

Explaining network profits

February 2018

- As with any business, profit margins are most accurately calculated when they include the cost of capital investment. This is particularly the case for energy network companies, which are capital intensive businesses.
- Even using a simplistic methodology that takes this into account, profit margins for DNOs in recent years would be between 5 and 7%, much lower than the higher figures recently claimed.
- For the same reason, dividend margins are best calculated with reference to the return on capital invested rather than as a ratio of cashflows in any one year.
- The cost of delivering gas and electricity via energy networks makes up about a quarter of the average dual-fuel energy bill. These costs are currently either flat or falling as we head into the next decade.

How omitting investment costs leads to inflated profit figures

- The simple total profits vs. revenue formula as used by the Energy & Climate Intelligence Unit (ECIU) in their recent *RIIO Carnival* report¹ omits the costs of investment into the networks delivered by DNOs, creating inflated and misleading profit figures in the process.
- Based on an ENA analysis of network companies' statutory accounts, the combined cost of this investment by DNOs was £5.22bn for the first two years of the RIIO price control (2015/6 and 2016/7).
- The cost of investment is spread over the lifespan of the assets it's invested in (typically between 40 and 60 years). Network companies' statutory accounts for that period reflect that cost.
- The following table illustrates the impact that the cost of this investment would have on claimed returns for DNOs by adjusting a total profits vs. revenue formula:

Illustration of how investment costs are not accounted for in a "total profits vs. revenue" analysis ²	DNO figures for 2015/16 £m	DNO figures for 2016/17 £m	Total DNO figures for RIIO to date £m
<i>Profit for the year that is attributable to equity shareholders</i>	1904.0	1774.2	3678.2
1. Statutory depreciation and amortisation expense allowance	1103.0	1169.5	2272.5
2. Cost of investment activities	-2597.7	-2624.0	-5221.7
<i>Adjusted position reflecting 1 & 2 above</i>	409.3	319.7	729.0
<i>Revenue</i>	5816.2	6312.5	12128.7
"Capital reflective return" as an illustration of profits post-investment – i.e. Adjusted position as a percentage of revenue	7.0%	5.1%	6.0%

¹ *RIIO Carnival*, Energy & Climate Intelligence Unit (ECIU), January 2018

² Data compiled by Energy Networks Association from the statutory accounts for licenced Distribution Network Operators operating under the RIIO price control framework in Great Britain, for the years 2015/6 and 2016/7.

The shortcomings of a 'profit and loss' analysis

- Including cost of investment figures in this analysis is important because the revenue received by network companies funds capital investment.
- However, even this adapted model is still not the most accurate way of providing a fair representation of the level of returns network companies receive for the service they provide and capital investment they undertake.
- This is reflected by the most recent Ofgem annual reports for the RIIO price control, which show that DNOs actually invested £6.6bn in the period 2015-17³.

Dividends

- Analysis of the dividends paid out by network companies needs to reflect the return on the capital invested in infrastructure, not just the cashflow moving through the business.
- The return on capital invested is an appropriate measure to measure dividends, by which Ofgem sets for each price control through a rigorous process of substantial analysis spanning several years. This is set at 3.5% to 4% for RIIO. This is commonly accepted as the most appropriate way of analysing returns paid to shareholders.
- A simple 'dividend payout ratio' based on cashflow is an accounting method typically used for a retail type business that does not invest significant amounts of capital investment.

How the RIIO price control works

- The RIIO price control system incentivises network companies to continually reinvest profits, not only to improve network performance but also to reduce costs for consumers.
- Through the price control, companies are incentivised to deliver projects under budget through the promise of better returns, which results in a lower cost to the consumer.
- These types of 'win-win' incentives are fundamental to the operation of the price control system, the net result of which is that the RIIO system encourages downward pressure in bills for consumers whilst creating the conditions to attract the significant levels of investment needed for our network infrastructure.
- The level of capital investment through this system and at the scale required for managing energy networks means any analysis is inherently complex.
- As part of ENA's response to the RIIO2 Framework consultation in September 2017, network companies set out their commitment to ensuring the price control system is as transparent as possible.
- In 2018 ENA will set out more detail on how the system should be altered in relation to RIIO accounts and how we feel the system can provide investors, shareholders and the public with more transparent regulatory accounting information.

Further information

ENA is committed to ensuring that the public debate on energy is as informed and accurate as possible. If you would like to arrange a more detailed briefing on the issues raised in this note, please contact Ed Gill via Edward.gill@energynetworks.org

³ RIIO ED-1 Annual Report 2016-17, Ofgem, December 2017