

City workshop on transparency of energy company revenues, costs and profits

Retail Market Analysis team

03/11/2014

ofgem

1pm – **Introduction** (Neil Barnes, Associate Partner)

1:10 – **Consolidated Segmental Statements** (Diego Villalobos, Senior Economist)

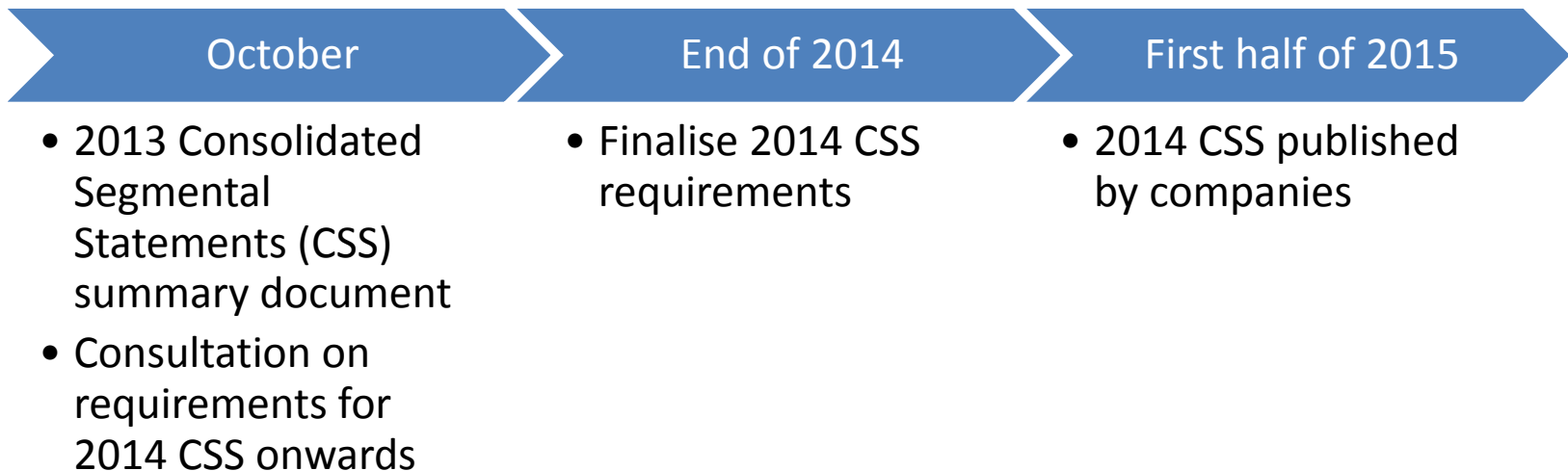
1:30 – *Questions/ Discussion*

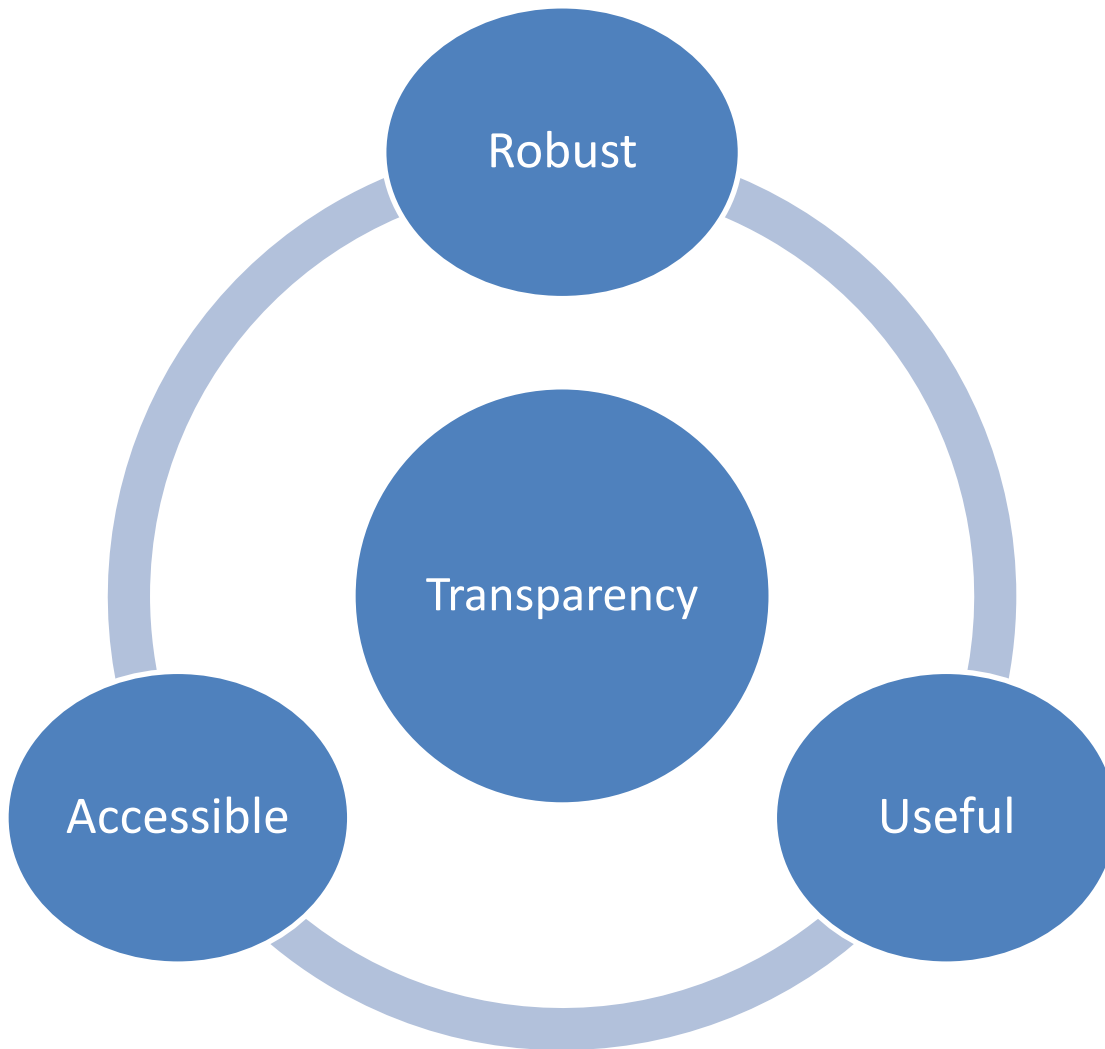
1:50 – **Supply Market Indicator** (Robyn Daniell, Senior Economist)

2:10 – *Questions/ Discussion*

2:30 – **Concluding remarks**

- Transparency of energy company profits is important
- Ofgem plays a crucial role in promoting this transparency
- Present our actions so far and how we propose to improve transparency further
- Engage City to understand your perspective and get feedback





Why is transparency helpful?

- ✓ Improves understanding
- ✓ Provides signals for new entry
- ✓ Helps us monitor and assess the market
- ✓ Promotes consumer confidence

Consolidated Segmental Statements

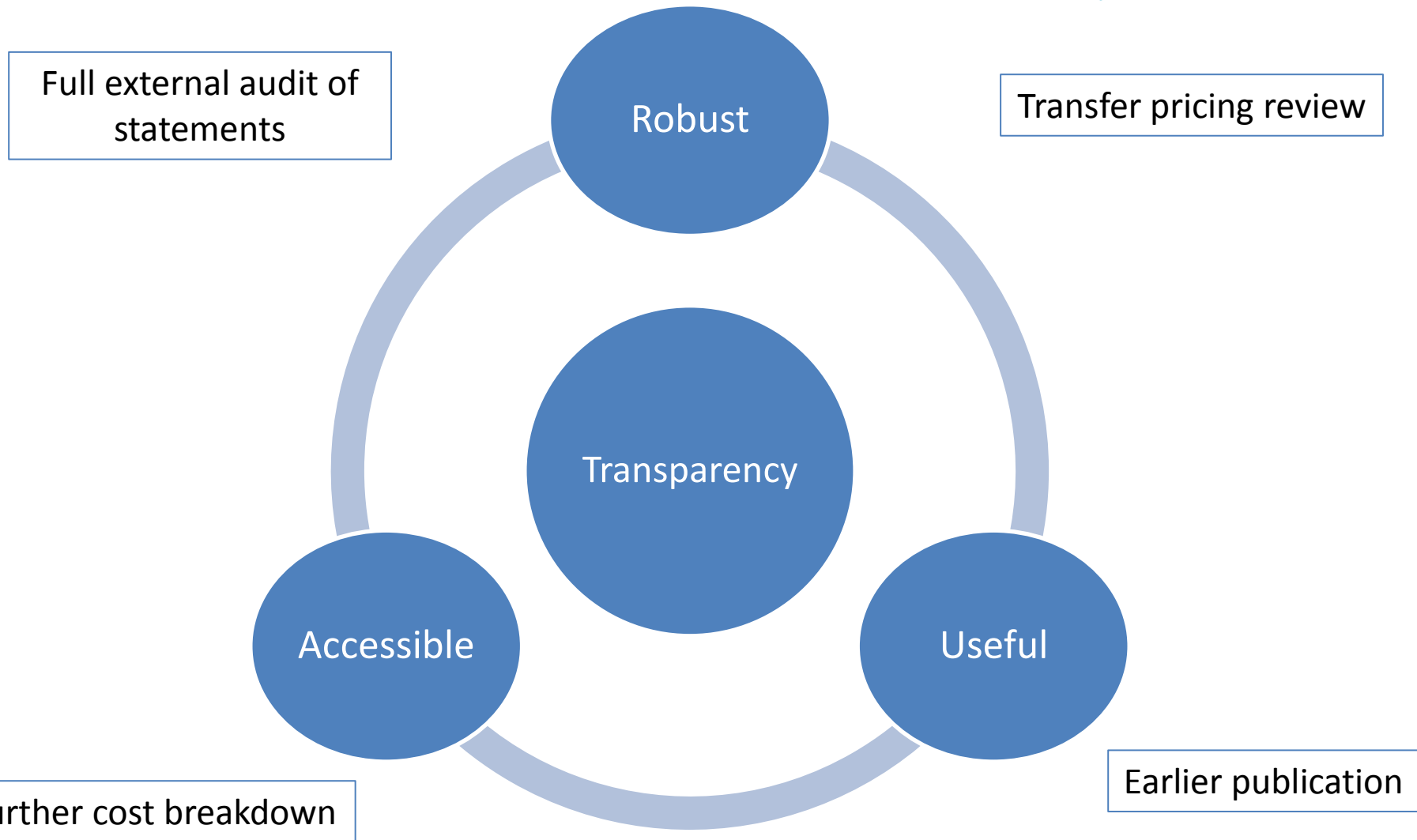
- Since 2009, we have required these companies to report annually on the revenues, costs and profits for their generation & supply activities

	Generation	Domestic supply		Non-domestic supply	
		Gas	Electricity	Gas	Electricity
Revenues	£m	£m	£m	£m	£m
Costs	£m	£m	£m	£m	£m
Operating profits	£m	£m	£m	£m	£m

Supply Market Indicator

- To complement the Statements, we have since 2009 published regular forward-looking estimates of cost trends in the domestic supply market

Before 2009, none of this information was readily available

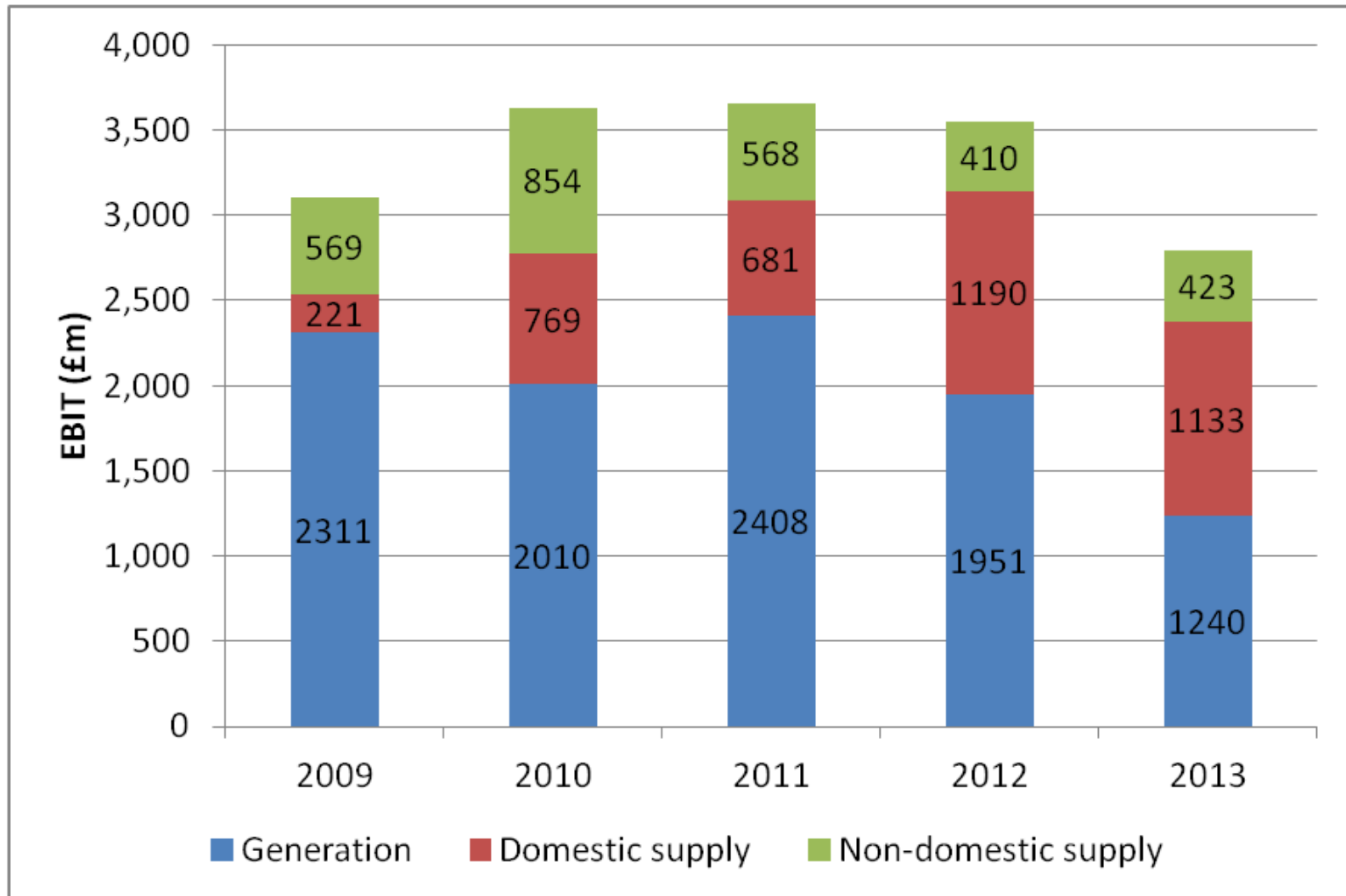


Proposed enhanced CSS template

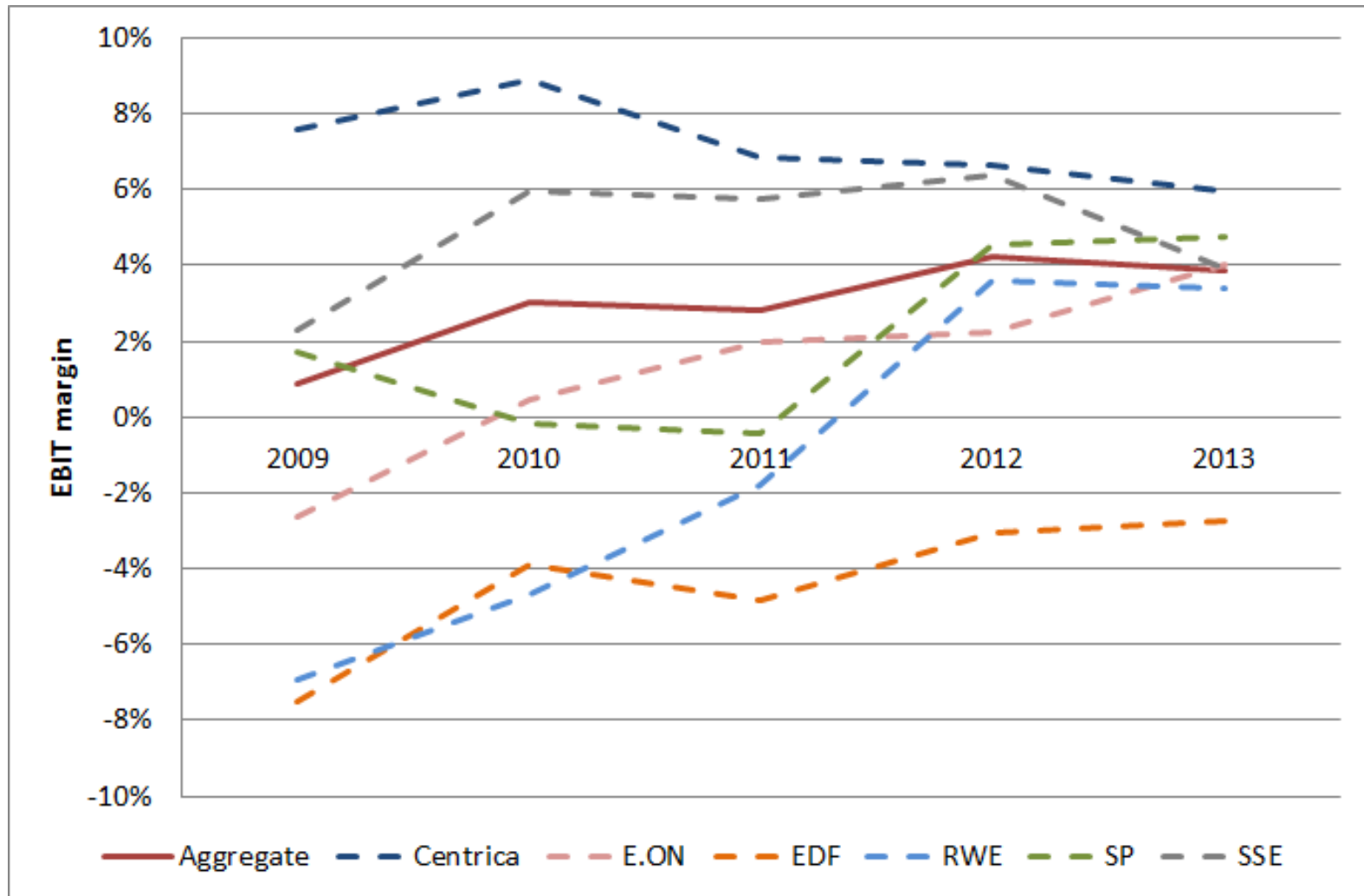
	Unit ¹	Electricity generation		Aggregate generation business ¹³	Electricity supply		Gas supply		Aggregate supply business ¹³
		Conventional	Renewable		Domestic	Non-domestic	Domestic	Non-domestic	
		20xx	20xx		20xx	20xx	20xx	20xx	
Total revenue	£M	£0	£0	£0	£0	£0	£0	£0	£0
Revenue from sales of electricity and gas ²	£M	£0	£0	£0	£0	£0	£0	£0	£0
Other revenue ³	£M	£0	£0	£0	£0	£0	£0	£0	£0
Total operating costs	£M	£0	£0	£0	£0	£0	£0	£0	£0
Direct fuel costs ⁴	£M	£0	£0	£0	£0	£0	£0	£0	£0
Transportation costs ⁵	£M	£0	£0	£0	£0	£0	£0	£0	£0
Env. & social obligation costs ⁶	£M	£0	£0	£0	£0	£0	£0	£0	£0
Other direct costs ⁷		£0	£0	£0					
Indirect costs ⁸	£M	£0	£0	£0	£0	£0	£0	£0	£0
WACO F/E/G ⁹	£/MWh, p/th	0	0	0	0	0	0	0	NA
Adjusted EBITDA ¹⁰	£M	£0	£0	£0	£0	£0	£0	£0	£0
DA	£M	£0	£0	£0	£0	£0	£0	£0	£0
Adjusted EBIT	£M	£0	£0	£0	£0	£0	£0	£0	£0
Exceptional items	£M	£0	£0	£0	£0	£0	£0	£0	£0
EBIT	£M	£0	£0	£0	£0	£0	£0	£0	£0
Interest	£M	£0	£0	£0	£0	£0	£0	£0	£0
Tax	£M	£0	£0	£0	£0	£0	£0	£0	£0
Net profit	£M	£0	£0	£0	£0	£0	£0	£0	£0
Volume ¹¹	TWh, therms	-	-	-	-	-	-	-	NA
Customer accounts ¹²	Thousands of accounts	NA	NA	NA	'000	'000	'000	'000	'000

- Overall (combined generation and supply) profits were down significantly on 2012
- Aggregate domestic supply profits flat on 2012 but still higher than previous years
- Domestic supply margins continue to vary significantly across suppliers

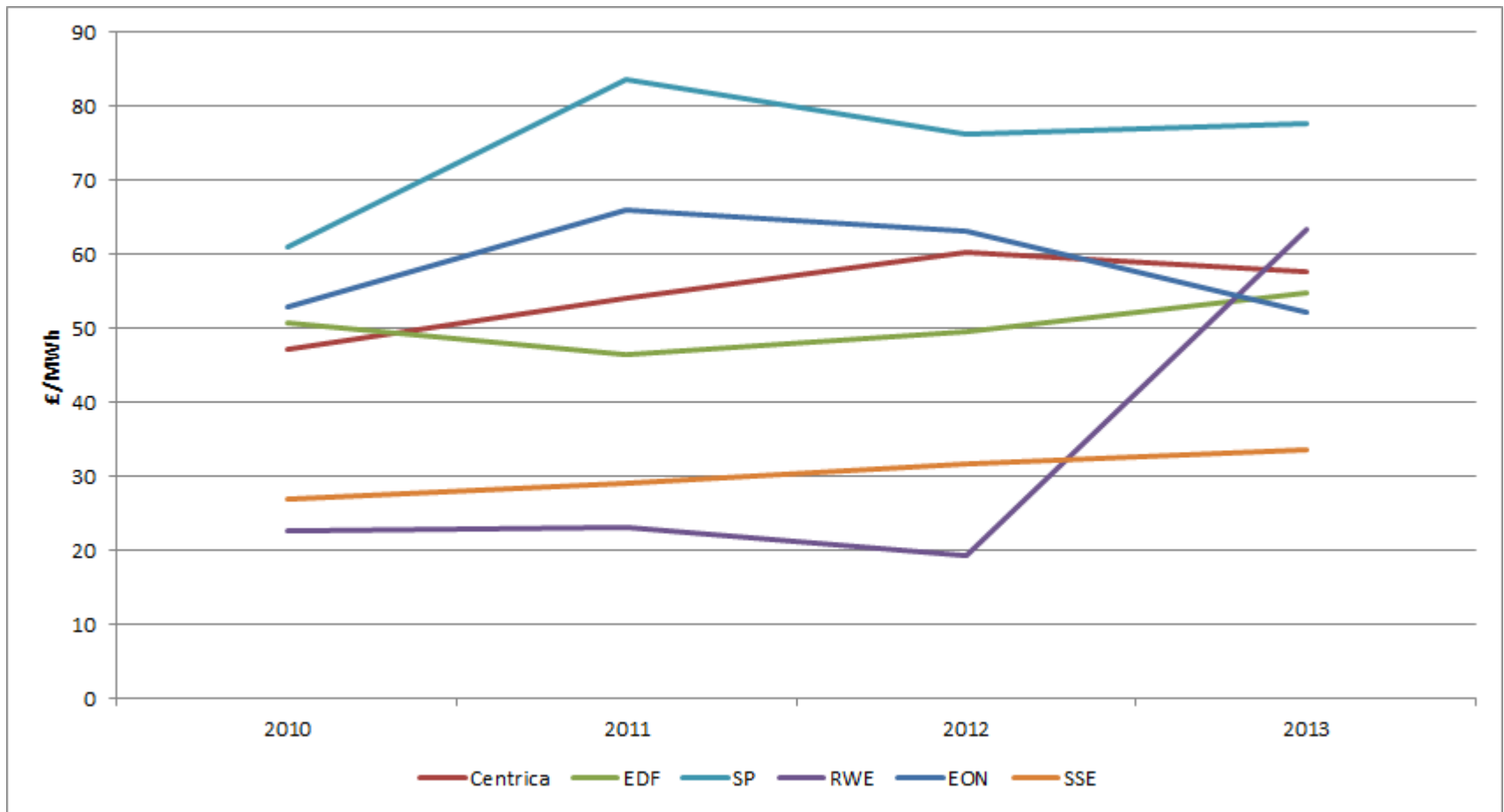
Overall profits down significantly on 2012



Domestic supply margins flat on 2012 but still higher than previous years



Generation revenue per unit



Very different between companies

Two main models

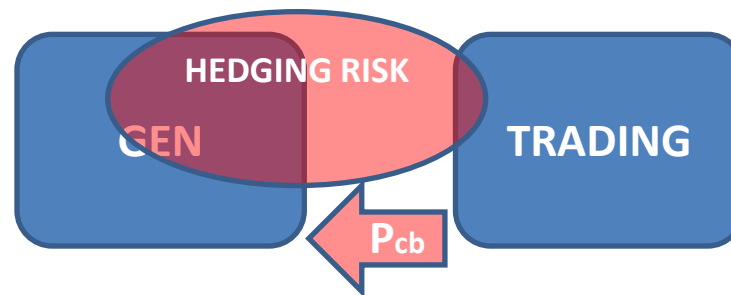
Toll generation

Generation capacity/capability is sold in advance for hedging or optimisation by Trading; Generation is effectively solely responsible for the running of plant.



Central broker

Generation is responsible for its hedging policy, which is implemented by Trading acting as a broker. Generation retain a greater level of risk in this model, including the risk of delivery on the day.



The business functions table

Centrica

SSE

BUSINESS FUNCTIONS TABLE

Year ended 31 December 2013 – analysis of business function's performance ⁽¹⁾

The table below illustrates where the business functions reside.

	Generation	Supply	Another part of business
Operates and maintains generation assets	✓	-	-
Responsible for scheduling decisions	✓	-	-
Responsible for interactions with the Balancing Market	✓	✓	-
Responsible for determining hedging policy	✓ (output)	✓ (demand)	-
Responsible for implementing hedging policy/makes decision to buy and sell energy	✓ (output)	✓ (demand)	-
Interacts with wider market participants to buy/sell energy	✓ (bilateral)	✓ (market and bilateral)	✓ (market and bilateral) ⁽²⁾
Holds unhedged positions (either short or long)	✓	✓	✓ ⁽³⁾
Procures fuel for generation	✓	-	-
Procures allowances for generation	✓	-	-
Holds volume risk on positions sold (either internal or external)	✓	✓	-
Matches own generation with own supply	-	✓ ⁽⁴⁾	✓ ⁽⁴⁾⁽⁵⁾
Forecasts total system demand	-	✓	-
Forecasts wholesale price	✓ ⁽⁶⁾	✓ ⁽⁶⁾	✓ ⁽⁶⁾
Forecasts customer demand	-	✓	-
Determines retail pricing and marketing strategies	-	✓	-
Bears shape risk after initial hedge until market allows full hedge	✓	✓	-
Bears short term risk for variance between demand and forecast	-	✓	-

Business Functions

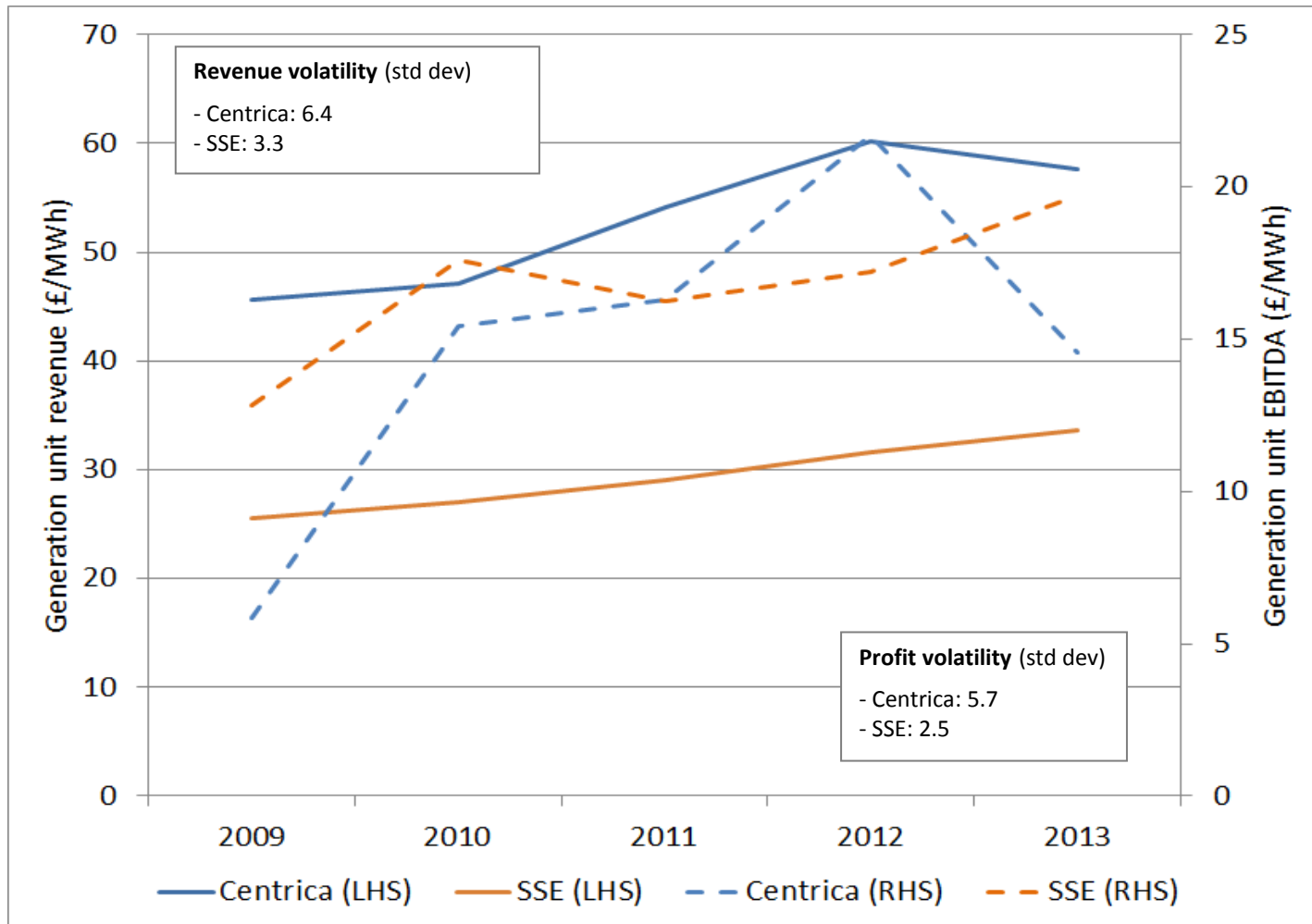
The business functions in SSE have been described already in this document. The column headed 'another part of the business' principally relates to EPM.

Business Function	Generation	Supply	Another part of the business
Operates and maintains generation assets	✓		
Responsible for scheduling decisions	P/L	P/L	P/L F
Responsible for interactions with the Balancing Market			P/L F
Responsible for determining hedging policy	P/L F	P/L	P/L F
Responsible for implementing hedging policy/makes decisions to buy or sell energy	P/L F	P/L F	P/L F
Interacts with wider market participants to buy/sell energy		P/L	P/L F
Holds un-hedged positions (either long or short)		P/L	P/L F
Procures fuel for generation		P/L	P/L F
Procures allowances for generation		P/L	P/L F
Holds volume risk on positions sold (either internal or external)		P/L	P/L F
Matches own generation with own supply		P/L	P/L F
Forecasts total system demand		P/L	P/L F
Forecasts wholesale price		P/L	P/L F
Forecasts customer demand		P/L	P/L F
Determines retail pricing and marketing strategies		✓	
Bears shape risk after initial hedge until market allows full hedge		P/L	P/L F
Bears short term risk for variance between demand and forecast		P/L	P/L F

Key:

- ✓ function and P&L impacting that area;
- P/L Profit/losses of function recorded in that area;
- F function performed in that area.

Two main models yield different results



- Wholesale costs are similar to those of the large energy companies
- Ovo became more cost efficient and achieved lower unit costs than the average of the larger companies

	Ovo		Large energy companies	
	<u>2012</u>	<u>2013</u>	<u>2012</u>	<u>2013</u>
Gas wholesale costs (p/therm)	68	70	62-70	70-77
Electricity wholesale costs (£/MWh)	57	58	58-67	58-67
Gas indirect costs (£/MWh)	6	5	4-7	5-6
Electricity indirect costs (£/MWh)	19	14	13-23	13-22
Gas profit margin	0%	1%	(4)-11%	(5)-9%
Electricity profit margin	(5)%	(1)%	(2)-5%	(1)-8%

- We are making concrete proposals for improving the CSS
 - Final decisions due around the end of the year
 - To be implemented for 2014 statements
- Keen for input from **all** stakeholders by 6 Nov (CSS@ofgem.gov.uk)
- We will review financial reporting requirements in 2016, in the light of the outcome from the CMA's investigation

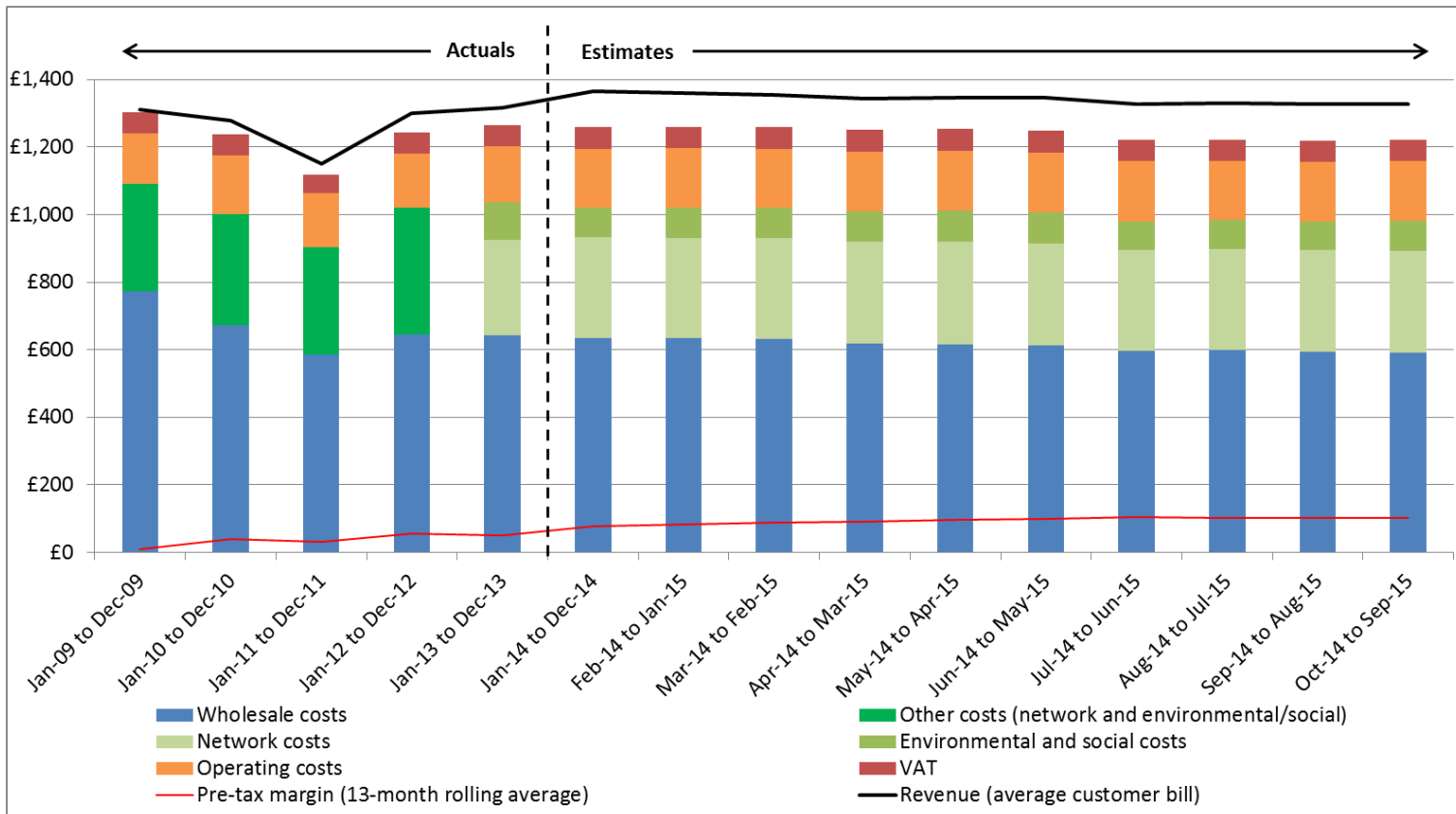
Questions for us, but also interested in your views on the following:

- What do you find valuable in the CSS?
- Does CSS facilitate investment?
- Proposed cost allocation and additional information
- Expanding requirement beyond VI companies

Supply Market Indicator (Domestic only)

CSS – audited *actual data* on revenues, costs and pre-tax profits. Necessarily backward looking.

SMI – forward-looking *estimates* of cost trends. Complements the CSS by filling the ‘information gap’.

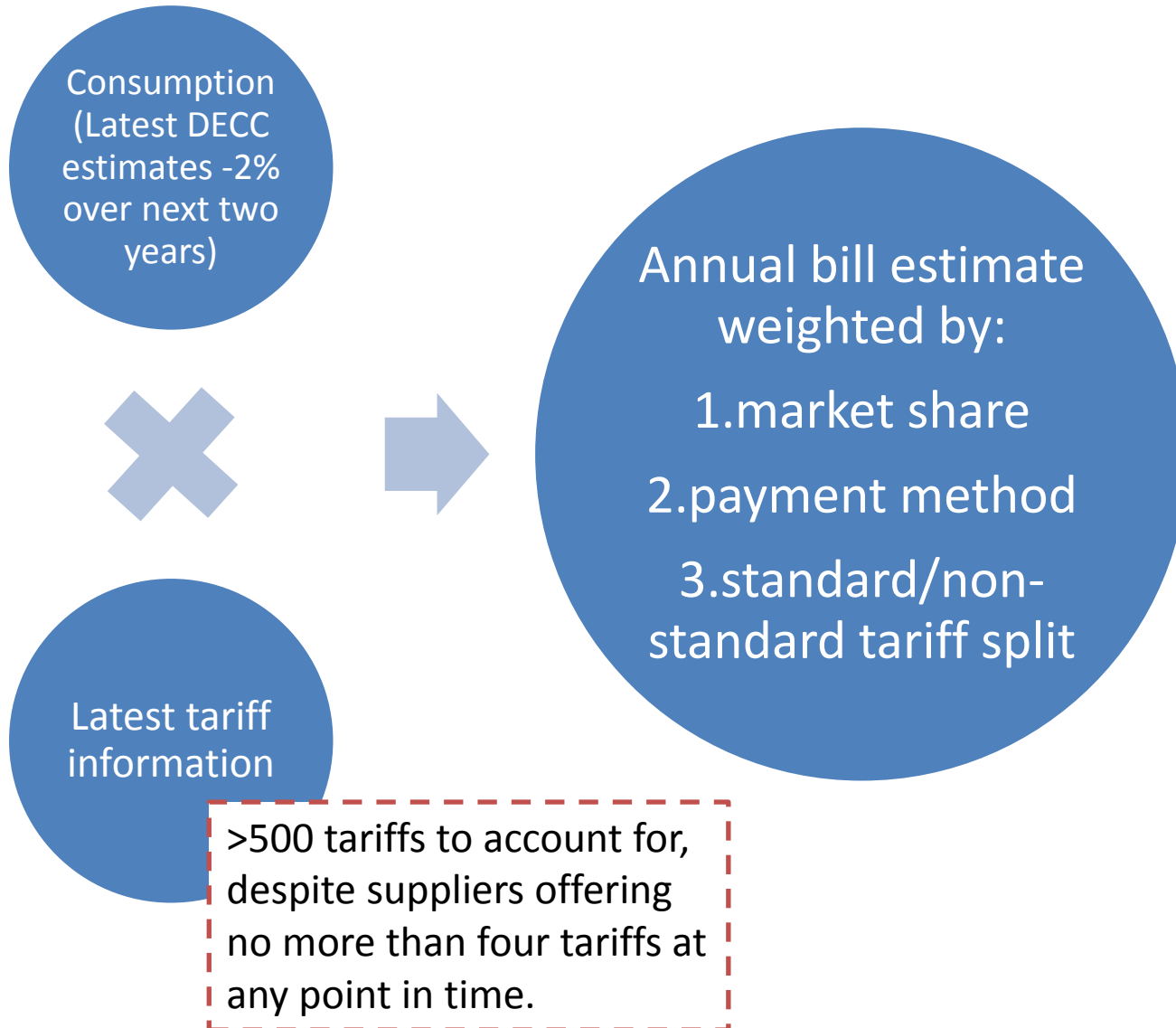


Supply Market Indicator (Domestic only)

	CSS (historic actuals)					-										
	Jan-09 to Dec-09	Jan-10 to Dec-10	Jan-11 to Dec-11	Jan-12 to Dec-12	Jan-13 to Dec-13	Jan-14 to Dec-14	Feb-14 to Jan-15	Mar-14 to Feb-15	Apr-14 to Mar-15 (r)	May-14 to Apr-15	Jun-14 to May-15	Jul-14 to Jun-15	Aug-14 to Jul-14	Sep-14 to Aug-15	Oct-14 to Sep-15	
Wholesale costs																
- Gas						£ 358	£ 357	£ 354	£ 343	£ 342	£ 336	£ 327	£ 323	£ 319	£ 315	
- Electricity						£ 229	£ 230	£ 230	£ 226	£ 226	£ 227	£ 221	£ 223	£ 222	£ 223	
- Unbilled volumes						£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 20	£ 20	£ 20	
- Gas reconciliation by difference						£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	
- Demand forecast error						£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	£ 16	
- Electricity imbalance costs						£ 1	£ 1	£ 1	£ 1	£ 1	£ 1	£ 1	£ 1	£ 1	£ 1	
TOTAL	£ 774	£ 673	£ 585	£ 646	£ 643	£ 636	£ 635	£ 633	£ 617	£ 617	£ 612	£ 597	£ 598	£ 594	£ 591	
Network costs																
- Gas network (transmission)						£ 13	£ 13	£ 13	£ 13	£ 13	£ 13	£ 13	£ 12	£ 12	£ 12	
- Gas network (distribution)						£ 130	£ 128	£ 127	£ 138	£ 138	£ 138	£ 136	£ 136	£ 137	£ 137	
- Electricity network (transmission)						£ 32	£ 32	£ 33	£ 34	£ 34	£ 34	£ 34	£ 35	£ 35	£ 35	
- Electricity network (distribution)						£ 116	£ 117	£ 118	£ 111	£ 111	£ 111	£ 110	£ 112	£ 112	£ 113	
- Balancing (BSUoS)						£ 6	£ 6	£ 6	£ 6	£ 6	£ 6	£ 6	£ 6	£ 6	£ 6	
- Total					£ 282	£ 297	£ 297	£ 297	£ 302	£ 302	£ 303	£ 298	£ 301	£ 302	£ 302	
Environmental and social obligation costs																
- Renewable Obligation Certificates (ROCs)						£ 38	£ 39	£ 40	£ 40	£ 41	£ 40	£ 40	£ 41	£ 41	£ 45	
- Gas Energy Companies Obligation (ECO)						£ 20	£ 20	£ 20	£ 20	£ 20	£ 20	£ 16	£ 17	£ 17	£ 17	
- Electricity Energy Companies Obligation (ECO)						£ 20	£ 20	£ 20	£ 20	£ 20	£ 20	£ 16	£ 17	£ 17	£ 17	
- Feed in Tariffs (FITs)						£ 10	£ 10	£ 10	£ 10	£ 10	£ 10	£ 11	£ 11	£ 11	£ 11	
- Gas WHD						£ 6	£ 6	£ 6	£ 6	£ 6	£ 6	£ 7	£ 7	£ 7	£ 7	
- Elec WHD						£ 6	£ 6	£ 6	£ 6	£ 6	£ 6	£ 7	£ 7	£ 7	£ 7	
- Government-funded rebate						-£ 12	-£ 12	-£ 12	-£ 12	-£ 12	-£ 12	-£ 12	-£ 12	-£ 12	-£ 12	
- Total					£ 111	£ 89	£ 89	£ 90	£ 92	£ 92	£ 92	£ 84	£ 85	£ 86	£ 90	
TOTAL*	£ 318	£ 329	£ 320	£ 373	£ 394	£ 385	£ 386	£ 387	£ 394	£ 395	£ 394	£ 383	£ 386	£ 388	£ 392	
Supplier operating costs																
- Operational (inc. meters and smart meters)						£ 167	£ 168	£ 168	£ 169	£ 170	£ 171	£ 171	£ 167	£ 167	£ 168	
- Depreciation and amortisation						£ 8	£ 8	£ 8	£ 8	£ 8	£ 8	£ 8	£ 7	£ 7	£ 7	
TOTAL	£ 148	£ 174	£ 159	£ 162	£ 168	£ 174	£ 175	£ 176	£ 177	£ 177	£ 178	£ 179	£ 174	£ 174	£ 175	
VAT	£ 62	£ 61	£ 55	£ 62	£ 63	£ 65	£ 65	£ 65	£ 64	£ 64	£ 64	£ 63	£ 63	£ 63	£ 63	
Total costs	£ 1,303	£ 1,237	£ 1,118	£ 1,243	£ 1,266	£ 1,260	£ 1,261	£ 1,260	£ 1,252	£ 1,253	£ 1,248	£ 1,222	£ 1,223	£ 1,219	£ 1,222	
Revenue (average customer bill)	£ 1,312	£ 1,277	£ 1,150	£ 1,300	£ 1,316	£ 1,365	£ 1,361	£ 1,356	£ 1,344	£ 1,346	£ 1,346	£ 1,328	£ 1,330	£ 1,329	£ 1,328	
Pre-tax margin (13-month rolling for SMI)	£ 10	£ 41	£ 32	£ 56	£ 49	£ 77	£ 82	£ 88	£ 91	£ 96	£ 101	£ 106	£ 102	£ 102	£ 103	
Pre-tax profit margin (%)		1%	3%	4%	4%	6%	6%	6%	7%	7%	7%	8%	8%	8%	8%	

What it is	What it is <i>not</i>
A forward-looking view of cost trends	A forecast <u>or</u> a statement of what profits have been made or are being made now
Representative of a 'typical' large supplier	Representative of any one large supplier
Based on publicly-available data	Based on real-time company data

- SMI relaunched March 2014 after significant methodology review
 - More **robust revenue estimation** (In addition to standard tariffs, we now include fixed and online tariffs)
 - **Greater cost disaggregation** to allow greater alignment with Consolidated Segmental Statements
 - **Unbilled volumes** included (revenue leakage estimate – e.g. theft, meter errors)
 - Use actual **CSS data** to inform assumptions (e.g. operating costs)

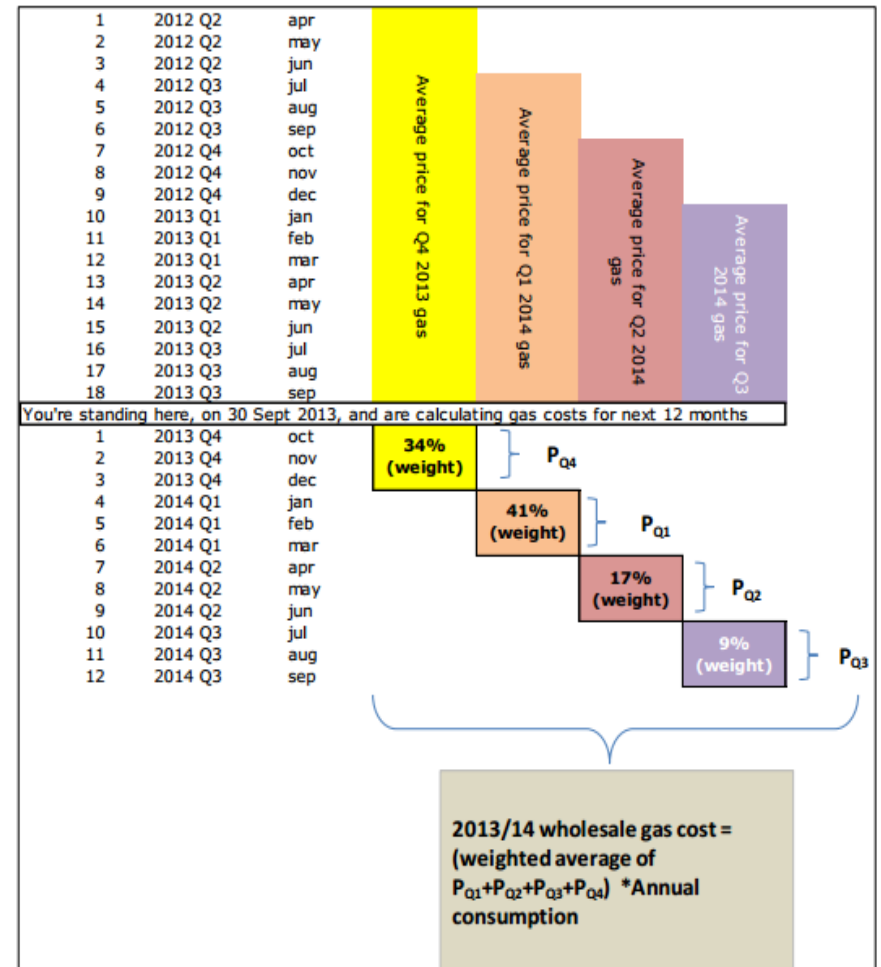


Internal model estimates **the expected cost of supplying energy to a customer over the next 12 months**

Key assumptions

- **Type of contracts:** costs are based on buying quarterly products for gas and seasonal products for electricity
- **Strategy:** costs are modelled on an 18-month hedging strategy, assuming a uniform volume of energy is purchased on each trading day
- **Other costs:** including demand forecast error, cost of unallocated gas, imbalance costs
- Also allocate **unbilled volumes** as a cost here

Example – estimating wholesale gas costs



- Network costs
 - Estimates based on latest charging statements & BSUoS
- Environmental and social obligation costs
 - Renewable obligation
 - Feed in Tariffs
 - Energy Company Obligation
 - Warm Home Discount
- Operating costs
 - Latest CSS information adjusted for inflation and smart meter cost estimates

How robust is the new methodology?

	SMI Jan 13-Dec 13 (£/ customer/ year)	2013 CSS (£/ customer/ year)	Difference (£)
Revenue (VAT added to CSS for comparison)	1,304	1,286	19
Wholesale	621	628	-7
Networks	288	276	13
Env/Soc	105	109	-4
Operating costs	162	157	5
Depreciation and Amortisation (DA)	7	7	0
VAT	62	61	1

The SMI estimate of the EBIT margin per dual fuel customer was £59 (4.5%). The comparable outturn margin from the CSS was £48 or 3.7% as a proportion of revenue including VAT.

- Need to be flexible to reflect market developments
- Will never have perfect information
- Keen for input from all stakeholders (SMI@ofgem.gov.uk)
- Continue to publish monthly

Questions for us, but also interested in your views on the following:

- How you currently (or could) use the SMI?
- Our current approach for estimating wholesale costs?

- We do a lot on transparency – to improve confidence in the market
- We are making concrete proposals for improving the CSS
 - Final decisions due around the end of the year
 - To be implemented for 2014 statements
- CSS & SMI are different but complementary tools
- We keep our approach to transparency under review

For further information please contact:

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