

Supplier Cost Index

19 January 2017

We are today launching a new supplier cost index, adding to our existing suite of website indicators

In this briefing we will:

1. Introduce the new indicator – including what its purpose is and how it relates to the other information on costs that we collect
2. Summarise the main points coming out of the January 2017 update
3. Provide some commentary – what do these cost trends mean for energy bills?

Part 1 - Introduction

Monitoring ongoing trends in suppliers' costs

- Trends in bills are of considerable interest to stakeholders. While we don't set suppliers' prices or regulate their profits, we do have an important role to play in terms of providing transparency about trends in energy prices and what is driving them, to help build trust and confidence in the market (one of the strategic outputs that we aim to deliver).
- Following a review of our previous Supply Market Indicator, and in the light of the findings of the CMA investigation, we carried out a consultation on a new indicator last summer. Following that consultation, we have decided to launch a new Supplier Cost Index.
- The new index is designed to help stakeholders understand what is happening to the main categories of industry costs (wholesale costs, network charges, and the charges to suppliers associated with government programmes) and, as such, the factors behind trends in energy prices.

What the new indicator does

- Shows whether the main costs of supplying energy are rising or falling, thereby providing context to understanding trends in prices
- Provides commentary on what is driving these trends

What the new indicator does not do

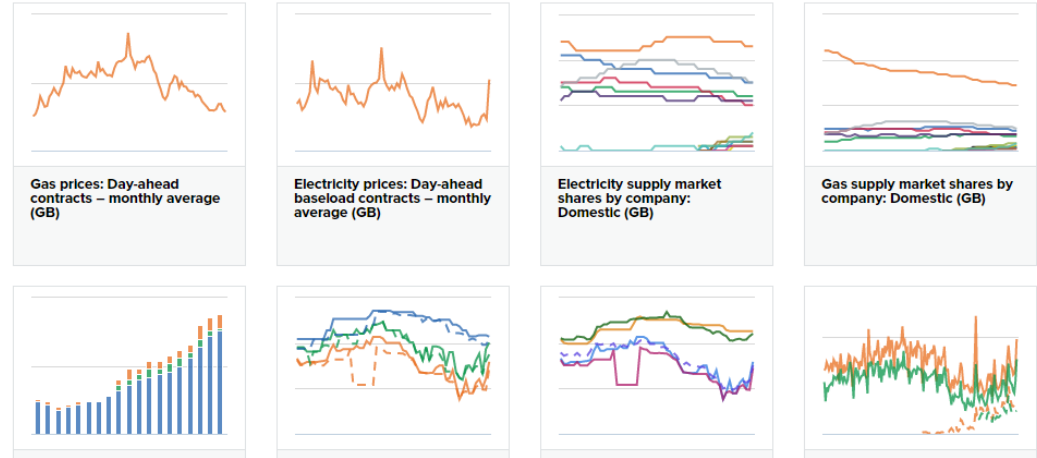
- Provide an estimate of suppliers' profits (this is available via suppliers' consolidated segmental statements, summarised on our website in existing indicators)
- Allow us to predict what prices suppliers will set, or when these will change
- On its own, show whether prices should be lower or higher
- Necessarily reflect the trends in the costs of any single supplier

- The new indicator forms one element of the much wider package of energy market indicators published on our website. These cover areas including tariffs, profits, consumer engagement, market structure, customer service, security of supply and wholesale market liquidity.
- Our main source of information on suppliers' costs and what is driving bills is the annual audited financial statements that we require large suppliers to publish ("consolidated segmental statements", or CSS). As these statements necessarily relate to previous financial years, they can provide only limited insight into the most recent changes in costs. It is this gap that the new index is designed to fill.
- The new indicator is therefore just one source of information relevant to understanding trends in energy bills. A full analysis of trends in bills (and what is behind them) is expected to be one of the topics covered in our first annual State of the Market report, to be published in the second half of 2017.

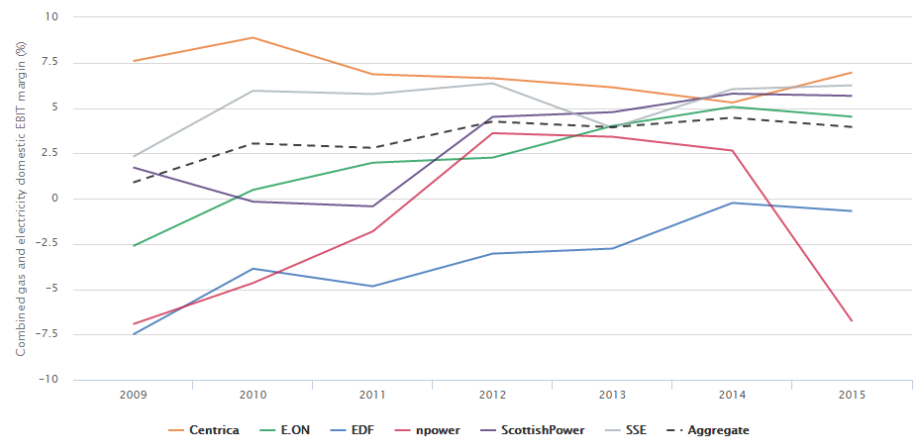
Table: 'Standard variable' rate tariff information

Supplier (1)	Number of customer accounts on standard variable tariffs (2)	Proportion of customer base on standard variable tariffs (%) (3)	Average annual cost of a standard variable tariff (£) (4)	Difference between a supplier's standard variable tariff and its cheapest tariff (£) (5)	Difference between a standard variable tariff and the average of the 10 cheapest tariffs (£) (6) (7) (8)
British Gas	6,639,056	74%	1,044	129	166
Co-operative Energy	96,158	42%	1,121	245	244
EDF Energy	1,943,277	56%	1,069	136	192
E.ON	3,170,499	73%	1,057	41	179
Extra Energy	36,641	14%	1,130	154	252
First Utility	175,208	19%	1,071	157	193
Npower	1,737,642	59%	1,077	180	199
Ovo	225,952	35%	1,064	67	186
ScottishPower	1,541,307	50%	1,081	129	203
SSE	3,864,044	91%	1,068	98	190
Utility Warehouse	503,955	94%	1,012	150	134

Data portal



Pre-tax domestic supply margins of large suppliers, combined gas and electricity



Our interactive charts and indicators



[All data charts](#)



[Retail market](#)



[Wholesale market](#)

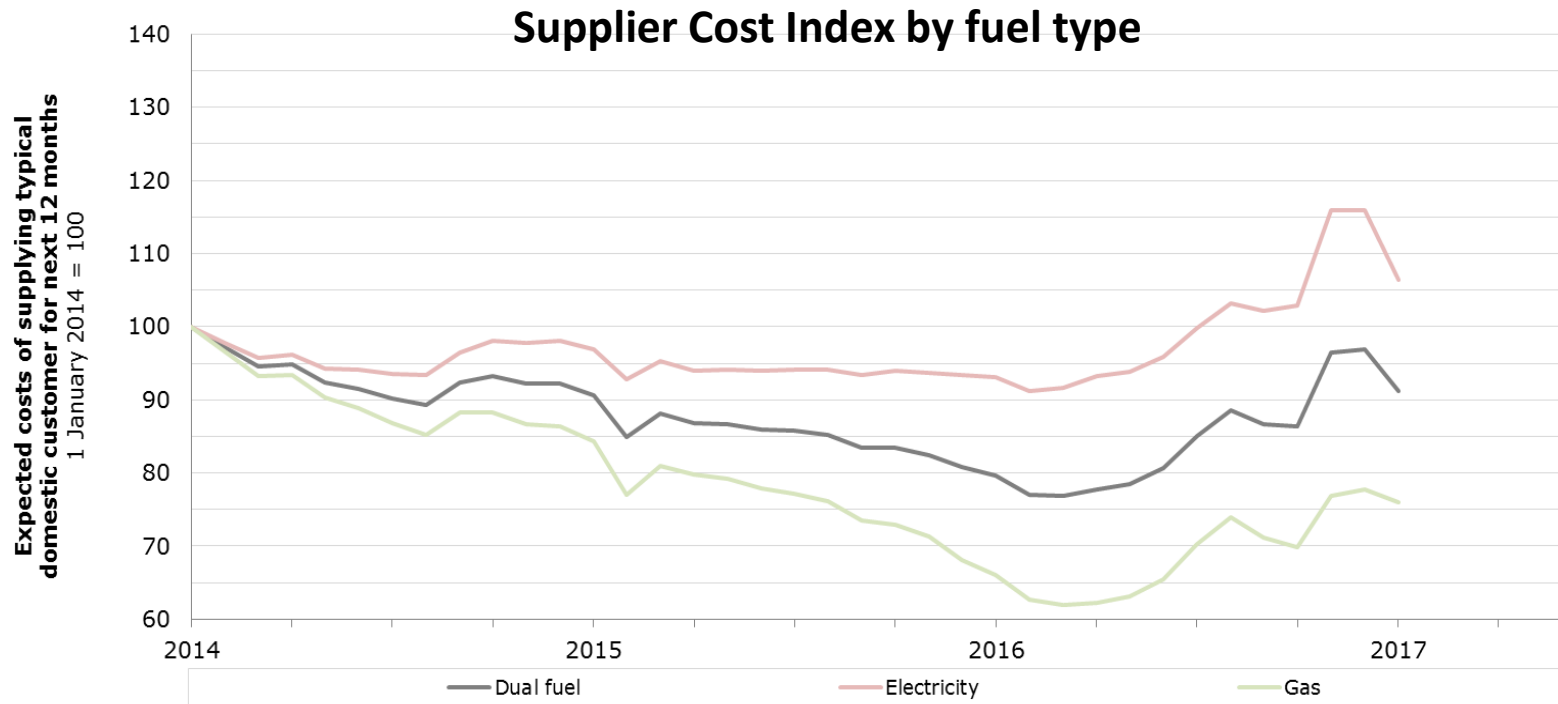


[Customer service](#)

Information on profit margins from annual consolidated segmental statements of large suppliers

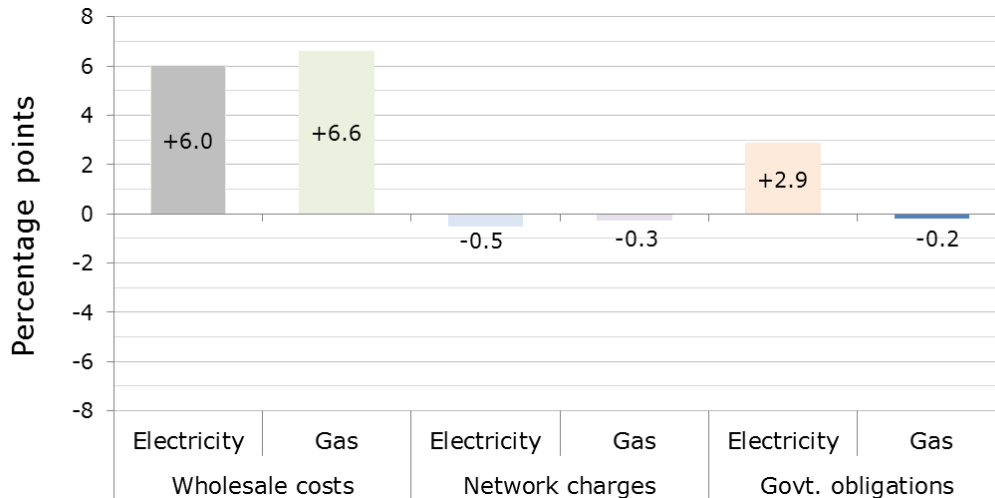
Part 2 – January 2017 update

- The Supplier Cost Index is calculated using publically-available data on wholesale prices, network charges and suppliers' obligations under government programmes. This is combined with assumptions about consumption and the overall scale of different types of cost.
- The index excludes trends in suppliers' own operating costs (such as the costs of billing or metering)
- The index shows trends in expected annual costs, covering the 12 months from the time of each update. So, for instance, the value of the index in January 2017 reflects expected costs for the period January to December 2017.
- Cost trends are estimated for a customer with typical consumption, held fixed over time (the same approach as used in the data we publish on price trends)
- Following today's launch, we intend to update the index next in February 2017, and then on a quarterly basis thereafter



- The SCI (dual fuel) was around 15% higher in January 2017 compared to January 2016.
- The steep rise in the second half of 2016 follows a long period of falling costs from 2014 to early 2016. The SCI (dual fuel) remains around 10% lower than its level at the start of 2014.
- Electricity costs fell by much less than gas costs over the period 2014 to early 2016 – although both electricity and gas costs have risen by a similar amount since then

Breakdown of year-on-year change in the Supplier Cost Index (Jan 2017)

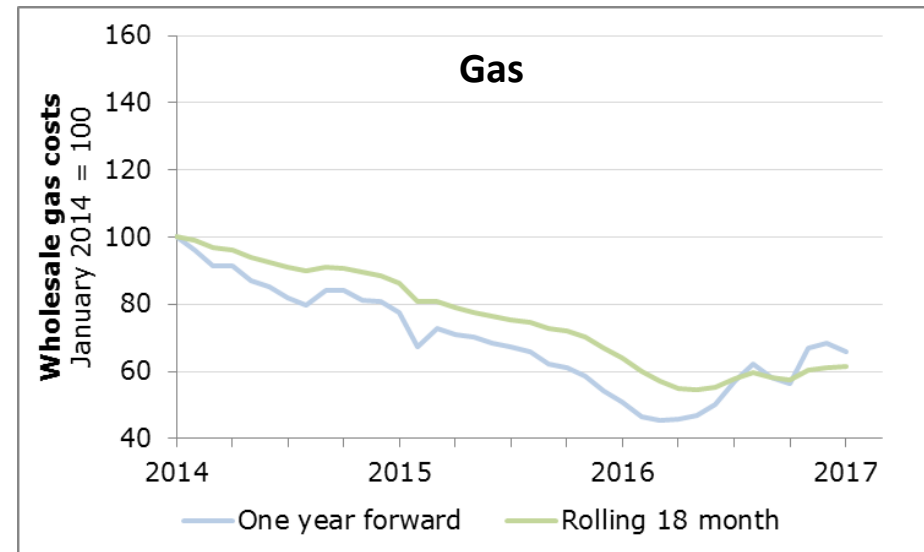
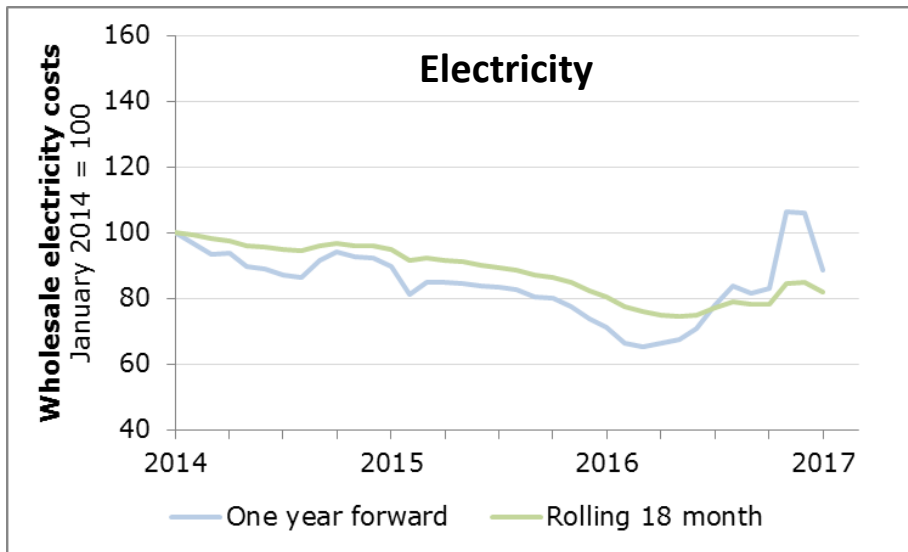


Note: +6.0 does not mean that wholesale electricity costs have risen by 6.0%, but that increases in wholesale electricity costs account for 6 percentage points of the 14.5% increase in the SCI

- The biggest factor in the 15% increase in the dual fuel cost index compared to a year earlier is a significant rise in wholesale gas and electricity prices. To a lesser degree, there has also been some upwards pressure as a result of increases in the expected costs of government programmes for electricity customers (particularly those supporting renewable energy).
- Note that relationships exist between the different categories of cost (eg lower wholesale costs may be associated with an increase in the costs associated with contracts for difference). Government programmes may also have other impacts on bills (eg greater expenditure on the Energy Company Obligation may lead to greater energy efficiency, and so lower bills). For this reason, the contributions cannot be interpreted as showing the overall impact of government programmes on bills: only the impact of the direct charges to suppliers associated with these schemes.

- The SCI is based on average prices of wholesale gas and electricity forward contracts in the month prior to the update (eg for the January 2017 update, it is based on a weighted average of prices in December of contracts covering quarter 1 2017, summer 2017, and winter 2017/18).
- However, different suppliers have different approaches to purchasing energy, and so their costs may have followed a different trajectory to that shown by the index. For example, many of the larger suppliers purchase energy for their SVT customers over an extended period (up to 2 years or more).
- The decision to base the index on wholesale prices in the most recent month follows the recommendation of the CMA to focus on trends in current rather than historic costs in our reporting. It means that the index will reflect wholesale energy costs as of the time of the update.

Suppliers that have hedged on a rolling basis are likely to have been insulated from the recent increases in wholesale prices. For example we expect that for a company that purchased its energy on a rolling basis over 18 months, the expected cost of supplying a dual fuel customer would be only slightly higher than a year earlier.



Source: Ofgem analysis of [ICIS](#) data

The 'one year forward' line shows the trend in wholesale costs for the coming year based on wholesale prices in the month preceding the update (as included in the Supplier Cost Index). The 'rolling 18 month' line shows the trend in wholesale costs for the coming year based on wholesale prices over the preceding 18 months.

Part 3 – Commentary

We've seen a number of suppliers increase the prices of their fixed tariffs in recent months. This largely tracks the increase in the cost index.

Most of the large suppliers have not increased their standard variable tariffs (and some have committed to not do so this winter). This is as we would expect:

- Our previous analysis – and that of the CMA – has suggested that prices for most customers on 'standard' variable tariffs were already too high, and did not fall by as much as costs between 2014 and mid 2016.
- We expect that the large suppliers will have been to a large extent insulated from recent wholesale price increases as a result of their hedging strategies

Even if recent cost increases are sustained, it is important that suppliers do all they can to protect their customers from price increases, for example by keeping their own costs down.

While we do not observe trends in suppliers' own operating costs from quarter to quarter (like profits, these are reported in the large suppliers' financial statements), we expect there to be significant opportunities for reductions, and for larger suppliers in particular to increase the efficiency with which they operate.

If suppliers do not keep their prices down, they risk losing customers to their rivals. The large suppliers lost around a million electricity customers to smaller and medium-sized suppliers between June 2015 and June 2016.

We are working to facilitate a more competitive, dynamic energy market, with more engaged consumers. Over time, we expect the changes we make to place greater competitive pressure on existing suppliers, and to encourage suppliers offering innovative new business models to enter the market.