Energy market investigation

Profitability of retail energy supply: profit margin analysis

16 March 2015

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the updated issues statement and the other working papers which accompany it. These papers do not form the market investigation reference group’s provisional findings. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional findings, which are currently scheduled for publication in May 2015, taking into consideration responses to the consultation on the updated issues statement and the working papers. Parties wishing to comment on this paper should send their comments to energymarket@cma.gsi.gov.uk by 7 April 2015.
The Competition and Markets Authority has excluded from this published version of the working paper information which the Inquiry Group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [身心健康].
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**Introduction**

1. On 8 December 2014, we published, and consulted on, a working paper setting out our proposed approach to assessing profitability at each stage of the energy supply chain in Great Britain, namely in power generation and retail supply (the profitability approach paper). This working paper concerns profitability in the retail supply of energy in GB (retail profitability).

2. This paper sets out the preliminary results of our analysis of profit margins and ratios. We primarily focused on two profit measures, namely profit after direct costs (gross profit) and earnings before interest and tax (EBIT), or gross profit less indirect costs and depreciation and amortisation (D&A). Based on these profit measures, we looked at a range of profitability ratios, in particular profit margins (ie a return on sales measure), profit per MWh (unit profit) and, when appropriate to do so, profit per customer account.

3. Our analysis was based primarily on the profit and loss (P&L) account information submitted to us in response to our financial information requests by the six largest vertically integrated suppliers (the Six Large Energy Firms) that supply both electricity and gas to residential (domestic), small- and medium-sized enterprises (SMEs) and larger industrial and commercial (I&C) customers (the retail segments).

4. This paper considers profitability for the three retail segments combined (the total supply business), and for each individual retail segment. We also compared the profitability results of the domestic supply businesses of the Six Large Energy Firms with those of the next four largest independent domestic energy suppliers in GB (the mid-tier suppliers).

5. Our analysis focused on the period covering the last seven financial reporting years, or financial year-ends (FYs), of the Six Large Energy Firms, ie FY07 to FY13 (the relevant period). We covered a shorter five-year period for the mid-tier suppliers, noting that Utility Warehouse and First Utility were the only mid-tier suppliers that had traded for the full five-year period.

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1 Competition and Markets Authority’s (CMA) Approach to Financial and Profitability Analysis working paper.
2 In alphabetic order, the Six Large Energy Firms are British Gas (or Centrica), E.ON, EDF Energy (EDF), RWE npower, Scottish Power, and Scottish and Southern Energy (SSE).
3 For the purposes of this paper, we have assumed that the domestic and SME retail segments combined, as reported in the Six Large Energy Firms’ P&L information, most closely represented the retail markets that were defined by our terms of reference. There was also a broad consensus from the Six Large Energy Firms that these ‘smaller business’ customers that formed part of our terms of reference would most appropriately be categorised under their SME customer category.
4 In alphabetical order, the four mid-tier suppliers are Co-Op Energy, First Utility, OVO Energy (OVO) and Utility Warehouse.
5 We adopted a convention to match a firm’s own financial reporting year as closely as possible to the calendar year (ie ending 31 December), such that the FY refers to the calendar year in which the majority of its months fell
6. The preliminary results of our analysis in this paper should be taken in conjunction with the preliminary results of our other strands of retail profitability assessment, in particular the further work we will be undertaking in relation to our profit margin analysis, as well as our analysis of retail profitability based on a return on capital employed (ROCE) measure.

7. Our work in relation to retail supply ROCE is ongoing and we have not yet drawn any preliminary conclusions from it. Many firms have had difficulty providing us with balance sheet information for their retail businesses. From the information provided, we observe large variations in balance sheet values for tangible fixed assets (including building and IT systems) and for working capital. We are examining the reasons for these variations and the extent to which they are due to differences in accounting treatment and allocation issues rather than reflecting substantive differences in the amount of capital that an energy retail business of a given size needs to operate. Some of the observed differences, eg in working capital, may be due to relative efficiencies (eg in debtor management). A further issue that we are considering is whether certain adjustments are required to account for off-balance sheet items, such as notional collateral and customer acquisition costs. We are continuing to analyse capital employed and are considering how to model the capital base of an efficient supplier on a modern equivalent asset basis.

8. The main body of this paper is structured to highlight the key preliminary findings of our analysis, and therefore the details of a significant part of our underlying analysis have been set out in a separate body of appendices.

9. We have structured the main body of this paper under the following subjects:

(a) Total supply business profitability: in paragraphs 10 to 16, we begin our analysis by looking at profitability at the total supply business level for the Six Large Energy Firms, ie for their three retail segments combined.

(b) Comparison of retail segmental profitability: in paragraphs 17 to 63, we set out the preliminary results of our profit margin and ratio comparisons between the domestic, SME and I&C retail segments for the Six Large Energy Firms. In particular, we focused on the differences in profitability between their domestic and SME retail segments, as well as on the key drivers of domestic supply profitability.

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into. To illustrate how we applied this convention, and for the avoidance of doubt: (a) for firms with financial reporting years ending 31 December, ie British Gas, E.ON, EDF, RWE npower, Scottish Power, First Utility and OVO, FY13 means their FY ended 31 December 2013; (b) for firms with financial reporting years ending 31 March, ie SSE and Utility Warehouse, FY13 means their FY ended 31 March 2014; and (c) for Co-op Energy, its financial reporting year ends on the fourth Saturday in January, therefore FY13 means its FY ended 25 January 2014.
(c) Profitability by domestic tariff type: in paragraphs 64 to 74, we compare the relative profitability of the Six Large Energy Firms’ domestic standard variable tariffs against their other tariff types, eg fixed tariffs.

(d) Indirect cost analysis: in paragraphs 75 to 104, we look at indirect cost ratios and compare these across the Six Large Energy Firms, as well as with the ratios of the four mid-tier suppliers, as one measure of their relative cost efficiency.

Total supply business profitability

Section overview

10. This section sets out our analysis of the Six Large Energy Firms’ retail profitability for their three retail segments combined, ie at the total supply business level.

Total supply business profit margins

11. Figure 1 shows the total annual energy volumes supplied by the Six Large Energy Firms on a combined basis, split by domestic and non-domestic supply.

FIGURE 1

Total supply business annual energy volumes (TWh) for the Six Large Energy Firms combined over the relevant period

Source: CMA analysis.
Note: Total energy volumes relate to both electricity and gas supply for all three retail segments, ie domestic, SME and I&C.
12. Figure 1 shows that total volumes supplied by the Six Large Energy Firms declined by 13% from 731 TWh in FY07 to 636 TWh in FY13. The sharpest single year fall in volumes occurred in FY11 for both domestic and non-domestic volumes, when they declined by 17 and 12% respectively.

13. Figure 2 shows that annual revenues for the Six Large Energy Firms’ total supply businesses increased by 37% over the relevant period from £33 billion to £46 billion.

![Figure 2: Total supply business revenues (£ billions) over the relevant period for the Six Large Energy Firms combined](image)

Source: CMA analysis.
Note: Total energy revenues relate to both electricity and gas supply for all three retail segments, ie domestic, SME and I&C.

14. Over the relevant period, EBIT more than trebled for the Six Large Energy Firms combined from £0.5 billion in FY07 to £1.6 billion in FY13 (see Figure 3).
FIGURE 3

Total supply business EBIT (£ billions) over the relevant period for the Six Large Energy Firms combined

![Bar chart showing total supply business EBIT (£ billions) over the relevant period for the Six Large Energy Firms combined.]

Source: CMA analysis.
Note: Total energy EBIT relate to both electricity and gas supply for all three retail segments, ie domestic, SME and I&C.

15. EBIT margins for the total supply businesses of the Six Large Energy Firms combined also increased over the relevant period, from 1.4% and 1.0% in FY07 and FY08 respectively to 2.8% by FY13, with a period high of 4.2% in FY10. Figure 4 sets out the annual total supply business EBIT margins for the Six Large Energy Firms combined over the relevant period.

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6 Annual total supply business EBIT margins for the Six Large Energy Firms combined were relatively higher between FY10 and FY12 than in any other year over the relevant period, ranging from 3.3% in FY11 to 4.2% in FY10.
16. We now turn to retail segmental profitability, which underpins the profit ratios above for the total supply business.

**Comparison of retail segmental profitability**

**Section overview**

17. This section sets out our analysis of profitability for each of the three retail segments, namely domestic, SME and I&C. We first set out the segmental profit ratios of the Six Large Energy Firms on a combined aggregated basis, before setting out their individual ratios. For certain areas of our analysis, we have presented our ratios on two different bases: (a) calculating profit margins and ratios based on aggregated figures over a given period (period total), and (b) on an annual basis.

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7 Eg, the FY13 EBIT margin for the Six Large Energy Firms combined (ie on an aggregated basis) would be calculated as the sum of the FY13 EBIT of the Six Large Energy Firms divided by the sum of their FY13 revenues.

8 Eg, the EBIT margin on a period total basis would be calculated based on the sum of the EBIT generated over the period (ie period EBIT), divided by the sum of the total revenues generated over the period (ie period revenues).
Retail segmental profitability on a period total basis

Retail segmental profitability for the Six Large Energy Firms combined

18. On a five-year period total basis, the Six Large Energy Firms combined generated an EBIT margin of 3.4% at a total supply business level. When we examined profit margins at a retail segmental level, we found that EBIT margins varied considerably between the different retail segments.

19. In Table 1, we set out the revenues, EBIT and EBIT margin by retail segment and for the total supply business on a five-year period total basis. We present the figures for the Six Large Energy Firms on a combined basis.

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Five-year period total revenues, EBIT and EBIT margins for the Six Large Energy Firms combined*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Domestic</td>
</tr>
<tr>
<td>Period revenues (£bn)</td>
<td>132</td>
</tr>
<tr>
<td>Retail segment % split</td>
<td>62%</td>
</tr>
<tr>
<td>Period EBIT (£bn)</td>
<td>4.3</td>
</tr>
<tr>
<td>Retail segment % split</td>
<td>59%</td>
</tr>
<tr>
<td>Period EBIT margin (%)‡</td>
<td>3.3%</td>
</tr>
</tbody>
</table>

Source: CMA analysis.

*When calculating figures for the Six Large Energy Firms on a combined basis, we have taken a simple sum of their individual figures.
†We have assumed that the domestic and SME retail segments combined represent the closest proxy to the ‘reference markets’ based on the available P&L information of the Six Large Energy Firms.
‡Period EBIT margin was calculated by dividing period EBIT by period revenues.
Note: Period total is calculated based on a simple sum of the relevant annual figures over the stated time period.

20. Based on Table 1, the reference market, as approximated by the combined domestic and SME retail segments, accounted for a significant proportion of the revenues and EBIT generated by the total supply businesses of the Six Large Energy Firms combined, ie 72 and 83% of period revenues and EBIT respectively. For the Six Large Energy Firms combined, the reference market generated a higher EBIT margin of 4.0% on a five-year period total basis, compared with 3.4% for the total supply business.

9 For FY07 and FY08, SSE was unable to provide a split of its non-domestic P&L information between its SME and I&C retail segments.
10 Ofgem’s terms of reference for the CMA’s investigation define the reference markets as the economic markets for the supply and acquisition of energy in GB, where for this purpose ‘energy’ means both electricity and gas, and both the wholesale and retail activities are included in the reference (with the exception of retail supply to larger businesses). Ofgem’s terms of reference are set out here.
11 We noted from our discussions with each of the Six Large Energy Firms that the threshold of what categorised ‘larger businesses’ from our terms of reference was not a definition they used to segment their financial reporting. There was also a broad consensus from the Six Large Energy Firms during these discussions that these ‘smaller business’ customers that formed part of our terms of reference would most appropriately be categorised under their SME customer category.
21. Table 1 also shows that the SME retail segment generated a significantly higher period EBIT margin of 8.4% when compared with the lower period EBIT margin generated by the domestic retail segment of 3.3%. The I&C retail segment, which did not form part of our reference market, generated the lowest period EBIT margin with 2.0%. We examine the key revenue and cost drivers behind the difference in profitability between the domestic and SME retail segments in paragraphs 24 to 42 below.

Retail segmental profitability by fuel type for each of the Six Large Energy Firms

22. Based on five-year period totals, Table 2 shows, for each of the Six Large Energy Firms, its percentage breakdown of period total revenues and the EBIT margin split by retail segment and fuel type. For each firm, we have highlighted the two retail segments (split by fuel type) that accounted for the highest percentages of its period revenues, and the highest period EBIT margins.

TABLE 2  Breakdown by individual firm of five-year period total revenues and EBIT margins

Source: CMA analysis.

*When calculating period revenues for the Six Large Energy Firms on a combined basis, we have taken a simple sum of their individual revenue figures over the stated time period.
†We have assumed that the domestic and SME retail segments combined represent the closest proxy to the ‘reference markets’ based on the available P&L information of the Six Large Energy Firms.
‡Period EBIT margin was calculated by dividing period EBIT by period revenues.

| TABLE 2 Breakdown by individual firm of five-year period total revenues and EBIT margins |
|-----------------------------------|-----------------------------------|

23. Based on Table 2, we summarise the key preliminary results below:

(a) Higher profitability in SME supply: we found that for the Six Large Energy Firms on a combined basis, the SME retail segment generated the highest EBIT margin for both fuel types: 7.9% for SME electricity supply and 10.1% for SME gas supply. These EBIT margins were significantly higher than in any of the other retail segments. This pattern of higher margins in SME supply for the Six Large Energy Firms combined was consistent with what we saw for each of the Six Large Energy Firms (with only one exception, namely SSE in SME gas supply),¹² where we found that for each of the Six Large Energy Firms the EBIT margin on SME supply was consistently greater than the EBIT margin on domestic supply for the same fuel type. We examine the key drivers behind the relatively

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¹² For SSE, its EBIT margin on gas was higher for domestic than SME supply. However, this may be largely explained by the relatively small size of its SME gas supply revenues, which accounted for 0.3% of its period revenues, compared with 4% for its SME electricity and 27% for its domestic gas.
higher EBIT margins in SME supply compared with domestic supply in paragraphs 24 to 42 below.

(b) SME electricity supply: at an individual firm level, SME electricity supply generated the highest or second highest period EBIT margin for all the Six Large Energy Firms, with the exception of [X] (see (c) below). [X].

(c) [X].

(d) Domestic electricity supply: for each of the Six Large Energy Firms, revenues from domestic electricity accounted for the highest or second highest percentage of its total supply business revenues, [X]. However, profitability on domestic electricity supply varied considerably across the Six Large Energy Firms, with EBIT margins on a period total basis ranging from [X].

(e) [X].

(f) I&C profitability: the I&C retail segment accounted for the highest or second highest percentage of period revenues for four of the Six Large Energy Firms, [X]. I&C accounted for a relatively smaller proportion of period revenues for [X]. At an individual firm level, the highest period EBIT margin in I&C supply was generated by [X], which was significantly lower than the highest period EBIT margins generated by any of the other Six Large Energy Firms across all the other retail segments, eg [X].

Comparison of SME and domestic profitability

24. We now turn to examine the key drivers behind the relatively higher profitability in SME compared with domestic supply.

25. In order to compare SME and domestic profitability, we divided the Six Large Energy Firms’ P&L information by the volume of energy supplied to arrive at unit revenues, unit costs and unit EBIT. This enabled us to compare their relative profitability based on a breakdown of prices (as measured by unit revenues) into its constituent cost and profit elements, ie a ‘cost stack’ for prices.

26. We first compare the unit revenues, unit costs and unit EBIT for domestic and SME electricity supply for the Six Large Energy Firms on a combined basis. We then compare these ratios for their domestic and SME gas supply.
Comparison of domestic and SME electricity profitability

27. Figure 5 illustrates how annual unit revenues for domestic and SME electricity supply for the Six Large Energy Firms combined are broken down into their various costs and profit components.
FIGURE 5

Comparison of unit revenue breakdown (£ per MWh) for domestic and SME electricity supply for the Six Large Energy Firms combined (FY09 to FY13)

Domestic electricity supply unit revenue breakdown

<table>
<thead>
<tr>
<th>Year</th>
<th>Unit EBIT</th>
<th>Unit Indirect (D&amp;A) costs</th>
<th>Unit Other direct costs</th>
<th>Unit Obligation costs</th>
<th>Unit Network costs</th>
<th>Unit Wholesale energy costs</th>
<th>Unit Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY09</td>
<td>111</td>
<td>61</td>
<td>7</td>
<td>17</td>
<td>17</td>
<td>23</td>
<td>3.47</td>
</tr>
<tr>
<td>FY10</td>
<td>109</td>
<td>59</td>
<td>7</td>
<td>17</td>
<td>18</td>
<td>27</td>
<td>1.65</td>
</tr>
<tr>
<td>FY11</td>
<td>120</td>
<td>63</td>
<td>10</td>
<td>18</td>
<td>18</td>
<td>32</td>
<td>2.41</td>
</tr>
<tr>
<td>FY12</td>
<td>130</td>
<td>62</td>
<td>15</td>
<td>18</td>
<td>18</td>
<td>34</td>
<td>4.91</td>
</tr>
<tr>
<td>FY13</td>
<td>138</td>
<td>61</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>34</td>
<td>4.91</td>
</tr>
</tbody>
</table>

Source: CMA analysis.
Note: Line and bar height both equal annual unit revenues. Indirect costs include D&A costs.

SME electricity supply unit revenue breakdown

<table>
<thead>
<tr>
<th>Year</th>
<th>Unit EBIT</th>
<th>Unit Indirect (D&amp;A) costs</th>
<th>Unit Other direct costs</th>
<th>Unit Obligation costs</th>
<th>Unit Network costs</th>
<th>Unit Wholesale energy costs</th>
<th>Unit Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY09</td>
<td>111</td>
<td>63</td>
<td>21</td>
<td>12</td>
<td>12</td>
<td>21</td>
<td>12.17</td>
</tr>
<tr>
<td>FY10</td>
<td>103</td>
<td>57</td>
<td>20</td>
<td>12</td>
<td>12</td>
<td>20</td>
<td>9.13</td>
</tr>
<tr>
<td>FY11</td>
<td>107</td>
<td>58</td>
<td>22</td>
<td>13</td>
<td>13</td>
<td>22</td>
<td>8.48</td>
</tr>
<tr>
<td>FY12</td>
<td>115</td>
<td>61</td>
<td>25</td>
<td>15</td>
<td>15</td>
<td>25</td>
<td>5.99</td>
</tr>
<tr>
<td>FY13</td>
<td>121</td>
<td>59</td>
<td>27</td>
<td>14</td>
<td>14</td>
<td>27</td>
<td>7.49</td>
</tr>
</tbody>
</table>

Source: CMA analysis.
Note: Line and bar height both equal annual unit revenues. Indirect costs include D&A costs.
28. To accompany Figure 5, we set out in Table 3, the annual gross and EBIT margins between FY09 and FY13 for domestic and SME electricity supply for the Six Large Energy Firms on a combined basis.

### TABLE 3 Domestic and SME electricity annual gross and EBIT margins for the Six Large Energy Firms combined*

<table>
<thead>
<tr>
<th></th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross margin</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic electricity</td>
<td>18</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>17</td>
</tr>
<tr>
<td>SME electricity</td>
<td>22</td>
<td>21</td>
<td>20</td>
<td>18</td>
<td>18</td>
</tr>
<tr>
<td><strong>EBIT margin</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic electricity</td>
<td>3.1</td>
<td>0.6</td>
<td>1.4</td>
<td>1.9</td>
<td>3.6</td>
</tr>
<tr>
<td>SME electricity</td>
<td>10.9</td>
<td>8.8</td>
<td>7.9</td>
<td>5.2</td>
<td>6.2</td>
</tr>
</tbody>
</table>

Source: CMA analysis.

*When calculating profit margins for the Six Large Energy Firms on a combined basis, we have based these calculations on a simple sum of their relevant financial measures.

29. For information, Table 3 of Appendix C sets out for domestic electricity supply the percentage of unit revenues accounted for by each unit cost item down to unit gross profit. This table provides a link between unit profits and profit margins, eg by definition, unit gross profit divided by unit revenues is equivalent to the gross margin, and the same is the case for gross profit per customer divided by revenues per customer. For the purpose of this analysis, however, we focus our profit ratio comparison between domestic and SME supply based on unit ratios.

30. Based on Figure 5 and Table 3 above, in each year over the period FY09 to FY13, unit EBIT, gross margin and EBIT margin in SME electricity supply consistently exceeded their respective measures in domestic electricity supply. Table 3 also shows that gross and EBIT margins in SME electricity have generally declined year-on-year over the period, although they have remained ahead of their respective domestic electricity EBIT margins.

31. However, these differentials in EBIT margins and unit EBIT did not appear to be driven by higher prices in the SME retail segment. Figure 5 shows that in FY09 unit revenues (a proxy for unit prices) were the same in both domestic and SME electricity at around £111 per MWh. However, since then, unit revenues for electricity have been consistently higher in domestic than in SME supply, with the gap widening year-on-year, eg in FY10 unit revenues in domestic electricity were around 5% higher than those in SME electricity. This price differential increased to around 12% in FY11 and FY12, and reached around 14% by FY13.

32. Figure 5 shows that the key driver behind the higher profit margins and unit EBIT in SME electricity appeared to be due to lower costs in SME supply in all
the main cost categories for each year over the period. In absolute terms, the biggest cost differences arose in relation to network and obligation costs, where the gap between domestic and SME supply generally widened year-on-year. For example, unit network costs were around £2 per MWh lower in SME electricity than in domestic electricity supply in FY07. By FY13, this gap had increased by more than three times to a difference of around £7 per MWh. Indirect costs per MWh were also lower for SME electricity by around £3 to £9 per MWh each year.

33. As part of our ongoing retail profitability analysis, we will be exploring the reasons why network and indirect costs on a per MWh basis should be materially higher for SME electricity than for domestic electricity, and why this differential has been widening over the period.

*Comparison of domestic and SME gas profitability*

34. Below, we repeat the above exercise, but this time we compare the profitability of gas supply between the domestic and SME retail segments. Similar to Figure 5 above, we compare the breakdown of unit revenues for domestic and SME gas supply over the period FY09 to FY13 (see Figure 6 below).
FIGURE 6
Comparison of unit revenue breakdown (£ per MWh) for domestic and SME gas supply for the Six Large Energy Firms combined (FY09 to FY13)

Domestic gas supply unit revenue breakdown

<table>
<thead>
<tr>
<th>FY</th>
<th>Unit EBIT</th>
<th>Unit Indirect (D&amp;A) costs</th>
<th>Unit Other direct costs</th>
<th>Unit Obligation costs</th>
<th>Unit Network costs</th>
<th>Unit Wholesale energy costs</th>
<th>Unit Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY09</td>
<td>7</td>
<td>1</td>
<td>5</td>
<td>2.07</td>
<td>6</td>
<td>35</td>
<td>35</td>
</tr>
<tr>
<td>FY10</td>
<td>19</td>
<td>7</td>
<td>5</td>
<td>2.07</td>
<td>6</td>
<td>34</td>
<td>34</td>
</tr>
<tr>
<td>FY11</td>
<td>21</td>
<td>9</td>
<td>6</td>
<td>1.81</td>
<td>5</td>
<td>39</td>
<td>39</td>
</tr>
<tr>
<td>FY12</td>
<td>23</td>
<td>2</td>
<td>5</td>
<td>2.82</td>
<td>6</td>
<td>42</td>
<td>42</td>
</tr>
<tr>
<td>FY13</td>
<td>25</td>
<td>2</td>
<td>6</td>
<td>1.92</td>
<td>7</td>
<td>45</td>
<td>45</td>
</tr>
</tbody>
</table>

SME gas supply unit revenue breakdown

<table>
<thead>
<tr>
<th>FY</th>
<th>Unit EBIT</th>
<th>Unit Indirect (D&amp;A) costs</th>
<th>Unit Other direct costs</th>
<th>Unit Obligation costs</th>
<th>Unit Network costs</th>
<th>Unit Wholesale energy costs</th>
<th>Unit Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY09</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>2.46</td>
<td>6</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td>FY10</td>
<td>18</td>
<td>7</td>
<td>7</td>
<td>4.99</td>
<td>7</td>
<td>38</td>
<td>38</td>
</tr>
<tr>
<td>FY11</td>
<td>20</td>
<td>7</td>
<td>7</td>
<td>2.85</td>
<td>7</td>
<td>37</td>
<td>37</td>
</tr>
<tr>
<td>FY12</td>
<td>23</td>
<td>7</td>
<td>7</td>
<td>4.49</td>
<td>6</td>
<td>41</td>
<td>41</td>
</tr>
<tr>
<td>FY13</td>
<td>24</td>
<td>7</td>
<td>7</td>
<td>4.58</td>
<td>6</td>
<td>42</td>
<td>42</td>
</tr>
</tbody>
</table>

Source: CMA analysis.
Note: Line represents unit revenues. Indirect costs include D&A costs.
35. As the unit ratios in Figure 6 show, these are smaller in absolute terms for gas supply than their respective unit ratios for electricity supply. Therefore, when considering unit ratio trends and comparisons, we considered it more meaningful to look at these separately for electricity and gas supply, rather than for electricity and gas combined.

36. Similar to Table 3, Table 4 sets out the annual gross and EBIT margins between FY09 and FY13 for domestic and SME gas supply for the Six Large Energy Firms on a combined basis. As for domestic electricity, we provide for information purposes, in Table 3 of Appendix C, the percentage of domestic gas unit revenues accounted for by each unit cost item down to unit gross profit. As mentioned above, this table provides a link between unit profit and profit margins.

**TABLE 4  Domestic and SME gas annual gross and EBIT margins for the Six Large Energy Firms combined**

<table>
<thead>
<tr>
<th></th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross margin</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic gas</td>
<td>14</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>17</td>
</tr>
<tr>
<td>SME gas</td>
<td>22</td>
<td>31</td>
<td>26</td>
<td>26</td>
<td>25</td>
</tr>
<tr>
<td><strong>EBIT margin</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic gas</td>
<td>–0.1</td>
<td>6.1</td>
<td>4.6</td>
<td>6.7</td>
<td>4.3</td>
</tr>
<tr>
<td>SME gas</td>
<td>6.5</td>
<td>14.4</td>
<td>7.7</td>
<td>10.8</td>
<td>10.9</td>
</tr>
</tbody>
</table>

Source: CMA analysis.

*When calculating profit margins for the Six Large Energy Firms on a combined basis, we have based these calculations on a simple sum of their relevant financial measures.

37. Similar to electricity supply, gross and EBIT margins and unit EBIT were higher in SME gas than domestic gas supply, and this pattern was consistent for every year over the period FY09 to FY13. These differences were relatively significant, eg over this period EBIT margins in SME gas were around 3 to 8 percentage points higher than in domestic gas.

38. As for electricity supply, we focus our comparison of domestic and SME gas profitability based on unit ratios. When examining the key drivers for the differences in the profitability levels between domestic and SME gas supply, Figure 6 shows that there was a consistent pattern of lower direct costs per MWh for SME gas than domestic gas supply. For example, network and obligation costs per MWh were lower in SME gas than domestic gas for every year over the period considered, and all but one year for wholesale energy costs. These differences, while small in absolute per MWh terms, were

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13 For example, network costs were around £2 per MWh lower in SME gas than domestic gas supply.
significant as a proportion of unit EBIT in gas in relative terms, eg FY13 unit EBIT for SME gas was around £5 per MWh.

39. Figure 6 also shows that these cost differentials between domestic and SME gas supply had generally widened over the period, eg while FY07 network costs were around £1 per MWh lower in SME gas than domestic gas, this differential increased to over £2 per MWh by FY13.

40. However, in contrast to what we found when we compared SME and domestic profitability in electricity supply above, we found that for gas supply:

(a) indirect costs were higher in SME than in domestic gas supply on a per MWh basis, which was the reverse of what we found for electricity supply; and

(b) unlike electricity supply, there was a mixed picture in relation to unit revenues for domestic and SME gas. For example, unit revenues in domestic gas supply were: (i) lower than SME gas in FY09 and FY10; (ii) broadly the same as SME gas in FY12; and (iii) higher than SME gas in FY11 and FY13.

41. Despite the mixed picture mentioned above in relation to domestic and SME gas supply unit revenues (and also compared with the unit revenue trends for electricity supply), these were relatively immaterial when compared with the cumulative effect of lower direct costs in SME gas, which primarily drove the higher unit EBIT and EBIT margins in SME gas supply, which was also the case for SME electricity supply.

42. As we mentioned for electricity supply above, as part of our further work in relation to this area, we will be examining the reasons for the relatively significant cost differentials between SME and domestic gas supply.

**Domestic supply profitability**

43. Having considered domestic supply profitability as part of our analysis comparing domestic with SME supply profitability, we now turn our focus on to domestic supply profitability and its trends over the relevant period. Table 5 below sets out the annual EBIT for domestic supply (split by fuel type) over the relevant period, together with a range of different profit ratios. The figures in Table 5 were based on the figures for the Six Large Energy Firms combined.
TABLE 5  Domestic supply profit ratios for the Six Large Energy Firms combined*

<table>
<thead>
<tr>
<th></th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EBIT (£m)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic electricity</td>
<td>489</td>
<td>354</td>
<td>396</td>
<td>70</td>
<td>179</td>
<td>270</td>
<td>523</td>
<td>7%</td>
</tr>
<tr>
<td>Domestic gas</td>
<td>−379</td>
<td>−356</td>
<td>−17</td>
<td>781</td>
<td>539</td>
<td>942</td>
<td>624</td>
<td>N/A</td>
</tr>
<tr>
<td>Domestic supply</td>
<td>110</td>
<td>−6</td>
<td>379</td>
<td>852</td>
<td>718</td>
<td>1,211</td>
<td>1,148</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>EBIT margin (%)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic electricity</td>
<td>4.5%</td>
<td>2.7%</td>
<td>3.1%</td>
<td>0.6%</td>
<td>1.4%</td>
<td>1.9%</td>
<td>3.6%</td>
<td>−22%</td>
</tr>
<tr>
<td>Domestic gas</td>
<td>−4.1%</td>
<td>−3.1%</td>
<td>−0.1%</td>
<td>6.1%</td>
<td>4.6%</td>
<td>6.7%</td>
<td>4.3%</td>
<td>N/A</td>
</tr>
<tr>
<td>Domestic supply</td>
<td>0.6%</td>
<td>0.0%</td>
<td>1.5%</td>
<td>3.4%</td>
<td>2.9%</td>
<td>4.3%</td>
<td>3.9%</td>
<td>613%</td>
</tr>
<tr>
<td><strong>Unit EBIT (£/MWh)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic electricity</td>
<td>4.21</td>
<td>2.99</td>
<td>3.47</td>
<td>0.61</td>
<td>1.65</td>
<td>2.48</td>
<td>4.91</td>
<td>17%</td>
</tr>
<tr>
<td>Domestic gas</td>
<td>−1.06</td>
<td>−0.97</td>
<td>−0.05</td>
<td>2.07</td>
<td>1.81</td>
<td>2.82</td>
<td>1.92</td>
<td>N/A</td>
</tr>
<tr>
<td>Domestic supply</td>
<td>0.23</td>
<td>−0.01</td>
<td>0.83</td>
<td>1.73</td>
<td>1.76</td>
<td>2.74</td>
<td>2.66</td>
<td>1,044%</td>
</tr>
<tr>
<td><strong>EBIT per customer (£)</strong>†</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic electricity</td>
<td>18.89</td>
<td>13.47</td>
<td>15.09</td>
<td>2.67</td>
<td>6.72</td>
<td>10.21</td>
<td>19.89</td>
<td>5%</td>
</tr>
<tr>
<td>Domestic gas</td>
<td>−17.57</td>
<td>−16.35</td>
<td>−0.71</td>
<td>35.39</td>
<td>24.18</td>
<td>42.50</td>
<td>28.28</td>
<td>N/A</td>
</tr>
<tr>
<td>Domestic supply</td>
<td>2.31</td>
<td>−0.13</td>
<td>7.86</td>
<td>17.57</td>
<td>14.68</td>
<td>24.90</td>
<td>23.71</td>
<td>923%</td>
</tr>
</tbody>
</table>

Source: CMA analysis. N/A means ‘not applicable’ for calculating a percentage change given the negative starting figure in FY07.

*When calculating profit ratios for the Six Large Energy Firms on a combined basis, we have based these calculations on a simple sum of their relevant financial measures.
†EBIT per customer was based on total annual EBIT generated by the Six Large Energy Firms divided by the number of domestic customer accounts.

44. Based on Table 5, for the Six Large Energy Firms combined, total domestic supply EBIT increased by more than ten times over the relevant period from £0.1 billion in FY07 to £1.1 billion in FY13, primarily driven by higher EBIT in domestic gas supply, which increased from an EBIT loss of –£0.4 billion in FY07 to £0.6 billion in FY13.

45. The trends in each of the different profit ratios, namely EBIT margins, unit EBIT and EBIT per domestic customer account, showed a similar pattern of increasing profitability in domestic supply over the relevant period, driven primarily by increased profitability in domestic gas supply. For example, domestic supply EBIT margins increased from 0.6% in FY07 to 3.9% in FY13, driven primarily by increased profitability in domestic gas supply, where EBIT margins were negative between FY07 and FY09, but grew to 6.1% in FY10, and ranged from 4.3 to 6.7% thereafter.

46. In relation to domestic electricity, while the FY13 EBIT margin in domestic electricity supply of 3.6% was lower than FY07 levels of 4.5%, we noted that on unit EBIT and EBIT per customer measures FY13 levels were higher than FY07 levels. We also noted that the profit ratios generated in domestic electricity, while generally declining between FY07 and FY10, increased year-on-year between FY10 and FY13, which resulted in unit EBIT being higher in FY13 (at £4.91 per MWh) than FY07 levels (at £4.21 per MWh), and EBIT per customer in FY13 (at £19.89 per customer account) being higher than FY07 levels (at £18.89 per customer account).
47. In relation to domestic gas supply, in Table 2 above, we showed that:

(a) [\(\times\)];

(b) out of the Six Large Energy Firms, [\(\times\)] respectively generated the second and third highest period EBIT margins in domestic gas with [\(\times\)], with domestic gas accounting for [\(\times\)] of their respective period total supply business revenues; and

(c) over the same period, both [\(\times\)] generated negative EBIT margins in domestic gas on a period total basis, while [\(\times\)] generated a period EBIT margin of [\(\times\)].

48. To the extent that these variations in period EBIT margin performances for each of the Six Large Energy Firms in relation to their respective domestic gas and electricity supply (as shown earlier in Table 2) may be driven by differences in profitability at a tariff type level is considered in more detail in the next section.

**Domestic profitability on a per customer account basis**

49. In Table 5, we introduced the profit ratio based on a per customer account basis, ie EBIT per domestic customer account. Figure 7 sets out the revenues per domestic energy customer account (including both fuel types) broken down by their constituent cost and profit components. We calculated these based on dividing total domestic supply revenues and costs (for both fuel types combined) by the total number of domestic electricity and gas customer accounts for the Six Large Energy Firms on a combined basis. The resulting ratios show the revenues, costs and EBIT generated from each domestic customer account. We also set these per customer account ratios separately for domestic electricity and gas in Appendix A, eg unit revenues per domestic electricity account represent a proxy for the annual electricity bill per domestic electricity account.\(^{14}\)

\(^{14}\) In relation to revenues, costs or profit per customer account, we noted that year-on-year movements in these ratios may be sensitive to consumption levels, which in turn could be affected by a number of different factors, including the impact of prices, customer gains and losses, unseasonal weather and greater household energy efficiency. In order to control for changes in consumption levels affecting these per customer account ratios, one method is to calculate unit ratios that, to a large extent, control for changes in consumption levels. For the purposes of looking at the impact of changes in prices and costs on profitability, unit ratios and profit margins may therefore be more appropriate measures than per customer account ratios.
Based on Figure 7:

(a) annual revenues per customer – based on adopting revenues per customer account as a proxy for annual energy bills, the average annual single fuel energy bill (i.e., either electricity or gas, but not dual fuel) per customer increased from £420 in FY07 to £604 in FY13, an increase of 44% over the period, or 1.44 times.

(b) annual EBIT per customer – an average single fuel bill generated an EBIT for the Six Large Energy Firms (on a combined basis) of £2.31 in FY07, which increased by more than ten times to £23.71 by FY13.

We note that the revenues, costs, and EBIT per customer account shown in Figure 7 represents the annual electricity or gas revenues per domestic customer account, i.e., on a single fuel basis. A dual fuel customer would be counted as two customer accounts.

Therefore, an estimate of a dual fuel bill based on revenues per customer could either be:
(a) the annual revenues per domestic energy customer account multiplied by two; or

(b) more preferably, the sum of: (i) the annual revenues per domestic electricity customer account; and (ii) the annual revenues per domestic gas customer account. As mentioned above, the charts setting out the ‘cost stack’ for revenues per customer account in domestic electricity and domestic gas separately are set out in Appendix A.

53. Based on the approach described in paragraph 52(b) above and the charts in Appendix A, we compared for the Six Large Energy Firms combined their annual revenues in FY07 and FY13 for each domestic electricity account, domestic gas account and the combined total. We also set out their annual EBIT per account figures. These calculations are set out in Table 6.

<table>
<thead>
<tr>
<th></th>
<th>FY07</th>
<th>FY13</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Annual revenues per account†</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic electricity</td>
<td>415</td>
<td>557</td>
<td>34%</td>
</tr>
<tr>
<td>Domestic gas</td>
<td>426</td>
<td>660</td>
<td>55%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>841</td>
<td>1,217</td>
<td>45%</td>
</tr>
<tr>
<td><strong>Annual EBIT per account†</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic electricity</td>
<td>18.89</td>
<td>19.89</td>
<td>5%</td>
</tr>
<tr>
<td>Domestic gas</td>
<td>-17.57</td>
<td>28.28</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1.32</td>
<td>48.16</td>
<td>3,555%</td>
</tr>
</tbody>
</table>

Source: CMA analysis. N/A means ‘not applicable’ for calculating a percentage change given the negative starting figure in FY07.

*These figures have been calculated for the domestic electricity and gas supply businesses of the Six Large Energy Firms combined.
†Per customer account ratios was based on the sum of the annual figures generated by the Six Large Energy Firms divided by the number of domestic customer accounts.

54. Based on Table 6, and under our assumption that the annual revenue per customer account represents a proxy for the annual bill, between FY07 and FY13:

(a) regarding revenues per customer account – the annual electricity bill increased by 34% and the annual gas bill increased by 55%. For a dual fuel customer therefore, the annual bill (as estimated by the sum of the annual revenue per domestic customer account for electricity and gas) increased by 45% from £841 in FY07 to £1,217 in FY13.

(b) regarding EBIT per customer account – the annual EBIT generated by the Six Large Energy Firms on a dual fuel customer increased significantly over the relevant period from £1.32 in FY07 to £48.16 in FY13, driven entirely by the increase in the EBIT generated on domestic gas. The EBIT generated on domestic electricity in FY13 remained broadly in line with FY07 levels.
We now turn to introduce the mid-tier suppliers and consider their profitability for comparison purposes against the profitability of domestic supply for the Six Large Energy Firms. We noted that over the period FY09 to FY13 only Utility Warehouse and First Utility had traded for the full five-year period. In relation to the other mid-tier suppliers: (a) Co-Op Energy commenced trading in December 2010, and therefore we have three full years of its trading information, i.e., from FY11 to FY13; and (b) OVO commenced trading in September 2009. However, we only received full 12-month P&L information for OVO down to EBIT for FY11 to FY13 based on a common December FY.

Over the period FY09 to FY13, all the mid-tier suppliers saw considerable growth in their domestic customer base, which translated into year-on-year growth in their respective revenues and gross profit over the period. Figure 8 below shows the number of domestic electricity and gas customer accounts for each of the mid-tier suppliers over the period FY09 to FY13.

FIGURE 8

Mid-tier suppliers’ domestic customer accounts (‘000s) from FY09 to FY13

Source: CMA analysis.
Notes: [\textcopyright] 57. However, with the costs of acquiring customers accounted for within their respective indirect cost base, this growth had a significant impact on their respective EBIT figures over the period. Appendix B shows the annual revenues, gross profit and EBIT generated at a total supply business level for each of the mid-tier suppliers over the period FY09 to FY13. We also set out...
in the same appendix the impact of adding back customer acquisition costs to EBIT, to calculate EBIT before costs to acquire customers (EBITC2A).

58. However, we questioned the comparability of using an EBITC2A measure given the differences in each firm’s definition and interpretation of which items should be included in its calculation of customer acquisition costs (see Appendix B for their individual definitions). We therefore considered whether it was more meaningful to make comparisons between the Six Large Energy Firms and the mid-tier suppliers based on their gross margins. We address this issue below.

**Comparison of Six Large Energy Firms’ and mid-tier suppliers’ gross margins**

59. In Figure 9, we set out the annual and period gross margins for each of the mid-tier suppliers at a total supply business level over the period FY09 to FY13.

**FIGURE 9**

Mid-tier suppliers’ annual and period gross margins (FY09 to FY13)

Source: CMA analysis.
Notes: [ ]

60. In Figure 10, we set out the annual and period domestic supply gross margins for the Six Large Energy Firms combined. Given the differences in the time periods covered by the P&L information of each of the mid-tier suppliers, we calculated the Six Large Energy Firms’ period gross margins based on three-, four- and five-year period totals.
Six Large Energy Firms combined domestic annual and period gross margins (three-, four- and five-year period total basis)

Source: CMA analysis.

Note: Annual gross margins for domestic supply for the Six Large Energy Firms combined was calculated for each year based on the sum of their annual domestic gross profit divided by the sum of their annual domestic revenues. The period totals were based on the sum of gross profit and revenues over a three-, four- and five-year period to correspond with the different time periods covered by the mid-tier suppliers’ P&L information.

61. Based on Figures 9 and 10, the period gross margins for the Six Large Energy Firms ranged from 17 to 18% based on three-, four- and five-year period totals. [\%] compared with a three-year period gross margin of 17% for the Six Large Energy Firms combined.

62. Based on this preliminary comparison, the mid-tier suppliers \([\%]\) appeared to generate lower gross margins on a period total basis than the Six Large Energy Firms combined. However, this was despite the mid-tier suppliers incurring lower obligation costs than the Six Large Energy Firms. In Appendix C, we set out the unit revenue breakdown for each of the mid-tier suppliers’ domestic electricity and gas businesses, and compare these with the unit revenue breakdown for the Six Large Energy Firms’ domestic electricity and gas businesses. Based on Appendix C, one of the primary drivers behind the differences in the unit ratios of the mid-tier suppliers and the Six Large Energy Firms related to the lower unit obligation costs of the mid-tier suppliers. These differences arise because obligations are based on the number of customer accounts, and become mandatory once a firm exceeds a certain customer account size threshold, typically 250,000 customer accounts.18 We noted that

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18 Some of these obligations such as the ECO and WHD become mandatory when electricity and gas customer accounts reach 250,000, while the FiT becomes mandatory from 250,000 electricity customers.
out of the four mid-tier suppliers, only Utility Warehouse exceeded the threshold for obligations to be mandatory for the whole period:

(a) [●].

(b) First Utility told us that it became liable for costs in relation to ‘small-scale’ feed-in-tariff (FiT), Energy Companies Obligation (ECO) and Warm Home Discount (WHD) for the first time in FY13.

(c) OVO told us that it did not meet the thresholds for ECO and WHD over the period considered.

63. Based on the above, and as part of our further analysis in this area, we will be exploring the extent to which we may be able to adopt the mid-tier suppliers’ profitability as a benchmark against which to compare the profitability of the Six Large Energy Firms.

Profitability by domestic tariff type

Section overview

64. This section sets out the preliminary results of our analysis to assess profit margins by tariff type. Our analysis focused on the domestic electricity and gas tariffs of the Six Large Energy Firms over the relevant period and, in particular, examined the relative profitability of their standard variable tariffs (by fuel type) compared with their other variable and fixed tariff types.

65. This section is structured under the following headings:

(a) Methodology: in paragraphs 66 to 69, we discuss our methodology for this analysis, in particular we explain how we overcame data limitations to calculate profit margins by tariff type.

(b) Preliminary results: in paragraphs 70 to 74, we set out the preliminary results of our analysis, and further areas for investigation in relation to our tariff type profitability analysis.

Methodology

66. As part of our initial request for information, we requested the Six Large Energy Firms to provide us with their domestic supply revenues and direct costs split by tariff type on a monthly basis. However, we were told by the Six Large Energy Firms that they did not routinely record or segment their information in this manner, and any allocation would not be to the accuracy we would require. The information we received by tariff type showed their
monthly revenues and volumes split by tariff type. The time period over which this information could be provided by each of the Six Large Energy Firms also varied (as we set out later). SSE was unable to provide us with a reliable breakdown of its revenues and volumes by tariff type to the level of accuracy required, and we will be seeking clarification from SSE concerning its allocations. We have therefore excluded SSE from our analysis at this stage.

67. Given that for each of the Six Large Energy Firms we had a complete set of annual P&L information for domestic electricity and gas, including their relevant annual direct and indirect cost figures covering the relevant period, we used the percentage breakdown of monthly revenues and volumes data by tariff to allocate the annual P&L information by tariff type. We briefly explain our methodology below, and summary tables of our results can be found in Appendix D:

(a) Calculating revenues by tariff type: for each firm and for each of its fuel type, we calculated the percentage split of revenues by tariff type from the monthly data. We then applied these percentages to annual total revenues in its P&L data to derive annual revenues by tariff type.

(b) Calculating gross profit and margin by tariff type: for each firm and for each of its fuel type, we calculated the percentage split of volumes by tariff type based on monthly data, and applied these percentages to annual direct costs to derive annual direct costs by tariff type. Together with the annual revenues we calculated in (a) above, we were able to calculate a stylised gross margin by tariff type for each fuel type.

68. This methodology was based on two key assumptions:

(a) We can overlay trends from a monthly data set onto annual P&L information; and

(b) when calculating gross margin, the major direct cost items, ie wholesale energy, network and obligation costs, do not vary by tariff type.

69. We now turn to the preliminary results of our profitability analysis by tariff type.

Preliminary results

70. Table 7 sets out the average gross margins by tariff type for the Six Large Energy Firms (with the exception of SSE) over the period for which we were able to calculate each firm's gross margins by tariff type. We note that the tariff type categories reported to us varied from firm to firm. As part of our ongoing analysis in relation to our tariff profitability analysis, we will seek to split out the data for standard variable tariffs when this had not been
separately split out from its other variable tariff types. In this paper, we focus on the differences between fixed tariffs and standard variable tariffs.19

<table>
<thead>
<tr>
<th>TABLE 7</th>
<th>Average gross margin by tariff type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: CMA analysis.</td>
<td></td>
</tr>
</tbody>
</table>

*EDF’s figures exclude month-end adjustments, the impact of which are not material.
Notes: These figures are a simple average for each year that we had the information for and not a total sum average except for the average non-standard figures which are total sum averages to take into account the relative contributions of each tariff. These figures are a simple average for each year that we had the information for and not a total sum average except for the average non-standard figures which are total sum averages to take into account the relative contributions of each tariff.

71. In Table 7, we have highlighted in grey the tariff type with the highest average gross margins for each of the relevant firms’ electricity and gas tariff types. Our findings, based on these preliminary results, were as follows:

(a) Significance of standard variable tariffs’ contribution to revenues: each of the five firms generated a significant proportion of their domestic revenues from standard variable tariffs (or variable tariffs when this was not separated out). For example, these tariff types accounted for at least [X] of each firm’s total domestic electricity revenues (and up to [X] for some firms), with a similar pattern in domestic gas, where these tariffs accounted for the highest proportion of revenues, and between [X] and [X] of domestic gas revenues for three of the Six Large Energy Firms.

(b) Domestic electricity tariffs: for domestic electricity, all five firms had a higher gross margin on their standard variable (or variable) tariffs compared with their other tariffs (on an aggregated basis) and four out of the five firms generated a higher gross margin on their variable tariffs compared with their fixed tariffs. [X].

(c) Domestic gas tariffs: a clearer pattern emerged for domestic gas tariffs, where all five firms generated a higher gross margin on their variable or standard variable gas tariffs. We found that there were significant variations, [X], between these firms in relation to the extent to which their variable tariff gross margins were higher than their gross margins on their fixed tariffs.

72. From this analysis, the five major firms generated higher gross margins on their standard variable (or variable) tariffs than on their other non-standard variable tariffs combined.

19 When variable is not split out between standard variable and other variable, at this stage variable can be considered a proxy for standard variable.
73. However, we would note that in order for the relatively large differences we found in gross margins by tariff type to be fully explained by differences in their relative costs to serve, the costs to serve standard variable (or variable) tariff customers would need to be significantly higher for each firm than their costs to serve fixed tariff customers.

74. Therefore, in summary, based on our tariff profitability analysis above:

(a) with only one exception (ie [☐]), all the firms covered by our analysis generated higher gross margins on their standard variable (or variable when this was not split out) tariff customers for each fuel type than on their fixed tariff customers; and

(b) while the costs to serve may be higher for variable tariff customers than for fixed tariff customers, the size of the differences in gross margins would mean that the costs to serve variable tariff customers would likely need to be significantly higher than for fixed tariff customers to explain fully the higher gross margins that we found for standard variable tariff customers.

Indirect cost analysis

Section overview

75. In this section, we considered whether there was any evidence to suggest that the Six Large Energy Firms had not faced sufficient competitive pressure to reduce their indirect (operational) costs.

76. Past studies have suggested that indirect costs had not been falling for the Six Large Energy Firms, and that the gap between the best and worst performers in this regard was significant:

(a) In its 2008 Probe, Ofgem noted that operational costs were rising faster than the rate of inflation, and that the gap between the best and worst operational costs on a per customer account basis was around 90%. Ofgem noted in its report at the time that some of the Six Large Energy Firms had programmes in the pipeline to reduce these costs going forward.\(^\text{20}\)

(b) In its 2012 report, the Institute for Public Policy Research (IPPR) stated that in a competitive market it would not be unreasonable to expect operational cost savings of at least 2.5% a year. It found that the

\[^{20}\text{Ofgem, Energy Supply Probe, Initial findings report, October 2008, pp95&96.}\]
differential between the best and worst operational costs was over 100%, and concluded that competition did not appear to be driving down costs, or forcing their convergence.\textsuperscript{21}

77. In a well-functioning market, all things being equal, we would expect competition to drive market participants to improve services and seek efficiencies. These efficiency gains should manifest themselves in reduced costs, and over time the gap between the highest and lowest cost suppliers should converge. In this section, we considered whether there was any evidence of the Six Large Energy Firms generating efficiency savings in indirect costs over the period of review, from FY07 to FY13.

78. This section is structured under the following headings:

\(a\) Methodology: in paragraphs 79 to 82, we discuss how we measured indirect cost savings.

\(b\) Preliminary results: in paragraphs 83 to 104, we set out the preliminary results of our analysis, and the areas for further investigation.

\textit{Methodology}

79. We focused our analysis on the indirect cost base given that this largely comprised the operational costs of meeting customers’ day-to-day needs. These costs can be controlled by energy suppliers more so than their direct costs. Our analysis was predominantly focused on the indirect cost base of the Six Large Energy Firms. However, for comparability purposes, we have also considered the indirect costs of the four mid-tier suppliers.

80. Given that all the relevant firms vary in size, an analysis of their total indirect costs in absolute terms would not provide us with an indication of their relative cost efficiency. To take into account the effect of a firm’s size, we sought to adopt a suitable metric against which to calculate and compare indirect cost ratios between the Six Large Energy Firms. Most of the Six Large Energy Firms told us that the number of customer accounts was a key metric for looking at indirect costs, although when looking at individual cost categories the appropriate metric may change.

81. We considered that the number of customer accounts represented the most appropriate measure, given that it closely corresponded with the number of customer contracts held by a supplier, and was therefore a key driver (but not the only driver) of indirect costs. The number of customer accounts would also

\textsuperscript{21} IPPR, \textit{The true cost of energy}, April 2012, pp26-28.
be closely aligned with the number of bills generated and therefore was likely to be a good indicator for the level of customer contact and any associated costs. For the purposes of this analysis, we therefore adopted indirect costs per customer account as our indirect cost ratio measure. We also converted indirect costs into real terms based on taking FY07 as the base year (see Appendix E for the details of these adjustments).

82. For the purposes of our analysis, we looked at indirect cost ratios at a total supply business level, as well as by retail segment split by fuel and by indirect cost component (ie the individual elements of a supplier’s indirect cost base).

**Preliminary results**

**Total supply business indirect cost ratios for the Six Large Energy Firms combined**

83. In Table 8, we set out the indirect cost ratios at a total supply business level for the Six Large Energy Firms on a combined basis from FY07 to FY13.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total indirect cost ratios*</th>
<th>Year-on-year movement</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY07</td>
<td>£81</td>
<td>N/A</td>
</tr>
<tr>
<td>FY08</td>
<td>£83</td>
<td>4%</td>
</tr>
<tr>
<td>FY09</td>
<td>£83</td>
<td>-1%</td>
</tr>
<tr>
<td>FY10</td>
<td>£81</td>
<td>-2%</td>
</tr>
<tr>
<td>FY11</td>
<td>£76</td>
<td>-7%</td>
</tr>
<tr>
<td>FY12</td>
<td>£75</td>
<td>-1%</td>
</tr>
<tr>
<td>FY13</td>
<td>£74</td>
<td>-2%</td>
</tr>
</tbody>
</table>

Source: CMA analysis.

*We calculated indirect cost per customer account by dividing total indirect costs in real-terms divided by total customer accounts across the total supply business. The averages for each year is a simple average of the six ratios for each firm.

Notes: For the purposes of restating indirect costs into real terms, we adopted FY07 as the base year. ‘N/A’ means ‘not available’. [22].

84. Based on Table 8, indirect costs fell by around £6 per customer account between FY07 and FY13. We found that from a peak of around £83 per customer account in FY08, costs had fallen year-on-year by around 2% each year on average, to around £74 per customer account by the end of FY13.

85. The above comparison, however, masks the underlying trends in each individual firm’s performance, and we consider these below.

22 While we acknowledge that the number of customer accounts may not a perfect metric against which to measure all indirect costs, we considered that this measure benefited from being measured reasonably consistently across each of the Six Large Energy Firms, and therefore enables greater consistency and comparability across the relevant firms.
Table 9 shows the indirect cost ratios at a total supply business level for each of the Six Large Energy Firms from FY07 to FY13 (see also Appendix F for further details for each of the Six Large Energy Firms).

**TABLE 9**

| Source: CMA analysis. |

| *We calculated indirect cost per customer account by dividing total indirect costs in real terms divided by total customer accounts across the total supply business. The averages for each supplier is a simple average of the six ratios for each year. Note: For the purposes of restating indirect costs into real terms, we adopted FY07 as the base year.* |

87. Based on Table 9, we found that:

(a) both [X] had each made relatively large improvements over the relevant period to their individual indirect cost base; in particular, we found that these two firms were the primary drivers for the cost reductions seen for the Six Large Energy Firms on a combined basis;

(b) the average gap between [X] (with the lowest indirect cost ratios) and [X] (with the highest) was around [X] per customer account, or a percentage difference of [X]; and

(c) in considering the impact of higher indirect costs on [X] profitability – and based on (b) above – we calculated that, if [X] had generated indirect cost ratios in line with [X], this would have the effect in most cases of turning [X] EBIT losses into an EBIT profit for its total supply business.

88. We noted that an analysis of total indirect costs per customer account at a total supply business level would not make a distinction between customers in different retail segments, eg between a domestic customer account and an SME customer account. Below, we carried out our indirect cost analysis on a retail segmental basis, focusing on the two retail segments that formed part of our reference markets, namely domestic and SME supply.

**Retail segmental indirect cost ratios for domestic and SME supply by fuel type**

89. Table 10 shows the average segmental indirect cost ratios for domestic supply (split by fuel type) for each of the Six Large Energy Firms for the period FY09 to FY13. The detailed figures behind this table are set out in Appendix G.
90. Based on Table 10 and Appendix G, we found that, while there were peaks and troughs in their respective indirect cost ratios with some firms demonstrating no significant cost reductions, there appeared to be no consistent trend of increasing costs. We also found that:

(a) both \([\times]\) and \([\times]\) demonstrated the strongest trends in cost reductions over the relevant period, as was the case for their respective total supply business indirect cost ratios; and

(b) the ranking of the indirect cost ratios for each of the Six Large Energy Firms’ domestic retail segments was broadly consistent with the ranking we found for their respective total supply businesses above, eg with \([\times]\) generating the lowest indirect cost ratio, and \([\times]\) generating the highest.

91. Table 11 shows the segmental average indirect cost ratios for SME supply (split by fuel type) for each of the Six Large Energy Firms for the period FY09 to FY13 (see also Appendix G for further details).

92. Based on Table 11 above, in conjunction with Appendix G, we found that:

(a) year-on-year movements in indirect cost ratios were more volatile for the SME retail segment than for the domestic retail segment;

(b) the rankings for SME indirect cost ratios were slightly different from the similar rankings we found for the domestic retail segment and total supply business levels for the Six Large Energy Firms; for SME indirect cost ratios, \([\times]\) generated the lowest ratio while \([\times]\) generated the highest; and

(c) only \([\times]\) indirect cost ratios showed significant reductions in indirect cost ratios over the period.
93. We considered that the reason for the more varied picture for indirect cost ratios in the SME retail segment was likely to depend to some extent on the relative significance of the SME retail segment for each of the Six Large Energy Firms. For example, [33].

94. We now consider the components of indirect costs on a more granular basis to look at trends in different cost categories.

**Total supply business indirect costs by cost category**

95. In relation to our analysis of the individual components of indirect costs, we categorised indirect costs into six broad ‘standardised’ categories, namely the costs relating to: (a) bad debts; (b) metering; (c) sales and marketing; (d) customer service; (e) central services; and (f) other costs. We then requested each of the Six Large Energy Firms to allocate their total indirect costs to each of these six categories. This analysis was conducted at the total supply business level.

96. Table 12 sets out the average indirect cost ratios at a total supply business level for each of the Six Large Energy Firms over the relevant period.

<table>
<thead>
<tr>
<th>TABLE 12</th>
<th>Total supply business average indirect cost ratios* for the Six Large Energy Firms by category (FY07 to FY13)</th>
</tr>
</thead>
</table>

Source: CMA analysis.

*Indirect cost item per customer account. The average was based on a simple average of the annual indirect cost item ratios over the period FY09 to FY13.

Note: For the purposes of restating indirect costs into real terms, we adopted FY07 as the base year.

97. In Appendix H, we describe the trends we saw in each of these indirect cost categories. Based on Table 12 and Appendix H, we found that:

(a) [33] generated the lowest indirect cost ratios across most of the indirect cost categories, and significantly outperformed its peers in relation [33];

(b) [33] both had significantly higher sales and marketing cost ratios relative to their peers; [33] sales and marketing costs were over [33] higher than

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23 We defined each indirect cost category as follows: (a) bad debts: comprising in-year bad debt write-offs and movements in bad debt provision; and their debt collection, legal costs, debt reminders and other associated debt collection costs; (b) metering: comprising meter asset charges, transaction charges, meter reading costs and other associated costs; (c) sales and marketing: comprising costs associated with customer acquisition and retention, as well as the costs associated with white label arrangements; (d) customer service: comprising their costs for billing, credit management, call centres, customer relations (including complaints handling), cash control and other costs associated with customer service provision; (e) central services: comprising their central office recharges, IT and property costs and those costs associated with each of these; and (f) other items: comprising any other indirect cost items that may not on their own be material and do not fit into the above categories.
the lowest cost per account supplier with \([\times]\) being over \([\times]\) higher; \([\times]\) also generated a significantly higher central service cost ratio than the other suppliers, being almost \([\times]\) higher than the next highest ratio; and

\((c)\) \([\times]\) generated the lowest customer service cost ratios, while \([\times]\) had significantly higher customer service cost ratios than all the other Six Large Energy Firms, with a cost ratio almost \([\times]\) higher than the next highest supplier.

**Indirect cost ratio comparison with the mid-tier suppliers**

98. As noted in our methodology above, we compared the indirect cost ratios of the Six Large Energy Firms with those of the four mid-tier suppliers.

99. The financial information that could be provided by the mid-tier suppliers was not as detailed as that provided by the Six Large Energy Firms, and therefore our analysis was limited to calculating their indirect cost ratios at a total supply business level rather than on a retail segmental basis, although we would note that the mid-tier suppliers predominantly supply the domestic retail segment.

100. Table 13 shows the indirect cost ratios for each of the four mid-tier suppliers.

<table>
<thead>
<tr>
<th>TABLE 13</th>
<th>Total supply business indirect costs per customer account for the mid-tier suppliers</th>
</tr>
</thead>
</table>

Source: CMA analysis.

*We calculated the period average indirect cost per customer account by calculating a simple average of each year’s indirect costs per account.
†For the purpose of our indirect cost ratio analysis, we used OVO’s P&L information that reported to different financial year-ends for FY09 to FY11. Therefore, FY09 and FY10 are reported to 30 June year-ends, while FY11 represents a six-month accounting period, and FY12 and FY13 are reported to 31 December year-ends. Given that FY11 represented a partial year, we did not include FY11 indirect cost ratios for OVO in its average calculation.
Note: For the purposes of restating indirect costs into real terms, we adopted FY07 as the base year.

101. Based on Table 13, we found \([\times]\). This represents one of the areas of further investigation in relation to our indirect cost analysis.

102. Turning to the other three mid-tier suppliers in turn, we noted that \([\times]\). This comparison is represented graphically in Figure 11.

**FIGURE 11**

Comparison of total supply business average indirect cost ratios between the mid-tier suppliers and the Six Large Energy Firms

Source: CMA analysis. For the purposes of restating indirect costs into real terms, we adopted FY07 as the base year.
Note: We calculated the average indirect cost ratio based on a simple average of the annual ratios for each firm.
103. Based on Figure 11, the mid-tier suppliers compared relatively favourably against the Six Large Energy Firms.

Summary of our indirect cost analysis

104. Based on our analysis above, we found that overall:

(a) \[\text{[X]}\] benefited from the lowest overall indirect cost ratios for its total supply business and for its domestic supply business, while \[\text{[Y]}\] incurred the highest indirect cost ratios at both its total supply business and domestic retail segment levels, with little indication that \[\text{[Z]}\] was making any significant improvements in relation to its indirect cost base; over the period of review the gap between the lowest \[\text{[X]}\] and highest \[\text{[Y]}\] indirect cost ratios had not significantly reduced;

(b) \[\text{[X]}\] both improved their indirect cost base the most over the period of review, ie in terms of reducing their indirect cost ratios;

(c) within the SME retail segment, \[\text{[X]}\] generated the highest indirect cost ratios with \[\text{[Y]}\] generating the lowest; and

(d) despite proportionately spending more on customer acquisitions, the indirect cost ratios for the mid-tier suppliers compared favourably to the Six Large Energy Firms.
## Appendix A: Domestic profitability per customer account

### Breakdown of domestic revenues per customer account (by fuel)

1. Figure 1 shows for domestic electricity the revenues per domestic electricity customer account broken down into its constituent cost and EBIT components. The figures presented represent the revenues, costs and profits for domestic electricity supply for the Six Large Energy Firms combined. Below the chart for domestic electricity, we repeat this for domestic gas.

![Chart](chart.png)

**FIGURE 1**

Breakdown of annual revenues per domestic customer account (by fuel type) for the Six Large Energy Firms combined (FY07 to FY13)

**Domestic electricity (£ per customer account)**

<table>
<thead>
<tr>
<th>Year</th>
<th>EBIT</th>
<th>Indirect (D&amp;A) costs</th>
<th>Other direct costs</th>
<th>Obligation costs</th>
<th>Network costs</th>
<th>Wholesale energy costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY07</td>
<td>415</td>
<td>93</td>
<td>19</td>
<td>18.9</td>
<td>71</td>
<td>214</td>
</tr>
<tr>
<td>FY08</td>
<td>491</td>
<td>97</td>
<td>27</td>
<td>31</td>
<td>74</td>
<td>279</td>
</tr>
<tr>
<td>FY09</td>
<td>481</td>
<td>98</td>
<td>31</td>
<td>13.5</td>
<td>98</td>
<td>263</td>
</tr>
<tr>
<td>FY10</td>
<td>474</td>
<td>108</td>
<td>32</td>
<td>15.1</td>
<td>72</td>
<td>257</td>
</tr>
<tr>
<td>FY11</td>
<td>488</td>
<td>112</td>
<td>40</td>
<td>2.7</td>
<td>72</td>
<td>256</td>
</tr>
<tr>
<td>FY12</td>
<td>533</td>
<td>130</td>
<td>62</td>
<td>6.7</td>
<td>73</td>
<td>255</td>
</tr>
<tr>
<td>FY13</td>
<td>557</td>
<td>138</td>
<td>73</td>
<td>10.2</td>
<td>75</td>
<td>249</td>
</tr>
</tbody>
</table>
Domestic gas (£ per customer account)

Source: CMA analysis.
Note: Line represents revenues per domestic customer account. Indirect costs include D&A costs.
Appendix B: Mid-tier suppliers’ financial performance

Introduction

1. This appendix sets out the annual revenues, gross profit and EBIT for each of the mid-tier suppliers based on their available P&L information for the period FY09 to FY13. We also set out their annual customer acquisition costs, which we used to calculate their EBITC2A measures (defined as EBIT adjusted for the add-back of customer acquisition costs).

Revenues, gross profit and EBIT

2. Figure 1 below shows the annual revenues, gross profit and EBIT generated at a total supply business level for each of the mid-tier suppliers over the period FY09 to FY13.

FIGURE 1

Mid-tier suppliers’ total supply business revenues, gross profit and EBIT (FY09 to FY13)

Annual revenues (£m)

Annual gross profit (£m)

Annual EBIT (£’000s)

Source: CMA analysis.
Note: [×].

3. Based on the figures above, each of the mid-tier suppliers saw their revenues increase year-on-year over the period FY09 to FY13, but EBIT profitability was only achieved in the latter years:

(a) [×].

(b) [×].

(c) [×].
Impact on EBIT of customer acquisition costs

4. Given the relatively rapid pace of growth in their respective revenues and customer base, we considered the impact of customer acquisitions on the mid-tier suppliers’ EBIT figures, by adding back their respective customer acquisition costs (EBITC2A). We asked each of the mid-tier suppliers to provide us with their annual customer acquisition costs over the period under consideration. We noted that in the absence of an industry standard definition of customer acquisition costs, the mid-tier suppliers used their own definitions.

5. Table 1 sets out each of the mid-tier suppliers’ annual customer acquisition costs, and their definitions of these costs.

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Annual customer acquisition costs for the mid-tier suppliers (FY09 to FY13)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: CMA analysis.</td>
<td></td>
</tr>
</tbody>
</table>

* [X].† [X].‡ [X].§ [X].

6. In Figure 2, we present the mid-tier suppliers’ adjusted EBIT after adding back the costs to acquire customers, ie EBITC2A.

FIGURE 2

Mid-tier suppliers’ annual EBITC2A* (£’000s) (FY09 to FY13)

Source: CMA analysis.

*EBITC2A means EBIT before costs to acquire customers.

7. Based on these EBITC2A figures, we present in Figure 3, the corresponding EBITC2A as a return on sales measure of profitability (EBITC2A margin).

FIGURE 3

Mid-tier suppliers’ annual and period EBITC2A margins (FY09 to FY13)

Source: CMA analysis.
Notes: [X]

8. Based on the above, given the relative materiality of the level of customer acquisition costs for the mid-tier suppliers’ EBIT figures, the add-back of customer acquisition costs had a material impact on their respective EBIT figures. With the exception of [X], the add-back of customer acquisition costs
resulted in EBIT profitability being achieved a year earlier than would otherwise have been the case.
Appendix C: Domestic supply unit revenues for the mid-tier suppliers

Introduction

1. In this appendix, we set out the unit revenue breakdown for the domestic electricity and gas businesses of Co-op Energy, First Utility and Utility Warehouse. We noted that we did not have the appropriate split for OVO for the period under review.

Unit revenue breakdown for the mid-tier suppliers

2. Table 1 sets out the unit revenue breakdown for the domestic electricity and gas businesses of Co-op Energy, First Utility and Utility Warehouse.

| TABLE 1 | Unit revenue (£ per MWh) breakdown for domestic electricity and gas for the mid-tier suppliers |
| ____________________________ | ____________________________ |
| Source: CMA analysis. |

Note: We noted that we did not have the appropriate split for OVO for the period under review.

Unit revenue breakdown for the Six Large Energy Firms

3. Table 2 sets out the annual unit revenue breakdown for the domestic electricity and gas businesses for the Six Large Energy Firms on a combined basis over the period FY09 to FY13.

| TABLE 2 | Unit revenue (£ per MWh) breakdown for domestic electricity and gas for the Six Large Energy Firms* |
| ____________________________ | ____________________________ |
| Source: CMA analysis. |

*The annual unit ratios were based on the Six Large Energy Firms combined, when the numerator and denominator each represented the sum of the annual figures of all of the Six Large Energy Firms.
Comparison between mid-tier suppliers and Six Large Energy Firms

4. Table 3 restates the figures in the above tables as a percentage of unit revenues, e.g., unit wholesale energy costs are restated as unit wholesale energy costs as a percentage of unit revenues for a given year.

<table>
<thead>
<tr>
<th>TABLE 3 Unit revenue components as a percentage of unit revenues (%) for the relevant firms*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Six Large Energy Firms combined</strong></td>
</tr>
<tr>
<td>Revenues</td>
</tr>
<tr>
<td>Wholesale energy costs</td>
</tr>
<tr>
<td>Network costs</td>
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<tr>
<td>Obligation costs</td>
</tr>
<tr>
<td>Other direct costs</td>
</tr>
<tr>
<td>Gross margin</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Co-op Energy</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
<th>FY09</th>
<th>FY10</th>
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<th>Utility Warehouse</th>
<th>FY09</th>
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</table>

Source: CMA analysis of P&L information submitted by the Six Large Energy Firms and the mid-tier suppliers.

*We restated the unit ratio for each cost item as a percentage of unit revenues. Unit gross profit as a percentage of unit revenues is also the gross margin.
Appendix D: Profitability by fuel and tariff type for the Six Large Energy Firms

Introduction

1. In this appendix, we set out the figures used to calculate the revenues, direct costs and indirect costs by tariff type for each of the Six Large Energy Firms (with the exception of SSE).

2. The percentages for revenue and direct costs by tariff type was based on their monthly revenue and volume information, which were overlaid onto their respective annual P&L information to provide us with annual revenues and direct costs by tariff type.

British Gas

3. In relation to British Gas, Table 1 sets out simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>British Gas: average* tariff profitability (FY09 to FY13)</th>
</tr>
</thead>
</table>

Source: CMA analysis.

*Simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

E.ON

4. In relation to E.ON, Table 2 sets out simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

<table>
<thead>
<tr>
<th>TABLE 2</th>
<th>E.ON: average* tariff profitability (FY09 to FY13)</th>
</tr>
</thead>
</table>

Source: CMA analysis.

*Simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

EDF

5. In relation to EDF, Table 3 sets out simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.
TABLE 3  EDF: average* tariff profitability (FY10 to FY13)

[Excel Table]

Source: CMA analysis.

*Simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

RWE npower

6. In relation to RWE npower, Table 4 sets out simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

TABLE 4  RWE npower: average* tariff profitability (FY10 to FY13)

[Excel Table]

Source: CMA analysis.

*Simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

Scottish Power

7. In relation to Scottish Power, Table 5 sets out simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

TABLE 5  Scottish Power: average* tariff profitability (FY11 to FY13)

[Excel Table]

Source: CMA analysis.

*Simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.
Appendix E: Indirect cost information

Introduction

1. This appendix sets out the limited number of adjustments we made to the indirect costs of the Six Large Energy Firms.

Adjustment for inflation

2. To eliminate the effects of inflation on indirect costs, we calculated the indirect cost ratios in ‘real terms’, using the Consumer Price Index (CPI) as our deflator and FY07 as our base year.\(^1\)

3. Using the annual CPI movement taken from the Office for National Statistics, we deflated the costs of years FY08 to FY13 to make them comparable to 2007 prices. The annual CPI change used for each of the Six Large Energy Firms and the deflator applied to FY08 to FY13 can be seen in Table 1:

<table>
<thead>
<tr>
<th>Deemed Financial Year</th>
<th>Financial Accounts Year End</th>
<th>Firm</th>
<th>Annual CPI index</th>
<th>Deflator (Costs x %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2007</td>
<td>31 December 2007</td>
<td>British Gas, E.ON, EDF, RWE npower and Scottish Power.</td>
<td>2.1%</td>
<td>100.0%</td>
</tr>
<tr>
<td>FY 2008</td>
<td>31 March 2008</td>
<td>SSE</td>
<td>2.5%</td>
<td>100.0%</td>
</tr>
<tr>
<td>FY 2009</td>
<td>December 2008</td>
<td></td>
<td>3.1%</td>
<td>96.9%</td>
</tr>
<tr>
<td>FY 2009</td>
<td>March 2009</td>
<td></td>
<td>2.9%</td>
<td>97.1%</td>
</tr>
<tr>
<td>FY 2009</td>
<td>December 2009</td>
<td></td>
<td>2.9%</td>
<td>94.1%</td>
</tr>
<tr>
<td>FY 2009</td>
<td>March 2010</td>
<td></td>
<td>3.4%</td>
<td>93.8%</td>
</tr>
<tr>
<td>FY 2010</td>
<td>December 2010</td>
<td>As above</td>
<td>3.7%</td>
<td>90.6%</td>
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<tr>
<td>FY 2010</td>
<td>March 2011</td>
<td></td>
<td>4.0%</td>
<td>90.0%</td>
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<tr>
<td>FY 2011</td>
<td>December 2011</td>
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<td>4.2%</td>
<td>86.8%</td>
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<tr>
<td>FY 2011</td>
<td>March 2012</td>
<td></td>
<td>3.5%</td>
<td>86.9%</td>
</tr>
<tr>
<td>FY 2012</td>
<td>December 2012</td>
<td></td>
<td>2.7%</td>
<td>84.5%</td>
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<tr>
<td>FY 2012</td>
<td>March 2013</td>
<td></td>
<td>2.8%</td>
<td>84.5%</td>
</tr>
<tr>
<td>FY 2013</td>
<td>December 2013</td>
<td></td>
<td>2.0%</td>
<td>82.8%</td>
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<tr>
<td>FY 2013</td>
<td>March 2014</td>
<td></td>
<td>1.6%</td>
<td>83.1%</td>
</tr>
</tbody>
</table>

Source: Office for National Statistics. CPI data set used last updated 16 December 2014.

*Simple average gross margins (by tariff type) based on all the years for which we could assess its tariff profitability.

Additional adjustments to indirect costs

4. We describe some of the other minor adjustments we made to the indirect costs for each of the Six Large Energy Firms (when applicable):

(a) \[\text{[\ldots]}\].

\(^1\) Office for National Statistics. CPI data set used last updated 16 December 2014.
(b) \[ \infty \].

(c) \[ \infty \].
Appendix F: Total indirect cost ratios for the Six Large Energy Firms

Introduction

1. This appendix sets out the total indirect cost ratios for each of the Six Large Energy Firms over the relevant period.

Total supply business indirect cost ratios

2. Table 1 sets out the total customer accounts, the nominal and real total indirect costs and the indirect cost ratio (ie £ per customer account). The table is split by firm and by year with a simple average of the seven years shown at the foot of the table.

TABLE 1 Annual total supply business indirect costs and ratios (FY07 to FY13) and average ratios*

*Simple average of the seven years shown at the foot of the table.
Appendix G: Retail segmental indirect cost ratios for the Six Large Energy Firms

Introduction

1. This appendix sets out the indirect cost ratios for each of the Six Large Energy Firms’ domestic and SME retail segments (split by fuel type) over the period FY09 to FY13.

Retail segmental indirect cost ratios

2. Table 1 sets out the indirect cost ratios (ie £ per customer account) in real terms for domestic and SME supply, split by fuel type.

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Domestic and SME indirect cost ratios in real terms (FY07 to FY13) and average ratios £/account*</th>
</tr>
</thead>
</table>

Source: CMA analysis.

*Simple average of the five years shown at the foot of the table.

Note: All costs are reported in real terms with 2007 as the base year to make the figures comparable to others in the indirect cost analysis.
Appendix H: Indirect cost categories for the Six Large Energy Firms

Introduction

1. This appendix sets out the indirect cost ratios for each of the Six Large Energy Firms based on the six broad indirect cost categories we used for the purpose of our analysis.

Indirect cost ratios split by category

2. Table 1 shows for each of the Six Large Energy Firms the indirect cost per customer account for each of their indirect cost categories.

TABLE 1 Total supply business indirect cost ratios by cost category for the Six Large Energy Firms

*Simple average of the seven years shown at the foot of the table.

Commentary on indirect cost ratios by cost category

3. Based on Table 1:

(a) Bad debt cost ratios: each firm showed a similar trend, with all the Six Large Energy Firms showing a spike in bad debt costs from the impact of the financial crash and subsequent recession. The biggest peaks in bad debt cost ratios were seen for [X], with [Y] showing the smallest peak. After this peak, the cost ratios fell to similar levels seen in FY07. We note that this trend did not significantly alter when looking at bad debts as a percentage of revenues.

(b) Metering cost ratios: over the period, this cost ratio remained relatively flat for most of the Six Large Energy Firms. The gap between the highest ([Z]) and lowest ([W]) ratios narrowed over the period.

(c) Sales and marketing cost ratios: we note that this cost ratio would be heavily influenced by each firm’s business and customer acquisition strategy. We found that over the period of review all the Six Large Energy Firms reduced their sales and marketing cost ratios on a per customer account basis. The firms that had spent the most in sales and marketing (ie [V]) reduced their costs the most and the firm that spent the least,
[佚], reduced its costs the least. Over the period of review, on average [佚] had the lowest cost ratio and [佚] the highest.

(d) Customer service cost ratios: these ratios were significantly higher for [佚] than for all the other Six Large Energy Firms. Over the period, while these ratios fell for [佚], they remained significantly high relative to the other suppliers. [佚], although significantly lower in its cost ratios than [佚], showed year-on-year increases in its customer service cost ratio. [佚] showed the strongest signs of cost reductions over this period.

(e) Central service cost ratios: were significantly higher for [佚] than the other Six Large Energy Firms. [佚] central service costs also increased over the period, while [佚] incurred the lowest average central service cost ratio.
Appendix I: Mid-tier suppliers’ indirect cost ratios

Introduction

1. This appendix sets out the indirect cost ratios for the mid-tier suppliers.

Mid-tier suppliers’ indirect cost ratios

2. Based on the indirect cost information provided by the four mid-tier suppliers, we calculated total indirect costs per customer account. These results are set out in Table 1. In calculating their indirect cost ratios, we would highlight that:

(a) to make these figures comparable to the other parts of our indirect cost ratio analysis, all figures were adjusted for inflation based on CPI using 2007 as the base year; the adjustment made is reported in the table below; and

(b) the average provided at the bottom of the table is a simple average; for OVO, it excludes FY10 because this was a 6-month accounting period as a result of a year-end change during 2011. In the table below, for OVO, FY09 relates to the period ending 30 June 2010, FY10 is for the 12 months to 30 June 2011, FY11 is for the six months to 31 December 2011, and for both FY12 and FY13 the financial year matches the calendar year.

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Total supply business indirect cost ratios for the mid-tier suppliers</th>
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</thead>
</table>

Source: CMA analysis.

Note: All costs are reported in real terms with 2007 as the base year to make the figures comparable to others in the indirect cost analysis.