Review of Electricity Company Profitability

Revised Edition for 2013

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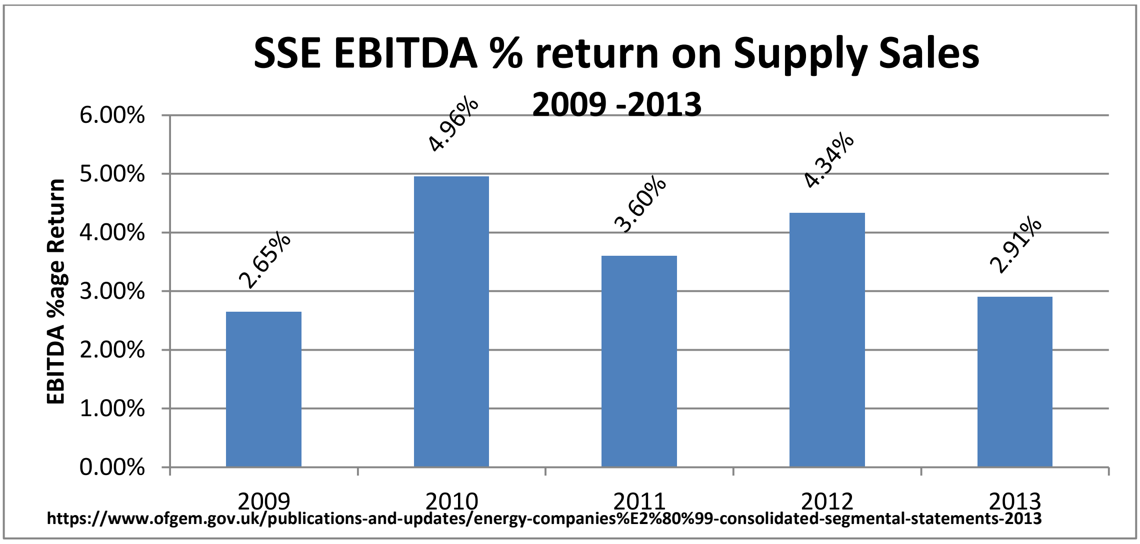
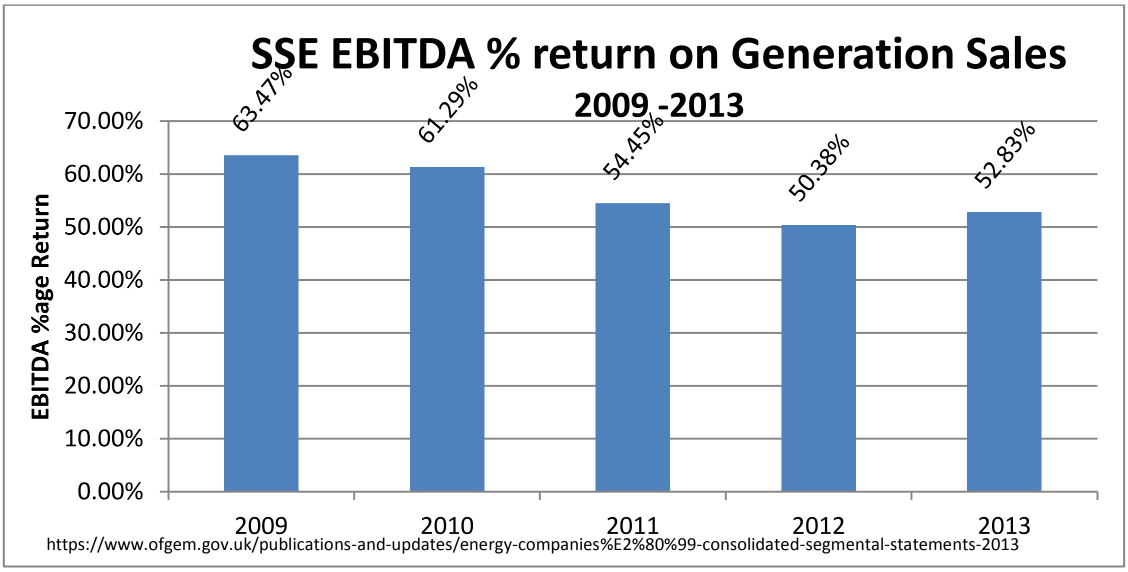
Last year I watched the evidence given by the Supply Directors of some of the major energy companies, usually referred to as the "Big Six" before the Energy & Climate Change Select Committee at the House of Commons in the run-up to Christmas. They presented a uniform story of low returns which no-one could consider were exhibiting evidence of monopoly or oligopoly profit.

I investigated whether or not what they had said was true, this year I've revised my findings.

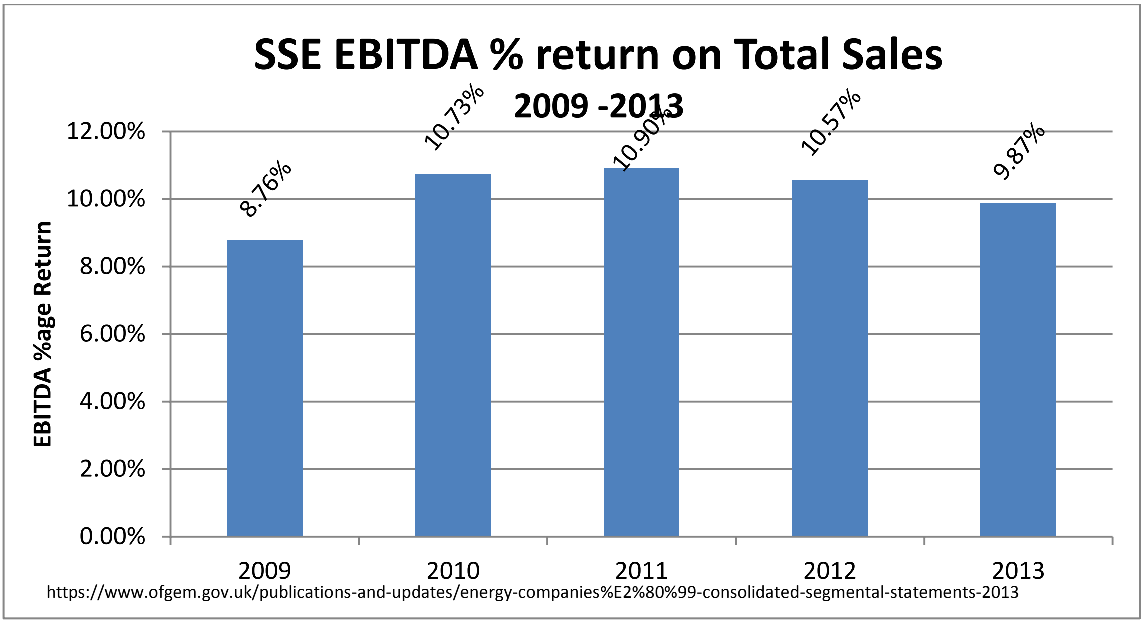
Scottish & Southern Energy show that their Supply business – their retail arm selling electricity to customers was earning low returns. This position is illustrated in the graph below:



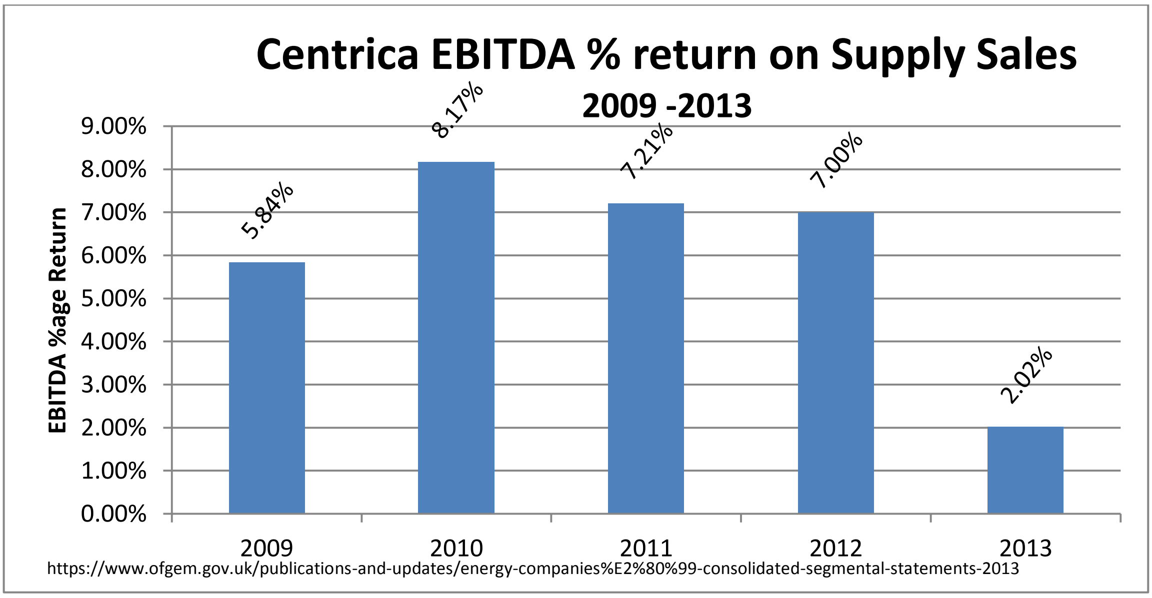
It is fair to say the supply business does earn low returns. I was struck by the phrase "in our retail business" which was repeatedly used. I wondered what we'd encounter if we looked at the rest of their business. Each of the "Big Six" is split into a Supply business and a Generation business. The returns earned by the Generation business which produces the electricity is shown below:



Although returns have fallen in recent years SSE still earns over 50% on Generation Sales, in 2013 almost 53%. Of every £1 earned from sales, over 50p is profit. No mention was made of this in the evidence given. OFGEM always looked at the Supply/Retail side of these businesses. This as we can see would ensure they found nothing wrong.

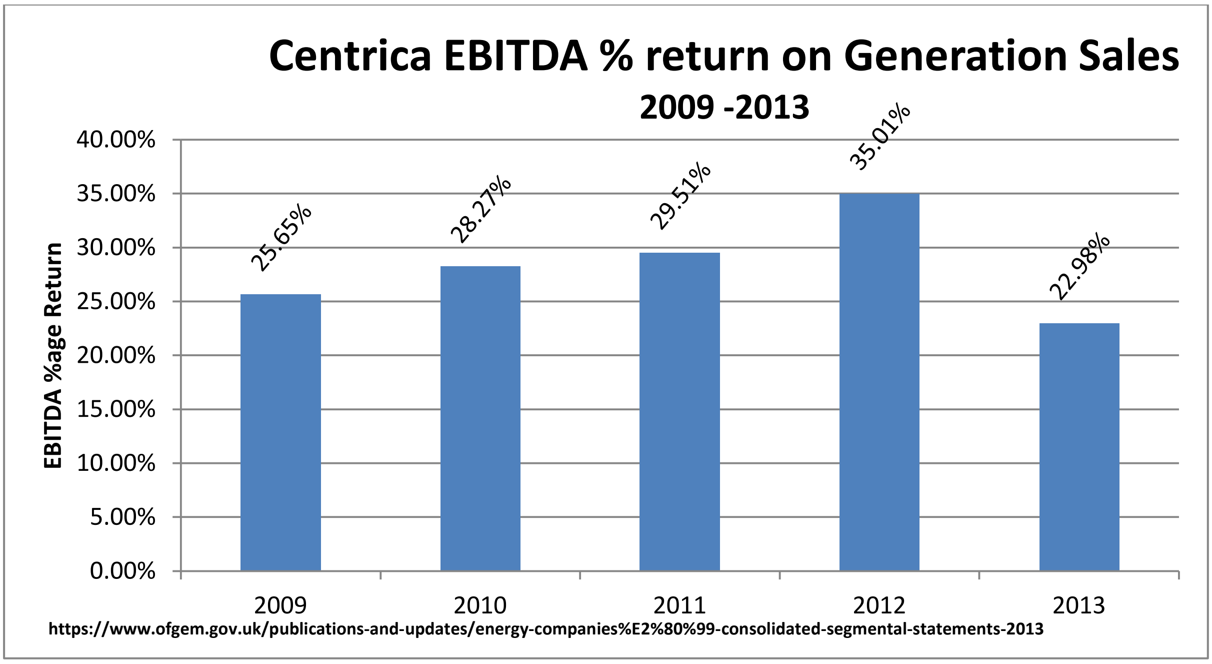


Rather than the 5% return claimed SSE earn a return of just under 10% on their business when Generation and Supply are looked at in the round. So much for SSE, what about the others?

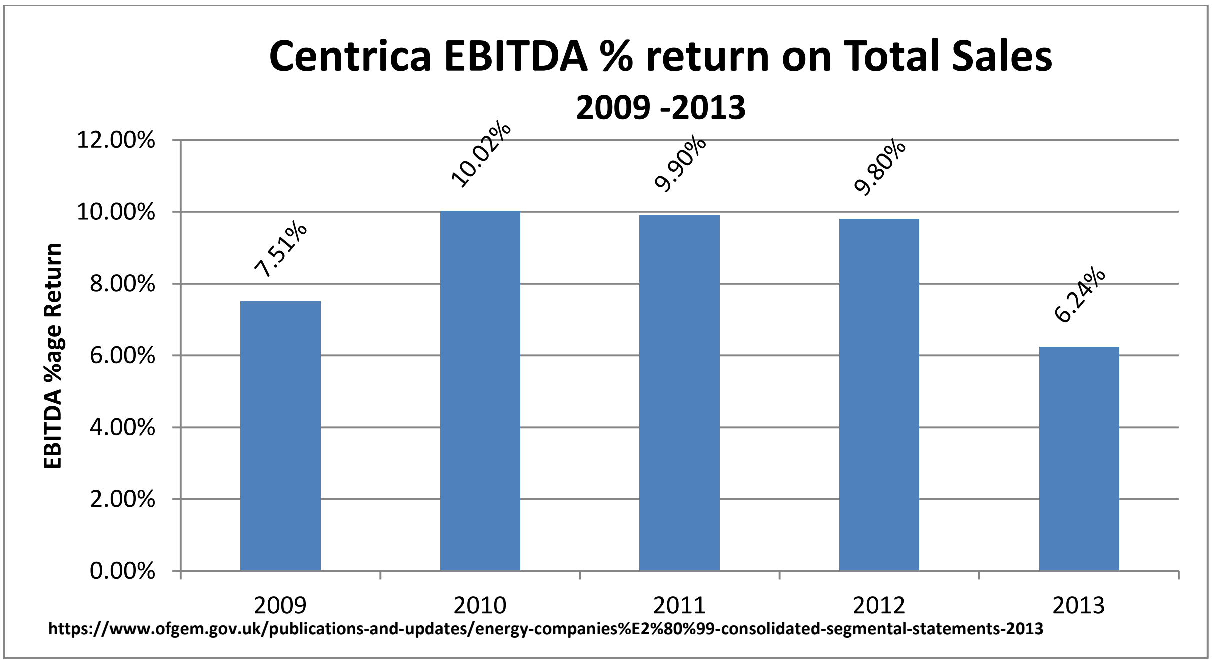


Centrica’s good return of 7% on their supply business in 2012 which made them the most profitable of the “Big Six” from this side of their operations evaporated in 2013. The supply side of their business is facing real competition and the return earned has fallen very significantly.

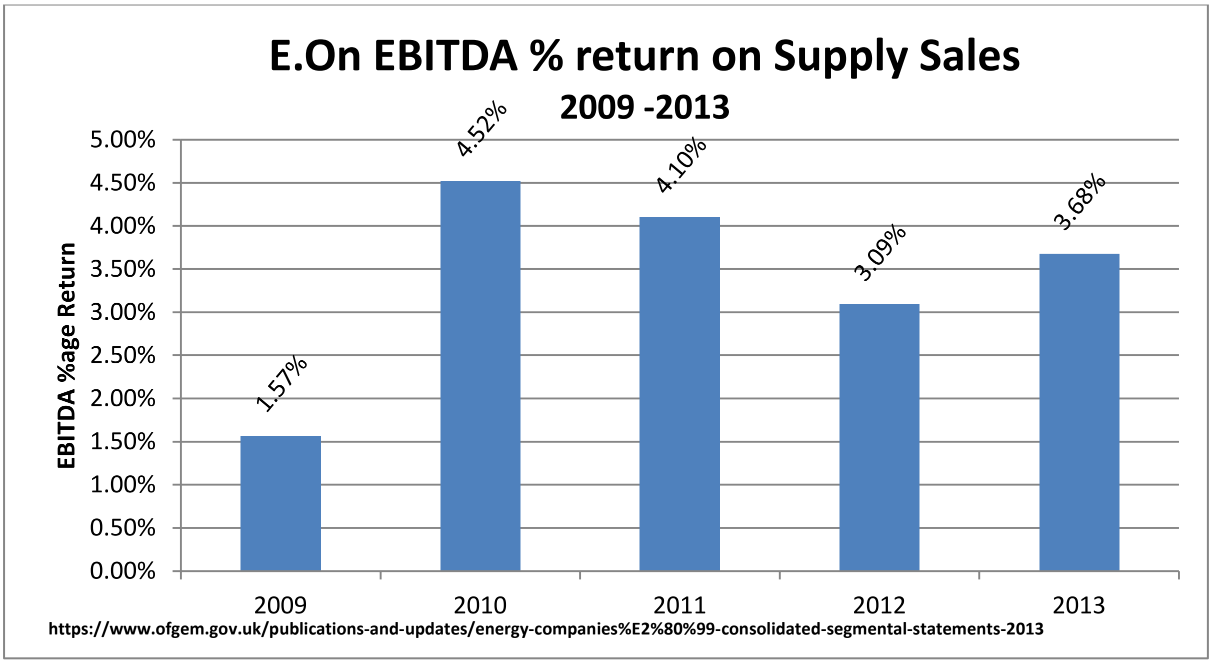
Centrica’s Generation arm performance is illustrated in the diagram below.



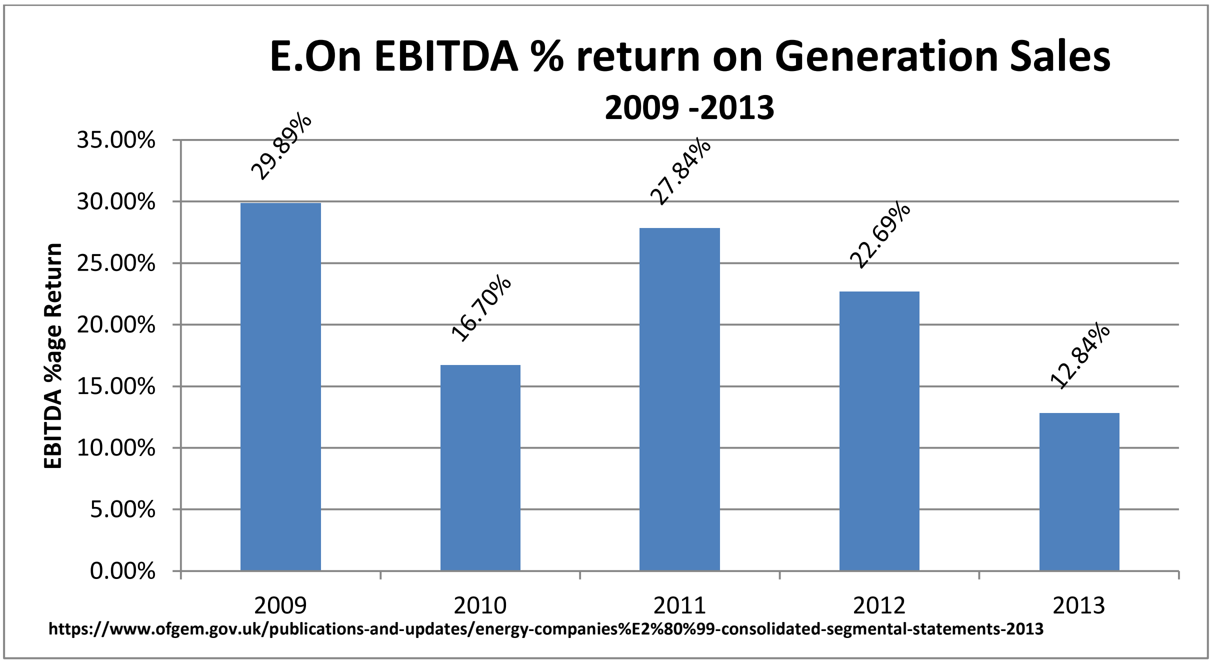
This shows that they have earned a 22.98% rate of return on EBITDA divided by generation sales in the most recent year for which figures are available. This was well down on the 35.01% return the year before.



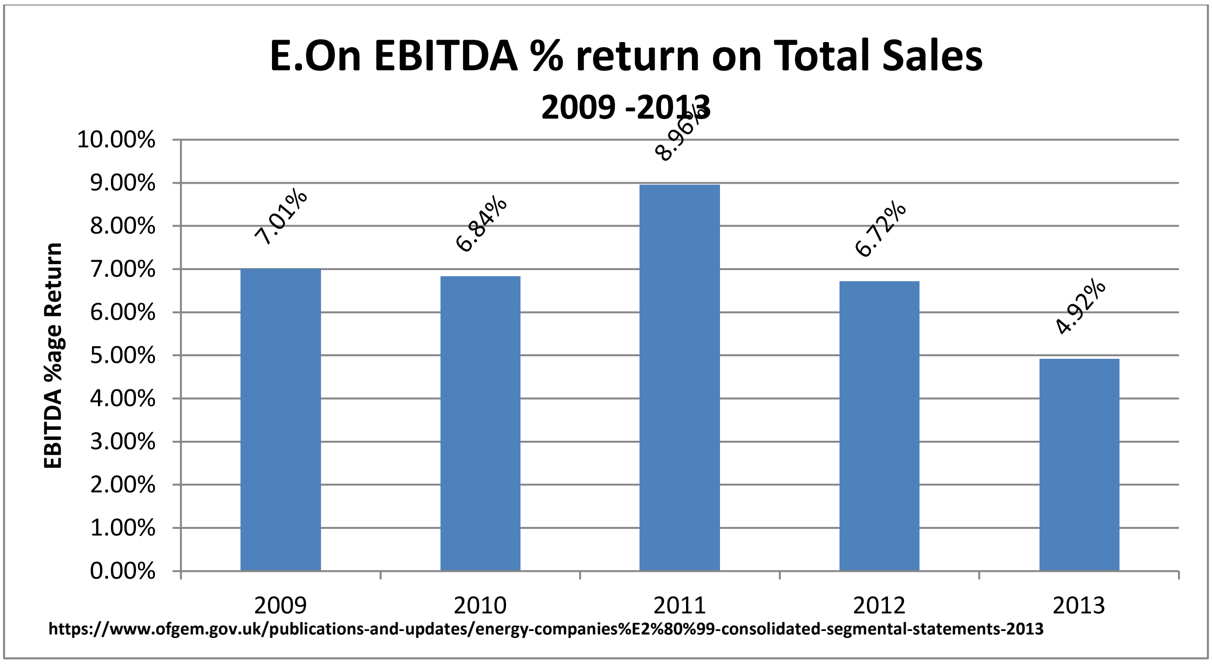
The overall position for Centrica has shown a decline over the year with the return being earned in 2013 at 6.24% down from 9.8% the year before.



E.On's return on Supply Sales to retail customers was 3.68% in 2013. This is up from 3.09% the year before.



E.On's return on Generation Sales fell steeply in the last year down from 22.69% in 2012 to 12.84% in 2013.



E.On's overall performance was also down from a return of 6.72% in 2012 on their business taken as a whole to 4.92% in 2013.

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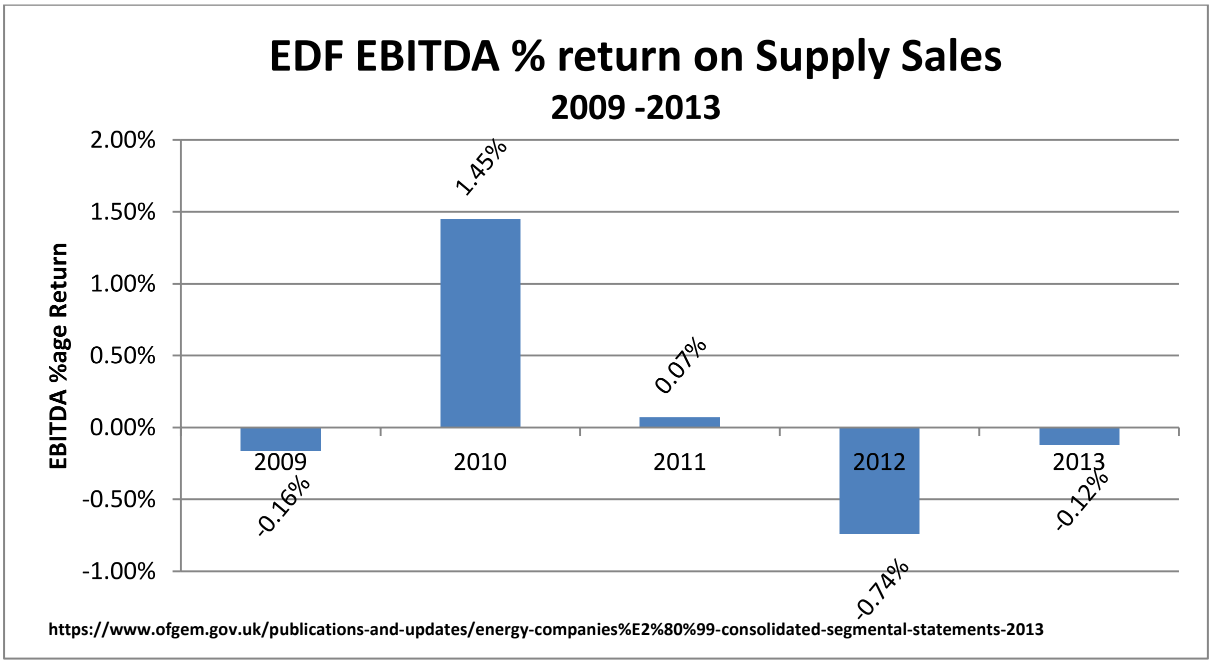
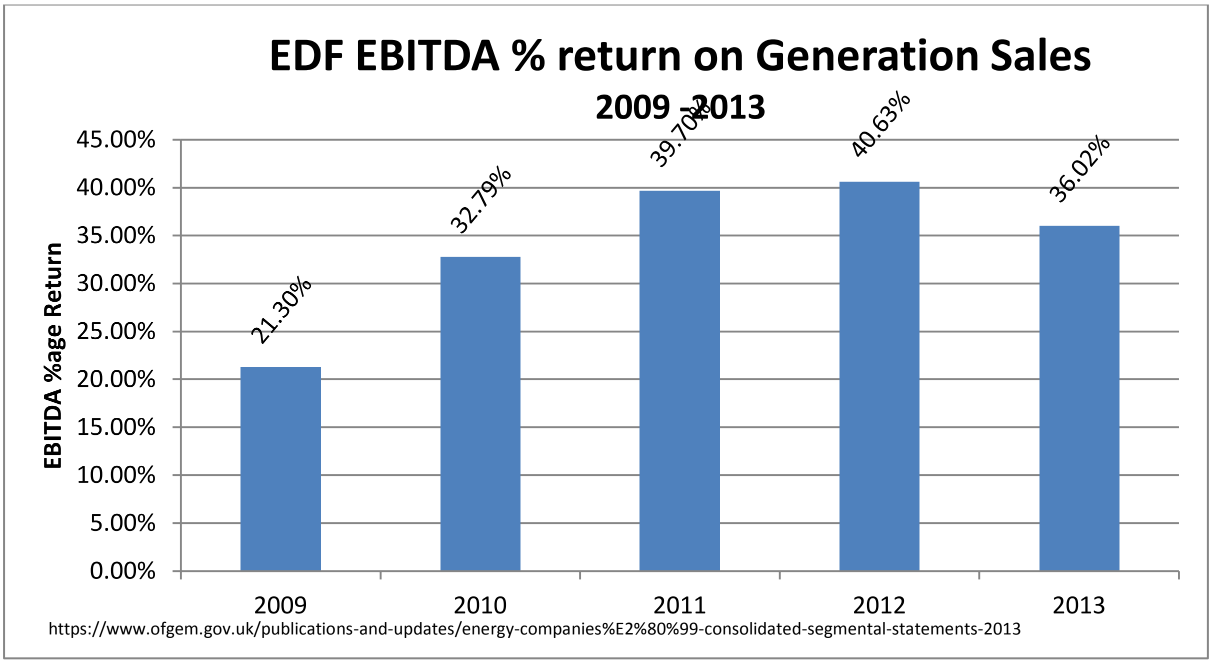
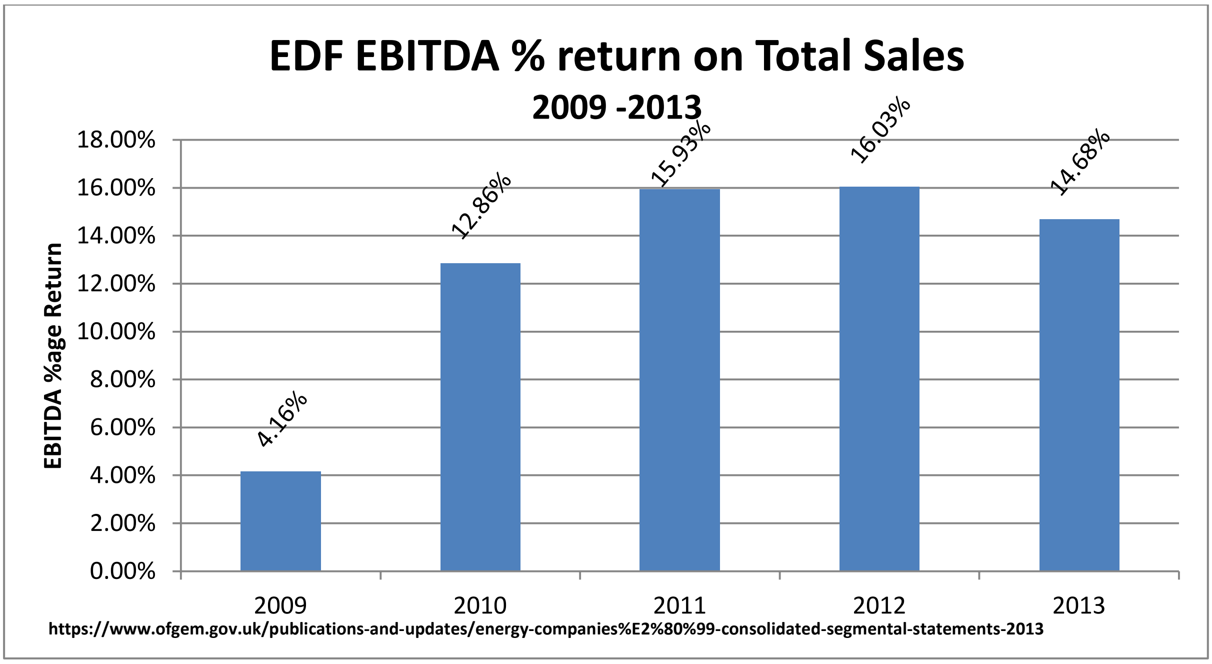


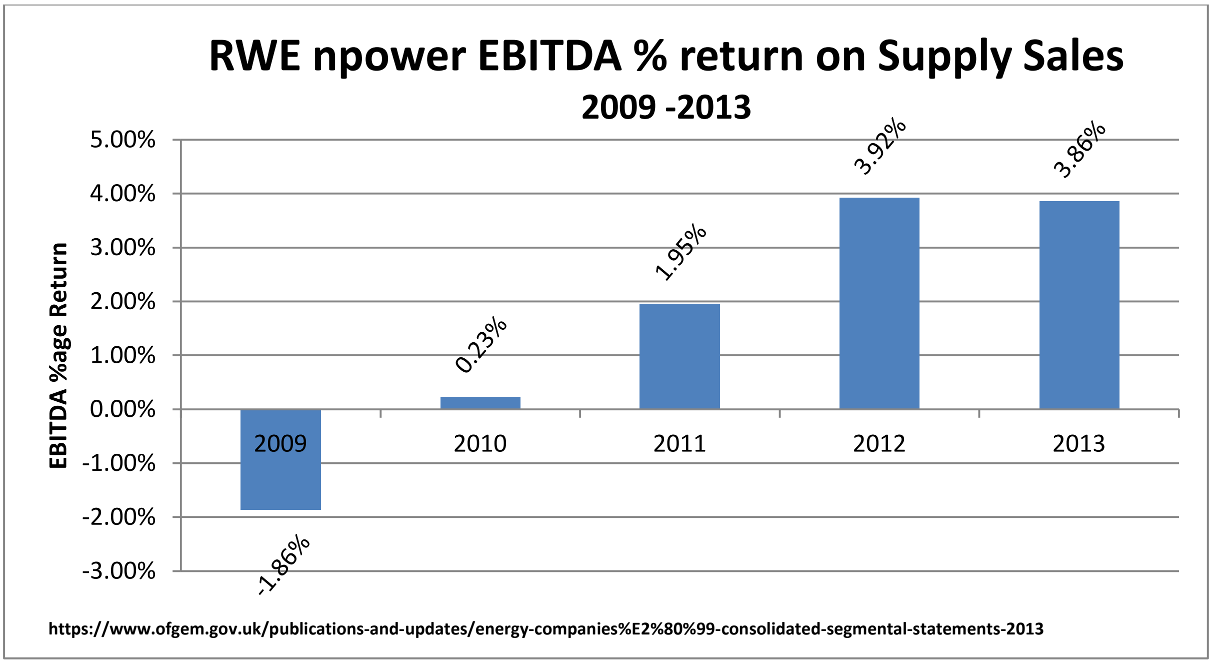
EDF's Supply business is the worst performing of the "Big Six" and has made almost no profit in the last five years. Before you start to weep for them, we'll move along to the next diagram....



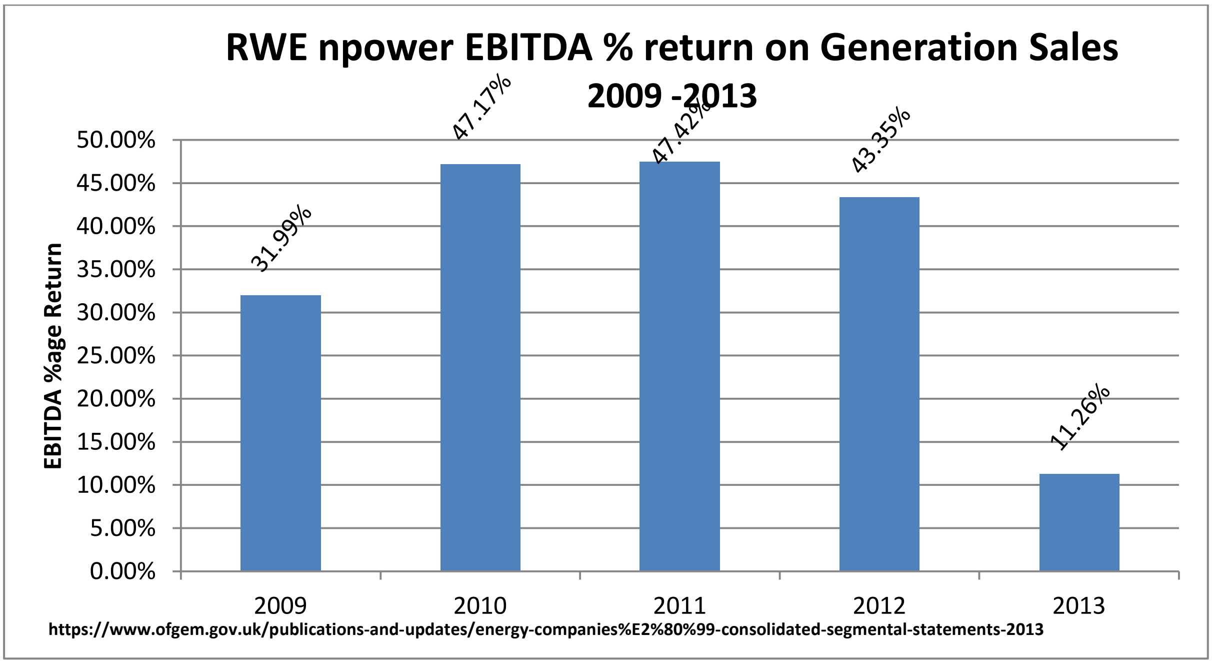
EDF earned a whopping 36.02% return from their Generation arm in 2013, down from a return of 40.63% in 2012. They've kept the profit in the part of the business which isn't exposed to much public scrutiny. Smart move!



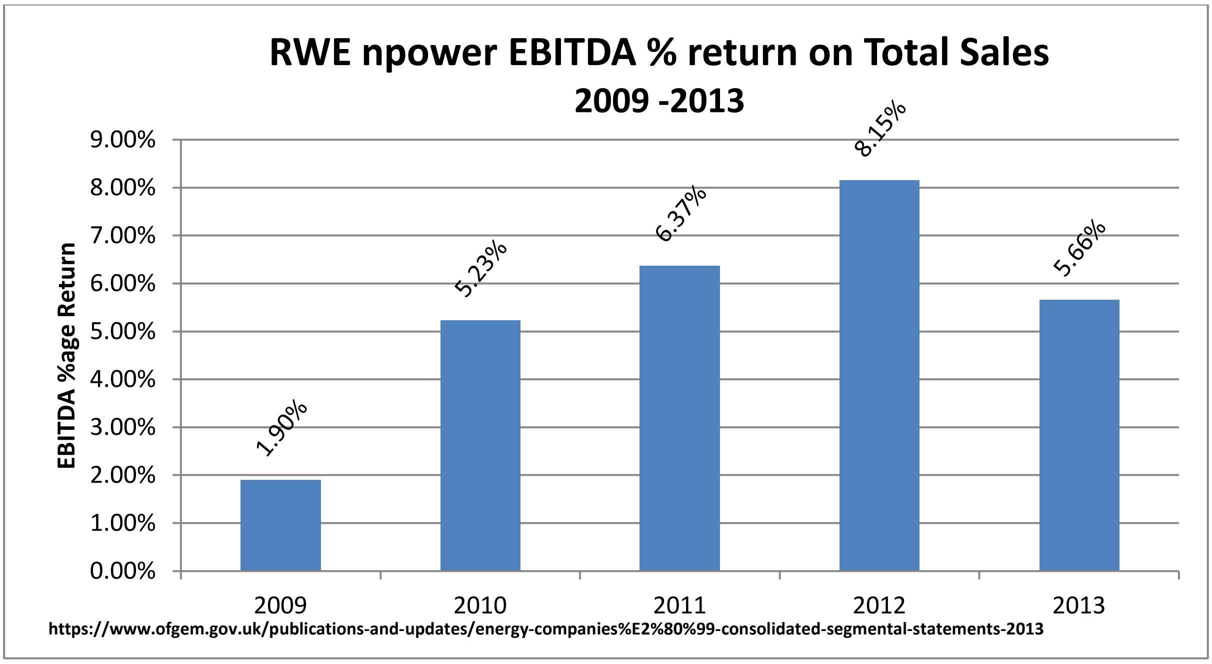
EDF's EBITDA return on Total Sales is 14.68%. And to think we were near to tears after the first graph. We're not crying now.....



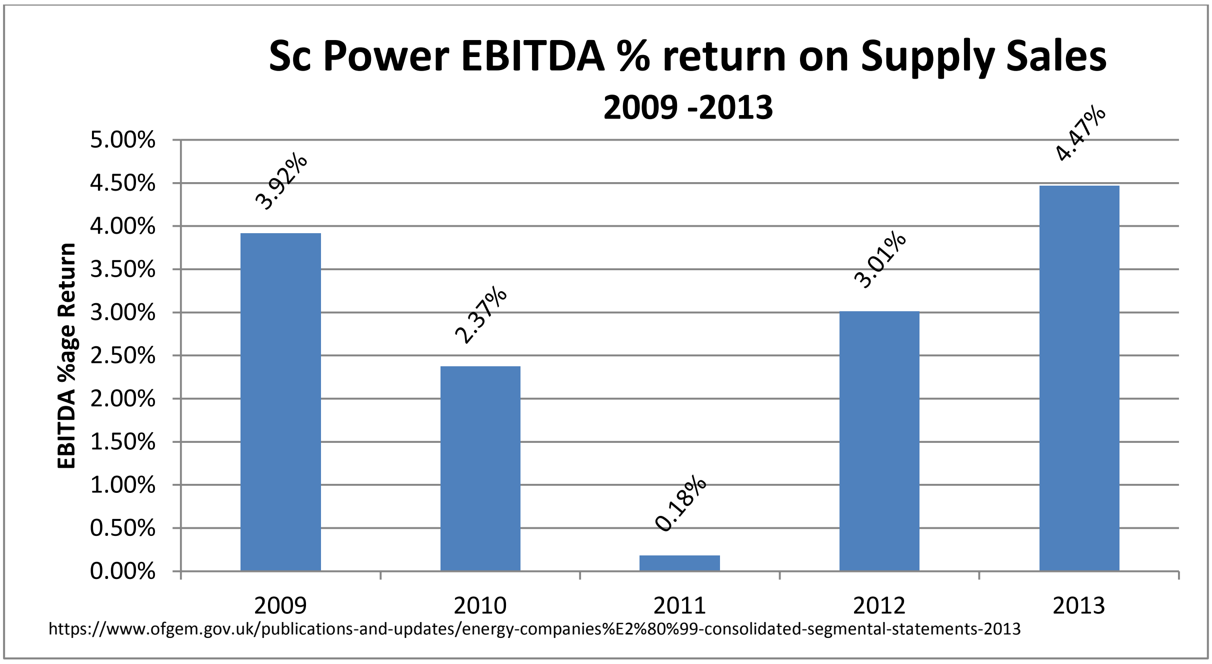
Bravo RWE npower, a year-on-year improvement in the performance of the Supply business has seen it return to profit, posting a return of 3.92% in 2012 and a marginally lower 3.86% in 2013.



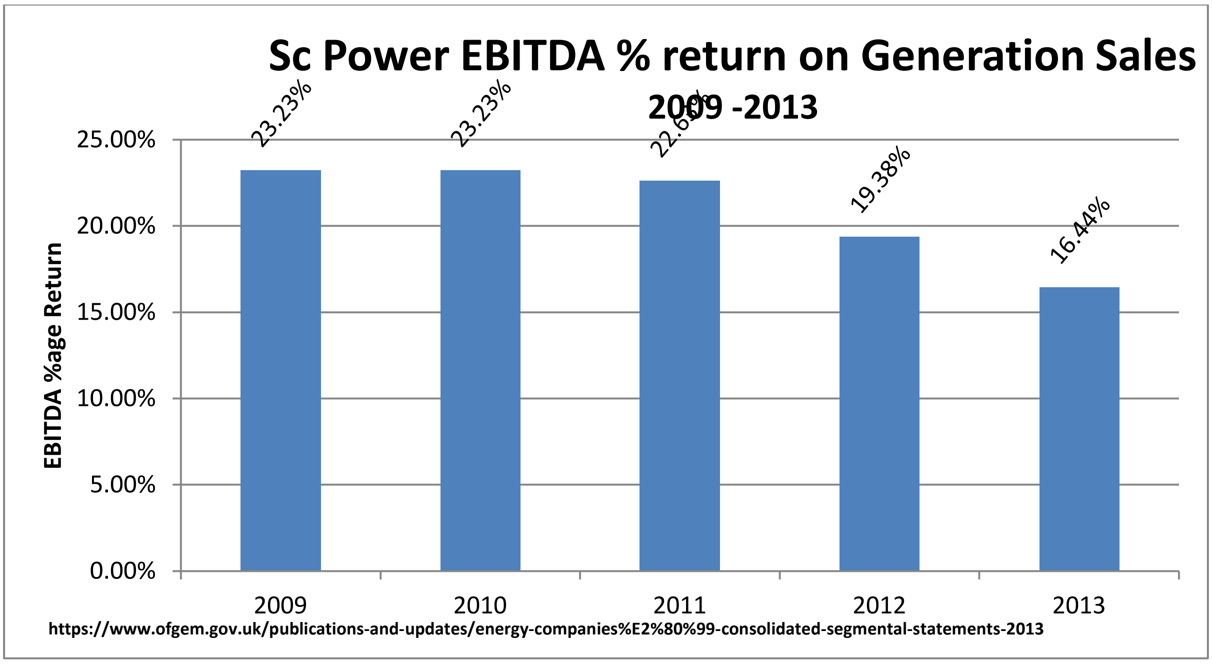
RWE has suffered a huge drop in its profit percentage from Generation sales. It fell from 43.35% in 2012 to 11.26% in 2013, a fall of just under three quarters.



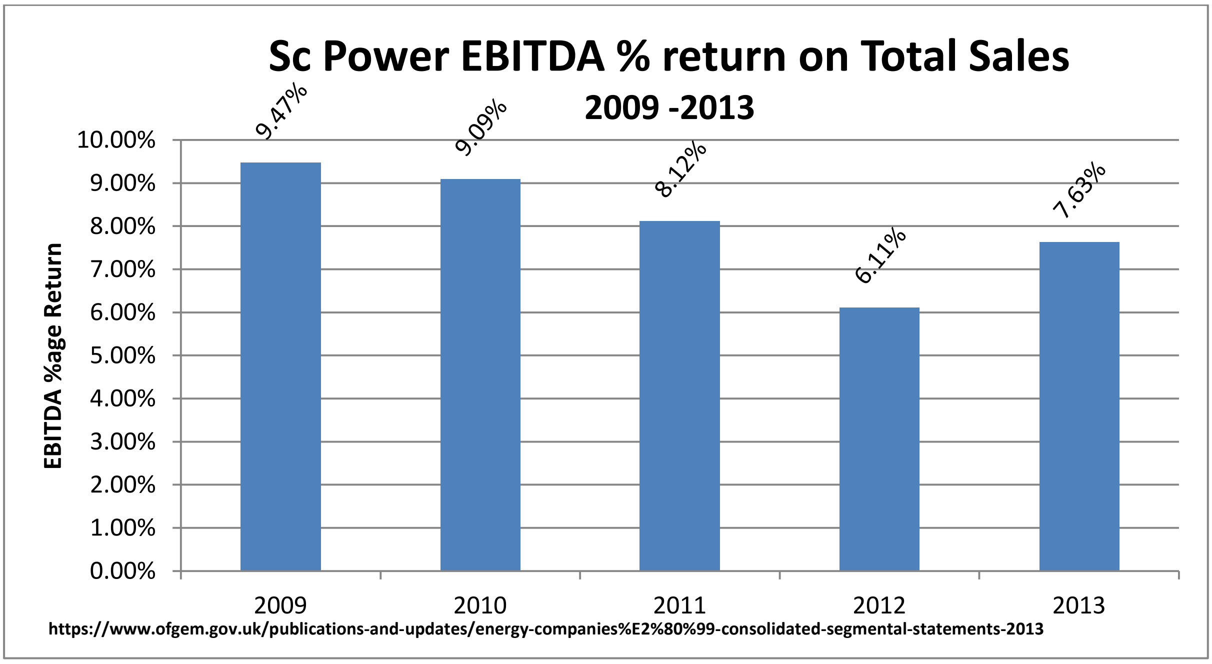
RWE's profits in their UK business rose steadily reaching 8.15% EBITDA over Sales in 2012. This performance wasn't maintained in 2013 when the return fell to 5.66% due to a collapse in generation profits.



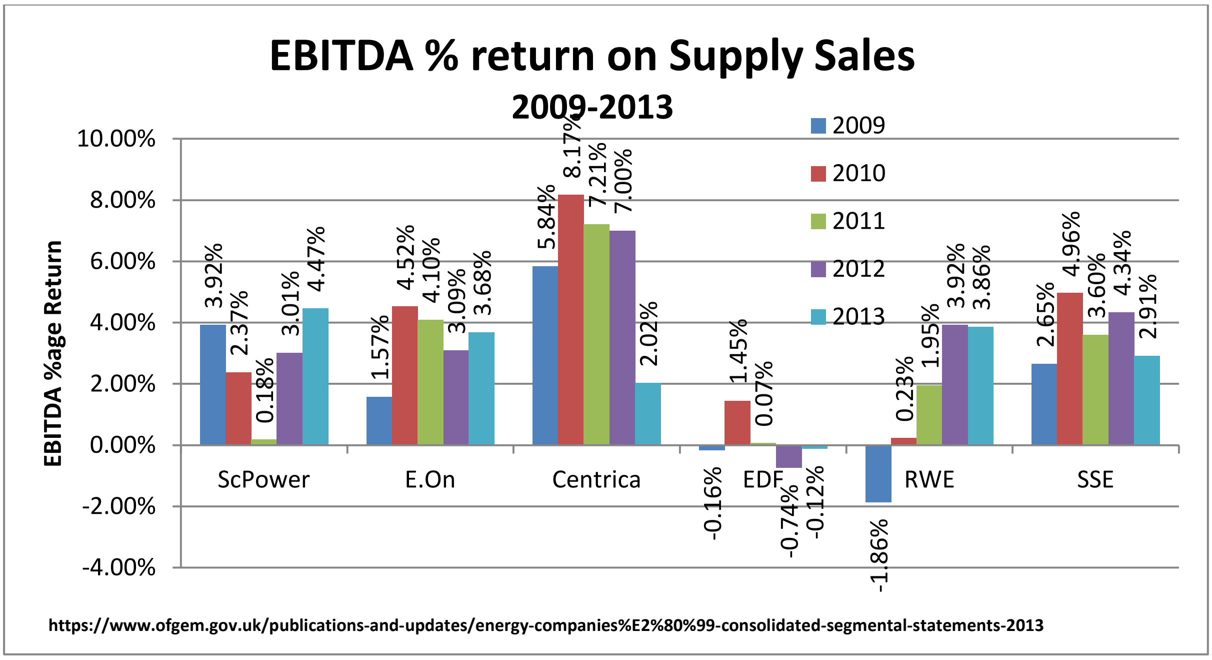
Scottish Power made a 4.47% return on Supply sales in 2013, up from 3.01% in 2012 to the highest rate seen in the last five years..



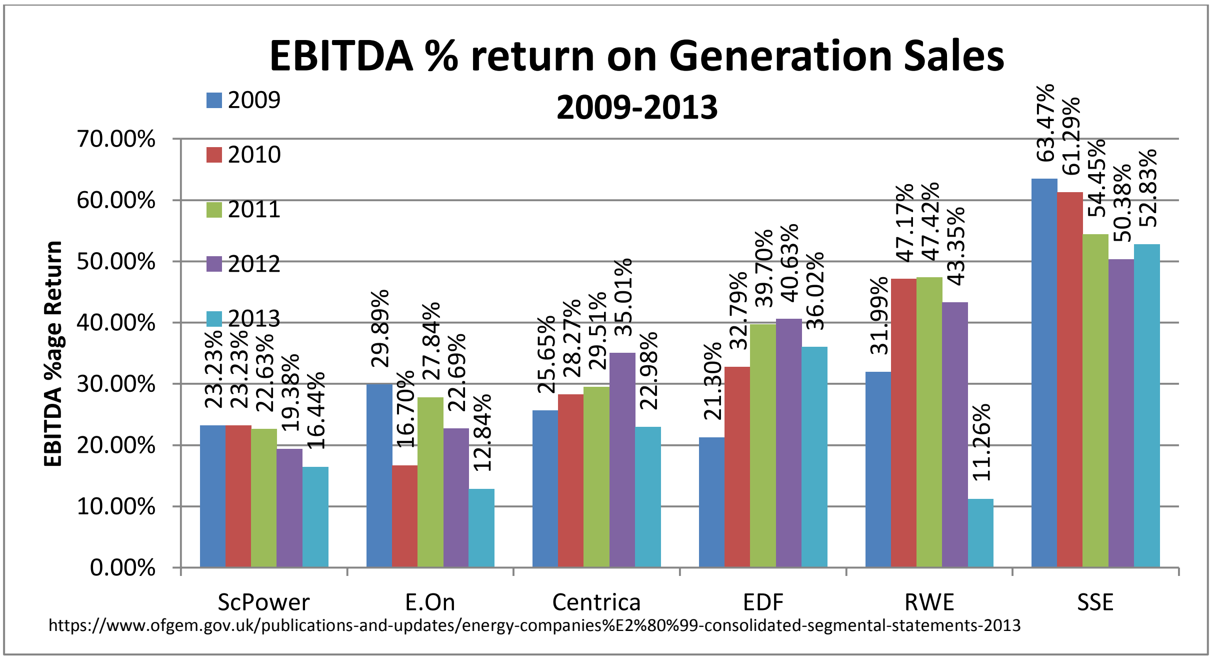
Scottish Power saw a big decline in generation profit percentage in 2012 and again in 2013, this will be partly due to the closure of Cockenzie and the run-down at Longannet.



Scottish Power has halted the decline in the return on Total Sales seen over the last four years. It saw the return on total sales increase to 7.63% in 2013.

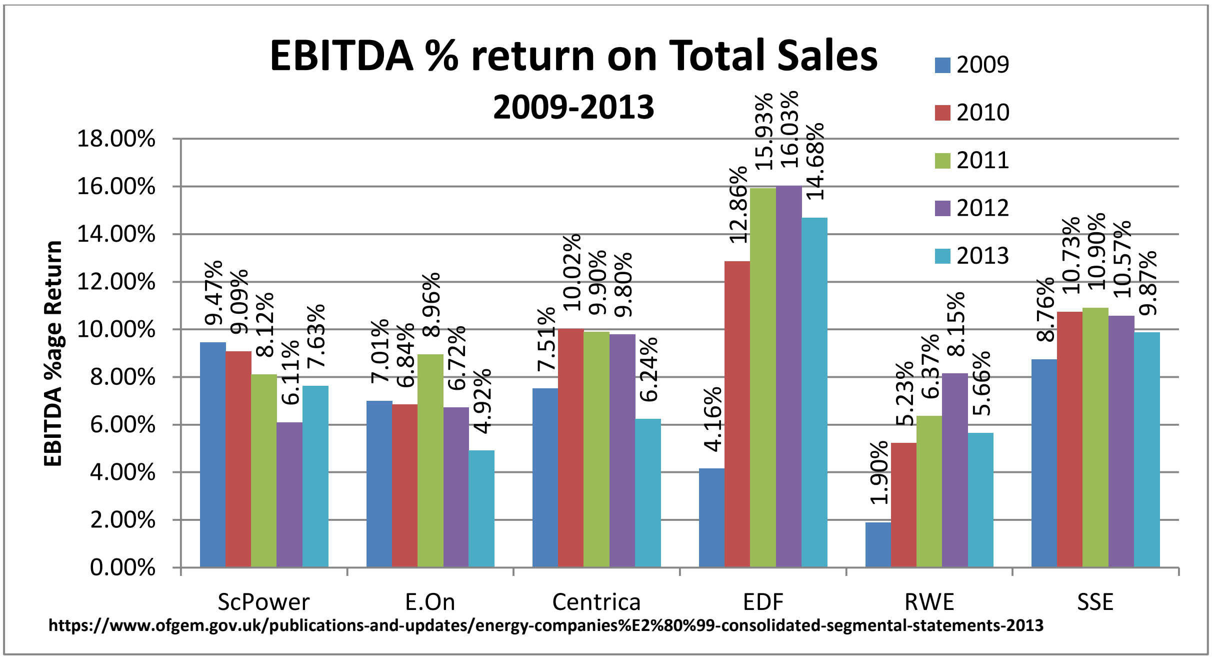


Looking at all of the firms together gives us a slightly different perspective. In terms of the Supply Business dealing with retail sales to customers returns don't look abnormal and the market seems to be competitive with other firms offering increased competition in recent years.



When we look at the Generation Sales the position is markedly different with SSE earning a 52% return and EDF a 36% return. These show clear evidence of abnormal returns above what would be expected in a competitive market.

I predicted the "Dash for Coal" would mean returns for 2013 would be very much higher. This wasn't the case due to reduced utilisation of assets in a mild winter. We should also consider whether input costs for raw materials are being set by any of the players through intra-company trading (central group buying) and also if cost of capital is determined by the market or by the firms own IRR.



What we have discovered for all of the companies is that their overall percentage return is much higher than the retail profit percentages shared with the Energy and Climate Change Select Committee. The Generation business is where the money is being made.

Returns of over 50% on generation make a mockery of the evidence given to the committee. Will anything be done about this? Since we last wrote OFGEM referred the market to the new Competition and Markets Authority (CMA). The CMA inquiry team headed by a former director of N-Power heading a committee of city grandees has produced interim findings suggesting things are fine. The above analysis suggests that things are not fine in the generation market. It is to be hoped that generation will be looked at again before final conclusions are drawn.

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