
At 31 March 1997																
Net book value																
Subsidiary undertakings Other investments'																
9 Stocks Raw materials and consumables Work in progress																
10 Debtors Amounts falling due within one year: Trade debtors Amounts owed by parent undertaking Amounts owed by subsidiary undertakings (or other businesses) Amounts owed by associated undertakings Other debtors Prepayments and accrued income Deferred tax asset Advance Corporation Tax recoverable Dividends receivable																
Amounts falling due after more than one year: Amounts owed by subsidiary undertakings Advance Corporation Tax recoverable Prepayments and accrued income Other debtors																
11 Creditors: amounts falling due within one year Bank loans and overdrafts Other loans Payments received on account Trade creditors Amounts owed by subsidiary undertakings (or other businesses) Amounts owed to associated undertakings Other creditors Corporation Tax Other taxation and social security Accruals and deferred income Proposed dividends																

12 Creditors: amounts falling due after more than one year Eurobonds Accruals and deferred income																
13 Provisions for liabilities and charges At 1 April 1996 Applied during the year Charged to the profit and loss account																
At 31 March 1997																
Provisions at 31 March comprise: Restructuring Other																
14 Reconciliation of operating profit (loss) to net cash inflow/(outflow) from operating activities Operating profit (loss) Exceptional costs Depreciation charges* (Profit) loss on disposal of tangible fixed assets* Monetary working capital adjustment Cost of sales adjustment Increase (decrease) in unrealised revaluation surplus on stocks (Increase)/Decrease in stocks* (Increase)/Decrease in debtors* Increase/(Decrease in creditors* Increase/(Decrease) in provisions*																
Net cash inflow/(outflow) from operating activities before exceptional costs Net cash outflow relating to exceptional costs																
Net cash inflow/(outflow) from operating activities																
**** Excludes the movement related to exceptional items and disposals***																
15 Gross cash flows RETURNS ON INVESTMENTS AND SERVICING OF FINANCE Interest received Interest paid Dividends and other income received from fixed asset investments Distribution from [ ]																
NET CASH INFLOW (OUTFLOW) FROM RETURNS ON INVESTMENTS AND SERVICING OF FINANCE																
TAXATION ACT on distribution of NGG shares Other Corporation Tax paid																
TOTAL TAX PAID																
CAPITAL EXPENDITURE Purchase of tangible fixed assets Customers’ contributions to tangible fixed assets Sale of tangible fixed assets																
TOTAL CAPITAL EXPENDITURE																
ACQUISITIONS AND DISPOSALS																

Purchase of shares in [ ] Disposals ESOP options exercised and disposal of own shares Net (additions) disposals of fixed asset investments																
NET CASH (OUTFLOW) INFLOW FROM ACQUISITIONS AND DISPOSALS																

	Other Activities			Corporate			Adjustments Arising on Consolidation			Group		
	At 1.4.96	Cash flow	At 31.3.97	At 1.4.96	Cash flow	At 31.3.97	At 1.4.96	Cash flow	At 31.3.97	At 1.4.96	Cash flow	At 31.3.97
16 Analysis of cash as shown in the balance sheet Cash at bank and in hand Bank overdrafts												
Net cash Eurobonds Other loans												
Debt												
Current asset investments'												
Net debt												
** Excluding amount due from PSB*												

Statement of amounts allocated and apportioned between the separate businesses Year ended 31 March 1997	**Distribution**		**Supply**		**Second Tier Supply**		**Generation**		**Other Activities**		**Total Apportioned/ Allocated**	
	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
Profit and loss account Distribution costs and administrative expenses: Electricity marketing Billing and collection Training and welfare Premises related costs and general charges Administration and other activities												
Balance sheet Creditors (amounts falling due within one year): Trade creditors and accruals												
Provisions for liabilities and charges												

Statements of amounts allocated and apportioned between the separate businesses (continued)

Year ended 31 March 1997

Basis of apportionment

Distribution costs and administrative expenses

Apportionments (where applicable) reflect the principles in paper CSC 194 (DAG 62) as amended and are as follows:

(a) Electricity marketing

Electricity marketing has been allocated on the basis agreed with OFFER (reference our letter of 24 September 1996), whereby Distribution marketing is specific to that business, while Supply marketing is allocated 85 per cent Supply, 15 per cent Distribution to reflect the proportion (45 per cent) of Supply marketing which is brand/Corporate image related, of which one third is assessed as being to the benefit of the Distribution business.

(b) Billing and collection (including customer record maintenance)

Customer enquiry, billing and collection staff salaries and related costs have been apportioned based on assessments of the quality and quantity of the work content relative to the principles outlined in the paper CSC 194.

(c) Training and welfare

i) Training - reflects apportionment of related staff receiving training and career development;
ii) Welfare - apportionments based on salaries allocated to businesses.

(d) Premises related costs and general services:

i) Premises related costs (rents, rates etc)

Non-operational offices: apportioned pro-rata to salaries of staff employed in each building per business.
Shops, depots, stores: reflecting measured assessment of utilisation, floor area etc.

ii) General services

Includes such items as telecommunications, costages and office maintenance. Where these are premises related they have been apportioned in accordance

with the principles outlined above. Computer service costs have been apportioned based on an assessment of each project / system utilised by the individual businesses. Specific computer service costs in respect of energy account billing reflect CSC 194 principles, that is, reading processing 100 per cent Distribution (other than Second Tier Supply); bill preparation and mailing 100 per cent Supply (other than Second Tier Supply).

(e) Administration and other activities

Administrative support staff salaries and associated expenditure have been re-apportioned on various bases according to category of cost:

i) Individual departmental assessments, using measurement techniques where appropriate, to achieve an attribution of functional workload across the separate businesses.

ii) For employee-related costs (for example, payroll, personnel), apportionment has been based on salaries allocated to businesses.

iii) For corporate overheads not directly attributable to a separate business, a 50 per cent net asset / 50 per cent salaries basis has been used.

Working capital

The only debtor and creditor balances which have been apportioned are Corporate balances which cannot be specifically identified with individual businesses. These values have been split on a 50 per cent net asset / 50 per cent salaries basis.

Provisions

The majority of these have been allocated specifically. Remaining provisions are apportioned on a 50 per cent net asset / 50 per cent salaries basis.

Statement of amounts charged from and to the separate businesses	**Distribution**		**Supply**		**Second Tier Supply**		**Generation**		**Other Activities**		**Corporate**		**Adjustments Arising on Consolidation**		**Group**	
Year ended 31 March 1997	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m	1997 £m	1996 £m
Amounts charged to:																
Distribution																
Supply																
Second Tier Supply																
Generation																
Other activities																
Corporate																
Total internal turnover																
Categories of recharge:																
Distribution use of system and excluded service charge																
Electricity sales																
Electricity consumption on group premises																
Non-regulated business internal recharges																
Information technology charges																
Capital sales																
Other																

Statement of amounts charged from and to the separate businesses (continued)

Year ended 31 March 1997

Basis of charge

Distribution use of system and excluded service charges

Use of system and associated excluded service charges calculated and recharged to the Supply businesses based on published tariffs and actual unit consumptions. The charge also incorporates an adjustment for unbilled income evaluated at relevant tariff rates.

Electricity sales

Sale of electricity generated from renewable energy sources (land fill gas).

Electricity consumption on group premises

Calculated electricity consumption on group premises based on factual meter readings, or assessment, evaluated at relevant tariff rates.

Non-regulated business internal recharges

Transactions between non-regulated businesses are at commercially negotiated rates.

Information Technology

Costs recharged from subsidiary business **[ ]**.

Capital sales

Capital work undertaken by the electrical contracting and other non-regulated businesses is at commercially negotiated rates.