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for all gas and electricity customers

Wholesale and retail energy prices explained

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Ofgem is today publishing its first report on wholesale and retail prices to help customers gain a wider understanding of the relationship between the two.

What drives wholesale prices?

Wholesale costs account for around 60 per cent of a customer's energy bill and are a major consideration in suppliers' retail pricing decisions. Wholesale costs, in turn, depend on a range of factors. A key factor is the price of oil which rose to a peak of $147 a barrel in 2008. Oil prices were cited by suppliers as being one of the primary reasons for last year's retail price increases.

Oil prices have a major impact on Britain's wholesale gas prices because Britain imports around 40 per cent of its winter gas demand from Europe. Many prices paid under gas contracts in Europe are linked to crude oil product prices and changes in oil prices take between six and nine months to affect European gas prices. Any changes in wholesale gas prices in Britain have an impact on wholesale electricity prices as gas is used to generate around 40 per cent of Britain's electricity. However factors such as the cost of coal and carbon and the availibility of power stations also affect the wholesale electricity price.

Wholesale energy prices have fallen recently. Are these reductions being passed on to customers?

The relationship between wholesale and retail energy prices is complex for a number of reasons. A key factor is that suppliers have a range of strategies for buying wholesale gas and electricity ahead of physical delivery. This is known as hedging. The wholesale cost models used in Ofgem's report are based on firms starting to purchase energy 1-2 years ahead of delivery. Hedging means that suppliers may not pass on increasing wholesale costs immediately to customers. However it also means that falling wholesale costs may not immediately result in reductions in the retail price. Suppliers incur costs when changing prices which is another reason why the retail price will not always reflect the wholesale cost the supplier is facing at a particular point in time.

As part of its probe into the energy supply market Ofgem examined the relationship between wholesale and retail energy prices. Ofgem found no evidence to suggest that increases in wholesale costs have been passed through to customers to a greater extent when wholesale prices rise compared with when they fall.

Wholesale energy prices have fallen recently. Are these reductions being passed on to customers? (continued)

Wholesale prices in Britain have been falling since last summer and Ofgem anticipated that suppliers would reduce prices this year in response. Five suppliers have now announced price custs for some of their customers.

- British Gas is cutting gas prices by 10 per cent for 7.5 million of its customers.
- Scottish and Southern Energy is cutting electricity prices by 9 per cent and gas prices by 4 per cent on average.
- E.ON is cutting its electricity prices by 9 per cent for 4.1 million of its customers.
- EDF is cutting its electricity prices for customers in London, the South East, the South West, Wales and Scotland by an average of 8.8 per cent.
- Scottish Power is cutting its gas prices by an average of 7.5 per cent and its electricity prices by an average of 3 per cent.

Ofgem routinely monitors the market to ensure that the prices customers pay reflect market conditions and the quarterly publication of the wholesale and retail price reports will provide increased transparency in this area.

What impact do environmental programmes and network investment have on customer bills?

Large numbers of customers switch supplier in Britain each year which maintains pressure on suppliers to price competitively so they can win and retain customers. The switching rate between December 2007 and November 2008 was 5.3 million. However the costs of the Government's environmental programmes are increasing and this erodes the capacity for reductions in bills. The need to upgrade energy networks and infrastructure to maintain secure supplies, connect more renewables and import more gas also adds costs onto customer bills. It is therefore unlikely that Britain will see a return to the low retail prices of the start of this decade.

Other supply costs amount to approximately £180 out of a domestic customer’s electricity bill and £180 out of their gas bill. These costs result principally from environmental programmes and network charges.

Environmental programmes that have an impact on bills

- The EU Emissions Trading Scheme (EU-ETS) which puts a price on pollution emitted by electricity generators and heavy industry. Generators relect the costs of the EU ETS in the wholesale price of electricity.
- The Carbon Emissions Reduction Target (CERT) is a Government policy that sets energy suppliers targets for reducing carbon emissions by providing energy efficient measures to domestic consumers. Suppliers pass on the costs of meeting these targets to gas and electricity customers. The Government has announced its intention to increase the scale of this programme which could increase the amount customers would have to pay.
- The Renewables Obligation, which sets energy suppliers targets to source increasing amounts of green electricity each year. Suppliers pass on the costs of meeting this programme to electricity customers.
- The Government is introducing a new Community Energy Savings Programme (CESP) later this year. It is an obligation on energy suppliers and generators to work in partnership with councils and other local organisations to deliver central heating, insulation and energy efficiency measures into people’s homes. It will also encourage greater use of district heating. The CESP, which will be administered by Ofgem, will run from 2009 to 2012 in addition to the CERT. As with the CERT, the costs will be passed on to gas and electricity customers.
- The Government’s new renewable energy strategy, which includes plans for a feed-in tariff for small-scale renewables and an incentive for renewable heat, will further increase bills.

Network investment programmes also impact on bills:

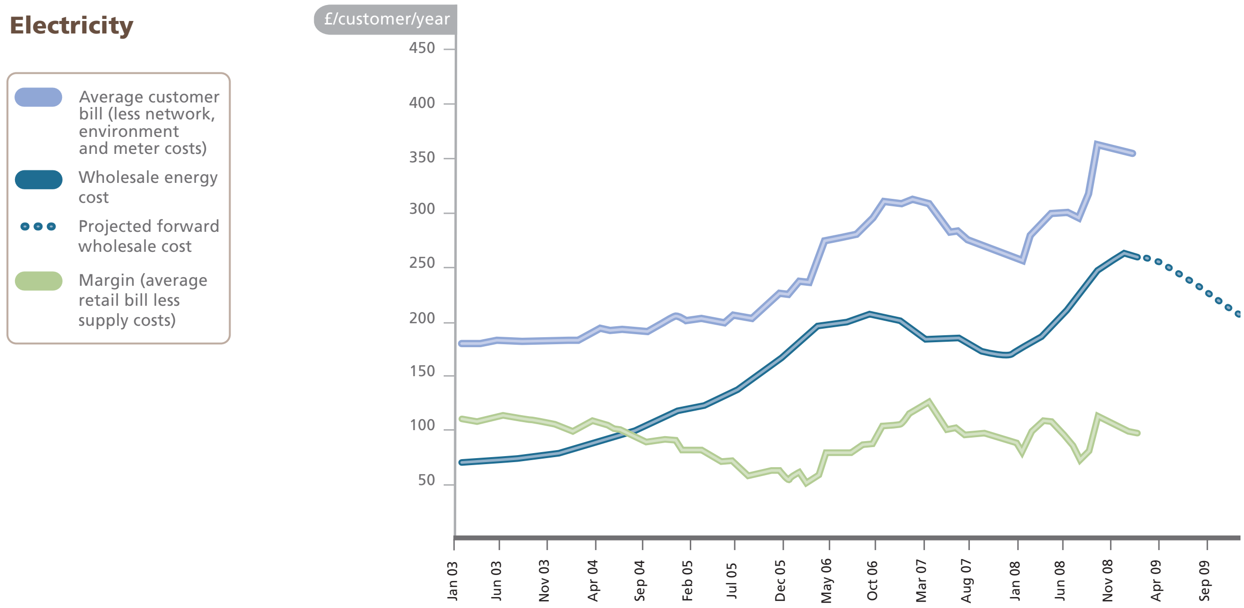
- To maintain secure and safe gas and electricity supplies, upgrades to the energy networks are needed, which include replacing ageing electricity and gas infrastructure. Electricity network companies also need to invest in their networks to connect increasing amounts of renewable generation.
- Companies recover the costs for these investment programmes through transmission and distribution charges on customer bills. The charges are based on the price controls Ofgem sets for the companies every five years. Ofgem’s role is to ensure the controls strike the right balance between allowing the companies adequate revenues and protecting the interests of customers.
- The proportion of a gas and electricity bill that is made up of energy transmission and distribution charges is displayed in the graphs on the following page.

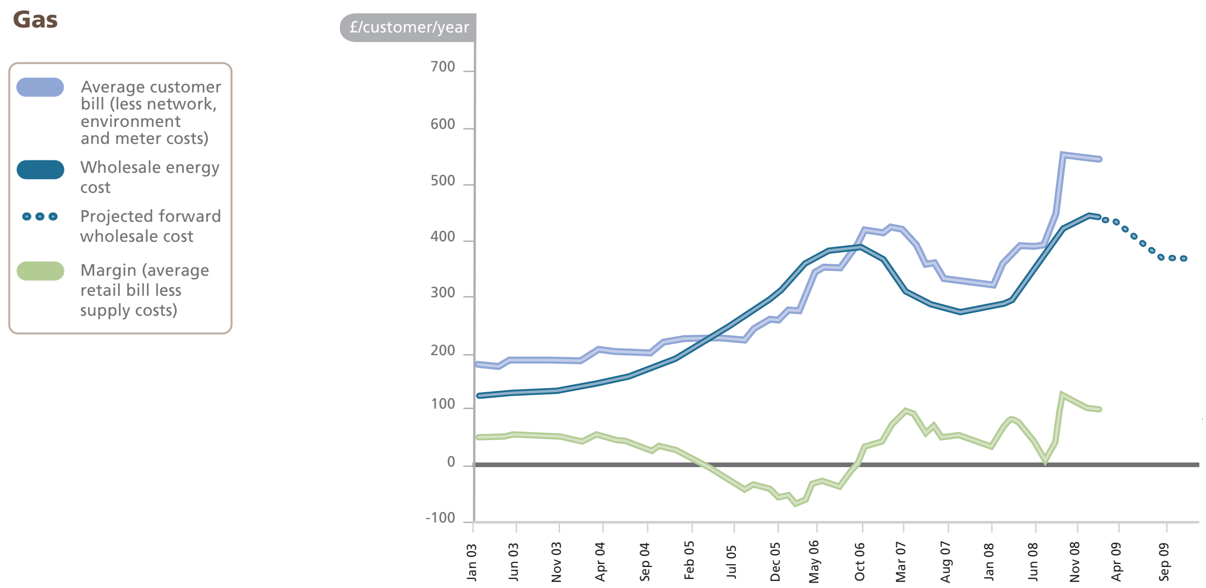
Comparing wholesale and retail prices

Suppliers have various hedging options. In the graphs below Ofgem has used an 18-month hedge, whereby firms start purchasing wholesale energy on the forward market 18 months before delivery. The graphs show that suppliers' wholesale energy costs, based on this hedging strategy, peaked in December 2008 and started to decline in 2009.

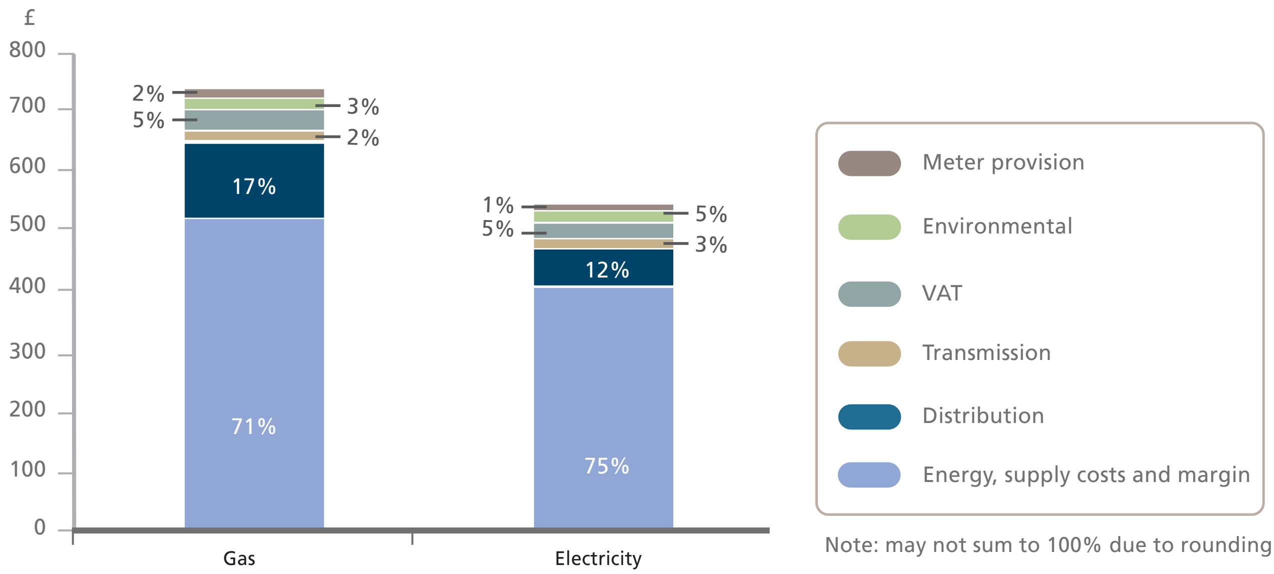
In electricity, the gross margin is currently around £95 per customer while in gas it is £103 per customer. The margins have increased since the summer due to the retail price increases and a levelling off of the wholesale cost increases due to lower wholesale prices. The gross margin is calculated as the difference between the retail prices (less network, environmental and meter costs) and the wholesale energy cost. In addition to operating profit, the gross margin also includes suppliers' own internal operating costs such as customer service staffing, IT, marketing, billing and bad debt costs.

The decision by five of the six major suppliers to cut bills will result in the average margins being reduced. However the analysis presented in the report does not include these price cuts. It is envisaged the next quarterly report will incorporate these changes.





The following graphs show the various components for household gas and electricity bills on 1 February 2009



Note: may not sum to 100% due to rounding

Electricity consumption of 4000 kWh, Gas consumption of 18,200 kWh. These new consumption figures are based on more recent information on average annual energy use. The previous figures were 3,300 kWh for electricity and 20,500 kWh for gas

Ofgem's energy supply market probe

Ofgem has conducted a forensic probe into the energy retail markets and it has found no evidence of cartel-like behaviour or indications that retail prices are rising by more than can be justified by wholesale costs.

However Ofgem has found that competition is not yet fully effective in all segments of the market and is proposing to take action this year in several areas to remedy issues of concern.

The remedies proposed include:

- introducing new licence requirements which will for example ensure broad cost reflectivity between different payment methods;
- tougher rules on doorstep selling;
- more transparency in financial reporting;
- working with industry to address concerns around low ;levels of liquidity in the electricity wholesale market;
- new requirements on suppliers to provide information to help consumers to get the best deal for their energy; and
- introducing new measures to stamp out unfairness in contract terms in the small business supply market.

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