West Midlands
Industrial Energy Taskforce

Urgent action to address business energy costs – What is wrong and some ideas on how to put it right.

Executive Summary

A consequence of the way the energy market is designed is that market turbulence provides considerable scope for energy companies and intermediaries to make money (completely rationally) but the economic consequences and the uncertain investment environment this creates are entirely borne by business customers and some regional economies (with little opportunity for mitigation).

Most business customers cannot act as effective drivers of desirable competitive market outcomes because the commercial energy market is opaque and impenetrable, and the costs and time involved in even quite large businesses acquiring the necessary knowledge to be effective market participants are excessive. There was no time at all to acquire these competencies in the last year.

For many years energy costs were relatively insignificant for many enterprises so flaws in market design were not very visible. The focus on designing energy markets to encourage competition in generation and investment is understandable, but lacks balance or a whole economy perspective.

Volatility in commercial energy costs thus has a greater negative impact on the economy of diverse manufacturing or hospitality-based regions than it does on the economy of regions based on non-energy-intense industries (such as financial services) or with significant energy generation or based around large industrial complexes, able to generate and trade their own power.

The pace and magnitude of change and cost increases in the past 18 months now make these flaws very clear and threaten sound businesses and economic growth. An energy market reform process is a vital but inadequate response (as it will inevitably take years). Discount schemes are helpful to some companies, but for many are irrelevant and simply funnel funds back into energy suppliers. They also exacerbate market opacity and can create opportunities for customer exploitation.[1]

More urgent and targeted intervention in support of critical mid-sized industries is required. Of the 220,000 firms in the West Midlands, for example, we estimate that 3-4000 urgently need help.

The focus of government attention should be on finding the most efficient and cost-effective way to target the limited available support on these 3-4000 companies. SIC codes and formulae are very broad brush and inefficient (especially with appeals) but are the current proposal. More cost-effective approaches might be built around some or all of:

- A delegated hardship fund for regional leaders and bodies to allocate to the most vulnerable and strategic companies
- A requirement on energy suppliers to waive contracts failing to meet agreed criteria (and perhaps to fund this in lieu of a general windfall tax)
- Creation of a secondary market for existing supply contracts, with government and/or energy company funds injected centrally to make these commercially viable, and enabling suppliers to bid in to make more competitive offers to customers

[1] The government has both of these in place, but neither will save West Midlands businesses that face unsustainable tariffs in 2023 and 2024.

WMIETF Secretariat, Feb 2023 evidence@wmindustrialenergy.co.uk

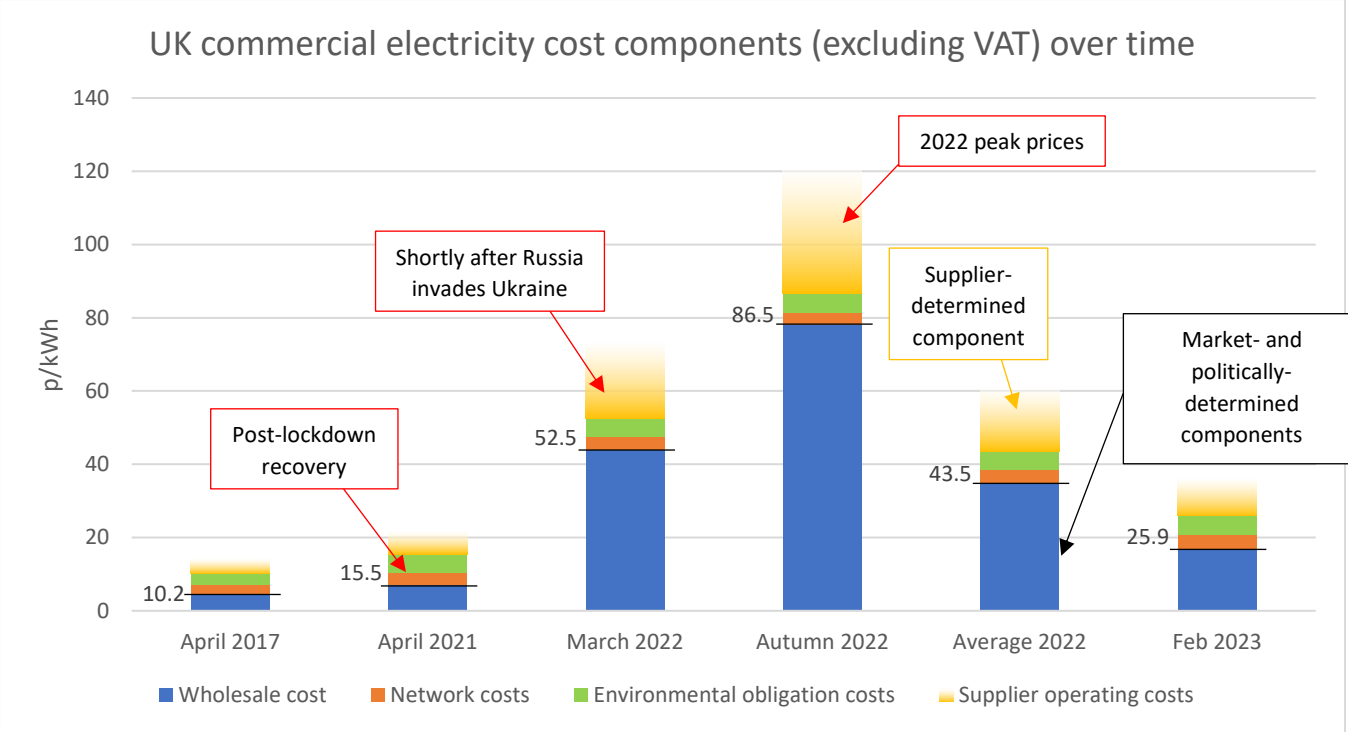
Introduction

This paper explains how commercial energy costs are structured, why commercial contracts are opaque and undermine UK economic competitiveness, and suggests some initial ideas for more efficient and cost-effective ways than a price cap or discount scheme to mitigate the impact of market design on otherwise competitive reginal economies.

How are business energy costs determined?

Business energy costs can be broken down into components, each of which is set in a different way. The size of some of these components are determined by markets, but others are determined by government or individual suppliers. This paper explains who does what and the consequences for our economy.

The chart below illustrates these components of industrial and commercial electricity unit costs, and how they have varied since 2017.[2]



Estimated proportions of each component of energy costs comparing prices from the past 6 years, showing how recent events have changed where energy costs come from. Labelled figures are the total non-supplier-determined cost. This chart does not include VAT, which is charged at 20% but most industrial consumers can reclaim. Supplier operating costs and margins vary by supplier and may also include broker fees and commission. These costs are unregulated (hence the top segment of each bar is shown as variable height).

There are four components in the unit charge (per kWh) paid by an individual company. Variation in each of these is driven in distinct ways.

The **wholesale price** is driven by global market forces (e.g., wars, national reserves) and by UK market design (e.g., a structural choice by government to link gas and electricity prices). It is the price paid by energy suppliers for electricity they buy on the open market (i.e., excluding any they

[2] Gas prices are structured in a similar way, although the per unit figures are different.

generate themselves). The exposure to global market forces makes this price volatile, as illustrated in the chart. The chart also only shows day-ahead spot prices: like other commodities it is also possible to buy power for delivery in the future at different prices, so actual prices paid by suppliers are more complex. The UK market design means that relatively low and stable costs of renewables and nuclear power are not reflected in open market electricity prices.[3]

All non-wholesale components of energy prices are sometimes termed 'non-commodity' costs, but in practice this covers three distinct types of cost.

Network costs are negotiated between the government regulator (Ofgem) and network companies at five yearly intervals and are largely fixed, then shared back across all customers. These are payments for the pipes and wires through which electricity and gas reach businesses and homes. The level of cost (i.e., how much we invest in our fixed infrastructure, including in maintaining it and ensuring everyone has access to it, even after storms etc) is agreed through a political process. This process enables us to make strategic choices including, for example, how much electrical or hydrogen network capacity we build to support industrial and transport demand in a lower carbon economy; or trade-offs between enabling widespread access to the grid for new connections and avoiding building capacity that remains unused.

Environmental and social obligations (levies) are also negotiated – typically directly between government and global investors - as part of 'business models' put in place by government to incentivise private investments in socially-desirable projects such as non-polluting wind farms, nuclear power stations, and energy efficiency schemes. They are again relatively fixed, but vary slightly over time as they can include formulae linked to wholesale prices. In practice they can best be thought of as contractual interest and loan repayments against investments made in the past between many organisations, including manufacturing industry, and government.[4]

Supplier operating costs and margins are under the control of individual energy suppliers (and also sometimes include broker sales commissions and similar[5]). These include the normal commercial operating costs of the supplier as well as their profit (which supports future investments). They also reflect the trading position of the supplier in relation to their customer base. For example, the supplier may choose to buy all their power at spot rates, or (more realistically) they will purchase a mix of spot and forward contracts – sometimes years ahead – at different prices. At the same time, they are offering their customer base a portfolio of fixed and variable tariffs, each representing a contractual commitment. The degree to which supply and purchase contracts align creates both risk and trading margin for the supplier. This is sometimes referred to as their trading position.

An example is the best way to illustrate how this market framework works through to reality. Consider a single customer who is about to be put out of business because they have a two year

[3] Instead the difference between the high wholesale price and low costs of renewable and nuclear production flow back into the investors in these generation sources (typically global energy companies) and government. They argue this helps fund necessary future investment.

[4] Current levies include Contracts for Difference; Feed in tariffs; Renewable Obligation Certificates; Climate Change Levy.

[5] Brokers sometimes act between the customer and supplier either for a fee, or on a commission basis. Just as with financial advice, it is worth companies knowing how their broker is paid, as commissions based on percentages of value in volatile markets (and/or hidden in unit costs) can act as incentives for brokers to do long term deals that act against customer interests. Some customers are now taking group legal action where they believe this may be the case for them: https://harcusparker.co.uk/campaigns/energy-litigation/.

fixed tariff set at 60p/kWh for electricity with their supplier. They bought this at the peak of market volatility in October 2022, in some desperation, when spot prices were 50-60p/kWh.

The underlying cost structure of this example contract could take one of three broad forms, using extreme cases to illustrate what is in practice a range of possible outcomes.

1. Their supplier might only ever buy power at spot prices but still be willing to sell fixed rate contracts with business customers. So the supplier was paying around 50-60p/kWh when they sold the contract, but are now paying 14p/kWh. This is a highly risky position for the energy supplier in theory (as spot prices might go up again above 60p) but is also highly profitable in the short-term, as it means the supplier is now making profits of 40p or more per unit (before any insurance or hedging costs they might choose to incur).

2. A much more conservative supplier might, however, only ever buy supply contracts to match the deals it does with its customers. In this case, the supplier will have bought long-term power (for say 55p/kWh) at the same time they sold the contract to their business customer at 60p/kWh (allowing 5p for network and environmental costs, their own costs and a small margin for themselves and any broker). There is no trading risk, but also little profit for the supplier.

3. A third possibility is that the supplier bought or acquired power on a long-term contract last October for say 40p/kWh, and still sold it to the customer at 60p/kWh. Suppliers who own their own generation assets or who are large enough to hold and manage portfolios of hedged forward contracts may be able to do this. This is also a position effectively with little trading risk, but now contains an exceptional profit for the supplier which might in some circumstances amount to abuse of a privileged market position, particularly if the supplier uses part of their 20p/kWh profit to pay large bonuses to brokers for selling such contracts to customers when they know government subsidies will mask any short-term impact.

All three of these contracts look identical to the customer (60p/kWh) but the options for commercial recourse or policy correction are completely different.

In the first contract the supplier is making exceptional profits through a highly risky (arguably irresponsibly so) trading strategy; in the second the supplier is making virtually no profit at all by being very conservative (to the extent that they could easily put both their customers and themselves out of business, but it's pointless pursuing them for abusive practices, for example); and in the third they are cynically exploiting their market position and government schemes, or the customer has foolishly or unluckily bought a contract which in a more transparent market would not be viable.

The volatile market conditions that characterised 2022 made it easier for less scrupulous suppliers and intermediaries to trap customers in unsustainable contracts. The way the government's EBRS and EBDS schemes are linked to wholesale prices unfortunately exacerbates this opportunity, in particular by allowing suppliers to mask the impact of unsustainable pricing until after customers have signed business-destroying fixed rate contracts.[6]

[6] The Energy Bill Relief Scheme (EBRS) and Energy Bill Discount Scheme (EBDS) operate by applying headline discounts to each kWh a supplier sells. The subsidy is paid direct to the supplier, not the customer.

It's impossible in practice to know whether a tariff being charged by a supplier reflects their actual costs and a reasonable profit, or instead is exploitative and opportunistic pricing. More generally, it makes the UK commercial energy market a rich generator of unintended, undeserved and undesirable economic outcomes: fundamentally sound manufacturing and hospitality businesses across the West Midlands and elsewhere being put out of business by accident.[7]

Smaller commercial customers are particularly vulnerable because they are not protected by the Regulator and Ombudsman in the same way as domestic customers[8]; nor do they have the capacity and scale to participate in the energy market direct or renegotiate obviously dangerous contracts like large commercial and industrial companies. In particular, where energy costs have historically been a relatively small part of their turnover, this has made them easy prey for less scrupulous and commission-based sales practices.

How might these issues be addressed?

In the medium and longer-term, market reform is clearly required, and the government recognises this and has already initiated a review of electricity market arrangements (REMA) which will address some of these issues. This will realistically impact the market from 2025-2030 onwards. It might include mechanisms such as ringfenced fixed or lower cost renewable power pools allocated to industrial customers or zones.

More immediately, measures such as effective regulation of commercial energy brokers and commercial energy contracts would be sensible, and models are available from similar markets such as financial services. Standardised forms of contracts, formal broker accreditation schemes, and recourse to a regulator or ombudsman all seem appropriate and are relatively low cost.

However, such measures still remain medium-term and will not help businesses locked into excessive contracts during the peak of price volatility in autumn 2022. In the West Midlands, surveys suggest that in the manufacturing and hospitality sectors, between 10-20% of businesses fall into this category (currently paying more than 50p/kWh for electricity on fixed term contracts). This is around 4000 substantive companies across the region.[9]

The focus of government attention should be on finding the most efficient and cost-effective way to target the limited available support on these 3-4000 companies. SIC codes and formulae are very broad brush and inefficient (especially with appeals) but are the current proposal. More cost-effective approaches might be some or all of:

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- Creation of a secondary market for existing supply contracts, with government and/or energy company funds injected centrally to make these commercially viable, and enabling suppliers to bid in to make offers to customers (ideally with standard contracts).

[7] 'Accident' here means multiple commercial actors simply behaving rationally given a market design.

[8] There is regulatory protection for 'micro' businesses, defined as businesses using less than 100,000 kWh of electricity a year, or employing fewer than 10 people and turning over less than EUR2M, but in practice even a single successful restaurant can exceed this (and is highly unlikely to have an energy manager).

[9] https://www.gov.uk/government/statistics/business-population-estimates-2021. 3-4000 is an estimate based on excluding companies with no employees and taking 10-20% of manufacturing and hospitality businesses based on the latest taskforce survey results.