



Making a positive difference  
for energy consumers

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## Launch of the Supplier Cost Index

One of the ways we work to improve outcomes for energy consumers is by seeking to foster trust and confidence in the energy markets. We can do this by providing impartial and authoritative information on key market trends. Trends in energy bills are of considerable importance to consumers – and price increases have in the past proved to be a source of distrust in the industry. For this reason, an important area of our market monitoring involves tracking trends in the costs that make up bills.

On 3 August 2016, we published a report titled "[Monitoring trends in suppliers' expected costs](#)" in which we sought views on what regular information we should provide to help improve transparency around ongoing trends in suppliers' costs. That consultation described our proposal to replace the old supply market indicator (SMI) with a new Supplier Cost Index.

We have received a wide range of views on what information we should publish. The key points raised are summarised in the appendix to this letter. Some stakeholders favoured continuing the approach used in the old SMI; others preferred the proposed new cost index; while some questioned whether a cost indicator should be published at all.

The main areas of contention related to the scope of the information we should publish (and in particular whether our indicator should include an estimate of suppliers' expected profit margins) and how the information should be presented on our website. Relatively few objections were raised in relation to the detailed methodology used to estimate trends in the different elements of expected costs, although a number of specific comments were received on how the methodology could be improved.

### *The Supplier Cost Index*

Having considered responses to the consultation, we have today launched our new [Supplier Cost Index](#). The index draws on publically-available information to estimate ongoing trends in the main elements of costs that a supplier incurs in supplying a typical domestic customer.<sup>1</sup> It shows whether industry costs are rising or falling over time and what is driving this (ie the relative contribution of wholesale prices, network charges and the charges to suppliers associated with government programmes designed to, for example,

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<sup>1</sup> A full description of the methodology used to calculate the index is provided on our website [here](#). We do not at this time intend to publish the underlying model, given that this methodology note gives a full description of how the index is calculated.

support renewable electricity generation and improve energy efficiency). In this way, it helps to improve transparency as to the factors behind ongoing trends in energy bills.

The indicator does not have a single intended audience – we expect a range of different stakeholders to have an interest in trends in suppliers' costs. Based on our experience with the SMI, we expect the index to be of particular interest to the media, consumer groups, and government.

### *Costs and prices*

The cost index is designed to provide insight into ongoing trends in the cost pressures that suppliers face, and to provide a useful benchmark to which trends in prices can be compared. However, the index is neither able nor intended to predict what prices suppliers will set or when these will change: an increase or decrease in the index should not be interpreted as showing that prices either will (or should) increase or decrease by the same amount.

One reason for this is that, in the retail markets, decisions about energy prices and when to change them are commercial decisions taken by individual energy suppliers. In making these decisions, suppliers will have regard not just to their costs, but also to the prices of their competitors – they will face pressure to keep their prices down or otherwise risk losing customers to their rivals. It is this pressure which will dictate how movements in costs are passed through to customers.

Furthermore, while the index will track broad trends in industry costs, the costs of any one supplier may follow a different trajectory to the index. One reason for this is that the index reflects trends in forward wholesale prices in the most recent month. However, in practice, the approach taken by different suppliers to purchasing energy varies considerably, with many buying energy for some of their customers on a rolling basis over long periods of time, to reduce their exposure to month-on-month fluctuations in wholesale prices. This means that these suppliers will be to some extent insulated from increases in wholesale prices, and less able to take advantage when wholesale prices fall.

Another reason a supplier's costs may depart from the index is that it does not include the costs that suppliers incur in relation to operating their own businesses (such as the costs of billing, or bad debt). The extent to which suppliers are able to pass on these supplier-specific costs will depend on the competitive pressures they face – however in the long run, we'd expect efficient suppliers to be able to cover these costs in the prices they set, or else to exit the market.

### *Profit margins*

Unlike the SMI, we do not intend to provide an estimate of an industry profit margin alongside our new cost index. Profit margins are difficult to forecast, because they depend on suppliers' future revenues, which in turn will depend on the prices they choose to set and how much their customers actually consume (affected by, among other factors, the weather). Suppliers' profit margins also depend on individual suppliers' own realised costs, which – as described above – will depend on their behaviour in the market and vary from company to company.

A forward-looking margin estimate as produced as part of the old SMI is also difficult to compare with published figures in suppliers' financial statements. Partly, this is because one reflects an expectation while the other is based on realised costs. However this is also because there will be differences in the period and customer groups covered. Producing different estimates of suppliers' profits (one of which is subject to uncertainty) risks creating confusion, rather than increasing transparency.

Providing reliable information on suppliers' profits will, however, continue to be a key focus of our market monitoring. We already provide information on trends in [profits](#) and [profit margins](#) on our website and as part of our annual assessments of the retail market (see our report on [Retail energy markets in 2016](#)). From 2017 onwards, we will enhance our analysis of supplier profits as part of our annual reporting, in line with the CMA's recommendations.

#### *Next steps*

We will update the index quarterly. Following the launch of the new index, we envisage making these updates in February, May, August and November. We expect updates to typically take place at the end of each month, covering trends in costs up to the start of the month.

In contrast to the process described in the consultation document, we propose to rebase the index once a year in May. Data from previous versions of the index will be catalogued on our website, so that a record exists of the content of the index at different points in time.

The methodology used to estimate suppliers' costs will be kept under ongoing review<sup>2</sup>, as will the charts and tables we publish on the website<sup>3</sup>. We welcome comments or suggestions on the cost index at any time, including how it is presented, and how it might be changed to better meet its objectives. These should be sent to [marketmonitoring@ofgem.gov.uk](mailto:marketmonitoring@ofgem.gov.uk).

We also intend to carry out more thorough reviews on a periodic basis, to ensure that the indicator is meeting its objectives, and to reflect developments in the market which have affected the costs that suppliers face. As part of this review process, the index will be compared with information on suppliers' realised costs.

Yours faithfully



**Neil Barnes**

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<sup>2</sup> For instance, in some cases, the approach used to estimate certain elements of suppliers' costs may need to change from one update to the next to reflect the best available information at any given point in time. Where this takes place, we will provide a description of the information used to estimate trends in suppliers' costs.

<sup>3</sup> For instance, we may decide to publish further charts in future updates, so as to provide greater detail about ongoing trends in the different categories of costs.

## **Appendix 1 – summary of responses to the consultation**

In what follows, we summarise stakeholders' views on the main aspects of the proposal, and our response to the submissions received.

### **Percentage changes vs £-per-customer estimates of cost trends**

Most respondents agreed with the proposal to use index numbers rather than reporting £-per-customer cost estimates. One respondent stressed that both £-per-customer and % estimates have advantages and disadvantages, and which is more useful will depend on the purpose that the indicator is being used for. Another respondent suggested that £-per-customer figures should be used, because these would be easier to reconcile with other datasets.

While we recognise that presenting a £-per-customer estimate of costs has advantages, we have decided to focus our reporting on an index number showing percentage changes in costs, as per our original proposal. Doing so aligns with the intended objective of the indicator, which is to help stakeholders understand trends in costs and what is behind them (rather than absolute levels of costs – transparency on which is provided by the financial statements which we require suppliers to produce). It also helps to simplify comparisons. We consider that publishing the main index on two different bases would risk making the indicator more complex.

### **Which costs are included in the index**

One respondent argued that operating costs should be included in the model, as excluding these costs would mean that the monitoring tool would provide an incomplete picture of cost trends and so would reduce supplier accountability. Most other respondents agreed with our proposal to exclude suppliers' operating costs from the model, although many suggested that it was important to provide transparency around trends in indirect costs that are not entirely within suppliers' control, such as the costs of the smart meter rollout.

Having considered the arguments received, we have decided to exclude operating costs from the index. This is for two reasons. First, because they are largely within suppliers' control, these costs are more difficult to estimate on an ongoing basis using publicly-available data. Second, we expect these costs to generally be less relevant from the perspective of understanding pricing behaviour, because they are more likely to be supplier-specific, and more likely to be fixed. While in the long term suppliers' will seek to cover their indirect costs in the prices they set, it is movements in industry marginal costs which we would expect to primarily drive prices in a competitive market.

We will, however, continue to provide analysis of suppliers' operating costs as part of our annual analysis of the financial statements of the six large energy companies.

### **Weighting**

Most respondents agreed that the consolidated segmental statements of the six large energy companies were the best available source for information on the relative importance of different categories of costs, used to weight the different cost components to produce the cost index. Some respondents suggested adjusting these costs to account for the fact that the costs in these statements would reflect the demand profile of these suppliers' customers, rather than necessarily the cost breakdown for a customer with typical domestic consumption.

We have decided to use the consolidated segmental statements to weight the different components of the cost index. We intend to update weights in May each year – when doing so, we will review our approach, and may seek to adjust for, eg, the impact of temperatures on gas consumption.

## **Profit margins**

Three respondents argued that Ofgem should continue to provide an estimate of suppliers' profit margins as part of our regular reporting. One stakeholder argued that many of the concerns with the old SMI could be overcome by providing different estimates of expected profit margins for customers on standard variable and fixed tariffs.

The remaining respondents argued that Ofgem should not publish a profit margin, highlighting concerns around the reliability of previous estimates included in the SMI, as well as the extent to which these were in the past misinterpreted as a measure of the profit that suppliers were making, and the detrimental impact on trust in the industry.

As described above, we have decided to not include an estimate of suppliers' expected profit margins within our quarterly reporting on cost trends. Margins are difficult to forecast, because they depend on suppliers' future revenues, which in turn will depend on the prices they choose to set and how much their customers actually consume (affected by, among other factors, the weather). They will also depend on individual suppliers' own realised costs, which – as described above – will depend on their behaviour in the market and vary from company to company. We do not consider that these problems would be solved by producing separate forward-looking estimates for customers on standard variable and fixed term contracts, although as part of our work on financial reporting we are considering whether to request the information required to calculate out-turn profit margins for different product types.

A forward-looking margin estimate as produced as part of the old SMI is also difficult to compare with published figures in suppliers' financial statements. Partly, this is because one reflects an expectation while the other is based on realised costs. However this is also because there will be differences in the period and customer groups covered. Producing different estimates of suppliers' profits (one of which is subject to significant uncertainty) risks creating confusion, rather than increasing transparency.

Providing reliable information on suppliers' profits will, however, continue to be a key focus of our market monitoring. We already provide information on trends in [profits](#) and [profit margins](#) on our website and as part of our annual assessments of the retail market (see our report on [Retail energy markets in 2016](#)). From 2017 onwards, we will enhance our analysis of supplier profits as part of our annual reporting, in line with the CMA's recommendations.

## **Prices**

A number of respondents told us that the cost index could not be easily compared with trends in prices. For instance, they flagged that the cost index will not include the totality of suppliers' costs and that suppliers' actual hedging strategies may differ to the wholesale cost benchmark used in the index.

One respondent argued that – particularly if an estimate of profit margins was to no longer be produced – a price index should be provided alongside (or superimposed on top of) the cost index, to highlight diverging trends, and help to hold suppliers to account.

In our view, the index will provide a useful benchmark against which trends in suppliers' prices can be compared. While the index does not include operating costs, as described

above, in general we would expect changes in these costs to be less relevant where suppliers are setting their prices. As described below, we also think the wholesale cost index – based on the prices of forward wholesale contracts over the preceding month – will provide a relevant benchmark against which prices can be compared (although we recognise that many suppliers are likely to be somewhat insulated from monthly wholesale price movements by longer term hedging strategies).

At the same time, taken on its own, the index is neither able nor intended to predict what prices suppliers will set at any given point in time; when these will change; or whether prices should be lower. Generally, it will be useful to consider other information alongside the cost index (such as information on historic profit margins or observed hedging strategies) to gain further insight into the nature of the relationship between suppliers' costs and their prices.

We already publish information on our website showing trends in the prices of standard variable tariffs and the cheapest tariffs on the market, as well as trends in prices for different payment types. Over time we expect to add to and develop these indicators, to reflect trends in pricing dynamics in the market. Because we already publish this information, we do not consider it necessary to create a separate price index.

## **Wholesale costs**

A number of respondents highlighted that wholesale costs would vary significantly across tariff types and suppliers, depending on hedging behaviour and customer profiles. It was suggested that we should therefore publish trends for a range of hedging strategies, or make clear in the presentation of the index that the wholesale element of costs would provide a guide to the cost specifically of supplying a one-year, fixed-term contract.

A number of further detailed points were raised, including:

- A concern that the index would be subject to volatility, because it was based on monthly snapshots of wholesale prices.
- A query about whether relying on the prices of monthly products up to six months out for both gas and electricity was valid, given the liquidity of such contracts
- A suggestion that more granular information on seasonal demand patterns should be used, and that this information should be weather-corrected and take into account public holidays
- Queries about the assumed split between baseload and peak electricity contracts
- That balancing and shaping costs should be taken into account

We do not agree that the wholesale cost index used will only be a relevant benchmark for one-year fixed term contracts, and will not be a relevant comparator to trends in standard variable tariffs. We recognise that in practice, many suppliers purchase energy (particularly for their customers on standard variable tariffs) over longer time horizons with significant implications for their realised costs. Nevertheless, looking at annual forward prices will provide a guide to the actual opportunity cost of delivering gas and electricity over the coming 12 months at any given point in time. The CMA has described in its final report its view that this is a more relevant basis on which to consider wholesale costs (see for example paragraph 18.132 of its [Final Report](#)).

This is not to say, however, that our wholesale cost index will be the only relevant basis for understanding the relationship between retail prices and wholesale costs. Analyses of the actual hedging strategies used by suppliers – and the impact these have had on their costs – will be a key focus of our ongoing analysis of the retail markets, including as we take forward the CMA's recommendations in relation to the large suppliers' financial reporting.

With respect to the detailed comments, we have not at this time made changes to the information on seasonal demand used to estimate the index. This is averaged over the previous two years to account for weather patterns (an approach consistent with that used to estimate typical domestic consumption values), which we consider to be of sufficient granularity for our purposes. We have also not changed the assumed split between baseload and peak electricity products – these assumptions will have only a minor impact on movements in the cost index over time, and we consider it useful to keep this consistent with the assumption used in the methodology used to set the prepayment price cap.

We have, however, changed the basket of forward contracts which the wholesale index is tied to, now including only those products covered by the secure and promote market-making obligations for electricity (month + 1, month + 2, quarter + 1, season +1 and season +2). Full details are provided in the [methodology note](#).

## **Network costs**

In general, respondents supported the proposed approach to estimating network costs. A number of detailed points were raised, including proposals that:

- A weighted rather than simple average of gas transmission charges across exit zones should be taken
- Electricity transmission charges should not be uplifted for transmission losses
- Balancing charges should be rolled forward from previous periods rather than using National Grid's latest forecasts

In addition, one respondent argued that regional consumption differences should be taken into account for gas, and that the alternative approach of dividing network companies' revenue by meter points would provide a fair approximation of the average cost per meter in each region.

We have made a number of minor changes to the methodology to reflect the comments received – the full revised methodology is described in the [methodology note](#). We have not included any allowance for regional consumption differences for gas, as this would be inconsistent with the objective of the index to track the costs of supplying a domestic customer with consumption equal to medium typical domestic consumption values.

## **Charges to suppliers associated with government programmes**

Respondents' views on our proposed methodology for estimating the costs of government programmes were mixed. Many stakeholders pointed out the limitations of relying on government impact assessments. Some stakeholders suggested relying on information on the realised costs of different programmes as an alternative. Others highlighted the challenges associated with assuming costs for future periods would be equal to costs for historic periods, given that actual expenditures were often not uniform throughout delivery periods.

Any forecast will be subject to uncertainty, especially where these involve projections over long periods of time. Nevertheless, we consider that government impact assessments will often provide the best available forecast of the cost of different programmes.

Our approach to estimating charges associated with government programmes will be to use the best available information on the future costs of a scheme at the time of the update. In some cases this will be from government impact assessments. We will monitor information on realised costs, to help us understand any instances where projected scheme costs in these documents may be inaccurate.