Appendix 9.1: Microbusinesses

Contents

Introduction

1. This appendix covers the retail supply of gas and electricity to microbusinesses.

2. There are six main sections in this paper. The first two provide background material, while the others cover the main potential issues in the supply of energy to microbusinesses:

   (a) Describing microbusinesses: This section explains how microbusinesses are defined and notes some characteristics of these customers.

   (b) Describing the SME markets: This section provides information about the SME markets structure, covering the suppliers present, the tariffs they offer and the regulatory context.

   (c) Engagement: This section looks at a range of evidence related to the level of engagement by microbusiness customers.

   (d) Transparency: This section covers the availability of price information for microbusiness customers, including the roles of TPIs and PCWs.

   (e) Margins: This section reports figures for EBIT margins for SMEs as a whole. It then looks at average revenues and gross margins for specific tariffs and sizes of microbusinesses.

(f) Outcomes: Building on the margins results, this section provides more detail on three specific areas: auto-rollover contracts, deemed and OOC tariffs, and outcomes for customers of different sizes.

Describing microbusinesses

Microbusiness definition

3. The terms of reference for this market investigation[1] cover the supply of energy to microbusinesses, following Ofgem's definition of a microbusiness.

4. Ofgem defines a microbusiness as a non-domestic customer that meets at least one of the following criteria:

   (a) it employs fewer than ten employees (or their full time equivalent) and has an annual turnover or balance sheet no greater than €2 million; or

   (b) it consumes no more than 100,000 kWh of electricity per year; or

   (c) it consumes no more than 293,000 kWh of gas per year.[2]

5. These upper bounds of energy consumption would typically cost a business around £10,000 per fuel (before VAT).[3] Ofgem estimated that microbusinesses now account for 1.6 million electricity meter points and 0.55 million gas meter points.[4]

6. However, information is not always specifically available for microbusinesses. In various places, this appendix refers to evidence in the following categories:

   - non-domestic customers (all business customers, including those in the I&C markets);
   - SMEs (smaller businesses – although there is no industry standard definition); or
   - microbusinesses (applying all or part of the Ofgem definition).

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[1] Ofgem (2014), *Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain*, p30.
[2] If a non-domestic customer qualifies under only one of the consumption criteria, it is regarded as a microbusiness only for that fuel. The definition of microbusinesses has changed over time. It was originally defined by government for the purposes of the complaints handling standards and redress scheme. The definition was then updated following Ofgem's Energy Supply Probe and again following its Retail Market Review.
[3] As of Q1 2012. Ofgem (2012), *The Retail Market Review – draft impact assessment for the updated proposals for businesses*.
[4] Ofgem (2014), *Proposals for non-domestic automatic rollovers and contract renewals*, pp40–41.

7. This issue is partly due to the fact that suppliers generally do not distinguish between microbusinesses and SMEs.[5] Suppliers we have spoken to apply the additional microbusiness requirements to all SMEs unless they are explicitly identified as not being microbusinesses.[6] Furthermore, as shown in Table 1, each of the Six Large Energy Firms categorises SMEs in a different way, and these differ from the Ofgem microbusiness definition.

Table 1: Small and medium-sized enterprise definitions

	Electricity	*Gas*
Ofgem (microbusiness definition)	Consumption up to 100,000 kWh a year.	Consumption up to 293,000 kWh a year.
Centrica	Consumption up to 5,000,000 kWh a year and <20 sites.	Consumption up to 10,000,000 kWh a year and <20 sites.
E.ON	Consumption up to 1,000,000 kWh a year, not half-hourly metered and <20 sites.	Consumption up to 1,500,000 kWh a year and <20 sites.
EDF Energy	Profile classes 3 and 4, meters that are not part of groups of 50 or more sites and do not have complex metering.	Consumption up to [✂] a year ([✂] a year for new customers).
RWE npower	Consumption up to [✂] a year.	Consumption up to [✂] per year.
Scottish Power	Profile classes 3 and 4, single sites only.	Consumption up to 73,268 kWh a year, single sites only.
SSE	Profile classes 3 to 8, single sites only.	Quarterly billed customers, single sites only.

Source: Parties' responses

8. In our data work, we classified microbusinesses using only their annual consumption.[7] Some suppliers told us that this would be a more appropriate definition, as it would reflect the information available to them.[8]

[5] We understand that this is partly because it is difficult for suppliers to collect and update information on customers' turnover and employee count.
[6] RWE told us [✂].
[7] To be precise, we classified meters (rather than customers). For more information on our data work, see the Margins section below.
[8] For example, Haven Power described the current definition as 'practically unworkable'. (Drax (2015), *Response to updated issues statement*, p12).

Microbusiness characteristics

9. At the start of 2014 there were an estimated 5.2 million UK private sector businesses, 96% of which had fewer than ten employees; these accounted for 33% of private sector employment and 19% of private sector turnover.[9]

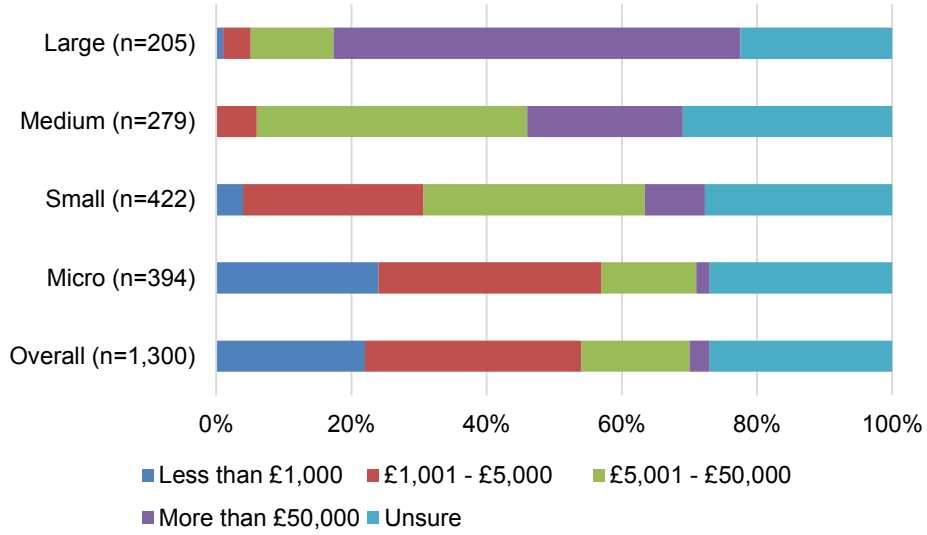
10. Small businesses, defined by the Department for Business, Innovation and Skills as those with fewer than 50 employees, make up the largest number of businesses across all industry sectors, although they are not spread evenly across all sectors. At the start of 2014 there were 950,000 small businesses operating in the construction sector, 18% of all small businesses. A further 779,000 (15%) were in professional, scientific and technical activities and 538,000 (10%) in the wholesale and retail trade.[10] Small businesses are therefore a diverse group, and diverse in their energy needs.

11. Several parties told us that the business activity of a non-domestic customer can be important to a supplier. For example, Ovo Energy told us that pubs and takeaways were sometimes unattractive customers due to the risk of bad debt.

12. As part of a 2013 survey conducted on behalf of Ofgem, non-domestic customers were asked to estimate how much they had spent on energy in the previous year (including VAT). As shown in Figures 1 and 2 below, most microbusinesses spend substantially less on their electricity and gas each year than larger businesses. 59% (51%) of large businesses had spent more than £50,000 on their electricity (gas) in the previous year compared with just 2% (2%) of microbusinesses. However, some microbusinesses spend significant amounts on energy: 16% had spent more than £5,000 on their electricity and 13% had spent more than £5,000 on their gas.

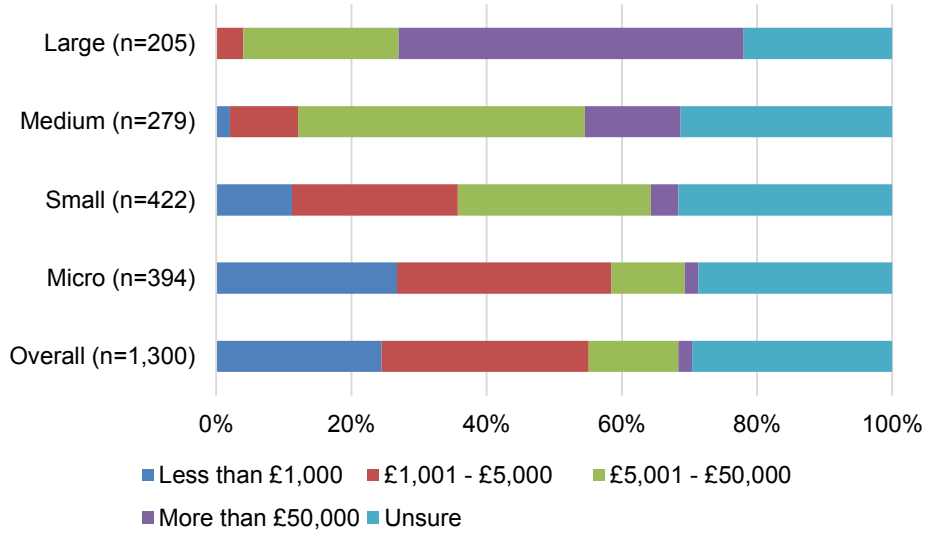
[9] Department for Business, Innovation and Skills (2014), *Business population estimates for the UK and regions 2014*, p4.
[10] Department for Business, Innovation and Skills (2014), *Business population estimates for the UK and regions 2014*, p12.

Figure 1: Reported annual amount spent on electricity by size of business



Source: The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p73.

Figure 2: Reported annual amount spent on gas by size of business



Source: The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p74.

13. At the lower end, some microbusinesses spend similar amounts to domestic customers. 24% of microbusinesses reported that they spent less than £1,000 a year on electricity, and 27% less than £1,000 a year on gas.[11] This compares with a mean figure for electricity and gas combined of £1,276 for

[11] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), pp73–74.

domestic customers.[12] According to a survey for the Federation of Small Businesses (FSB), 44% of its members spend under £2,000 a year on energy, and 57% spend under £3,000 a year.[13] However, the largest microbusinesses use substantially more than domestic customers – for example the upper threshold for electricity consumption in Ofgem's microbusiness definition is around 30 times typical domestic consumption.[14]

14. As shown in Table 2 below, microbusinesses do not spend a greater proportion of their costs on energy than non-domestic customers as a whole. The figures are almost identical for each category.[15]

Table 2: Annual spend on electricity or gas as a percentage of all business costs

% of customers

	Electricity		*Gas*	
	Microbusinesses	*All non-domestic*	*Microbusinesses*	*All non-domestic*
Less than 5%	43	43	46	46
5% to 10%	13	12	9	9
More than 10%	2	2	3	2
Unable to provide an estimate	41	42	42	42

Source: The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), pp74–75.

Describing the SME markets

SME suppliers

15. As a simple measure of supplier activity, there are more active suppliers in the SME gas and electricity markets than in the domestic gas and electricity markets. There are 33 active electricity suppliers and 35 active gas suppliers in the SME markets, compared to 24 active electricity suppliers and 24 active gas suppliers in the domestic markets.[16] There are several possible reasons why a supplier might choose to be active in SME supply only: for example,

[12] TNS BMRB (2014), *Retail Market Review baseline survey: report prepared for Ofgem*, cited in Ofgem, Micro-Business Consumers Memo, p6.
[13] FSB (2014), *FSB 'Voice of Small Business' survey panel – April/May 2014 energy survey*, p10.
[14] 3,200 kWh per year (Ofgem (2013), *Decision: new typical domestic consumption values* (letter to interested parties), p2).
[15] Ofgem commissioned another survey in 2014. Although the results were published in 2015, the interviews were carried out in autumn 2014. We therefore refer to this as the 2014 survey. Source for the dates of the fieldwork: BMG Research (2015), *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), p1). The 2014 survey did not break down this information to microbusiness level. However, across its sample, it found many more businesses where gas or electricity accounted for over 10% of costs (compared to the 2013 survey). For example, in 2014, 34% of microbusinesses and small businesses estimated that electricity made up over 10% of their costs – the equivalent figure in the 2013 survey was only 4%. (BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p17).
[16] Ofgem (2014), *List of Active Suppliers* (updated September 2014, received 19 December 2014).

lower levels of regulation, an ability to build scale more quickly, or perceived higher returns.

16. Suppliers continue to enter the SME markets. For example, Extra Energy started to supply non-domestic customers in March 2014. There may also be growth from existing suppliers – [✂].Existing suppliers of one fuel may also start supplying the other fuel – for example, Corona and DONG Energy both started supplying electricity in 2014, having previously been gas suppliers. This implies that there are limited barriers to entry in these markets.

17. However, some non-domestic suppliers do not serve smaller businesses. We spoke to Haven Power (a non-domestic supplier) as part of the case study interviews. Haven Power said that it did not supply very low consumption businesses because the volumes involved would be too small to cover its costs.[17] In general though, Haven Power said that the SME markets were as competitive as the I&C markets.

Shares of supply

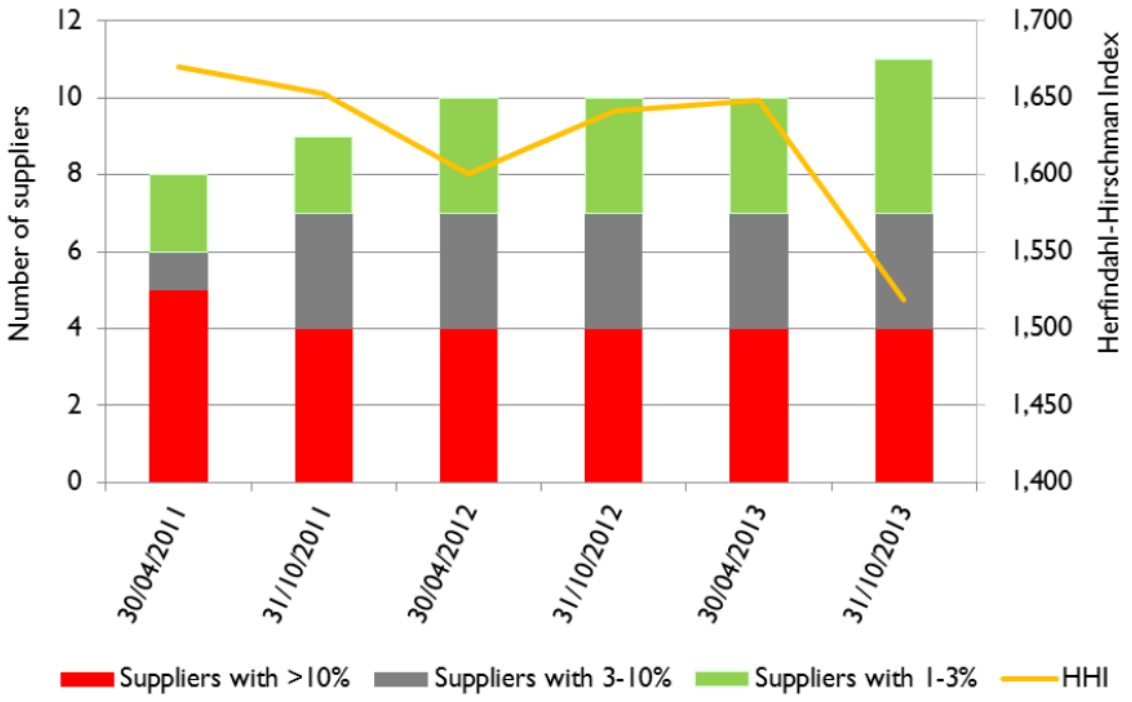
18. There is no single reliable source of data for shares of supply to microbusinesses, and it is possible that the microbusiness segment has a different split of supplier activity compared to the SME gas and electricity markets as a whole. We therefore report information from several sources on shares of supply: shares estimated by Cornwall Energy, and our calculations based on data provided to us by Elexon, by a selection of suppliers, and by Distribution Network Operators. These sources cover different groups of customers.

Cornwall Energy data – SMEs

19. Cornwall Energy produced a report in April 2014 that included specific figures for suppliers in the SME markets. Although Figures 3 and 4 below only include suppliers with a share greater than 1%, they still indicate that there were 11 electricity and 13 gas suppliers with at least this share. The combined share by volume of the Six Large Energy Firms was 88.7% in electricity[18] and 66% in gas.[19]

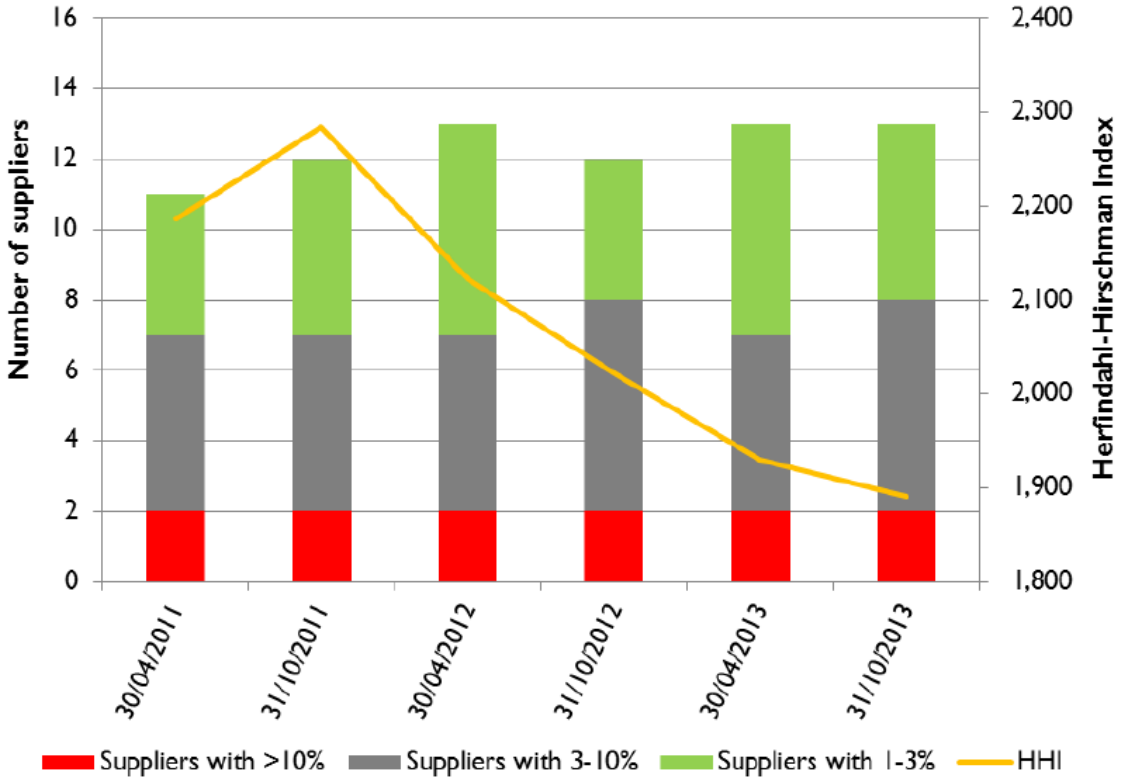
[17] RWE told us it did not believe that Haven Power was typical.
[18] Cornwall Energy (2014), *Competition in British business energy supply markets: an independent assessment for Energy UK*, p13.
[19] Cornwall Energy (2014), *Competition in British business energy supply markets: an independent assessment for Energy UK*, p16.

Figure 3: Shares of supply and Herfindahl–Hirschman indices for small and medium-sized enterprise electricity volume



Source: Cornwall Energy (2014), *Competition in British business energy supply markets: an independent assessment for Energy UK*, p13.

Figure 4: Shares of supply and Herfindahl–Hirschman indices for small and medium-sized enterprise gas volume

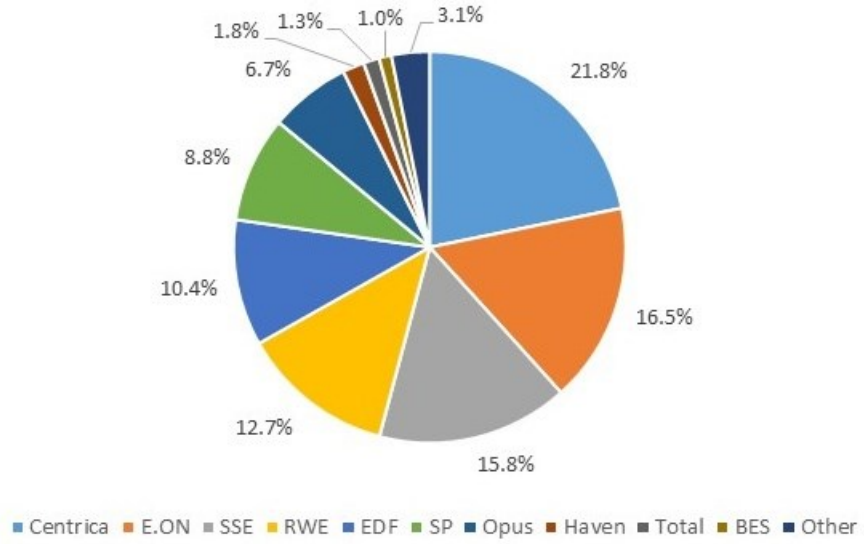


Source: Cornwall Energy (2014), *Competition in British business energy supply markets: an independent assessment for Energy UK*, p16.

Elexon data – non-half hourly metered electricity

20. We considered shares in non-half hourly metered electricity, using data from Elexon.[20] This allowed us to look at suppliers' shares (by volume) in individual profile classes. In general, smaller non-domestic customers tend to be in profile classes 3 and 4 (although each profile class has a mix of different sizes of customers).[21] We calculated HHIs for each profile class in December 2014. The HHIs in profile classes 3 and 4 were around 1,400,[22] and the shares are shown in Figure 5 below. These were slightly lower than the HHIs for profile classes 5 to 8, which were all over 1,500. This source does not suggest that there is higher concentration in the supply of electricity to smaller microbusinesses, compared to other non-half hourly metered customers.

Figure 5: Shares of electricity volumes in profile classes 3 and 4



Source: CMA analysis of Elexon data.
Note: Data is based on annualised view from December 2014.

Supplier data – by consumption band

21. Profile classes are only a proxy for different sizes of customers. We therefore used information from 14 of the largest suppliers to estimate shares in different consumption bands. We received data for gas and electricity. We focus on the results for the smallest two consumption bands, as these are

[20] The data was based on annualised views of volumes, taken at snapshot points in time.
[21] Statement based on CMA analysis of another Elexon dataset. This showed the number of meters with different levels of annual consumption in 2013. For example, around 60% of meters in profile class 3 had an annual consumption under 10 MWh. However, 14% had an annual consumption over 30 MWh. In contrast, 83% of meters in profile class 8 had an annual consumption over 30 MWh, but there were still 12% of meters with an annual consumption less than 10 MWh.
[22] According to the merger assessment guidelines, a market with a HHI over 1,000 is considered concentrated, and a market with a HHI over 2,000 is considered highly concentrated. (Competition Commission and Office of Fair Trading (OFT) (2010), *Merger assessment guidelines*, p40).

likely to have the most comprehensive coverage.[23] We report results below for 2014.

22. These share figures are not completely accurate, and will tend to slightly overstate each supplier's share due to the omission of some smaller suppliers. Suppliers had to make various assumptions to provide us with granular data from their own systems. While we tried to ensure comparability where possible, there are still some inconsistencies.[24] Therefore we view them as indicative.

23. We look first at electricity. For the smallest electricity meters (with under 10 MWh of annual consumption), Figure 6 below shows that three suppliers (Centrica, [✂] and [✂]) had a share by volume of over 20%. There were a further four suppliers with a share of around 5% or higher. The HHI in this category was over 1,750. There was a similar HHI for the next largest consumption band.[25]

Figure 6: Shares of supply by volume to electricity meters with an annual consumption under 10 MWh, 2014

[✂]

Source: CMA analysis of data from the Six Large Energy Firms, Corona, Extra Energy, Gazprom, GDF Suez, Haven Power, Opus Energy (Opus) and Total.

24. In gas, Centrica also had the largest share, as shown in Figure 7 below. For the smallest gas customers (with under 30 MWh of annual consumption), Centrica's share by volume was around 40%. There were three more suppliers with a share of around 10% or higher, and a further two with a share over 5%. The HHI in this consumption band was over 2,250. The HHI was slightly higher in the next consumption band.[26] These figures suggest that concentration is fairly high, and that there is higher concentration for supply to smaller microbusinesses in gas than in electricity. This chart also indicates that the Six Large Energy Firms are more important for the supply of gas to small microbusinesses (with a combined share of 81%), compared to the

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[23] For practical reasons, we only asked suppliers to provide information on customers held in their SME (as opposed to I&C) systems. This means that some meters were not included in our data.
We compared the figures for the number of electricity meters in each consumption band from Elexon (in 2013) and from our data (at the end of 2014). For meters with annual consumption below 10MWh, our data had 98% of the number of meters in the Elexon data. For meters with annual consumption between 10 and 30 MWh, the equivalent figure was 91%. We therefore have reasonably good coverage in these bands.
However, the coverage was lower in the larger consumption bands. We therefore do not report results in bands above 30MWh. This is because the number of meters excluded from each supplier's data may vary depending on how they allocated customers between SME and I&C systems.
We did not have an equivalent comparator dataset for gas. We therefore followed the same practice as electricity and looked only at the smallest two consumption bands.
[24] For example, E.ON's market share figures exclude those microbusiness customers who are managed within its Corporates business segment. Those customers are excluded from our analysis throughout this appendix.
[25] Meters with an annual consumption between 10 and 30 MWh of electricity.
[26] Meters with an annual consumption between 30 and 100 MWh of gas.

supply of gas to SMEs as a whole (Cornwall Energy reported a combined share of 66% – see paragraph 19).

Figure 7: Shares of supply by volume to gas meters with an annual consumption under 30 MWh, 2014

[✂]

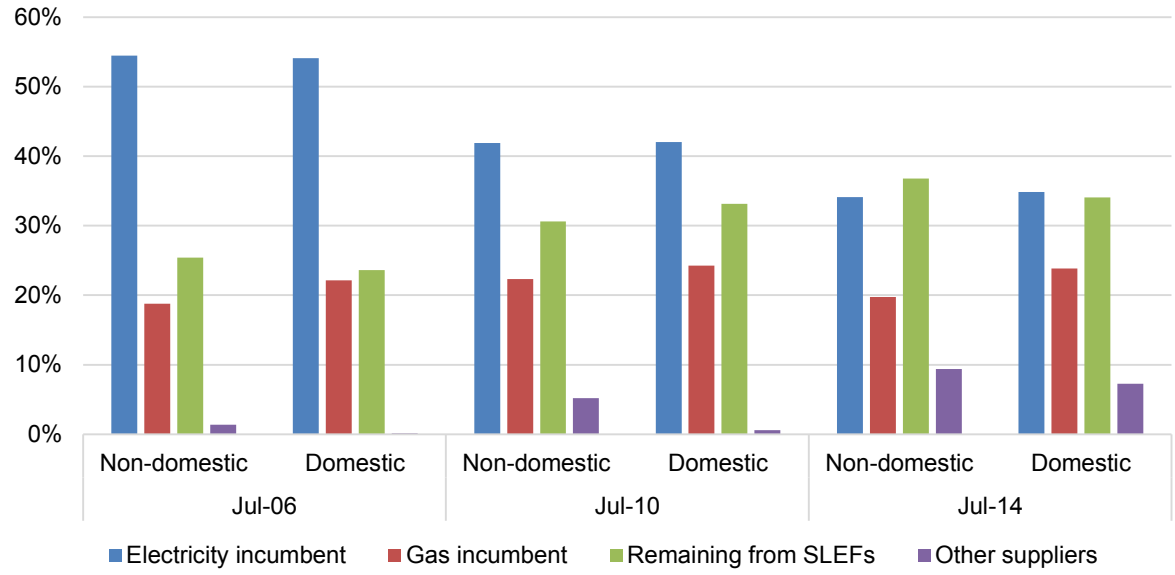
Source: CMA analysis of data from the Six Large Energy Firms (except EDF Energy), Corona, Dong Energy, Extra Energy, Gazprom, GDF Suez, Opus and Total.
Note: Scottish Power is included in the 'other' category.

Distribution Network Operator data – non-domestic electricity by region

25. Figure 8 shows shares of supply by number of meter points in the SME and domestic electricity markets at three points in the last ten years.[27] The broad patterns have remained similar between domestic and SME over this period. The average share of the former regional electricity incumbent in each region[28] fell in the SME market from 55% in July 2006 to 34% in July 2014. The share of Centrica, the former national gas incumbent, stayed broadly the same (19% in July 2006 and 20% in July 2014). Meanwhile, over the same time period, the share of the non-incumbents among the Six Large Energy Firms increased from 25% to 37% and the share of other suppliers increased from 1.4% to 9.4%. This suggests that since market liberalisation new suppliers have been able to enter non-domestic energy supply and grow their non-domestic customer base over time.

[27] Although this does not split out microbusinesses, they account for the large majority of businesses (see paragraph 9 above) and so the results should give a good indication of shares among microbusinesses.
[28] The incumbent share is calculated as the total number of meters supplied by the former electricity incumbent in each region divided by the total number of meters in the country. Therefore, this represents the share on a national basis that is still with the regional electricity incumbents.

Figure 8: Non-domestic and domestic electricity supply shares of meter points



Source: CMA analysis of Distribution Network Operator data on number of meters per supplier by region.
Note: SLEFs = Six Large Energy Firms.

26. We also looked at each region separately in the same data, and found that the share of the electricity incumbent in 2014 was generally similar to the national figure of 34%. The difference from the national figure was five percentage points or fewer in all but one region. This was North Scotland, where in July 2014 the electricity incumbent had a significantly higher share of [✂].

Tariffs

27. Unlike the domestic markets, we understand that microbusiness contracts are largely single fuel. This may be due to non-domestic customers using varying proportions of gas and electricity, meaning that a dual-fuel tariff would be less well-suited for many.

28. Another difference from the domestic markets is that electricity is more important than gas for SMEs. An estimate by Cornwall Energy suggested that SMEs spend £4.4 billion on electricity, making up three-quarters of total spending across both fuel types (£5.8 billion).

29. The Six Large Energy Firms all told us that all tariffs that they offered to SMEs were also available to microbusinesses (with the exception in some cases of microbusinesses handled under corporate/I&C account management). The broad tariff types available to microbusinesses[29] are:

[29] In general, the same broad tariff types are offered by the Six Large Energy Firms and other suppliers.

(a) Tariffs with fixed prices:

(i) Fixed-term contracts: These contracts have fixed prices which are valid for the whole contract period. Suppliers generally offer fixed-term contracts to new customers (ie acquisition fixed-term contracts) or existing customers at the end of the fixed-term period (ie retention fixed-term contracts). These contracts are typically offered for a duration of one to four years and are generally the cheapest option available to non-domestic customers at acquisition or contract renewal. The majority of non-domestic customers are on these contracts. Unlike a domestic customer, a non-domestic customer does not generally have the option of leaving during a fixed-term contract.

(ii) Auto-rollovers: When a non-domestic customer's existing fixed-term contract comes to an end, in some cases this will automatically be followed by an extension of the duration of the existing fixed-term contract or a new fixed-term contract, if the customer takes no action. The customer will receive a notification of the terms of the new (or extended) fixed-term contract, which is likely to include a different price to the original contract. The Six Large Energy Firms and Opus have stopped offering these tariffs recently (in most cases, in 2014).[30] We use the term 'replacement products' to refer to the broad set of tariffs which suppliers now use in place of auto-rollovers. Some suppliers have replaced auto-rollovers with fixed-term contracts which a customer can leave after giving notice (notice products). We consider that these differ from auto-rollovers.[31]

(b) Tariffs with variable prices:

(i) Evergreen contracts: These contracts have no termination date and the prices are changed periodically.[32] We understand that these tariffs are of limited importance for acquiring new non-domestic customers.[33]

(ii) Deemed tariffs: These tariffs apply to non-domestic customers that have not signed up to a contract but consume energy. This may occur in two instances: when a non-domestic customer moves into a new property and starts to consume energy without a contract with a

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[30] Some customers currently remain on these tariffs until their existing contracts expire. RWE told us that it no longer enforces auto-rollover terms in existing contracts.
[31] See paragraph 178 for further discussion of other types of replacements for auto-rollover contracts.
[32] These may also be known as 'tariff' or 'variable' products.
[33] For example, Scottish Power told us that its SME acquisition activity was almost entirely based on fixed-price contracts, and that it believed this also to be the case for the rest of the market.

supplier or when a fixed-term contract is terminated but the supplier continues to supply the customer. This second possibility can arise if the original contract does not expressly say what will happen after termination and the existing customer continues to consume energy at the premises. A contract is deemed to exist, and a non-domestic customer will remain on this tariff unless it takes action to switch, with price changes being applied automatically. There is a specific licence condition for deemed tariffs, which requires suppliers to ensure that the terms of these tariffs are not unduly onerous.[34]

(iii) OOC: This applies to non-domestic customers that have terminated their contracts, but have not yet switched to a new supplier. Non-domestic customers are defaulted to this type of tariff[35] and will remain on this tariff unless they take action to switch, with price changes being applied automatically.

30. Other niche tariffs may also be available to microbusinesses. For example, there are shorter-term fixed-price contracts specifically targeted at new business start-ups and repayment plans for businesses struggling to pay their energy bills. Some suppliers have tariffs designed specifically for customers that have not changed contract since privatisation; [✂] said that these tariffs are provided under the provisions of the Former Tariff Schemes established through the Utilities Act of 2000. There are also some tracker products linked to wholesale prices.

31. The main channel used by the Six Large Energy Firms to acquire SME customers was telesales. This accounted for around 50% of sales in 2013. The next most significant channel was TPIs, which were responsible for 30% of sales. Other channels used included suppliers' own websites and face-to-face sales.[36]

32. Suppliers have different approaches to payment methods, although the main distinction appears to be between direct debit and standard credit (payment on receipt of a bill). Payment by direct debit can be incentivised – EDF Energy told us that there was a 7% discount for payment by fixed monthly direct debit. Scottish Power said that direct debit was the only payment option it offered to new SME customers. Standard credit can involve a range of payment methods, including cash, cheque or bank transfer. Other approaches appear to be of limited importance: SSE said that 'Business customers are not offered pre-payment metering', while E.ON said that other payment methods (pre-

[34] Standard Licence Condition 7 of the Electricity/Gas Supply Standard Licence Conditions.
[35] This will have been provided for in the original contract.
[36] See Section 7: Nature of retail competition.

payment, standing order and pay as you go) were used by only [✂] of its SME customers.

33. Some suppliers require customers with low creditworthiness to provide security deposits. These amounts can be significant. Centrica said that a security deposit was equal [✂] (whichever is larger), while Scottish Power said that it asked for a security deposit [✂]. However, Scottish Power told us that this applied to only 4% of its customers. Several independent suppliers also ask for substantial deposits from high risk customers – for example, Corona told us that a deposit was generally equal to three or four months' consumption. E.ON's SME business and EDF Energy do not normally require security deposits.

Regulation

34. There are fewer supply licence conditions for non-domestic supply than for domestic supply. This means that there are some significant differences between domestic and non-domestic regulation. For example, a non-domestic customer can conclude a binding contract over the phone, without a cooling-off period. However, there are some additional regulations that apply when a supplier is dealing with microbusinesses, but not when dealing with other non-domestic businesses.

35. The main licence condition applying to microbusinesses is Standard Licence Condition (SLC) 7A. SLC 7A was introduced as part of the Energy Supply Probe in October 2009 with the aim of improving engagement among microbusinesses.[37] It introduced specific requirements for suppliers when dealing with microbusiness customers and on the terms and conditions applicable to contracts between suppliers and microbusinesses. In summary:

(a) suppliers must try to identify whether a non-domestic customer is a microbusiness;

(b) suppliers must provide information to microbusinesses before entering into a contract;

(c) within ten days of entering into a contract or renewing a contract with a microbusiness suppliers must provide contract information;

(d) suppliers must provide contractual information to microbusinesses 30 days before renewing a contract;

[37] Ofgem (2009), *Energy Supply Probe - proposed retail market remedies (decision document)*, p30.

(e) information on bills must be plain and intelligible;

(f) suppliers cannot change contract terms on the grounds that the customer no longer meets the microbusiness definition;

(g) the maximum notice microbusinesses have to give to end a contract is 90 days, although this does not prevent a supplier from signing a fixed-term contract with a microbusiness; and

(h) the maximum length of an auto-rollover contract is one year.

36. Ofgem made changes to SLC 7A with effect from 31 March 2014 as part of the Retail Market Review. This included requirements to provide additional information on bills, such as the contract end date and the last date a customer can give notice of termination. Ofgem recently reported on the implementation of these billing requirements. It noted that 25 suppliers had included all the additional information required on bills. However, seven suppliers had failed to include at least one of these pieces of information.[38]

37. Ofgem made further changes to SLC 7A in November 2014, which took effect from 30 April 2015. The changes were: to reduce the maximum notice period required at the end of a fixed-term contract to 30 days,[39] to require suppliers to provide current prices and annual consumption details on renewal letters, and to make suppliers acknowledge termination notices from microbusinesses within five working days. At an earlier stage, some stakeholders had put forward the idea of banning auto-rollovers.[40] Ofgem decided not to ban auto-rollovers, although it said that it would carry out further work in this area.[41]

38. As well as SLC 7A, some additional pieces of regulation apply to microbusinesses but not to other non-domestic customers. Microbusinesses have the right to raise complaints with the Energy Ombudsman (like domestic customers).[42] Similarly, a version of the Customer Objective and Standards of Conduct applies to microbusinesses, although there are some differences from the equivalent domestic supply requirements.[43]

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[38] Ofgem (2015), *Open letter on compliance monitoring – non-domestic suppliers*, p2.
[39] This standardises the process for renewals of fixed-term contracts. A customer now receives a renewal letter 60 days before its contract expires. It then has a 30 day renewal window to arrange a new contract for itself. If the customer has taken no action by the end of this window, then at the end of its current contract the supplier will place it on the default option set out in the renewal letter.
[40] Ofgem (2014), *Proposals for non-domestic automatic rollovers and contract renewals*, p16.
[41] Ofgem (2014), *Decision on automatic rollovers and contract renewals for micro-business consumers (letter to interested parties)*, p5.
[42] Article 2(1) of the Gas and Electricity Regulated Providers (Redress Scheme) Order 2008.
[43] Standard Licence Condition 7B of the Electricity/Gas Supply Standard Licence Conditions.

39. There have also been voluntary industry developments in recent years. Many suppliers have limited back-billing[44] for microbusinesses to one year.[45] Many suppliers have also ended auto-rollovers.

40. Some parties commented on recent regulatory developments. Haven Power said that the amount of regulatory change made it difficult to operate.[46] SSE also told us that the requirement to provide a renewal letter at least 60 days before contract expiry, with a quote valid through the renewal window,[47] affected the risk premium included in the quote. EDF Energy told us that it supported the existence of specific protections for microbusinesses (although it did not agree with the microbusiness definition). RWE said that it supported most of the regulations applying to microbusinesses, such as the requirement to put contract end dates on bills. However, it said that there were some examples where it thought the level or form of regulation was inappropriate in this particular segment.

41. We have taken these regulatory developments into account when looking at this segment. However, we are conscious that many of these changes are recent, and not properly reflected in the data available to us.

Introduction to issues

42. The previous two sections provided background about this segment. We now cover the issues in the microbusiness segment. This is broken down into four sections. We investigated issues under the following four topics:

    (a) Engagement: we investigated whether some microbusinesses have lower levels of engagement in the retail energy markets. This may be partly due to innate factors, such as the size of these businesses.

    (b) Transparency: we considered whether the negotiated nature of supply and lack of published tariffs in the SME gas and electricity markets may reduce transparency and increase search costs. We considered whether there were other ways that customers may learn about prices, such as TPIs or PCWs.

    (c) Margins: we compared EBIT margins for SMEs with those for other markets. We compared average revenues and gross margins for different sizes of SMEs and different tariff types.

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[44] A back-bill is a delayed request for payment issued to a customer for previously unbilled consumption.
[45] Ofgem (2013), *Micro-business back-billing: publication of supplier data covering April 2012 – March 2013*, pp1–2.
[46] Case studies on barriers to entry and expansion in the retail supply of energy working paper.
[47] See footnote 39 above.

(d) Outcomes: we looked at the prices that different types of customers pay, and investigated whether differences between them appeared to be cost-justified. If not, then certain types of customer may be getting poor outcomes. We considered whether these customers may be ones for which competition was not likely to be working effectively.

43. We do not address gas and electricity settlement in this appendix but our observations on the current system of gas settlement in the domestic markets included in Appendix 8.6: Gas and electricity settlement and metering also apply to microbusinesses. Similarly, our observations on the absence of a firm plan for moving to half-hourly settlement for domestic electricity customers and of a cost-effective option of elective half-hourly settlement included in Appendix 8.6 also apply to microbusinesses as the majority of them are currently assigned to profile classes 3–4[48].

Engagement by microbusinesses with energy supply

44. There is no single way of measuring customers' engagement with the supply of their energy. We therefore consider a range of factors below. These suggest that the level of engagement by some microbusinesses appears to be low. We recognise that there is a spectrum of engagement, and that other microbusinesses do take an active interest in their energy supply contracts. We also note that in general, indicators of engagement among microbusinesses appear to be better than among domestic customers.

45. In this section we consider a variety of indicators of engagement, including: tariff types chosen; time with current supplier, switching between suppliers; search activity and familiarity with current contract. We also draw on internal documents and parties' views. We then discuss possible reasons for lack of engagement (paragraphs 75 to 79).

Tariff types

46. Many customers have actively chosen their current tariffs. However, a substantial minority are on types of tariffs that signify a possible lack of engagement, listed below. For the purposes of this appendix, we refer to these as 'default tariffs'. These tariff types (defined at paragraph 29 above) are:

[48] Profile classes 3-4 include Non-Domestic Unrestricted Customers and Non-Domestic Economy 7 Customers. 'Unrestricted' in this context means a single tariff whatever the time of day (in contrast to class 4) and without a stipulated maximum demand (in contrast to classes 5-8).

(a) auto-rollover tariffs;

(b) evergreen tariffs;

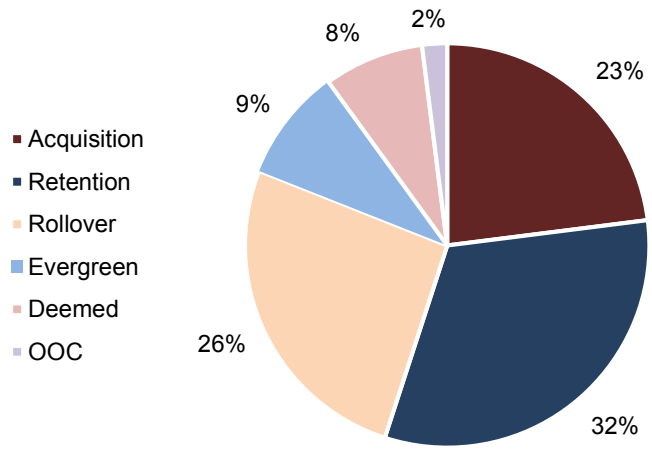
(c) deemed tariffs; and

(d) OOC.

47. Customers on these tariff types are not necessarily less engaged: for example, a customer may prefer the flexibility of an evergreen contract; or may be on an OOC tariff on a transitory basis while in the process of changing supplier. However, as we report below (paragraph 172), we have found that prices are generally significantly higher on these tariff types, and so we view spending more than transitory periods on them as a sign of a possible lack of engagement.

48. Figures 9 and 10 below show the split of tariff types in 2013 for customers treated by suppliers as microbusinesses. In electricity, 45% of microbusinesses were on default tariffs. The largest proportion of these were on rollover[49] contracts (26% of microbusinesses). The picture was similar in gas – 49% of microbusinesses were on default tariffs. Again, the largest default tariff type was rollover contracts (23% of microbusinesses).

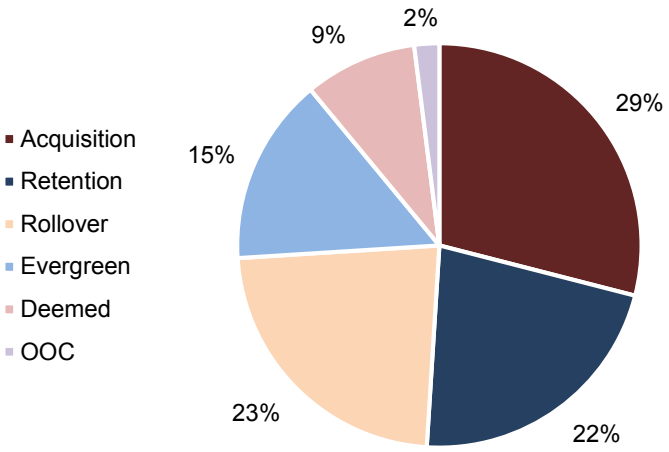
Figure 9: Tariff types for microbusinesses on 1 April 2013 – electricity



Source: Ofgem (2014), *Proposals for non-domestic automatic rollovers and contract renewals*, p41.

[49] By 'rollover' we include all tariffs that customers are rolled over onto by default. This includes, but is not limited to, auto-rollovers. For example, a customer could be rolled over onto an evergreen contract, or a fixed-term contract with an exit clause.

Figure 10: Tariff types for microbusinesses on 1 April 2013 – gas



Source: Ofgem (2014), *Proposals for non-domestic automatic rollovers and contract renewals*, p41.

49. We note that this data was from two years ago. However, we have also received updated information from the Six Large Energy Firms on the split of tariff types, across SMEs as a whole, rather than just those treated as microbusinesses. As Figures 11 and 12 show, this suggests that the pattern above is still broadly correct: default tariffs represent just under half the SME markets (although proportions vary between suppliers).

Figure 11: Tariff types for small and medium-sized enterprises – electricity

[✂]

Source: Parties' data, CMA analysis.
Note: [✂].

Figure 12: Tariff types for small and medium-sized enterprises – gas

[✂]

Source: Parties' data, CMA analysis.
Note: see figure above.

50. Based on information provided by suppliers, we also looked at the proportion of volumes supplied through acquisition tariffs in each consumption band. In gas, there was no pattern of larger customers being more likely to be on acquisition tariffs (which would be a potential sign of engagement) than smaller customers. The pattern was slightly different in electricity, with several of the Six Large Energy Firms supplying a greater proportion of their larger SME customers through acquisition contracts than their smaller customers.[50] However, this did not generally apply to the independent suppliers we studied.

[50] For some of the Six Large Energy Firms, larger electricity customers were also less likely to be supplied through default products than smaller customers. Not all suppliers were able to distinguish between retention and rollover products, so we are not able to look at this for all suppliers.

Time with current supplier

51. We have data on the length of time that SME customers have been with their current supplier, for five of the Six Large Energy Firms. A customer that stays with a supplier for a long time could be satisfied with the tariff offering and service provided. This customer may also have actively switched between tariffs from the same supplier. However, it is also possible that this customer has remained with the same firm due to inertia.

52. Drawing on information provided by suppliers, we look at customers that have been with one of the Six Large Energy Firms for six years or more.[51] In electricity, the proportion of SME customers that have not switched supplier in at least the past five years is up to around 50% (EDF Energy, SSE).[52] In gas, only 16% of EDF Energy's SME customers have been with it for six or more years, compared with around half of Centrica's SME customer base.[53]

53. Some customers have been with the same supplier since privatisation. E.ON told us that 7.6% of its SME customers in January 2015 were 'legacy' customers who had not switched supplier, not changed location and were not a new connection. [✂]. RWE's data showed that [✂] of its electricity meters were on its evergreen tariff for customers who had not changed tariff since privatisation. However, some of these legacy customers may still display interest in energy.[54] The proportion of customers on evergreen tariffs (many of whom have never switched supplier or tariff) is relatively low – this was 9% in electricity and 15% in gas (according to figures 11 and 12 above).

54. E.ON provided information that allowed us to segment its customer base by current tariff and the number of years spent with E.ON.[55] This showed that there were significant differences between tariffs. For example, a large proportion [✂]% of E.ON's evergreen customers[56] in profile classes 3 and 4 had spent at least [✂] with it. In contrast, only a small proportion ([✂]) of deemed customers in profile classes 3 and 4[57] had been with E.ON for this long (and would not necessarily have been on a deemed tariff for that amount of time). Half of deemed customers had been with E.ON for [✂].

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[51] Not all parties were able to report the equivalent statistic for longer periods than six years.
[52] Note that the figure for one of these suppliers was based on a simple average across the 14 regions. The weighted figure for GB will be requested from the supplier and may differ from this simple average.
[53] These figures can be higher for individual regions. In electricity, the highest proportion not switching supplier in at least the past five years was around 85% (SSE in South Wales). The equivalent for gas was around 60% (Centrica in London).
[54] RWE told us that some of the customers it has had since privatisation contacted it more than 30 times in the past three years.
[55] This shows the total time that a customer has spent with E.ON, rather than the time spent on its current tariff.
[56] Tariff named BEP.
[57] Tariff named Electric Deemed.

Switching

55. Switching supplier is one measure of customer engagement, and helps to exert competitive pressure on suppliers. Below, we look at the extent to which microbusinesses have switched supplier, first in the past year, and then over a longer period. The evidence suggests that some microbusinesses are not switching (even over a five year period).

56. Switching is a useful indicator of engagement. However, we need to place the statistics in context.

    (a) Many SME contracts were longer than one year – meaning that a customer on a fixed-term contract would be unable to switch every year. Looking across suppliers at the end of 2014, the median proportion of acquisition contracts longer than one year was over 70% in both gas and electricity. However, Ofgem research has estimated that on 1 April 2013, 23% of microbusinesses were on acquisition tariffs for electricity, and 29% for gas.[58] This still suggests that a clear majority of microbusinesses had not switched in the past year.

    (b) A 2013 survey carried out for Ofgem asked for the reasons why customers had not switched during the past 12 months. 69% of microbusinesses that had not switched said that they were satisfied with their current supplier. The next most important reason given was that the level of savings was not sufficient to justify switching (43% of microbusinesses).[59,60] This is a reminder that choosing not to switch may be a positive decision by a customer rather than a sign of disengagement. In Ofgem's 2014 survey, only 19% of SMEs who had not switched in the previous 12 months cited 'It was too complex and time consuming to find a new tariff or supplier' as a reason for not switching.

Switching within the past year

57. We have made a number of observations about switching among microbusinesses:

    (a) 20% of businesses with one to four employees and 24% of businesses with five to nine employees switched supplier in the past year (according

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[58] Ofgem (2014), *Proposals for non-domestic automatic rollovers and contract renewals*, p41.
[59] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p46.
[60] The 2014 survey carried out for Ofgem indicated that this reason was less important. For both companies with 1–4 employees, and companies with 5–9 employees, 18% said that they did not believe switching would result in significant savings. (BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p43).

to a 2014 survey for Ofgem).[61] (These categories both fall within Ofgem's microbusiness definition).

(b) This level of switching among microbusinesses is higher than the level found in the domestic markets.[62]

(c) However, switching among microbusinesses is lower than among larger SMEs.[63] The pattern of microbusinesses being slightly less likely to switch than other non-domestic customers was also noted in a survey for Ofgem in 2013.[64] This survey found that 14% of microbusinesses had switched energy supplier in the previous 12 months.[65] In comparison, 18% of small businesses and 19% of medium-sized and large businesses reported switching supplier in the previous year.[66]

(d) Switching among microbusiness energy customers is comparable to the switching rate among small business insurance customers. Datamonitor reported in 2013 that 21.2% of microenterprises switched their insurance provider at their last renewal.[67]

(e) The reported switching rate for microbusinesses increased between the two surveys carried out for Ofgem. Some suppliers also told us that there had been an improvement in engagement over the past few years. E.ON said that the churn rate of its SME customers increased from [✂] in 2010 to [✂] in 2014. Centrica said that the proportion of its SME customers who negotiated at renewal or switched had increased from 39% in 2009 to 54% in 2013.

58. There are a number of potential explanations for the increase in switching between June–August 2013 and September–November 2014 (the dates when the two sets of survey fieldwork were carried out). These could include:

(a) **Several suppliers ending the use of auto-rollovers.** However, some of the major suppliers had not yet stopped rolling customers over during this period.[68]

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[61] BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p37.
[62] TNS BMRB (2014), *Retail Market Review baseline survey: report prepared for Ofgem*, p10.
[63] BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p37.
[64] There were various differences between the two surveys – in particular, the 2014 survey did not include medium and large businesses. The two surveys also structured questions in different ways.
[65] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p42.
[66] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p42.
[67] Datamonitor (2013), *Switching on the rise in SME insurance.*
[68] RWE stopped automatically rolling over customers in November 2014. Scottish Power stopped adding the auto-rollover term to contracts sold to existing customers from April 2014. Scottish Power first moved customers onto its replacement product in February 2015.

(b) **The introduction of the non-domestic Retail Market Review reforms,** such as the requirement to put contract end dates on bills.[69]

(c) **Increased broker activity targeting small businesses** (see paragraph 103).

(d) **Increased media and political interest in energy.** There was a large spike in domestic switching in autumn 2013.[70] Similar factors (as in the domestic markets) might have raised microbusiness customers' awareness of energy and encouraged them to switch.

59. We do not have sufficient evidence to determine which (if any) of these explanations was responsible for the increase in switching. It is possible that a combination of factors contributed to the result.

Switching over a five year period

60. Despite the increase in switching, there is a proportion of microbusinesses that have not switched supplier over the past five years. The 2014 survey reported that 39% of businesses with one to four employees, and 28% of businesses with five to nine employees had not switched supplier over the past five years.[71]

61. The 2013 survey covered a wider range of non-domestic customers than the 2014 survey, so is not directly comparable. This survey indicated that the percentage who had not switched in the previous five years varied by customer size. 41% of microbusinesses[72] reported that they had not switched supplier over the past five years, while a further 19% were unsure how many times, if at all, they had switched supplier. The percentage of larger businesses reporting that they had not switched over the past five years was lower, falling to 19% for the largest businesses surveyed.[73]

Contract search activity

62. Customers may display a degree of engagement by considering whether to change their contract, even if they do not end up switching. A 2014 survey for Ofgem found that half of businesses with one to nine employees had looked

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[69] Paragraph 36 above.
[70] DECC (2015), Transfer statistics in the domestic gas and electricity markets in Great Britain.
[71] BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p36.
[72] Defined in relation to the number of employees.
[73] However, the proportion of large businesses that were unsure about their number of switches in the past five years was higher than for microbusinesses, at 32%. (The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p41).

into switching supplier or changing their contract within the past year.[74] This is higher than the proportion who switched.

63. This search activity may involve obtaining a number of quotes. Microbusinesses and small businesses that switched or considered switching supplier in the past five years obtained quotes from three suppliers on average.[75]

64. However, there was a proportion of customers who had never considered switching. This varied by customer size, with 26% of businesses with zero employees (ie owner-operators) having never considered switching, compared to 10% of businesses with ten to 49 employees.[76]

Familiarity with contracts

65. Given that the majority of businesses are on fixed-term contracts, it is important for them to know their contract expiry date. Knowledge of the expiry date of a supply contract may be a sign of engagement.[77]

66. A survey conducted by Cornwall Energy in 2013 estimated that among all business respondents, over a fifth of respondents (22%) did not know their contract expiry date. Slightly more microbusinesses were unaware of the date than larger businesses.[78]

67. However, the 2013 survey carried out for Ofgem found that only 13% of microbusinesses on fixed-term contracts did not know or were unsure of their contract end date. This was identical to the proportion across all non-domestic customers.[79] The 2013 survey also reported that 63% of microbusinesses and small businesses with a fixed contract knew (exactly or approximately) when they could start renegotiating their contract or give notice of termination.[80]

68. As noted in paragraph 36 above, Ofgem introduced a new requirement in March 2014 for suppliers to put on bills the last date to give notice of termination. This may have had an effect – the 2014 survey reported the proportion of microbusinesses and small businesses that knew when they

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[74] BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p29.
[75] Either directly or using a broker. BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p38.
[76] BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p38.
[77] However, Centrica said that a customer knowing its contract end date might be less important if it was not subject to an auto-rollover term. This is because the customer would be able to give notice at a later point in time, rather than being placed on another fixed-term contract.
[78] Cornwall Energy (2013), *Business and broker interaction in the energy market*, pp7–8.
[79] The Research Perspective and Element Energy (2013) *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p35.
[80] BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p32.

could start renegotiating or give notice of termination had increased from 63% to 73%.[81]

Internal documents

69. Internal documents from some suppliers recognise a lack of engagement among some customers, and note that this is particularly the case for smaller/lower consumption businesses.

70. [✂].

Figure 13: [✂]

71. [✂].

Figure 14: [✂]

72. Another E.ON document from 2012 said that one characteristic of the SME markets in 2012 was 'High proportion of customer base inert and choose not to shop around for the best price on a regular basis'.

Views from parties

73. Following the working paper, some parties agreed that engagement was lower for certain groups of microbusinesses. EDF Energy told us that there were differences in engagement between different sizes of customers. [✂]. Good Energy said that microbusinesses had similar engagement issues to domestic customers.[82]

74. In contrast, RWE disagreed that there was a problem with engagement. For example, RWE said that [✂]. Opus said that switching rates for small businesses depend on the priority they give to this activity, given other demands on their time. E.ON said that engagement was increasing, partly as a result of actions it was taking.[83] Centrica also said that engagement was increasing, and disagreed that engagement was low. SSE told us that engagement was not low.

Reasons for limited engagement

75. There are several possible reasons for low engagement by some microbusinesses. We discuss one of these (lack of transparency) in more

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[81] BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p32.
[82] Good Energy (2015), *Response to updated issues statement*, p6.
[83] E.ON (2015), *Response to updated issues statement*, pp49–50

detail in the section below (starting at paragraph 82), and we consider some other potential factors in this section. The points in paragraphs 76 to 78 were identified in a report for the FSB looking at small business customers across sectors.[84]

76. As noted in paragraph 12 above, microbusinesses spend less on energy in absolute terms than larger businesses. Energy represents a similar proportion of total business costs for microbusinesses compared to that for other non-domestic customers (paragraph 14 above). Microbusinesses may therefore have a lower incentive to engage in the energy markets than larger businesses, given that the absolute benefits from engagement are smaller.

77. The opportunity costs of engaging with the purchase of energy may also be higher for microbusinesses than for larger businesses. A microbusiness may not have spare staff time to use on non-core activities.

78. Microbusinesses, like domestic customers, may also have limited knowledge about the energy markets. In comparison, a larger non-domestic customer is more likely to have staff with specialist knowledge or procurement skills. In the 2013 survey conducted on behalf of Ofgem, more microbusinesses were dissatisfied with the ease of understanding offers available compared with larger businesses (24% of microbusinesses, compared with 17% of medium-sized businesses and 21% of large businesses).[85]

79. Another possible reason for low engagement could be the change of supply process (this sits between a customer signing a contract with a new supplier and being transferred over to the new supplier). A bad experience at this stage of the switching process may be a deterrent to future engagement. However, research has shown that microbusinesses and small businesses tend to be more concerned about earlier stages of the switching process such as choosing a contract, rather than the change of supply process itself.[86] This suggests that the change of supply process may not be a barrier to engagement.

Summary – engagement

80. Based on the evidence above, we can see that some microbusinesses do engage in choosing their energy contracts. We also note positive signs of a

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[84] Amelia Fletcher, Antony Karatzas and Antje Kreutzmann-Gallasch (2014), *Small businesses as consumers: are they sufficiently well protected? A report for the Federation of Small Businesses*, p7.
[85] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p53.
[86] Collaborate Research (2013), *Non-domestic consumers and the Change of Supply (CoS) process: qualitative research findings* (report for Ofgem), p5.

recent increase in switching between suppliers (although we are unsure of the cause of this).

81. However, we remain concerned that some microbusinesses appear to show limited engagement. Given that outcomes are significantly worse for customers that do not engage and end up on default tariffs (see paragraph 172), this suggests that engagement is important.

Transparency

Approach to pricing

82. In general, prices for business customers are negotiated individually and rarely published by energy suppliers. Many suppliers publish their deemed contract prices and some publish other variable contracts, but we understand these are unlikely to be the best deals in the market. Overall, this creates a lack of transparency (in an internal document from 2014, E.ON described the SME markets as a whole as 'increasingly complex & opaque'). However, suppliers are increasingly offering online quote services for some fixed-term contracts.

83. There are a number of potential consequences from a lack of transparency. Customers with less visibility of market prices may be less likely to try to switch supplier or tariff, as they may not be aware that there are better deals available. For customers that do decide to investigate their options, a lack of transparency may increase their search costs.[87] If a customer ends up in a negotiation with a supplier, it may be in a weak position if it has limited knowledge of its other options in order to benchmark offers.[88] For example, a new microbusiness may begin its energy supply with a deemed tariff – which tends to be high, as we discuss further below – and use that as a starting point for its expectation of an agreed tariff. With greater transparency, the business would expect an agreed tariff to be substantially lower than the deemed tariff.

84. The lack of transparency of pricing applies across the SME markets, and is therefore not specific to microbusinesses. However, when coupled with lower levels of engagement and possible barriers to engagement for microbusinesses, there may be a larger effect on microbusinesses.

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[87] RWE said that it would take [✂] for a potential customer to get a tailored quote from RWE. However, we note that getting quotes from multiple suppliers would still be time-consuming.
[88] Several suppliers noted that competitor quotes could play a role in negotiations. For example, Centrica told us that 'During discussions with the sales agent the customer can negotiate a lower price, factors we will consider are competitor prices…' RWE said that [✂].

85. It is possible that there are some advantages to a system that develops quotes for each customer. For example, this may allow a supplier to factor in the credit risks associated with supplying a customer and thus avoid adverse selection issues.[89] It may also allow the supplier to vary different contract aspects which might have mutually beneficial outcomes. EDF Energy told us:

> The customer will then be able to negotiate this price if they are willing to fulfil requirements that reduce cost or risk to EDF Energy, with the most relevant factors including clearing outstanding debt, signing up for online billing and service, providing up to date contact information, as well as product type, contract length and payment method.

Comments from parties

86. Some parties agreed with the view that transparency was an issue for microbusinesses. Scottish Power said that in the SME markets 'the level of transparency in terms of offerings in the market is considerably less than in domestic'. E.ON also told us that transparency was lower in the SME markets than the domestic markets.[90] EDF Energy said it agreed that lack of transparency was an issue.[91] The FSB told us that two-thirds of its members said they found it difficult to compare prices and tariffs. The FSB also said that 'energy contract terms and conditions are too complicated to understand and compare.'[92] It told us that the lack of published prices was making it more difficult for small businesses to search and to switch supplier.[93] Ofgem said that there was a lack of published prices.[94] It said that 'For smaller businesses with few resources and limited knowledge of the energy market, it could be difficult and time-consuming to search for the best contract.'[95]

87. Other parties disagreed that transparency was a problem. For example, RWE said that customers had sufficient information to engage in the market, and that there were no significant barriers to search. SSE also disagreed that

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[89] If a supplier set prices without reference to a customer's credit risk, its offer might be attractive to customers with high credit risks. This could lead it to gain a disproportionately large number of these consumers, which would have a consequential impact on the supplier's costs.
[90] E.ON (2015), *Response to updated issues statement*, p51
[91] EDF Energy (2015), *Response to updated issues statement*, p10
[92] Federation of Small Businesses, Response to Issues Statement, p3.
[93] Federation of Small Businesses, Response to Issues Statement, p4.
[94] Ofgem, Initial Submission, 21 July 2014, p68.
[95] Ofgem, Micro-Business Consumers Memo, p3. A quarter of microbusinesses and a fifth of small businesses that had not switched in the previous 12 months reported that it was too complex and time-consuming to find a new tariff or supplier to switch to (The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p46).

transparency was hindering engagement by microbusinesses. Centrica told us that microbusinesses had good access to prices from suppliers.[96]

Online quotes from suppliers

88. The Six Large Energy Firms and some other suppliers do offer online quote services, with some starting to provide these recently, meaning that the effects may not show up in our data on outcomes.

    (a) Centrica said that it introduced an online quote facility in March 2015, which allowed a customer to get a quote in two minutes.

    (b) EDF Energy said that it launched an online quote facility in February 2015.

    (c) E.ON told us that it received up to [✂] visits a month to its online quote page, although under [✂] of these convert into sales.

    (d) RWE has a quote facility on its website.[97] However, this may not offer the cheapest prices. RWE told us that its online prices were [✂].

    (e) Ovo publishes contract rates for SMEs on its website.[98]

    (f) Gazprom,[99] SSE[100] and Scottish Power[101] also offer online quotes.

89. The offering of simple online quotes should be positive for transparency and ease of engagement, as long as customers know that this is available. To the extent that this has developed recently, it is hard for us to investigate whether it is improving outcomes for customers.

TPIs and PCWs

90. One way of overcoming a lack of transparency is to receive assistance from an intermediary. PCWs help domestic customers to compare offers from different suppliers. TPIs (also commonly referred to as brokers) are important for larger businesses participating in the retail energy markets. However, there are limited PCW services available to microbusinesses, while there are issues with the activities of some TPIs.

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[96] Centrica (2015), *Response to updated issues statement*, p25.
[97] npower website.
[98] Ovo Energy business price list.
[99] Gazprom business electricity website.
[100] SSE business energy website.
[101] Scottish Power business energy website.

91. We discuss PCWs specifically in the next section (from paragraph 138). This section therefore focuses primarily on TPIs. We introduce the role of TPIs, and describe how they are used by microbusinesses. We then discuss the conduct of TPIs, and their commission arrangements.

Role of third party intermediaries

92. TPIs act as intermediaries between non-domestic customers and energy suppliers. Ofgem estimates that there are over 1,000 TPIs operating in the SME energy markets, from large organisations to individual advisers, receiving around £200 million of revenue a year from fees and commissions. TPIs operate a range of business models. For example, they may present offers from a range of suppliers, represent one particular supplier or multiple suppliers and/or offer energy advice to customers.[102] TPIs may also seek to provide a wider range of services, such as advising on energy efficiency. There are also some very small-scale examples of collective switching schemes for small business energy customers.[103]

93. TPIs are an important route to market for suppliers. As noted in paragraph 31 above, TPIs represented 30% of non-domestic sales by the Six Large Energy Firms in 2013. The proportion of acquisitions through TPIs was higher for some of the Six Large Energy Firms – [✂].New suppliers rely heavily on TPIs as their main sales channel.[104] If this sales channel was not working effectively, this could therefore have a particular impact on smaller suppliers.

Usage of third party intermediaries

94. Broker usage may vary by size of business. The 2014 survey carried out for Ofgem reported that 25% of businesses with one to nine employees used a broker as their main source of information when choosing their current contract. Small businesses (ten to 49 employees) were more likely to use a broker – 37% of them gave this as their main source.[105]

95. In the 2014 survey, after adding in PCWs and telephone services, 39% of businesses with one to nine employees reported that their main source was either a broker, a PCW, or telephone service.[106]

96. Centrica told us that some microbusiness customers would use a TPI to obtain information, but then contact a supplier directly. Centrica said that this

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[102] Ofgem (2014), *Proposals for regulating non-domestic third party intermediaries (TPIs)*, p9.
[103] Switch Hampshire (2015), *End of scheme report*, p14.
[104] Ofgem (2013), *Third Party Intermediaries: exploration of market issues and options*, p14.
[105] BMG Research (2015), *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), p49.
[106] BMG Research (2015), *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), p49.

could lead to the statistics underreporting the use of TPIs by microbusinesses. This point may have been addressed by the survey questions, which asked about customers' main source of information.

97. The 2013 survey conducted for Ofgem suggested that microbusinesses are less likely to have used TPIs than larger businesses.[107] 11% of microbusinesses said they had chosen their current energy contract with the help of a broker, compared with 21% of medium-sized businesses and 23% of large businesses.[108,109] Microbusinesses were more likely than larger customers to use information directly from suppliers.

98. It appears that TPIs have a greater role for large businesses. EDF Energy told us that around 80% of the whole Great Britain I&C electricity customer base[110] use TPIs. Some TPIs (consultants) also provide a wider range of services to large business, such as energy management and reporting.[111]

Reasons for lower usage of third party intermediaries among smaller non-domestic customers

99. There are two reasons why smaller businesses may be less likely to use TPIs. The first is that TPIs may focus more on larger customers. The second is that many smaller customers distrust TPIs. We discuss these in turn.

TPIs targeting larger customers

100. It appears that TPIs are more likely to contact larger businesses:

(a) On being asked what best described the switching process (either to a new supplier or a new contract with their existing supplier) 25% of larger businesses reported having been approached by a broker or a switching site, while just 13% of microbusinesses were contacted.[112]

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[107] As noted at footnote 64, there were various differences between the customer base in the 2013 and 2014 surveys.
[108] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p31.
[109] We should be cautious about concluding that use of brokers has increased, based on the results of the two surveys. The 2014 figures may reflect a different way of classifying sources as brokers or switching sites. In the 2013 survey, 41% of microbusinesses said that they had chosen their current contract using either a broker or a switching site (either online or over the phone). (The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p31).
[110] These customers may be larger than those referred to as large businesses by the 2013 survey in the paragraph above.
[111] Cornwall Energy (2011), *Brokerage services for micro-business energy consumers*, report for Consumer Focus, p10.
[112] Cornwall Energy (2013), *Business and broker interaction in the energy market*, p9.

(b) Larger businesses were also more frequently contacted by brokers. Among businesses that had been approached by brokers, larger businesses recalled on average 15 approaches in the last year, compared with small businesses and microbusinesses that recalled an average of nine to 12 approaches respectively.[113]

101. Suppliers gave different views on which customers were targeted by TPIs. EDF Energy told us that TPIs were more interested in customers with an annual electricity consumption of over 20 MWh. However, RWE said that, in its experience, TPIs covered all sizes of non-domestic customers, including microbusinesses.

102. TPIs may prefer to focus on larger business customers because they can earn more commission. This may be proportional to consumption or spend, rather than a flat rate per switch. For example, Centrica told us that commission could be in the form of pence per day (as part of the standing charge), pence per kWh (unit rates) or as a percentage of standing charge and unit rates. E.ON said that 'The unit rate charged to the customer is then the base price plus the commission rate.' However, [✂] (a TPI) told us that its aim was to sign up as many customers as possible, whatever their size.

103. The 2014 survey did not provide a breakdown of the number of approaches by business size. However, for microbusinesses and small businesses combined, it reported an average of 28 approaches by brokers in the last year.[114] This is a substantially higher figure than reported in the 2013 survey.[115] Only 15% of customers covered by the 2014 survey said that they had not been contacted by a TPI in the past year.[116]

104. This increase in approaches could reflect a change in broker interest in these customers. E.ON told us that TPIs were increasingly active for smaller business customers.[117] Ofgem also reported feedback it had received about increases in broker activity in the SME markets. This has included increasing staff numbers, and reduced TPI margins as a result of increased competition.[118]

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[113] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p57.
[114] BMG Research (2015), *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), p50.
[115] We repeat the caveat that this may reflect methodological differences between the surveys.
[116] BMG Research (2015), *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), p51.
[117] E.ON (2015), *Response to updated issues statement*, paragraph 274.
[118] Ofgem, CMA meeting: further information on non-domestic TPI project (slidepack), 12 March 2015, p7.

Smaller customers distrusting TPIs

105. The lower use of TPIs among microbusinesses may also be explained by the less positive views about TPIs among microbusinesses compared with larger businesses. In Ofgem's 2013 survey, 32% of microbusinesses held a broadly positive view of energy brokers, compared with 43% of small businesses, 53% of medium businesses and 55% of large businesses.[119] (14% of microbusinesses responded 'don't know'.)

106. The equivalent question in Ofgem's 2014 survey found that only 20% of businesses with one to nine employees had a positive view of energy brokers. This was lower than the figure for small businesses (28%). In general, it appears that the proportion of microbusinesses and small businesses with a positive view of energy brokers fell between 2013 and 2014.[120]

107. These less positive perceptions may be the result of the sales approaches of certain TPIs. The FSB told us that there was a general lack of trust or confidence in TPIs, often based on poor previous customer experience or the aggressive sales approach carried out by some.[121] Of businesses that had been approached by a broker in the last year, microbusinesses were more likely than larger businesses to disagree that the broker had a professional tone, clearly identified themselves and provided accurate information about the services offered. However, of businesses that had used brokers, 80% were satisfied with the overall service provided.[122]

108. Other evidence from a survey by Cornwall Energy supports this, showing differing attitudes towards brokers between businesses of different sizes. It found that microbusinesses were less likely to agree that 'energy brokers make me better informed and able to make better choices in this area' than larger businesses (40% compared with 56%) and more likely to disagree with the statement (29% compared with 14%).[123]

109. The 2014 survey reported that only 12% of microbusinesses and small businesses who had consulted a broker (but not used them) had a positive view. This was similar to the figure for those who had not used a broker at all (14%).[124] However, 41% of those who used a broker had a positive view. This

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[119] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p56.
[120] BMG Research (2015), *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), pp57–58.
[121] Federation of Small Businesses, Response to Issues Statement, p4.
[122] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p61. (Note that the last statistic did not segment businesses by size.)
[123] Cornwall Energy (2013), *Business and broker interaction in the energy market*, p12.
[124] BMG Research (2015), *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), p57.

suggests that low positive views of TPIs are not solely held by customers with no experience of dealing with TPIs.

110. Broker usage may also be driven by differing levels of proactive interest by customers of different sizes. A TPI (Make It Cheaper) told us that 9% of its inbound enquires were from customers with an annual electricity consumption under 5 MWh. We do not have exact comparator data for the proportion of these customers – but Elexon data from 2013 indicated that 40% of non-domestic non-half hourly meters had annual consumption below this level.[125] This suggests that the smallest customers may be less likely to contact TPIs. Make It Cheaper noted that the smaller customers who do use its service display similar levels of satisfaction (eg based on Net Promoter Score) as other microbusinesses.[126]

Conduct of TPIs

111. There have been long-standing concerns about the behaviour of some TPIs, which have been documented by Ofgem and others, leading to Ofgem considering introducing a code of conduct (see below). These issues are generally felt to apply to a minority of TPIs.[127] This section looks at conduct by TPIs – we cover the specific issue of commission in the next section.

112. Consumer research conducted for Ofgem has indicated a variety of issues with TPIs.

(a) A 2012 study by Opinion Leader found some concerns about TPIs misrepresenting themselves as a customer's existing supplier or TPI. [128]

(b) Research from 2011 by Harris Interactive said customers felt they were subject to pressure sales techniques to encourage an immediate sale.[129]

(c) In 2012, Insight Exchange reported that customers had identified 'a series of unscrupulous behaviours.' In addition to the points above, this research

[125] CMA analysis based on Elexon data, for profile classes 3 to 8. This statistic will overstate the number of customers in this volume band, as some meters will belong to multi-site customers whose total volume is in a different volume band.
[126] Make It Cheaper told us that customers with electricity consumption of <5 MWH gave an NPS rating of 64, customers with consumption between >5 MWH and <15 MWH gave an NPS of 62, and customers with consumption between >15 MWH and <25 MWH gave an NPS of 64.
[127] Eg, Energy UK (2014), *Ofgem's proposals for regulating non-domestic Third Party Intermediaries (TPIs) – Energy UK response*, p2.
[128] Opinion Leader (2012), *Research findings on the experiences of non-domestic customers*, report for Ofgem, p24.
[129] Harris Interactive (2011), *Small and medium business consumers' experience of the energy market and their use of energy*, report for Ofgem, p24.

mentioned TPIs trying to confuse customers, and presenting partial evidence in disputes.[130]

113. Cornwall Energy produced a report on TPIs for Consumer Focus in 2011. Looking at data from September 2010, it found that over half of complaints by microbusinesses to the Consumer Direct service related to TPIs.[131] These complaints included instances of TPIs claiming to be acting for official purposes, making statements such as 'you have to register your meter with us' or saying it was 'working on behalf of Ofgem.'[132]

114. Issues mentioned in this report have also been mentioned elsewhere. Complaints about TPIs have also been made to Citizens Advice and the Energy Ombudsman, as well as to Consumer Focus.[133] Citizens Advice told us that it had concerns about the behaviour of brokers in the SME markets). The issue of TPIs claiming to provide meter registration has been reported, including by the BBC after an investigation.[134]

115. Suppliers have also identified issues with TPIs:

(a) Good Energy said that it had seen numerous occasions of Good Energy microbusiness customers being misled by brokers.[135]

(b) RWE gave examples of bad practices carried out by a minority of TPIs. These included cancelling customers' contracts without their permission, making 'misleading claims', and being unclear about which suppliers they represent.

(c) In response to an Ofgem consultation, Centrica said that some TPIs misled customers by claiming they covered all suppliers. Centrica also said some TPIs had provided false documents in the change of tenancy process.[136]

116. TPIs have also raised concerns about the behaviour of some other TPIs. Insight Exchange had discussions with TPIs, who mentioned the existence of

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[130] Insight Exchange (2012), *Research into the proposed Standards of Conduct: non-domestic customers*, report for Ofgem, p14.
[131] Cornwall Energy (2011), *Brokerage services for micro-business energy consumers*, report for Consumer Focus, p16.
[132] Cornwall Energy (2011), *Brokerage services for micro-business energy consumers*, report for Consumer Focus p16.
[133] Ofgem (2013), *Consultation: GEMA gaining enforcement powers under The Business Protection from Misleading Marketing Regulations (SI 2008/1276)*, pp4–5.
[134] BBC, *5 Live Investigates – Commercial Energy*, broadcast 22 April 2012.
[135] Good Energy (2015), *Response to updated issues statement*, p6.
[136] Centrica (2013), *Response to Consultation on Ofgem gaining enforcement powers under the Business Protection from Misleading Marketing Regulations*, p3

some 'cowboy operators.'[137] Make It Cheaper told us that there were particular issues related to businesses moving premises. It said that there have been reports of bad sales practices and large volumes of sales calls.

Poor behaviour by certain TPIs may reduce trust in TPIs more generally, and lead to customers being less engaged. E.ON said that it introduced its own code of conduct in 2012, due to concerns about the conduct of a small minority of TPIs, potentially undermining trust in TPIs as a whole.[138] SSE also said that poor behaviour by TPIs could lead to lower engagement.[139] The FSB said that there was a general lack of trust or confidence in TPIs, often based on poor previous customer experience or the aggressive sales approach carried out by some.[140] Insight Exchange quoted a TPI saying that 'There are now an awful lot of buyers who are suspicious of everybody and therefore it's that little bit more difficult to gain their trust.'[141]

117. This type of concern has been raised in other sectors. In its report on the energy efficiency sector, the OFT made similar suggestions that poor sales practices by some firms could harm consumer confidence and limit growth.[142]

Commission and incentives for TPIs

118. Many parties raised concerns about the commission paid to TPIs. Some of these were expressed as general concerns about a lack of transparency of TPI commissions.[143] Where details were given, the concerns fell into two broad areas: the impact on commission levels, and the impact on TPIs' incentives to sell particular products.

119. Before setting out these potential issues, we first provide some background on how commission works in this area.

Background on commission

120. Opus told us that the most common structure was for commission to be added to the per unit rate set by the supplier. In this case, the non-domestic customers' bill would show only a total price that included this commission, with the supplier passing on the relevant portion to the TPI. In other cases the

[137] Insight Exchange (2012), *Research into the proposed Standards of Conduct: non-domestic customers*, report for Ofgem, p30.
[138] E.ON (2015), *Response to updated issues statement*, paragraph 288.
[139] SSE (2015), *Response to updated issues statement*, paragraph 8.13.15.
[140] Federation of Small Businesses, Response to Issues Statement, p4.
[141] Insight Exchange (2012), *Research into the proposed Standards of Conduct: non-domestic customers*, report for Ofgem, p30.
[142] OFT (2012), *Energy efficiency – empowering customers, encouraging growth*, OFT 1472, p11.
[143] Eg Centrica; First Utility (2015), *Response to updated issues statement*, p46; RWE [✂].

final unit price might be set by the supplier, with a portion of this being paid to the TPI as commission.

121. This process does not seem to be well-understood by non-domestic customers. The 2014 survey reported that only 5% of microbusinesses and small businesses that had used a broker reported that they had been charged for this service. The survey commented: 'That so few respondents are aware indicates a lack of clarity of the cost of broker services'.[144]

122. Ofgem told us that smaller non-domestic customers might only use one TPI (single homing).[145] If this is the case, when coupled with a lack of understanding of the way TPIs earn income, this may mean that there is weak demand-side pressure on commission rates.

Commission levels

123. Some parties raised concerns about the levels of commission:

(a) The Energy Shop said it expected that some TPIs would be able to earn very high levels of return due to the lack of transparency.[146]

(b) [✂] A supplier told us that some TPIs charged excessive commissions of 2–3p/kWh.

124. Ofgem said it understood that some suppliers place limits on the amount of commission that TPIs can charge. This is to prevent the supplier suffering reputational damage from the price quoted by the TPI to a customer. The existence of caps on commission was supported by the results of a 2015 request for information by Ofgem issued to six suppliers. This showed that four of the suppliers used commission caps. This use of caps suggests that non-domestic customers themselves are not exerting strong downward pressure on commissions (eg by multi-homing).[147]

Incentives

125. Our concern here relates to customers' expectations of TPIs. If customers expect TPIs to push certain products, or to only present a limited set of options, they can multi-home.[148] If enough customers do that, then TPIs may

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[144] BMG Research (2015), *Micro and Small Business Engagement in Energy Markets* (report for Ofgem), p53.
[145] Ofgem meeting, 12 March.
[146] The Energy Shop (2015), *Response to updated issues statement*, paragraph 5.3.2.2.
[147] Multi-homing occurs when a customer obtains quotes from several different sources. In contrast, single-homing is when a customer only gets quotes from a single source.
[148] In its report for Consumer Focus, Cornwall Energy noted that if several TPIs or suppliers credit checked a customer in a short period, this might reduce the customer's credit score. This might therefore place some

compete effectively and result in good outcomes for most or all customers. However, if customers only use one TPI, which we believe may be the case for many customers[149] – either because of the costs of multi-homing or because they expect to get a 'best of market' offer from the first TPI they speak to – then competition between TPIs may not work effectively.

126. Opacity regarding commissions may exacerbate this. While transparency over the level of commissions is not necessarily a goal in itself,[150] better understanding of commission structures may lead to increased customer engagement and competition between TPIs.

127. Several parties have said that TPIs might face incentives to sell certain products, which would result in non-domestic customers not being offered the most appropriate rates. These incentives fall into two categories: incentives based on the price of the contract, and incentives based on the volume of contracts sold.

128. In relation to price incentives:

(a) In its 2011 report for Consumer Focus, Cornwall Energy said that TPIs might be presenting offers that were not their most advantageous for customers because suppliers were skewing commission payments towards the deals they wanted to sell.[151]

(b) EDF Energy told us that brokers would balance the different commissions earned from various suppliers against the best product or price for the customer.

(c) Scottish Power said that customers should have greater understanding of some broker behaviour (than they do at present). Scottish Power gave the example of the practice of some suppliers in promoting uplift commissions to brokers (in which the higher the price accepted by the customer, the higher the commission earned by the broker).[152]

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limitations on a customer's ability to multi-home. (Cornwall Energy (2011), *Brokerage services for micro-business energy consumers*, report for Consumer Focus, p18).

[149] See paragraph 122 – this would also be consistent with the lack of awareness of TPI charges reported in paragraph 121.

[150] The US Federal Trade Commission carried out a controlled experiment of the effects of commission disclosure on mortgage decisions. It found that a significant proportion of customers thought that the products where commission was disclosed were more expensive, even when they were actually the same price or cheaper than products where commission was not disclosed. (FTC (2004), *The effect of mortgage broker compensation disclosures on consumers and competition: a controlled experiment*).

[151] Cornwall Energy (2011), *Brokerage services for micro-business energy consumers*, report for Consumer Focus, p14.

[152] Scottish Power (2015), *Response to updated issues statement*, p32.

129. In relation to volume, Energylinx for Business told us that some suppliers required the TPI to deliver a minimum number of switches per month, and said that this could encourage TPIs to prioritise offering these suppliers' products, even if these were not the best products for customers. Ovo Energy also told us that commission structures from some suppliers could encourage TPIs to recommend certain products in order to meet particular sales levels that led to higher levels of commission, even though they may not be the best deal for the customer.

130. Suppliers may also try to incentivise TPIs using non-commission incentives such as corporate hospitality. For example, an internal document from a mid-tier supplier ([✂]) showed it was using this technique

131. Some TPIs may choose to present products in a way that is not affected by commission differences, in order to build a reputation. Energylinx for Business told us that for the products where the commission was under its control, it set the same commission for each product, so that this did not adversely influence customer choices. Make It Cheaper also told us that it aimed to receive the same amount of commission from each supplier, and its advisers have no visibility of the commission, so that it could provide unbiased advice. It said that this was part of its proposition to customers, and so this practice would not necessarily apply to all TPIs.

Ofgem's proposals for third party intermediaries

132. Due to concerns about poor customer experience of using TPIs and the potential negative impact on future engagement that this may have, Ofgem has developed a draft code of practice for non-domestic TPIs.[153] The purpose is to build consumer trust and confidence when using TPIs. The draft code of practice sets out standards for TPIs when dealing with customers, such as: including clearer information, fair marketing tactics and effective monitoring and complaints redress.[154]

133. In August 2014, Ofgem proposed that the code should be underpinned by a licence condition on suppliers to work only with code-accredited TPIs.[155] Ofgem has published a further open letter on the project's next steps. It

[153] There are two existing codes of practice – but their coverage is limited. One is operated by E.ON, which is only a single supplier. (E.ON (2015), *Response to updated issues statement*, paragraph 288). The other is operated by the Utilities Intermediaries Association. It told us that its Code of Practice covered 18.5% of the TPI segment in electricity and 11.5% in gas
[154] Ofgem (2013), *Code of practice for non-domestic third party intermediaries* (draft).
[155] Ofgem (2014), *Proposals for regulating non-domestic third party intermediaries (TPIs)*, p4.

intends to take into account the CMA's findings on TPIs in general and any specific effects on microbusinesses and SMEs.[156]

134. Many parties told us that they supported action in this area. Several suppliers told us explicitly that they supported Ofgem's proposal for a code of practice.[157] For example, Centrica said that there would be a clear benefit to customers from the proposed code of practice. Make It Cheaper (a TPI) was also in favour of a TPI code of practice. It said that the requirements for authorisation by the Financial Conduct Authority (FCA) in insurance helped to provide consumer confidence. [✂] (also a TPI) hoped that the code of practice would increase trust.

135. Other suppliers, including EDF Energy, made more general statements in favour of regulation of TPIs.[158] RWE said that it supported the idea of regulation of TPIs, although it said that Ofgem's latest proposals were inadequate and underdeveloped. RWE told us that there should be direct regulation of TPIs based on standards of conduct instead.

136. Ofgem has already gained one tool which it can use to address certain forms of poor behaviour by TPIs. In November 2013, Ofgem acquired powers under the Business Protection from Misleading Marketing Regulations.[159] Ofgem's powers allow it to accept undertakings from or apply for an injunction against anyone carrying out misleading marketing to businesses.[160]

Summary on TPIs

137. TPIs have the potential to help customers engage with energy markets and reach good outcomes. However, this may be undermined if customers do not trust TPIs. Our evidence suggests that there have been long-standing concerns about the conduct of a minority of TPIs; that some TPIs may not offer customers the best tariffs for the customer; and that customers lack information about how they pay for TPIs' services. These issues may not apply to all TPIs, but they may affect customer perception of all TPIs. This may deter the use of TPIs and form a barrier to higher levels of engagement.

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[156] Ofgem (2015), *Next steps on our project for a code of practice for the non-domestic third party intermediary (TPI) sector*.
[157] E.ON (2015), *Response to updated issues statement*, paragraph 289. SSE (2015), *Response to updated issues statement*, paragraph 8.13.15. Scottish Power (2015), *Response to updated issues statement*, p32. Centrica,
[158] Also, Good Energy (2015), *Response to updated issues statement*, p6.
[159] The Business Protection from Misleading Marketing Regulations 2008. (SI 2008 No. 1276). Ofgem was granted its powers under The Business Protection from Misleading Marketing (Amendment) Regulations 2013. (SI 2013 No. 2701).
[160] Explanatory memorandum to the Business Protection from Misleading Marketing (Amendment) Regulations 2013, p2.

Price comparison websites

138. In this section, we focus on specific issues facing firms providing online comparison services. Online comparison services allow a customer to compare prices from different suppliers, without needing separate interaction by phone or in person. A further aspect may be the ability to switch a customer using an online service.

139. As discussed in the price comparison websites appendix, the use of PCWs can reduce search costs for domestic customers by providing a one-stop shop for personalised quotes.[161] PCWs are widely used in the domestic markets. For example, the CMA customer survey reported that, of domestic customers surveyed that had switched energy supplier in the past three years, around two-thirds used a PCW to find information.[162]

140. As acquisition and renewal prices are not generally published in the SME markets, this model of online searching does not apply. Some companies that operate domestic PCWs do offer services to non-domestic customers but in most cases, only through their call centres. We are aware of one non-domestic PCW (Energylinx for Business). Energylinx for Business provides a service through its own website, and also provides the underlying technology to other PCWs ([✂]).

141. As well as being a direct channel for customer switching, PCWs may generally help to make customers more informed. For example, a customer may be able to obtain an online quote as a benchmark for quotes from a supplier or broker. This transparency may help to sharpen competition between suppliers and between TPIs.

142. The question is why PCWs are not more prevalent for non-domestic energy. Harris Interactive reported that there was a demand among respondents for more comparison websites available for the SME gas and electricity markets, so that businesses could compare suppliers more easily online.[163] Energylinx for Business (a PCW) said that online services allowed customers to shop around and compare deals. Several suppliers also told us that there was the potential for PCWs to develop.[164]

143. There may also be firms that could provide a business energy PCW. Some firms operating domestic energy PCWs also provide insurance comparison

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[161] Appendix 8.3: Price comparison websites and collective switching.
[162] Appendix 8.3: Price comparison websites and collective switching.
[163] Harris Interactive (2011) *Small and medium business consumers' experience of the energy market and their use of energy*, report for Ofgem, p22.
[164] Centrica, First Utility (2015) *Response to updated issues statement*, p46.

services to businesses online.[165] [✂] said that it planned to launch a business energy PCW in 2015, using a white label provider and branded comparethemarket.com – although it said that this was subject to the outcomes of work by the CMA and Ofgem. However, a firm which provides other online comparison services to businesses [✂] told us that it had no plans to launch a full online comparison service for business energy. Business energy PCWs already exist in Germany.[166]

Potential challenges for PCWs

144. Various parties told us about potential issues that could make it more difficult to develop a non-domestic energy PCW. We discuss these in turn below. These do not appear to be insurmountable.

Complexity

145. The most common reasons we heard related to the complexity of the SME markets, compared to the domestic markets. We heard this from several suppliers,[167] and this was also supported by our discussions with two firms with experience operating PCWs:

(a) Energylinx for Business told us that the main challenge to the development of non-domestic PCWs was automating the process of receiving information from suppliers and customising it for users. For example, the SME markets had more meter types and tariffs than the domestic markets. However, Energylinx for Business said that its website was now able to deal with most customers.

(b) Make It Cheaper told us that it operated a domestic PCW and that it had built and used price comparison calculators for business customers. It said that both using a PCW and the switching process were more complex for a business customer than for a domestic customer, resulting in low visitor to sale conversion rates (<1%). This was because the business customer would need to provide additional pieces of information, such as its SIC business code, its consumption and its exact contract end date. Make It Cheaper told us that this meant that the conversion rate of visitors to switches was lower than in the domestic markets by a factor of 5. Make it Cheaper also told us that complexity made it difficult to ensure that a quote presented via an online calculator was accurate, compared to speaking to a customer directly. It said that more customers successfully

[165] Eg Compare the Market, Moneysupermarket.
[166] Eg Verivox.
[167] First Utility (2015), *Response to updated issues statement*, p46.

engage in switching when speaking to a call centre rather than self-serving via an online PCW by a factor of 25.

146. However, it is worth noting that suppliers and TPIs also have to deal with similar complexity. Several suppliers told us that they produced price matrices that could be provided to TPIs. Some suppliers also offered online quotes on their own websites (see paragraph 88 above). This suggests that there may not be an insurmountable barrier to developing a system of online quotes.

Inability to provide negotiation

147. Fixed-term contracts in these markets generally offer the possibility of negotiation (either with the supplier or the TPI). A PCW is unable to provide negotiated prices. However, this may not matter as much for smaller customers (for example if their energy needs are likely to be simpler than larger businesses).

Uploading information

148. Energylinx for Business told us that suppliers did not provide price information in a standardised format. It said it had tried in the past to provide suppliers with templates, but suppliers did not use these. This issue was also mentioned in Appendix 8.3 Price comparison websites and collective switching in relation to PCWs in the domestic markets, but may be more complex here given the extra information required and greater number of tariffs.[168]

Cost of advertising

149. Make It Cheaper said that the cost per click (CPC) of buying keywords such as 'business electricity' on Google had increased by a factor of 12 in the past nine years, due to advertiser demand rising fast against low and flat levels of business customer engagement. It said the CPC of domestic energy keywords (£1.57) is almost one tenth of the cost of business energy terms (£14.41). It said this made the economic model for call centre based price comparison challenging, and for online business price comparison unviable. This means that there may be significant costs to reaching non-domestic customers (given that there is limited use of PCWs at present in these markets, it is plausible that a PCW would need to advertise heavily in order to inform customers about its service).

[168] Appendix 8.3: Price comparison websites and collective switching, paragraph 98 above.

150. The cost of advertising per customer successfully acquired may also be high if conversion rates are low. If there are fixed costs of advertising, then the smaller size of the microbusiness segment would make it a less appealing target than the domestic markets for PCWs.

Auto-rollovers

151. Centrica said that the use of rollover contracts might have previously limited the development of PCWs, as customers coming to the end of a contract were only able to switch during a short period, before being rolled over. It said that this should no longer be an issue in future.

Credit checks

152. Energylinx for Business told us that for some suppliers it carried out a credit check before sending a contract to a customer. In other cases, the supplier carried out any credit checks at a later stage. This suggests that there may be several possible ways to fit credit checks into a PCW model.

Additional services

153. A TPI [✂] told us that it had considered introducing a PCW, but said that a telephone call would still be needed to explain the added services it provides (such as energy advice).

Behaviour of suppliers

154. Energylinx for Business said it had had a mixed response from suppliers it had approached for its PCW service. It told us that some did not want to list online, while others required a minimum volume of sales.

Contract signature

155. A firm which provides other online comparison services to businesses [✂] told us that business insurance contracts could be concluded without a verbal or electronic signature, whereas this was required in business energy. However, this firm referred to this as a 'just one factor'.

Fit with other activities

156. Many domestic PCWs offer switching services in a variety of products and benefit from cross-selling. However, PCW switching services to businesses generally are less widespread. For example, a domestic PCW [✂] told us that its site was generally focused on domestic customers, so this was more

closely aligned to offering a PCW for domestic energy customers, compared to business energy customers.

Summary on PCWs

157. It is clear that PCWs could deliver benefits for microbusiness energy customers through increased transparency. The current limited presence of PCWs, and the potential barriers listed above, suggest that it may be more challenging to operate a non-domestic PCW than a domestic one. However, on the basis of the evidence we have seen, it appears that there could be a viable business model for a non-domestic energy PCW.

Margins

158. In this section, we report the results of our analysis of the Six Large Energy Firms' profit margins for SME supply, and suppliers' comments on that analysis. We then look at gross margins (and average revenues), segmented by tariff type and consumption level.

Our profit margin analysis

159. Our analysis of retail profit margins[169] found that there were substantial differences in EBIT margins between markets for the Six Large Energy Firms. Over the years[170] 2009 to 2013, EBIT margins were over twice as large in the SME markets as in the domestic or I&C markets:

    (a) The combined EBIT margin for the Six Large Energy Firms in the SME markets was 8.4%, compared with 3.3% in the domestic markets.

    (b) The combined EBIT margin was lowest in the I&C markets at 2.0%.

160. We also looked at combined EBIT margins by fuel. The margin was larger for SME gas supply (10.1%) than for SME electricity supply (7.9%).

161. Consistent with this, we found that the Six Large Energy Firms' outturn revenue was significantly higher than the average of the competitive benchmarked unit revenue (a proxy for the competitive benchmark price) which we calculated: on average 15% higher for SME electricity and 10% higher for SME gas in FY2013 (both had been higher in previous years). These average revenue differences were substantially higher than for

[169] Appendix 10.2: Retail energy supply profit margin analysis.
[170] These years are the financial reporting years for each firm, which differ in some cases from the calendar year.

domestic supply (5% for electricity and 3% for gas). See Appendix 10.5: Assessment of the competitive benchmark in retail energy supply, Annex E: Average prices vs the competitive benchmark.

162. The SME category used in this analysis does not correspond to the definition of a microbusiness. This means that we do not have a specific figure for the EBIT margin on microbusiness supply. To the extent possible, we would like to understand whether margins are higher or lower for microbusinesses than for SMEs as a whole.

163. The results of this analysis suggest that there may be issues with competition in the SME markets. Our further work below investigates what sort of issues those may be.

Comments on our profit margin analysis

164. Several suppliers provided comments on our profit margin analysis working paper. These are set out in Appendix 10.5. Some suppliers said that the pattern of significantly higher profit margins in the SME markets compared to other markets did not, or no longer, applied to them. However, they did not dispute the individual figures that we used to calculate the margins for the Six Large Energy Firms in aggregate.

165. Suppliers also put forward several explanations for additional risks they face in the SME markets (compared to the domestic and/or I&C markets), which they said would justify higher margins. We do not have precise information to evaluate the materiality of each of the risks cited by suppliers. However, most costs should be deducted before the calculation of EBIT margins. (For example, higher levels of bad debt among SMEs than in other markets would not justify higher EBIT margins – the only relevant risk factor would be if the variability of bad debt were higher among SMEs). The SME markets would therefore have to be much more exposed to systematic risk, or require a much higher level of capital employed than other markets, in order to justify the extent of the difference in EBIT margins. Our provisional view is that the risks mentioned are not sufficient to justify such a large gap in EBIT margins between markets, and we have not seen any analysis or evidence to suggest otherwise.

Average revenues and gross margins

166. To go beyond the overall margin figures reported above, we looked at the outcomes for specific categories of customers. Based on our initial work, we identified the following areas of interest:

(a) Default tariffs (auto-rollover, evergreen, deemed and OOC).

(b) Former incumbent regions (for electricity).

(c) Smaller customers.

Data collection

167. We gathered data from the Six Large Energy Firms and three independent suppliers.[171] Despite best efforts, the suppliers could not all provide data in a consistent way at this level of detail. Due to these inconsistencies our approach has been first to look at suppliers individually. We then analysed the general patterns which stand out from the data, rather than focusing on comparing numbers from different suppliers.

168. The data covered 2012 to 2014.[172] It allowed us to make comparisons between:

- Consumption bands – for each fuel, we defined four bands based on annual consumption. Three of these fell within the microbusiness volume definition (we refer to these as small, medium and large microbusinesses), and the fourth was a group of larger SMEs. We asked suppliers to allocate meters to these consumption bands.[173]
- Product categories – as defined in paragraph 29 above.
- Regions.

169. We calculated figures for two outcomes of interest: average revenue per unit, and gross margins.

(a) There are a large range of microbusiness tariffs, and many prices are the result of negotiation or otherwise set individually for individual customers. This means that it was impracticable to look at individual prices. Instead, we used average revenues.

[171] Gazprom, Opus, and Total Gas and Power.
[172] From this point, we refer to the general parameters of the data we collected. These may not apply to each specific supplier. See Annex A to this appendix for firm-specific information and caveats.
[173] We used meters rather than customers due to data availability. This means that some of these meters will belong to larger multi-site customers, whose total consumption might be in a different volume band. Conversely, some larger SMEs may qualify as microbusinesses due to their balance sheet or number of employees.

(b) We tried to obtain comparable gross margin information where possible.[174] However, some suppliers were only able to provide gross margin information according to their own definitions.

170. Ideally, we would have also gathered information on net margins. However, most suppliers were unable to provide this information at the level of granularity we required.

Overview of results

171. Annex A contains the average revenue and gross margin results for individual suppliers. In this section we present overall charts. These are intended as general illustrations of the key points we have taken from this data.

172. Figures 15 to 18 below show average revenues and gross margins[175] for gas and electricity. The main results were as follows:

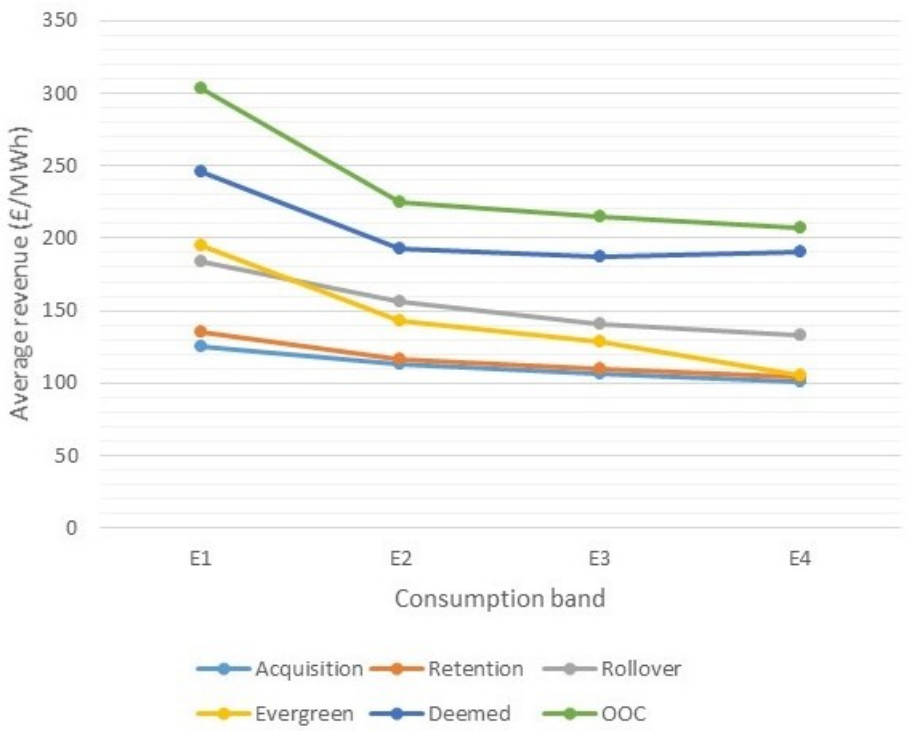
(a) We observed higher average revenues and gross margins for smaller customers compared to larger ones. This applied to some extent across consumption bands, though it was particularly noticeable for small microbusinesses.

(b) The highest average revenues and gross margins were on deemed and OOC tariffs. Average revenues and gross margins were also higher on rollover and evergreen tariffs, compared to acquisition and retention tariffs. Acquisition and retention tariffs had very similar average revenues and gross margins.[176] The differences in average revenues between tariffs were substantial in places – this implies that most of these customers could benefit from switching between tariffs.

173. These broad points were largely consistent across suppliers (see Annex A to this appendix).

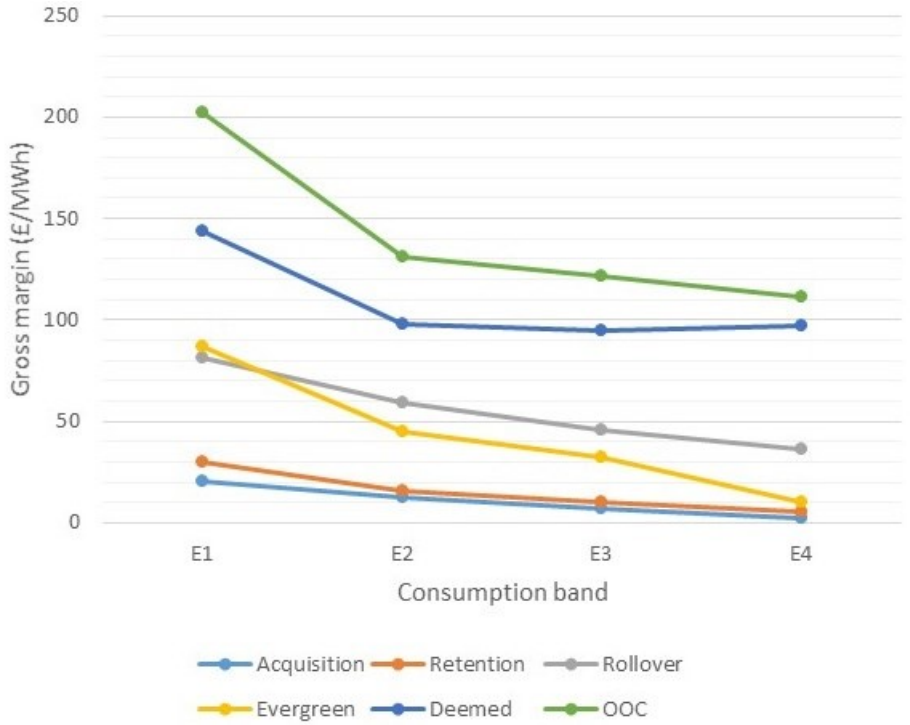
[174] Using the definition of revenue minus wholesale costs, network costs, environmental/social obligation costs, and imbalance costs.
[175] For the purposes of these illustrations, we examine both gross margins according to our uniform definition, and those labelled by parties according to their own definitions.
[176] Electricity evergreen average revenues were similar to those for acquisition and retention products in the largest consumption band (E4). However, there were relatively small volumes in this category, the majority of which came from one supplier.

Figure 15: Overall average revenues by tariff category and consumption band, electricity



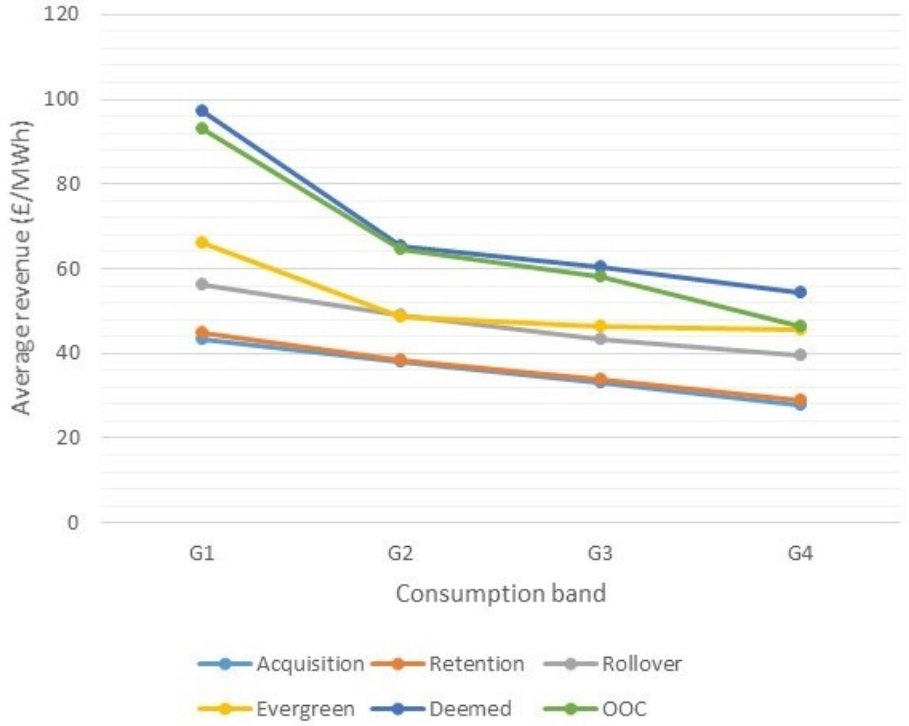
Source: CMA analysis of data from Six Large Energy Firms (except SSE), Gazprom, Opus, and Total Gas and Power. Data is from 2012 to 2014, except Centrica (2012 to Q3 2014) and Scottish Power (2014 only).
Notes:
1. Consumption bands: E1 was meters with annual consumption below 10MWh; E2 was meters with annual consumption between 10MWh and 30MWh; E3 was meters with annual consumption between 30 and 100MWh; E4 was meters with annual consumption between 100 and 500MWh.
2. A few suppliers included an 'other' tariff category. We do not report this in these charts, as it was not consistently defined.
3. Average revenues are volume weighted averages across suppliers.
4. SSE provided average revenue data, but not gross margins. We therefore excluded SSE from this chart for comparability with the gross margin chart. SSE's average revenue results are included in Annex C to this appendix.
5. Average revenues are before tax (ie excluding VAT and Climate Change Levy).
6. The rollover category is mostly made up of customers on auto-rollover contracts, but also includes the replacement products for a couple of suppliers.

Figure 16: Overall gross margins by tariff type and consumption band, electricity



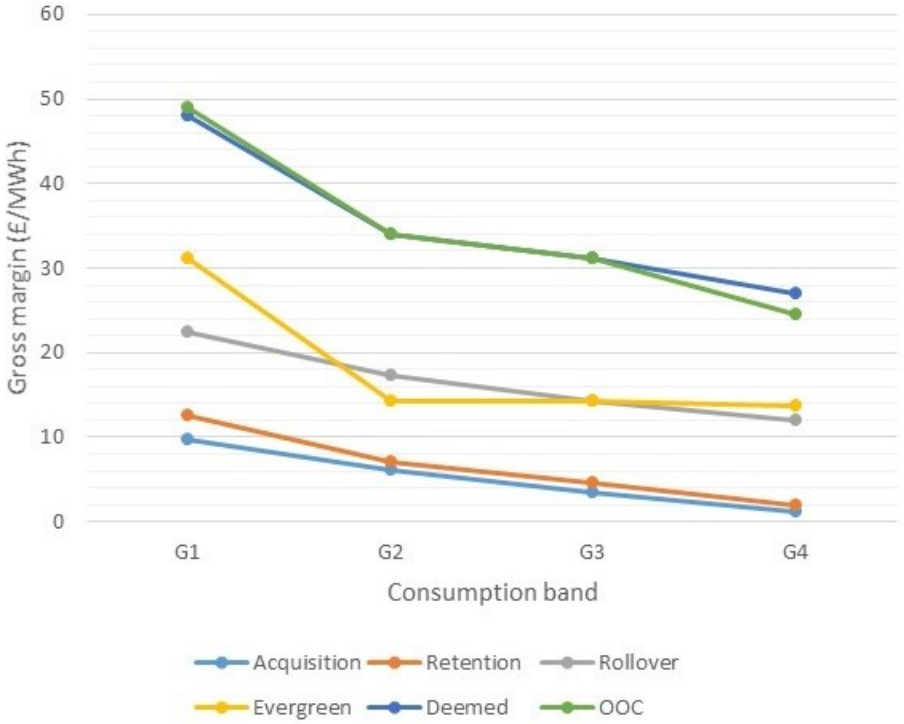
Source: CMA analysis of data from Six Large Energy Firms (except SSE), Gazprom, Opus, and Total Gas and Power. Data is from 2012 to 2014, except Centrica (2012 to Q3 2014) and Scottish Power (2014 only).
Notes:
1. Gross margins are volume weighted averages across suppliers.
2. The rollover category is mostly made up of customers on auto-rollover contracts, but also includes the replacement products for a couple of suppliers.

Figure 17: Overall average revenues by tariff type and consumption band, gas



Source: CMA analysis of data from Six Large Energy Firms (except EDF Energy and SSE), Gazprom, Opus, and Total Gas and Power. Data is from 2012 to 2014, except Centrica (2012 to Q3 2014) and Scottish Power (2014 only).
Notes:
1. Consumption bands: G1 was meters with annual consumption below 30MWh; G2 was meters with annual consumption between 30 and 100 MWh; G3 was meters with annual consumption between 100 and 293 MWh; G4 was meters with annual consumption between 293 and 1,500 MWh.
2. SSE provided average revenue data, but not gross margins. We therefore excluded SSE from this chart for comparability with the gross margin chart. SSE's average revenue results are included in Annex C to this appendix.
3. Average revenues are before tax (ie excluding VAT and Climate Change Levy)
4. The rollover category is mostly made up of customers on auto-rollover contracts, but also includes the replacement products for a couple of suppliers.

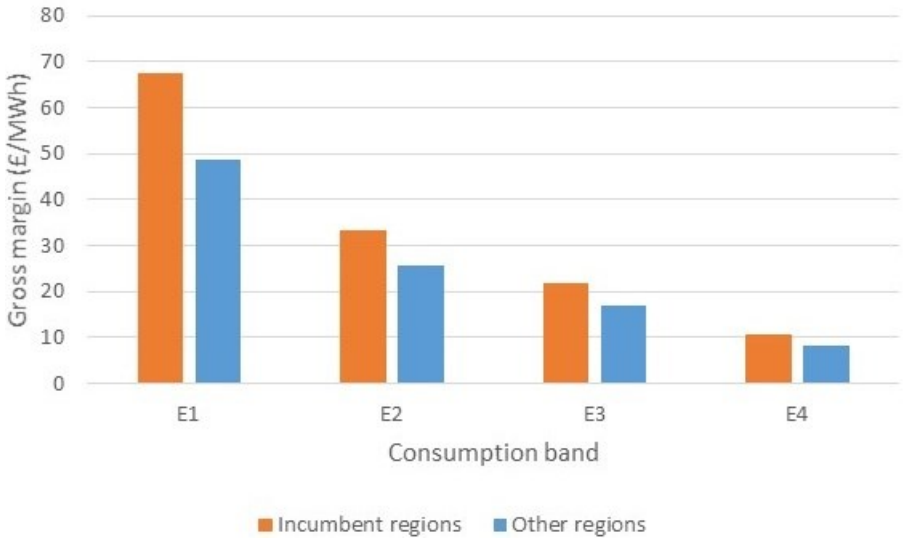
Figure 18: Overall gross margins by tariff type and consumption band, gas



Source: CMA analysis of data from Six Large Energy Firms (except EDF Energy and SSE), Gazprom, Opus, and Total Gas and Power. Data is from 2012 to 2014, except Centrica (2012 to Q3 2014) and Scottish Power (2014 only).
Note: The rollover category is mostly made up of customers on auto-rollover contracts, but also includes the replacement products for a couple of suppliers.

174. We also looked at gross margins on a regional basis in electricity, to look for potential incumbency effects. Figure 19 below shows the volume weighted average of gross margins by consumption band for former incumbent suppliers in their home regions, and for the same parties in other regions. In each consumption band, gross margins were higher in home regions than in other regions. This pattern of regional gross margins was also largely consistent across suppliers (see Annex A to this appendix).

Figure 19: Overall gross margins by consumption band and whether incumbent region, electricity



Source: CMA analysis of data from EDF Energy, E.ON, RWE and Scottish Power. SSE was unable to provide gross margin data. Data is from 2012 to 2014, except for Scottish Power (2014 only).

175. Incumbency in gas does not arise on a regional basis, because Centrica was the former national gas incumbent. Annex D includes discussion of potential incumbency effects in gas.

176. Our findings (both nationally, and regionally for electricity) were largely consistent across suppliers (see Annex A to this appendix). We therefore focused on investigating them further – we look at specific issues in turn in the remainder of this appendix.

177. Many of the same patterns were also observed in the information available in suppliers' internal documents. This information is presented in Annex B.

Outcomes: auto-rollovers

Types of rollover contract

178. The majority of non-domestic contracts have a fixed term. This creates an issue as to what happens at the end of that term if the customer does not take any action. There are four possibilities:

- Auto-rollovers: the customer is rolled over onto a new fixed-term contract with no exit clause.
- Notice contract: as above, but the customer can give notice (usually one month) at any time.

- Evergreen contract: the customer is rolled over onto a variable price contract[177] but can give notice at any time.

- OOC: the customer could be moved onto OOC terms.

179. In each case, the price the customer pays can be individual to that customer and need bear no relation to the price under the previous contract. Customers can also be rolled over multiple times (after each auto-rollover or notice term ends) and the price may change each time.

180. Until 2013,[178] auto-rollovers were widespread. Since 2013, the largest energy companies (including the Six Large Energy Firms and Opus) have gradually withdrawn auto-rollovers in favour of replacement (notice or evergreen) contracts, as a result of pressure from Ofgem and government.[179]

181. However, auto-rollovers are still used by many independent suppliers. The following suppliers told us that they use auto-rollovers for SME customers:

- Corona.

- DONG Energy.

- Extra Energy.

- Gazprom.

- Haven Power.

- Total Gas and Power.

182. These suppliers together accounted for 3% of electricity and 20% of gas volumes in 2014 among small and medium microbusinesses.[180]

183. Another mid-tier supplier [✂] told us that it would only roll a customer over at a continuation of its current rate, and only if this was economic for its own business.

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[177] This has some similarities to standard variable tariffs from the domestic market. However, in this case prices may be personalised to an individual microbusiness.
[178] EDF Energy stopped automatically renewing customers in October 2013.
[179] Number 10 and DECC launched a small business energy working group.
[180] Under 30 MWh of annual electricity consumption (E1 and E2) or under 100 MWh of annual gas consumption (G1 and G2). Source: CMA analysis of volume shares data (as used in paragraphs 23 and 24 above).

Effects of auto-rollovers

184. Auto-rollovers have been the subject of concerns from Ofcom,[181] the OFT[182] and the FCA,[183] as well as from Ofgem.

185. In a competition context, these concerns have been driven by the potential impact of auto-rollovers on switching.

- The OFT said that auto-rollovers could reduce switching because of inertia and/or increased switching costs, and that this could potentially dampen competition.[184]
- The FCA also raised the potential negative effect on switching as part of its cash savings market study (in relation to fixed-term bonds).[185]
- Ofcom concluded that auto-rollovers were likely to have a material effect on switching activity.[186] Ofcom commissioned an econometric study that looked at BT landline customers. It found that the monthly switching rate following an original fixed-term contract was lower for customers with an auto-rollover term (0.62% per month) compared to the overall sample of customers (0.95% per month).[187]

186. In general, auto-rollovers are more likely to be problematic if:

(a) customers receive substantially worse outcomes on auto-rollovers, such as higher prices than they could achieve if they could switch;[188]

(b) customers do not know if the auto-rollover contract price offered by their supplier is competitive;[189]

(c) customers have limited awareness of the auto-rollover term or how to avoid it;[190] and

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[181] Ofcom (2011), *Automatically renewable contracts – decision on a General Condition to prohibit ARCs*.
[182] OFT (2013), *Key issues in ongoing contracts: a practical guide*, pp10–11.
[183] FCA (2015), *Cash savings market study report*, pp75–76.
[184] OFT (2013), *Key issues in ongoing contracts: a practical guide*, p10.
[185] FCA (2015), *Cash savings market study report*, p76.
[186] Ofcom (2011), *Automatically renewable contracts - research into their effects and proposals for a General Condition*, p25.
[187] Ofcom (2011), *Automatically renewable contracts – decision on a General Condition to prohibit ARCs*, pp 30–31.
[188] In its cash savings market study, the FCA noted that auto-rollovers would create consumer harm if they were used to transfer customers to 'less competitive' products. FCA (2015), *Cash savings market study report*, p76.
[189] This is an issue in energy because wholesale costs vary substantially, so a customer cannot make a simple comparison between the price on the existing contract and the auto-rollover price. In a period of falling wholesale prices, a customer might see the same or lower price offered on an auto-rollover contract and yet still be worse off relative to other offers in the market.
[190] OFT (2013), *Key issues in ongoing contracts: a practical guide*, p10.

(d) some customers are rolled over erroneously.[191]

187. There has been some protection in place for microbusinesses, which would alleviate some of the concerns raised by the OFT.[192] For example:

- The length of a rollover contract has been limited to one year since 2009.[193]
- The supplier must inform the customer of the renewal terms 30 days before renewing a contract. From April 2015, the supplier must also include a customer's current price on its renewal letter.[194]

188. Auto-rollovers are less likely to be problematic if they deliver benefits to customers. There could be cost advantages to suppliers from renewing customers for a further fixed period, rather than moving a customer onto a notice contract. Possible benefits include:

(a) reduced risk in procuring energy for that customer; and

(b) spreading customer service costs over a greater volume of energy.

189. As compared to an evergreen contract, customers may value greater price certainty.

190. However, even if there are genuine cost savings they may not be passed on to customers. If customers move on to this type of contract by default rather than by active choice, then there is likely to be less of a competitive constraint on auto-rollover prices.

Outcomes when auto-rollovers were prevalent

Awareness and switching

191. It is possible that the microbusiness energy segment did not see some of the same issues with auto-rollovers as other sectors. For example, only a very small proportion of customers said that they had been rolled over without their knowledge. In the 2013 survey, this only applied to 2% of microbusinesses.[195] However, this does not mean that all customers were fully aware of the auto-

[191] In 2014, Ofgem found that Centrica had breached its licence by rolling over non-domestic customers who submitted valid termination notices. Ofgem (2014), *Notice of decision to impose penalty on British Gas*
[192] OFT (2013), *Key issues in ongoing contracts: a practical guide*, p10.
[193] See regulation section.
[194] See regulation section.
[195] The Research Perspective and Element Energy (2013), *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p33.

rollover term (paragraphs 65 to 67 above have information about customers' knowledge of their contracts).

192. In the 2014 survey, 41% of microbusinesses and small businesses who had not switched in the past 12 months said that they were tied to their existing contract as an explanation for not switching.[196]

193. We do not know what proportion of these were auto-rollover customers.[197] However, it seems reasonable that some of these customers were on auto-rollovers.[198] To the extent that these customers did not have additional reasons not to switch, the auto-rollover term may therefore have discouraged switching.

Outcomes

194. As noted in paragraph 172 above, we observed much higher average revenues and gross margins on auto-rollovers compared to acquisition or retention tariffs.

195. We did not receive any suggestions that cost differences could explain the size of these differences in average revenues and gross margins (there may be a small cost resulting from the risk of keeping an auto-rollover offer open for 30 days. This is due to the possibility of changes in wholesale prices during this period. In contrast, acquisition and retention quotes are generally only available for a shorter period, which reduces this risk).

196. The implication that net margins were higher on auto-rollovers than on acquisition or retention is supported by the net margin data we have from Opus. For example, for medium microbusinesses in electricity, average net margins were [✂].[199]

197. The outcomes observed are unlikely to be solely the result of the auto-rollover term. The business model of charging higher prices to less active customers does not rely on this particular contractual provision.

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[196] BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p43.
[197] These customers could be acquisition customers on products longer than a year, retention customers, or auto-rollover customers.
[198] Overall, the 2014 survey found that 23% of microbusiness and small business customers had switched in the past 12 months. (BMG Research (2015), *Micro and small business engagement in energy markets* (report for Ofgem), p43). This leaves 77% of microbusiness and small business customers who had not switched in the past 12 months. The proportion of the total population who had not switched in the past 12 months and who cited being tied into their existing contract as a reason for not switching was therefore 32%. (41% of 77%).
Taken with the number of customers switching in the past 12 months, this gives a figure of 55%. This is roughly comparable to the proportions of customers on acquisition and rollover products. (For example, see paragraph 47 above). It is therefore possible, but unlikely, that no auto-rollover customers cited this reason.
[199] [✂]

198. Paragraph 261 also reports that gross margins on electricity auto-rollovers varied by customer size, in a way which was unlikely to be cost-related.

Effects of removing auto-rollovers

199. We considered the effects of the switch by the largest suppliers away from auto-rollovers. The replacement product varies by supplier,[200] and our analysis of prices is limited by the short period since this switch.

Effects on engagement and switching

200. The change may lead to increased switching, since customers no longer have a narrow window to switch tariff or supplier. This provides greater opportunities for engagement.

201. One possible downside is that fewer customers may engage and/or switch at the end of their existing contract, since there is less urgency. However, it is also possible that suppliers and TPIs will target customers whose contracts have recently ended, so these customers may receive frequent encouragement to engage.

202. At this stage, we do not have firm information on the impact of the end of general use of auto-rollovers. However, there are some potential indications that switching has increased:

(a) The 2014 survey carried out for Ofgem reported a significantly higher rate of switching than the 2013 version (paragraph 57(e) above). There have been a range of recent developments (see paragraph 58 above), so we cannot necessarily attribute this to the move away from auto-rollovers.

(b) Centrica told us that as of April 2015, [✂] of the customers who moved onto its replacement (evergreen) tariff in September 2014 had since switched tariff or supplier.

Effects on outcomes

203. If there is an increase in switching, and if suppliers cannot determine that certain customers are unlikely to switch, then suppliers might charge more competitive prices to all customers on replacement products to respond to this

[200] EDF Energy, RWE and Scottish Power have notice contracts. Centrica, E.ON and Opus have evergreen contracts. SSE's replacement product is its Variable Business Rates, which is also its OOC product.

threat.[201] On the other hand, any increased costs from placing customers on a replacement contract could be passed onto consumers.

204. We looked at prices paid by customers of some suppliers ([✂]) since they discontinued auto-rollovers. This analysis was limited by the small amount of available data (Annex C describes the data, including further caveats). However, this analysis suggested that customers who moved onto a supplier's replacement product were not seeing better prices as a result of the removal of the auto-rollover term.

205. This was supported by messages from internal documents from some suppliers. An internal document from SSE showed its proposed tariff changes. The document proposed replacing its auto-rollover tariff type (gross margin of £[✂]/MWh) with a new variable tariff type (gross margin of £[✂]/MWh), due to the uncertainty around the length of time a customer would remain with SSE, as customers placed on the proposed new variable tariff type would be free to leave at any time. [✂].

206. We do not therefore have evidence at present that the move away from auto-rollovers has led to lower prices for customers on default tariffs.

207. There is also a possible effect on acquisition and retention tariffs. If the change in rollover type means that customers are staying with the supplier for less time on average, or paying a relatively high price for less time on average, then that may make customers less attractive to acquire or renegotiate with, and acquisition and/or renewal prices may be less keen. However, we understand that some suppliers (eg Haven Power) try to negotiate terms with customers as part of the normal contract renewal process rather than allowing them to roll over. This implies that their acquisition prices do not include a substantial chance of higher profit on a rollover.

Effects on competition

208. The current situation, where a number of suppliers have removed auto-rollovers but others have not, may distort competition by making it easier for the latter group to retain customers while still competing for the former's. Given our other provisional findings in this area, and given that the latter group has a relatively small share of the market (and that its customers may

[201] This is not the only potential strategy – a supplier might focus on trying to sign customers onto new fixed-term contracts.

be on average more engaged than the former's), we have not found it necessary to reach a view on the importance of this factor.

Arguments against banning auto-rollovers

209. Several arguments have been put forward as to why auto-rollover tariffs should not be banned.

(a) Ofgem noted that customers who moved onto a variable contract might no longer receive prompts to engage such as contract renewal letters. Haven Power also raised this point in response to the updated issues statement.[202]

(b) Haven Power also told us that rollover contracts provided choice for customers.[203]

(c) Suppliers previously told Ofgem that the costs of buying wholesale energy would be higher on notice contracts.[204]

210. We do not consider these to be strong arguments for allowing auto-rollovers. If prompts to engage are judged to be important, they can be mandated separately. We acknowledge that greater certainty over customer numbers and tenure may reduce the risk in buying wholesale energy. We note that most suppliers are also active in the domestic sector, where the majority of customers are not on tariffs with an enforced fixed term,[205] so they have to deal with this kind of uncertainty in any case. There is also no certainty in a sector where customers may cease operating. We do not see this type of uncertainty as a substantial cost.

Key observations on auto-rollovers

211. In the historical situation where the use of auto-rollovers was widespread, we consider that these contracts may not have been in consumers' interests. In particular, we observe that the margins on these contracts were high, and so a term which reduced the ability of customers to switch away from these tariffs may have led to consumer detriment.

212. The removal of auto-rollovers is likely to give customers greater opportunity to engage with the market, which is on balance a good thing. However, based

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[202] Drax (2015), *Response to updated issues statement*, p12.
[203] Drax (2015), *Response to updated issues statement*, p13.
[204] Ofgem (2014), *Proposals for non-domestic automatic rollovers and contract renewals*, p21.
[205] Either because they are on a standard variable tariff, or because they are on a fixed-term tariff with no exit fees.

on the evidence available to us,[206] this change does not appear to lead to lower prices for customers who fail to engage and roll over without negotiation. Therefore it has not significantly alleviated our wider concerns about transparency and engagement.

213. While auto-rollovers are no longer in widespread use, this has been due to informal pressure, and they could in principle be brought back by the larger suppliers. We have not seen strong arguments against formalising this prohibition through a licence condition.

214. A ban on auto-rollovers would be consistent with action in other sectors:

- Ofcom banned auto-rollovers in the landline and broadband sectors in 2011.[207]
- The FCA has proposed that fixed-term savings tariffs should not be automatically rolled over, unless the customer has made an explicit choice to accept this when the tariff was opened.[208]

Outcomes: deemed and out-of-contract tariffs

215. We do not see that there is a competitive constraint on the pricing of deemed or OOC tariffs. A customer does not make an active choice to end up on these tariffs – and any customer who does engage should move to a less costly tariff type, rather than switching to another supplier's deemed or OOC tariff. This explains why there is a licence condition relating to the pricing of deemed tariffs. However, there is no equivalent licence condition for OOC tariffs. The following section therefore focuses specifically on these two types of tariff.

Gross margins on deemed and OOC tariffs

216. We observed higher gross margins on deemed and OOC tariffs compared to other tariff types. For each supplier (where we had data), we calculated the difference in average gross margins between deemed and retention tariffs, and between OOC and retention tariffs. Table 3 below reports the median differences across suppliers.

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[206] See Annex C to this appendix.
[207] This applied to domestic customers and businesses with ten or fewer employees. Ofcom (2011), *Automatically renewable contracts – decision on a General Condition to prohibit ARCs*, p1.
[208] FCA (2015), *Cash savings market study report*, p76.

Table 3: Median gross margin difference across suppliers, comparing deemed and OOC tariffs against retention tariffs, and median percentage (gross margin difference divided by retention gross margin) – for medium microbusinesses

	Electricity £/MWh	Electricity %	Gas £/MWh	Gas %
Deemed minus retention	66	378	17	179
OOC minus retention	74	537	21	350

Source: Data from parties below, CMA analysis
Notes:
1. Electricity scope – meters with an annual consumption between 10 and 30MWh (consumption band E2).
2. Gas scope – meters with an annual consumption between 30 and 100MWh (consumption band G2).
3. Percentages calculated using retention gross margin as the denominator.
4. Data from Centrica, EDF Energy (electricity only), E.ON, [✂], Opus, RWE, Scottish Power and [✂].
5. Data covers 2012 to 2014 for all suppliers except Centrica (2012 to Q3 2014) and Scottish Power (2014 only).

217. Our data also showed higher average revenues on deemed and OOC tariffs compared to other tariffs. Along similar lines, previous Ofgem research found that the average annual electricity (gas) bill for a typical microbusiness on a deemed contract was 75% (58%) higher than on a retention contract.[209]

Costs on deemed and OOC tariffs

218. We examined whether the gross margins on deemed and OOC tariffs were the result of tariff-specific indirect costs.

Bad debt

219. Bad debt is the main cost that is higher for deemed and OOC tariffs than for other tariffs. For example, data from Opus showed that bad debt (plus credit operating costs) was nearly [✂] larger for deemed electricity customers than for those on retention contracts.

220. We asked the Six Large Energy Firms for the proportion of billed revenue they wrote off as bad debt for different tariffs.[210] The results for 2014 are shown in Table 4 below.

[209] All figures from Ofgem (2014), *Proposals for non-domestic automatic rollovers and contract renewals*, pp42–43.
[210] The proportion written off in a particular year is an estimate of the actual amount of revenue that is not recovered. Any differences from the actual amount of unrecovered revenue will be reflected in subsequent years.

Table 4: Bad debt write-off, SMEs (2014)

		Write-off (% of tariff revenue)		
Party	*Fuel*	*Fixed*	*Deemed*	*OOC*
Centrica	Both	[✂]	[✂]	[✂]
EDF Energy	Both	[✂]	[✂]	[✂]
E.ON	Electricity	[✂]	[✂]	[✂]
E.ON	Gas	[✂]	[✂]	[✂]
RWE	Electricity	[✂]	[✂]	[✂]
RWE	Gas	[✂]	[✂]	[✂]
SSE	Electricity	[✂]	[✂]	[✂]
SSE	Gas	[✂]	[✂]	[✂]
Indicative weighted mean	Both	[✂]	[✂]	[✂]

Source: Estimates from Centrica, EDF Energy, E.ON, RWE, SSE.
Notes:
1. E.ON, RWE, and SSE provided separate estimates for electricity and gas.
2. Data for 2014, except Centrica (2013).
3. [✂].
4. SSE provided separate percentage figures for each consumption band. SSE's figures included in the table were therefore weighted means of the estimates from individual consumption bands, weighted by the annual average volume in each combination of tariff type and consumption band.
5. Notes on weighted mean calculation:
   - We did not have data on revenues for one party (Centrica). This means that we could not use revenue as the weight. Instead, we used volumes. However, we doubled the volume figures for electricity – this reflects that a unit of electricity is very approximately twice as expensive as a unit of gas.
   - Volume figures used in weighting were for volumes supplied to microbusinesses in 2014.
   - For each tariff type, we report a weighted mean across both fuels – this reflects that two parties did not provide write-off estimates for each fuel separately.

221. The mean write-off rate for deemed tariffs is much higher than for fixed contracts.[211] To recover this cost, deemed prices would need to be set 35% higher than the prices for fixed contracts.[212]

222. We can translate the write-off percentages into indicative unit figures. For this, we use the overall average revenue figures reported (see Figures 7 and 8 above, Annex A to this appendix).[213] In electricity, the deemed write-off percentage would imply a unit write-off cost of £52/MWh, while the OOC percentage would translate to £51/MWh. This is compared to a £1/MWh figure for retention tariffs. The equivalent figures in gas would be £18/MWh for deemed, £15/MWh for OOC and £0.50/MWh for retention. When compared against Table 3 above, it appears that bad debt write-offs could explain some (but in most cases not all) of the difference in gross margins between deemed and retention tariffs, and between deemed and OOC tariffs. This analysis is only approximate[214] – but it does indicate the importance of bad debt write-offs.

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[211] For example, in an internal document from 2014, Centrica stated that 'We write off around 37% of our Deemed revenue annually compared to about 5% for the rest of our product range.'
[212] This figure is larger than the difference in write-off percentages between deemed tariffs and fixed contracts. When setting a price increment for deemed tariffs to cover the higher write-off percentage, the supplier needs to recognise that a proportion of the incremental revenue will also be lost as bad debt.
[213] We use the average revenue figures for medium microbusinesses (consumption bands E2 and G2).
[214] In particular, different groups of suppliers were used to calculate each set of figures (due to data availability).

223. Table 5 below also reports equivalent figures for some individual suppliers, (those for whom we have both gross margin and write-off data). Again, we see that bad debt write-offs could explain the majority, but generally not all, of the difference in gross margins when comparing deemed and OOC with retention tariffs (although results vary by supplier and tariff type).

Table 5: Differences in gross margins and indicative bad debt write-off rates for medium microbusinesses (£/MWh): comparing deemed and OOC tariffs with retention tariffs

Electricity: deemed minus retention		
Party	*Gross margin difference*	*Implied unit bad debt write-off difference*
Centrica	[✂]	[✂]
EDF Energy	[✂]	[✂]
E.ON	[✂]	[✂]
RWE	[✂]	[✂]

Electricity: OOC minus retention		
Party	*Gross margin difference*	*Implied unit bad debt write-off difference*
Centrica	[✂]	[✂]
EDF Energy	[✂]	[✂]
E.ON	[✂]	[✂]
RWE	[✂]	[✂]

Gas: deemed minus retention		
Party	*Gross margin difference*	*Implied unit bad debt write-off difference*
Centrica	[✂]	[✂]
EDF Energy	[✂]	[✂]
E.ON	[✂]	[✂]
RWE	[✂]	[✂]

Gas: OOC minus retention		
Party	*Gross margin difference*	*Implied unit bad debt write-off difference*
Centrica	[✂]	[✂]
EDF Energy	[✂]	[✂]
E.ON	[✂]	[✂]
RWE	[✂]	[✂]

Source: CMA analysis of data from Centrica, EDF Energy, E.ON and RWE.
Notes:
1. EDF Energy did not provide gas data on gross margins.
2. Average revenue and gross margin figures relate to medium microbusinesses (consumption bands E2 and G2).
3. Average revenue and gross margin data from 2012 to 2014, except Centrica (2012 to Q3 2014).
4. Implied unit bad debt write-off cost calculated by multiplying each firm's bad debt write-off estimate for a particular tariff by its average revenue figure for that tariff.

224. Table 4 reports a slightly lower mean write-off percentage for OOC tariffs than for deemed tariffs. However, this did not apply to all suppliers – two of them gave higher write-off estimates for OOC tariffs than for deemed tariffs. We are therefore cautious about drawing conclusions on the relative levels of bad debt write-offs between these tariffs.

225. Write-offs are not the only type of debt-related costs that suppliers face.

(a) Late payment may also increase a supplier's working capital needs. [✂]. [✂].

(b) In addition, there are costs of administering and collecting debt, including trace fees, legal fees, debt collection agency costs, warrant and de-

energisation costs. This can be a significant activity – for example, [✂]; and Opus told us that around [✂] of its employees worked in debt collection.

226. The high level of bad debt on deemed contracts may be caused by:

(a) the lack of supplier relationship with and knowledge of the customer, including payment history;

(b) the customer's ability to change supplier at any time without the supplier being able to object (although see paragraph 229 below); and/or

(c) the fact that many deemed customers are start-ups, with a higher risk of failure and consequently non-payment ([✂] said that 40% of new businesses fail within three years).

227. In theory, we would not expect OOC tariffs to have all the same bad debt risks as deemed tariffs. For example, the supplier should know the identity of the customer and its payment history, given it was recently in contract. Information from suppliers suggested that bad debt costs were slightly lower on OOC tariffs:

(a) In electricity, data from Opus showed that bad debt (and credit operating costs) was [✂] for deemed customers, compared to £63/MWh for OOC customers. In gas, the equivalent figures were [✂] for deemed, and £20/MWh for OOC.[215]

(b) E.ON's EBITDA model included estimates of indirect costs. In electricity, the estimated cost of bad debt was [✂] for deemed customers, compared to [✂] for OOC customers. In gas, the figure for deemed ([✂]) was also higher than the figure for OOC ([✂]).[216]

228. Several suppliers provided us with data on the types and credit scores of customers on different tariffs. These suggest that suppliers are less likely to have information about deemed and OOC customers, and that these customers may have higher risks than contract customers.

(a) Centrica provided the results of its internal credit scoring from October 2014. [✂] of its deemed microbusiness[217] accounts were in the highest risk category, while [✂] of microbusiness contract accounts were placed

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[215] All figures for medium microbusinesses (consumption bands E2 and G2). Source: [✂].
[216] All figures for customers in E.ON's 'Mid' category. (Annual consumption between 10 and 20 MWh for electricity, and between 15 and 75 MWh for gas). Source: [✂].
[217] Centrica's data segmented accounts into consumption bands (based on bill value). We report figures based on the consumption bands corresponding to the microbusiness volume definition.

in this category. Centrica was also less likely to have information on its deemed customers – [✂]% of microbusiness deemed accounts had no credit score, whereas this [✂] of microbusiness contract accounts.[218]

(b) [✂].[219]

(c) RWE was less likely to have a credit score for deemed and OOC customers than for contract customers. The proportion of customers in RWE's [✂].[220]

229. Some suppliers told us that they should be allowed to object to deemed customers leaving if they were in debt.[221] Our data showed that average revenues[222] were similar on deemed tariffs (where suppliers cannot object) and OOC (where they can). If suppliers saw lower bad debt on OOC tariffs than deemed tariffs, this should have allowed them to charge lower average revenues. We are therefore unconvinced that allowing objections would reduce the prices paid by deemed customers.

Other costs

230. Some costs unrelated to debt may also be higher on deemed and OOC tariffs than on other tariffs.

231. These may be indirect costs. For example, E.ON told us that costs to serve were higher for deemed and OOC customers.[223] This is supported by the data from Opus, which showed that the electricity cost to serve was nearly [✂] on deemed tariffs, which is almost twice as much as on retention and rollover contracts (around [✂]).[224]

232. There may also be direct cost differences. E.ON told us that it was hard to forecast the volume needs of deemed and OOC customers, which created risk.[225] This may cause additional imbalance costs on these tariffs – although this should only apply to the extent that the portfolio of deemed customers cannot be forecasted (direct cost differences would also not lead to higher gross margins).

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[218] CMA analysis of Centrica data.
[219] CMA analysis of EDF Energy data.
[220] CMA analysis of RWE data.
[221] EDF Energy, [✂]. Scottish Power (2015), *Response to updated issues statement*, p31.
[222] Our average revenue data generally reflected billed revenues (ie before deduction of bad debt) rather than actual revenues received (after deduction of bad debt).
[223] E.ON, *Response to updated issues statement*, p54.
[224] For a medium microbusiness, with an annual consumption between 10MWh and 30MWh. Source: CMA analysis of Opus data. Averages over 2012 to 2014.
[225] E.ON, *Response to updated issues statement*, p54.

Impact on customers

233. The evidence above suggests that gross margins on deemed and OOC tariffs would need to be significantly higher than on fixed-term contracts in order to cover the associated indirect costs. However, in some cases there may be a portion of gross margins that does not reflect indirect costs. In this section we assess how deemed and OOC prices vary between suppliers, how their level relates to costs, and the durations of customers' stay on these tariffs.

Differences between suppliers

234. Deemed prices vary noticeably between suppliers. Table 6 below shows information on deemed and OOC electricity prices in March 2015. Deemed unit rates varied between £132/MWh and £247/MWh. OOC unit rates also varied significantly (between £132/MWh and £257/MWh). Including the standing charge, the annual bill for a 10MWh deemed customer would be 71% higher with the most expensive supplier compared to the least expensive supplier. This equates to an annual bill difference of over £1,000.

Table 6: Published deemed and OOC electricity unit rates, March 2015

Supplier	*Deemed unit rate (pence/kWh)*	*OOC unit rate (pence/kWh)*
Centrica	21.6	22.5
EON	13.2	13.2
EDF Energy	15.0	18.1
RWE	24.7	25.7
SSE	17.8	14.4
Scottish Power	16.0	n/a
Opus	22.8	22.0
Haven Power	23.0	23.0

Source: data retrieved from suppliers' websites on 11 March 2015.
Notes:
1. Unit rates applying to customers in profile classes 3 and 4[226] in the London region. Standard metering and non-direct debt payment options selected (where offered).
2. RWE unit rates were those based on quarterly billing.
3. Haven Power unit rate given was the day rate – Haven Power charged a lower unit rate for night consumption.

Cost-justification – bad debt

235. In theory, we would not expect the riskiness of deemed customers to vary significantly between suppliers. However, the large differences in write-off rates observed in Table 4 could indicate that some suppliers have deemed customers who are at higher risk of default; or that suppliers have varying rates of success in collecting debt.[227]

[226] These are categories made up largely of small businesses. See paragraph 20 above for further information on profile classes.
[227] Rather than a difference in the underlying customer base, this could also indicate differences in debt collection practices between suppliers.

236. We also observed a tendency for suppliers with higher write-off rates (Table 4) to charge higher deemed prices Table 6 above. This suggests that differences in prices may partly be justified by differences in bad debt.

Cost-justification – information from pricing models

237. Some suppliers' average revenues on deemed tariffs were double those for retention tariffs.[228] Differences in bad debt may partly account for this. However, given the sizeable differences in deemed tariffs between suppliers, we investigate below whether pricing approaches may also contribute to these differences.

238. We note that there is already a specific licence condition in relation to deemed tariffs, which requires suppliers to ensure that the terms of these contracts are not unduly onerous. However, this appears to allow some latitude for suppliers to set high prices for these tariffs. We asked various suppliers how they calculated prices for deemed tariffs.

(a) An SSE document from 2013 included its rationale for its deemed tariff gross margin. It included a [✂]p/kWh addition for energy and balancing risk, with the justification that this reflected the premium for buying volumes in cash-out in the most expensive 300 half hours. However, the final deemed risk premium was agreed at [✂]/kWh, and covered a wider range of risk than only energy and balancing. This figure was used for subsequent reporting.

(b) SSE provided us with a breakdown of its most recent risk premiums for deemed and OOC tariffs (compared to a one year contract).[229] These had three components: energy imbalance, bad debt and an element to simplify the prices offered. SSE told us that the energy imbalance risk for deemed tariffs was based on the spread between the day-ahead price and the System Buy Price to give protection against the worst 30 days last year. This assumes that the supplier purchases all deemed volumes in cash-out, and has no ability to forecast the size of its deemed portfolio.

(c) RWE provided its model used to set deemed tariffs. [✂]. However, in the CMA's interpretation, this is a risk rather than a cost to RWE – the actual cost would depend on how RWE managed this risk (eg insurance).

(d) RWE's [✂].

[228] Based on data received from suppliers (see Annex A to this appendix).
[229] Last reviewed in February 2015.

(e) Centrica provided us with its pricing model for deemed and OOC tariffs. For the most recent entry (June 2014 for OOC, October 2014 for deemed), the net margin presented for electricity customers in profile classes 1 to 4 was [✂] for deemed customers and [✂] for OOC customers. For small non-daily metered gas customers, the net margin figure was [✂] for deemed and [✂] for OOC.

239. As shown in Figures 15 and 17 above, overall average revenues were higher for OOC tariffs than for deemed tariffs in electricity.[230] This is despite our expectation that OOC customers should not have all the same risks as deemed customers.[231] This may be partly the result of how suppliers price OOC tariffs. For example, RWE said that its 'Default' (OOC) tariff was priced at a premium over its deemed tariff, and told us: 'For power [electricity], [✂] to cover the additional risks and encourage customers to either move supplier or sign a new contract.'

Time on tariffs

240. The impact of deemed and OOC pricing decisions on customers would be mitigated if they only spent a limited time on these tariffs. However, some customers stay on these tariffs for a substantial period of time.

241. Based on data from 2013, Ofgem noted that the median duration of customers' stay on deemed and OOC terms was over one year.[232] The same pattern applied to many individual firms – Ofgem's data showed that the median customer tenure on deemed and OOC tariffs was over 300 days for most of the Six Large Energy Firms and some smaller suppliers.

242. This pattern does not necessarily apply to every supplier, particularly in relation to OOC tariffs. RWE told us that 60% of its OOC customers were on this tariff for less than one month. E.ON said that [✂] of customers on OOC prices left within two weeks.

243. Several suppliers told us that they proactively contacted their deemed and OOC customers to encourage them to leave these tariffs. For example, Opus told us that it approached its deemed customers to encourage them to switch to a cheaper fixed-rate price because it would prefer to have a contract in place with all its customers. This suggests that deemed and OOC customers should be aware that they can switch tariffs.

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[230] In gas, OOC average revenues were slightly lower than those on deemed.
[231] For example, see paragraph 227 above.
[232] Ofgem (2014), *Proposals for non-domestic automatic rollovers and contract renewals*, p43.

Summary – deemed and OOC tariffs

244. Deemed and OOC tariffs are special cases. They provide a valuable function by giving customers continuous access to energy, even when a contract is not in place. Given the nature of these tariffs, they have certain costs which are higher than other tariffs (especially bad debt). There are substantial variations in these prices between suppliers – although some of these variations may be linked to suppliers writing off different proportions of revenue as bad debt.

245. These tariffs only apply to a small minority of customers. Based on data from some of the Six Large Energy Firms, deemed and OOC tariffs together represented around 6% of electricity and 7% of gas supplied to microbusinesses.[233] Many customers spend only a short period of time on these tariffs (although some customers do spend much longer on these tariffs). Taken together, these factors suggest that the materiality of any issues with these tariffs may be limited. Therefore, we have not attempted to assess whether prices are fully cost-justified. This seems an area which Ofgem is well-positioned to investigate if it has concerns about individual suppliers' pricing.

Outcomes – regional incumbency

246. We found that the former electricity incumbents generally had higher gross margins in their home regions than elsewhere. We examined this issue in more detail in Annex D.

247. We concluded that regional incumbency is a sign of low engagement among certain customers. However, the data suggests that this may relate primarily to evergreen customers, who represent a small proportion of suppliers' microbusiness volumes. This limits the potential customer harm from incumbency. Therefore we have evaluated it as part of our overall view on engagement, rather than an issue in its own right.

Outcomes: by customer size

248. We saw above (paragraph 172 above) that gross margins on a given tariff tended to be higher the smaller the customer. This section examines whether these gross margin differences between customers of different sizes are cost-justified.

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[233] This information was only available for some of the Six Large Energy Firms (E.ON, EDF Energy, RWE, Scottish Power and SSE for electricity. E.ON, RWE, Scottish Power and SSE for gas). We calculated the proportion of the total volumes supplied to microbusinesses by these suppliers which were supplied on deemed or OOC tariffs. (This was based on data between 2012 and 2014, except for Scottish Power (2014 only)).

249. Several parties told us that we should look at outcomes by customer size. For example, Ofgem said that a key question was whether competition was working effectively for the very smallest non-domestic customers.

250. We break this down into two elements: looking at the smallest microbusinesses in particular, who generated especially high per unit gross margins, and then looking at differences between microbusiness/SME customers of other sizes, where the differences were smaller.

Small microbusinesses

251. We observed above that the highest gross margins were found for customers we classified as small microbusinesses.[234] However, information from various suppliers suggests that this does not translate into these customers delivering higher profits or net present values (NPVs).

(a) Opus submitted data on its net margins, as well as gross margins. For each tariff type, small microbusinesses had the highest average gross margins. However, in each case, the average net margin for small microbusinesses was no higher, on a unit basis, than for other customer sizes. This applied to both gas and electricity.[235]

(b) E.ON's EBITDA model is a forecast for the profitability of its existing portfolio, over a period of one year. E.ON provided a version from December 2014. E.ON's EBITDA model data was segmented into consumption bands. For each tariff type, the EBITDA figure for E.ON's smallest customers,[236] was no higher, on a unit basis, than for other customer sizes.

(c) [✂].

(d) RWE provided us with [✂] NPV data for customers.[237] This suggested that for RWE's [✂]. This applied to both gas and electricity.

(e) Centrica told us that it [✂] on its smallest customers. This involved the smallest [✂]% of its electricity customers and the smallest [✂]% of its gas customers.

252. These differences may be explained by indirect costs that are incurred on a per customer basis. This is because these costs would need to be spread

[234] Meters with an annual consumption below 10MWh of electricity or 30MWh of gas.
[235] CMA analysis of data provided by Opus. All figures were averages over 2012 to 2014.
[236] Below 5MWh of annual consumption for electricity or below 15MWh of annual consumption for gas.
[237] We refer to the snapshot from February 2015.

over a small number of units for small microbusinesses. We asked the Six Large Energy Firms which costs were incurred in this way. They generally said that a number of costs fell into this category, especially metering, customer service and marketing (see paragraph 256 for more detail on this).

253. The profitability of supplying small microbusinesses may also be affected by the allocation of shared costs. If these were allocated on a per customer basis, this could create a larger unit cost for small businesses (as the cost would be spread over a smaller number of units). This would be one possible explanation for negative NPVs recorded for small customers.

Comparing medium microbusinesses and larger SMEs

254. We also observed higher gross margins for medium microbusinesses[238] than for larger SMEs.[239] We want to investigate whether these are justified by indirect costs, or whether they result in higher profits for medium microbusinesses than for larger SMEs.

Per customer indirect costs

255. Some indirect costs may be incurred on a per customer basis. The smaller the number of units these costs are spread over, the higher the unit gross margin required to cover them.

256. We asked the Six Large Energy Firms to provide estimates of indirect costs incurred on a per customer basis. Suppliers had a range of views about which particular cost categories vary with customer numbers, but there were some common messages:

- EDF Energy, Centrica, [✂], E.ON and SSE all said that metering costs varied with number of customers (or meters/sites).
- Four respondents (Centrica, E.ON, [✂] and SSE) said that customer service costs varied with number of customers (or sites).
- Three respondents (E.ON, [✂] and SSE) said that sales and marketing costs varied with number of customers (we were told that new and existing customer numbers may both be drivers).

[238] Meters with an annual consumption between 10 and 30 MWh of electricity (E2), or between 30 and 100 MWh of gas (G2).
[239] Meters with an annual consumption between 100 and 500 MWh of electricity (E4), or between 293 and 1,500 MWh of gas (G4).

257. We present the analysis below based on each firm's estimate of the indirect costs incurred on a per customer basis (ie without harmonising the cost categories included).[240] We took the median from these responses (separately for each fuel). This gave us estimates for the annual cost incurred per customer, which were £88.03 for electricity and £140.76 for gas.[241]

258. We then transformed these annual figures into a per unit basis, for each of our consumption bands.[242] As expected, the large range in annual consumption between customers in our data leads to a large difference in these costs when presented on a per unit basis. For example, the resulting figure in electricity for small microbusinesses was £35.21/MWh, whereas for larger SMEs it was £0.44/MWh. However, the range was less extreme when comparing medium microbusinesses and larger SMEs – the electricity figure for medium microbusinesses was £5.87/MWh.

259. We examined whether per customer indirect costs could account for the differences in gross margins between medium microbusinesses and larger SMEs. Figure 20 below shows the results for electricity, while Figure 21 shows the results for gas. For comparability, we focus on the gross margins on fixed-term contracts.

Figure 20: Differences in average gross margins and differences in estimated per customer indirect costs – medium microbusinesses minus larger SMEs, electricity

[✂]

Source: CMA analysis of data from the Six Large Energy Firms (except SSE).
Notes:
1. [✂]
2. [✂]

Figure 21: Differences in average gross margins and differences in estimated per customer indirect costs – medium microbusinesses minus larger SMEs, gas

[✂]

Source: CMA analysis of data from the Six Large Energy Firms (except SSE).
Note: [✂]

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[240] As a sensitivity, we looked at only the three cost categories most commonly mentioned as being incurred on a per customer basis (metering, customer service, and sales and marketing – see paragraph 256 above). For each of these categories, we took the median estimate (where provided). We then added these together to give an alternative figure for the size of per customer costs. For both fuels, this was slightly lower than the figure calculated by taking the median of the overall estimates provided by each supplier. However, the difference was small (less than £10 per customer per year), so this would have little impact on the results.
[241] We checked these against profit and loss data from the Six Large Energy Firms (as used in our retail margins analysis). Using the figures from FY 2013, we added up the costs in the metering, customer service and marketing categories (assumed to vary with the number of customers), for SME electricity and SME gas. We divided this by the number of meters to give an average cost per meter. Taking the median across the Six Large Energy Firms, we obtained figures of £91 a year for electricity, and £166 a year for gas. These figures are similar to those based on each firm's estimate.
[242] As a simplified assumption, we used the lower quartile of each consumption band as the annual consumption figure (eg for customers in consumption band E2 (10–30MWh), this meant using an annual consumption figure of 15MWh). This is because we observed that average consumption in a given band was generally below the mid-point.

260. Our estimates of costs incurred on a per customer basis are only approximate. This means these charts should be interpreted as giving a broad impression of the potential difference in these costs between consumption bands, rather than as providing precise estimates.

261. In Figure 20, we can see that for acquisition and retention contracts, per customer costs may largely account for higher electricity gross margins for medium microbusinesses than larger SMEs. However, rollover electricity contracts for some suppliers have average gross margin differences that are four or more times larger than the estimated difference in per customer costs. One possible explanation for the larger differences on these tariffs might be if suppliers expect medium microbusinesses to have lower engagement than larger SMEs, and thus offer them worse rollover rates.

262. Based on Figure 21, it also appears that differences in per customer costs could broadly explain differences in average gross margins in gas between medium microbusinesses and larger SMEs. The possible exception was Centrica's rollover tariff, where the difference in gross margins was [✂] the estimated difference in per customer costs.

Net present values

263. RWE provided data on NPVs of its customers for electricity (see paragraph 16 of Annex D to this appendix for a description of this data and its caveats). To compare NPVs across different sizes of customers, we calculated the NPV per unit of annual consumption,[243] dividing the NPV figure by the mid-point volume of each of RWE's consumption bands. Figure 22 below shows the results for one year electricity contracts.[244]

Figure 22: RWE NPVs for SME electricity customers, per unit of assumed annual consumption

[✂]

Source: CMA analysis of data provided by RWE.

264. This chart suggests that [✂][245] [✂]. As noted in paragraph 17 of Annex D to this appendix, RWE told us that there were a number of limitations with this data.

[243] As we would expect the absolute NPV to be higher for larger customers, simply because they consume more units, other things being equal.
[244] We only present results for customers in consumption bands above 10 MWh, as this corresponds to our definition of medium microbusinesses.
[245] Above we defined this as meters with an annual consumption between 10 and 30 MWh of electricity, which does not correspond perfectly to RWE's classification.

265. E.ON also provided data on NPVs for current electricity customers.[246] Figure 23 below is based on the average NPV for a particular combination of consumption band and tariff type. We divided this by the corresponding average consumption figure,[247] in order to compare across consumption bands.[248]

Figure 23: E.ON average NPV per unit of average annual consumption – electricity contracts for profile classes 3 and 4

[✂]

Source: CMA analysis of E.ON data.

266. [✂][249] – possibly because this category included customers who had rolled over without negotiating. These customers may have a higher price currently; they might also be likely to face higher prices in future if they had shown themselves less likely to switch tariffs.[250]

Bad debt and credit

267. A potential explanation for some of the differences in gross margins between medium microbusinesses and larger SMEs could be differences in costs related to creditworthiness (bad debt and debt recovery). We have limited data to test this, but on the evidence available, this does not seem to be a significant factor.

268. RWE's data on revenue written off as bad debt provided a mixed picture [✂].

(a) [✂].

(b) [✂].

269. Opus's data on indirect costs showed little difference between bad debt costs for medium microbusinesses and larger SMEs. For rollover tariffs in electricity, the difference was less than [✂]. The equivalent difference in gas was also small [✂]).

270. We looked at E.ON's data on the results of credit checks. Larger SMEs were slightly more likely than medium microbusinesses to be accepted without

[246] See paragraph 18 of Annex D to this appendix for a description of this data.
[247] Taken from E.ON's model.
[248] As with the other NPV information, we only report consumption bands between 10 and 30 MWh, as this corresponds to our definition of medium microbusinesses.
[249] E.ON told us that this based on a model and assumptions which are a year old and therefore some of these assumptions will be out of date.
[250] However, this model was created after E.ON decided to abandon the use of auto-rollovers, and so does not assume that a customer would be subject to an auto-rollover in future.

restrictions, but the difference was less than one percentage point for both gas and electricity.

Summary – outcomes by customer size

271. We observed higher gross margins for small microbusinesses than for other customers in our data. However, these customers may be no more profitable than others, once per customer indirect costs are included. We therefore do not have specific concerns about small microbusinesses.

272. Gross margins were also higher for medium microbusinesses than for larger SMEs. In some cases, this may be justified by per customer indirect costs. However, based on the range of evidence available, there are some indications that supplying medium microbusinesses may be more profitable than supplying larger SMEs. We do not consider that the evidence on this point is conclusive. However, to the extent that this is true, it may be linked to lower engagement among microbusinesses than other SME customers. It would also be consistent with low transparency increasing switching costs, as these costs would be higher (relative to the cost of energy) for medium microbusinesses compared to larger SMEs.

Summary

273. We observed that a substantial number of microbusinesses are achieving poor outcomes in their energy supply. EBIT margins were generally higher in the SME markets than other markets (beyond what appears to be justified by risk).[251] We observed that average revenues are substantially higher on the tariff types that less engaged customers end up on, compared to those tariffs requiring an active choice by customers. These differences in revenues between tariffs go beyond what is justified by costs. We therefore have concerns that the less engaged customers on these tariffs are not exerting sufficient competitive constraints on energy suppliers. Our concerns are particularly around the various types of tariffs that customers are automatically moved on to if they have not engaged with energy supply at the end of a fixed-term contract.

274. These poor outcomes appear to arise from a lack of engagement among customers, which may stem partly from a lack of transparency around prices. This may in turn soften competition: in particular, suppliers do not seem to be automatically offering competitive prices to their existing customers at the end

of their existing contracts, or to existing customers who do not have a fixed-term contract.

275. One specific reason for poor outcomes for some customers is the behaviour of some TPIs, in two forms. The first is malpractice, which reduces the level of trust in all TPIs and discourages engagement. The second is the fact that some TPIs are incentivised not to give the customer the best possible deal. We are concerned that customers are not aware of this and therefore do not take steps to mitigate it (for example by consulting more than one TPI or seeking other benchmark prices). This is exacerbated by the lack of easily available benchmark prices due to both the nascent state of PCWs for non-domestic customers, and the fact that many tariffs are not published and benchmark prices have historically been hard to find (although the latter situation may be improving).

276. We also observed concerns around the practice of auto-rollover tariffs (where customers are signed up for a year at rates they have not negotiated and with no exit clause) due to its limiting effects on engagement (regardless of the level of prices). This practice has recently been discontinued by the largest suppliers, but not by some of the smaller ones. Therefore the current impact of this is relatively small.

277. We also observed that prices were very high on deemed and OOC tariffs. The evidence suggested that these may be to some extent cost-justified, although we could not conclude that this was entirely the case. We note that Ofgem has powers to investigate the pricing of deemed tariffs.

Annex A: Average revenues and gross margins for individual suppliers

1. This annex reports the average revenue and gross margin results for each individual supplier that provided this data. Suppliers are presented in alphabetical order.

2. Each table below is based on the full set of information provided by each firm. This covers 2012 to 2014 (except where stated).

Centrica

3. The key caveats we took into account in analysing Centrica's data are:

   (a) Centrica's data was based on forward looking estimates at the point of sale (for example, volumes were taken from the estimated annual consumption or annual quantity). All figures were on an annualised basis. This means that contract customers were only included in the data in the quarters where they signed a new contract.

   (b) For customers on variable tariffs, information was available about the whole portfolio, but only around the time of price changes. To reflect the price charged in each quarter, we filled in the remaining quarters using this information.

   (c) Centrica was unable to provide data for the full set of tariffs for the final quarter of 2014.

   (d) Centrica deducted metering costs before calculating its definition of gross margin.

   (e) As Centrica's data for contract customers was based on sales, it included some customers where the customer did not ultimately transfer. Centrica estimates these would make up 10 to 15% of acquisitions.

   (f) Centrica's data excluded customers in its I&C portfolio.

Table 1: Centrica – average revenue (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Centrica.

Table 2: Centrica – gross margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Centrica.

Table 3: Centrica – average revenue (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Centrica.

Table 4: Centrica – gross margin (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Centrica.

EDF Energy

4. The key caveats we took into account in analysing EDF Energy's data are:

   (a) Given the small scale of its SME gas business, EDF Energy only provided data in this format for electricity.

   (b) EDF Energy's data did not include electricity customers held in its I&C systems.

Table 5: EDF Energy – average revenue (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from EDF Energy.

Table 6: EDF Energy – gross margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from EDF Energy.

Table 7: EDF Energy – gross margin (£/MWh) by consumption band and whether incumbent region, electricity

	E1	*E2*	*E3*	*E4*
Other regions	[✂]	[✂]	[✂]	[✂]
Incumbent regions	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from EDF Energy.

E.ON

5. The key caveats we took into account in analysing E.ON's data are:

   (a) E.ON's data is derived from an allocation of actual volumes and revenues recorded in the books of accounts and supporting records. This allocation was carried out using industry consumption (estimated annual consumption or annual quantity) and customer prices as recorded by E.ON.

   (b) E.ON's data included multi-site customers (customers were placed into consumption bands based on individual meters rather than at a customer level).[252]

   (c) E.ON's data did not include microbusiness customers who are managed within its Corporates business segment.

   (d) E.ON excluded commission payments to TPIs from the revenue figures. This means that E.ON's gross margin figures did not need to cover such payments.

   (e) E.ON identified rollover customers by looking at those who moved onto a contract which was the same price as their initial offer.

   (f) De-energised products have been included in the Evergreen category. As these meters have no revenue associated with them, their inclusion will materially reduce the calculated Evergreen gross margin per MWh and revenue figures per MWh.

[252] E.ON said it believed it had a large number of customers where it supplied more than one site.

Table 8: E.ON – average revenue (£/MWh) by consumption band and tariff type, electricity

Category	*E1*	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from E.ON.

Table 9: E.ON – gross margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from E.ON.

Table 10: E.ON – gross margin (£/MWh) by consumption band and whether incumbent region, electricity

	E1	*E2*	*E3*	*E4*
Other regions	[✂]	[✂]	[✂]	[✂]
Incumbent regions	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from E.ON.

Table 11: E.ON – average revenue (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from E.ON.

Table 12: E.ON – gross margin (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from E.ON.

Gazprom

6. [✂].

Table 13: Gazprom – average revenue (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention and rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Gazprom.

Table 14: Gazprom – gross margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention and rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Gazprom.

Table 15: Gazprom – average revenue (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Gazprom.

Table 16: Gazprom – gross margin (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Gazprom.

Opus

7. Unlike other suppliers, Opus was able to provide information on net margins at the same level of detail as gross margins.

Table 17: Opus – average revenue (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Opus.

Table 18: Opus – gross margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Opus.

Table 19: Opus – net margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Opus.

Table 20: Opus – average revenue (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Opus.

Table 21: Opus – gross margin (£/MWh) by consumption band and tariff type, gas

Category	*G1*	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Opus.

Table 22: Opus – net margin (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Opus.

RWE

8. The key caveats we took into account in analysing RWE's data are:

   (a) RWE's data was made up of quarterly snapshots, each showing its entire portfolio. Each of these looked at forecast values (revenue, volume, gross margin) on an annualised basis.

(b) As the data was on an annualised basis, it assumed that the customer was on the same tariff for a full year. RWE said that this could overstate revenues and gross margins, if customers actually stayed for a shorter period of time.

(c) RWE provided a detailed explanation of the steps used to construct the data from various sources, which contained a number of caveats that we have taken into account in considering the weight to place on this evidence.

(d) RWE's gross margin was presented [✂].

(e) RWE's data excluded customers in its I&C systems. [✂].

Table 23: RWE – average revenue (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from RWE.

Table 24: RWE – gross margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from RWE.

Table 25: RWE – gross margin (£/MWh) by consumption band and whether incumbent region, electricity

	E1	*E2*	*E3*	*E4*
Other regions	[✂]	[✂]	[✂]	[✂]
Incumbent regions	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from RWE.

Table 26: RWE – average revenue (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from RWE.

Table 27: RWE – gross margin (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention	[✂]	[✂]	[✂]	[✂]
Rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from RWE.

Scottish Power

9. The key caveats we took into account in analysing Scottish Power's data are:

(a) Scottish Power's electricity data was based on single-site customers in profile classes 3 and 4. Its gas data covered its entire non-domestic portfolio.

(b) Scottish Power's data was only available for 2014.[253]

(c) Scottish Power was unable to segment retention and rollover tariffs.

(d) Scottish Power was only able to calculate direct costs at the level of its entire SME business.[254] These direct costs were then allocated on a unit (£/MWh) basis, in order to estimate gross margins. In reality, some direct costs might vary with customer characteristics – this would reduce the accuracy of the gross margin figures.

Table 28: Scottish Power – average revenue (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention and rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Scottish Power.

Table 29: Scottish Power – gross margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention and rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Scottish Power.

[253] Scottish Power provided a small amount of information for 2012 and 2013, but we dropped this as it was not available for all products.
[254] The only exception to this was electricity network costs.

Table 30: Scottish Power – gross margin (£/MWh) by consumption band and whether incumbent region, electricity

	E1	*E2*	*E3*	*E4*
Other regions	[✂]	[✂]	[✂]	[✂]
Incumbent regions	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Scottish Power.

Table 31: Scottish Power – average revenue (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention and rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Scottish Power.
Note: Scottish Power supplied a negligible volume to G3 deemed customers – this explains the extreme figure.

Table 32: Scottish Power – gross margin (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention and rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Scottish Power.
Note: Scottish Power supplied a negligible volume to G3 deemed customers – this explains the extreme figure.

SSE

10. The key caveats we took into account in analysing SSE's data are:

    (a) SSE was unable to provide disaggregated information on gross margins.

    (b) SSE was unable to separate out retention and rollover tariffs.

Table 33: SSE – average revenue (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention and rollover	[✂]	[✂]	[✂]	[✂]
Evergreen	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from SSE.

Table 34: SSE – average revenue (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
Acquisition	[✂]	[✂]	[✂]	[✂]
Retention and rollover	[✂]	[✂]	[✂]	[✂]
Deemed	[✂]	[✂]	[✂]	[✂]
OOC	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from SSE.

Total gas and power

Table 35: Total – average revenue (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Total.

Table 36: Total – gross margin (£/MWh) by consumption band and tariff type, electricity

	E1	*E2*	*E3*	*E4*
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Total.

Table 37: Total – average revenue (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Total.

Table 38: Total – gross margin (£/MWh) by consumption band and tariff type, gas

	G1	*G2*	*G3*	*G4*
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data from Total.

Annex B: Information on prices and margins from suppliers' internal documents

1. There was some information on prices and margins by tariff in the internal documents of most of the Six Large Energy Firms. We report some of this in the section below. These documents generally support the broad findings we took from our examination of suppliers' average revenues and gross margins.

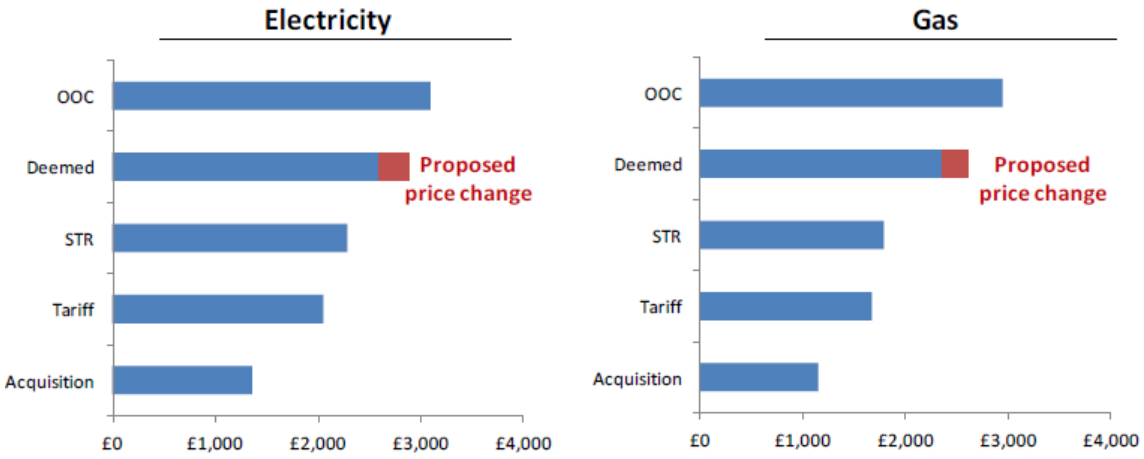
    - We note that prices are higher for default tariffs, especially deemed and OOC tariffs.
    - Gross margins also appear to be higher on these tariffs, although this may reflect certain additional costs of these tariffs, such as bad debt.
    - Only a couple of firms provided information on EBIT or EBITDA – but both of these suggested that profit margins were higher for default tariffs.

2. This information is not intended to be used to compare suppliers, given that it was not available in a consistent way. The documents are also historical, meaning that the situation may have changed (eg since the end of auto-rollovers).

Prices

3. Figure 1 below is taken from a 2014 Centrica internal document. It shows the annual bill for different tariffs, holding the level of consumption constant. It can be seen that the annual bill was around twice as large for deemed or OOC tariffs as for acquisition tariffs. The difference appeared to be larger for gas than for electricity.

Figure 1: Annual bills for different Centrica tariffs at constant consumption, January 2014



Source: Centrica
Note: STR stands for Straight Through Renewal (ie without negotiation). The chart is based on 'average' consumption (12 MWh electricity, 31 MWh gas a year).

4. [✂].

Figure 2: [✂]

[✂]

Source: EDF Energy.

5. Similarly, Figure 3 from RWE (2014) shows that unit rates for acquisition electricity tariffs (on the left-hand side) were [✂] than for other tariffs (on the right hand side). ([✂]). The price for auto-rollovers was [✂] acquisition tariffs. [✂] for RWE npower's Tariff products, which cover customers that have not switched since privatisation. [✂].

Figure 3: [✂]

[✂]

Source: RWE.

Margins

6. [✂].

Figure 4: [✂]

[✂]

Source: EDF Energy.

7. In an internal document from 2013, SSE stated that over [✂] of its gross margin from non-half-hourly metered customers came from those on auto-rollover or OOC tariffs. This was despite these customers making up only around [✂]% of the volume. SSE noted that this did not take into account indirect costs or possible higher costs of managing OOC customers.

8. An RWE internal document from 2014 also suggested that [✂]. The document stated that the average difference between [✂] per customer was [✂].

9. Internal documents from E.ON also made reference to the size of gross and EBIT margins. A presentation from 2011 on SME strategy said that 'the majority of groups are well above where you'd expect the [gross] margins to sit in a completely rational market.' However, this presentation also said that low volume electricity customers were [✂]% of customers, but contributed only [✂]% of gross margin and [✂]% of EBIT. This statistic does not suggest that higher profits were being earned from low volume customers as a group. In another document from 2012, E.ON stated that its loss-making customers were concentrated on low consumption acquisition.

10. However, [✂]. Figure 5 below shows the number of customers at each consumption level, split by levels of EBITDA margins. [✂].

Figure 5: [✂]

[✂]

Source: E.ON.

11. [✂].

Figure 6: [✂]

[✂]

Source: E.ON.

12. Figure 7 below, from Centrica (2012), [✂].

Figure 7: [✂]

[✂]

Source: Centrica.

13. [✂].

Figure 8: [✂]

[✂]

Source: Centrica.

Annex C: Initial indications of outcomes on products replacing auto-rollovers

1. This annex reports information from three suppliers on the initial outcomes for customers following the move away from auto-rollovers.

2. We only have data covering a very limited period of time since these suppliers stopped using auto-rollovers. We therefore include this analysis purely as an indication of the potential effect of this change.

Centrica

3. Centrica stopped automatically renewing customers in June 2014. Customers who would previously have been rolled over now move onto the 'Variable Price Plan' (VPP, since September 2014). This is a variable price contract, although Centrica said that it would expect to hold the price for a year. This is a new product, introduced since the end of auto-rollovers. We would categorise it as an evergreen tariff (although Centrica already had other evergreen tariffs, and we present it separately from those tariffs in the tables below).

4. Centrica provided a variable that allowed us to identify customers on the VPP tariff.[255] However, Centrica was not able to provide data for the final quarter of 2014. This means that the only data on VPP contracts relates to September 2014. We therefore compare average revenues and gross margins across tariff types in Q3 2014, recognising that this is only one month of data on VPP pricing.

5. Table 1 shows the results for electricity, while Table 2 shows the equivalent results for gas. The VPP results are in bold.

[255] This is at a slightly more detailed level than the standard set of six product categories used elsewhere in the analysis. In the data in Annex A, Centrica included the VPP product in the rollover category.

Table 1: Centrica average revenues and gross margins for medium microbusinesses (£/MWh), electricity – Q3 2014

Tariff	*Average revenue*	*Gross margin*
Acquisition	[✂]	[✂]
Deemed	[✂]	[✂]
OOC	[✂]	[✂]
Auto-rollover	[✂]	[✂]
Retention	[✂]	[✂]
Evergreen	[✂]	[✂]
VPP	[✂]	[✂]

Source: CMA analysis of data from Centrica.
Coverage is customers in consumption band E2.
Note: In the data in Annex A, both auto-rollover and VPP contracts were included in the 'Rollover' category.

Table 2: Centrica average revenues and gross margins for medium microbusinesses (£/MWh), gas – Q3 2014

Tariff	*Average revenue*	*Gross margin*
Acquisition	[✂]	[✂]
Deemed	[✂]	[✂]
OOC	[✂]	[✂]
Auto-rollover	[✂]	[✂]
Retention	[✂]	[✂]
Evergreen	[✂]	[✂]
VPP	[✂]	[✂]

Source: CMA analysis of data from Centrica.
Notes:
1. Coverage is customers in consumption band G2.
2. In the data in Annex A, both auto-rollover and VPP contracts were included in the 'rollover' category.

6. [✂].

7. [✂].

8. Centrica provided annualised forecasts for margins. VPP customers can leave during a year – for those who do, the margins actually earned may be lower than those in the tables above.

RWE

9. RWE stopped automatically renewing customers in November 2014. Customers who would previously have been rolled over now move onto the 'Flexible' tariff. This is a one year fixed tariff, which a customer can leave with 30 days' notice. This is a new product.[256]

10. RWE provided information allowing us to identify the Flexible tariff specifically.[257] We can therefore look at average revenues and gross margins

[256] The Flexible product 'launched fully in September 2014 for November renewals', although it was previously available on a trial basis.
[257] This is at a more detailed level than the product categories used in the other analysis. In Annex A, RWE's Flexible product is included in the evergreen category.

in the final quarter of 2014. Table 3 shows these results for electricity, and Table 4 shows results for gas. Results for the Flexible tariff are in bold.

Table 3: RWE average revenues and gross margins (conditional on payment) for medium microbusinesses (£/MWh), electricity – Q4 2014

Tariff	*Average revenue*	*Gross margin*
Acquisition	[✂]	[✂]
Deemed	[✂]	[✂]
Default	[✂]	[✂]
Flexible	[✂]	[✂]
Retention	[✂]	[✂]
Rollover	[✂]	[✂]
'Tariff'	[✂]	[✂]
Variable	[✂]	[✂]

Source: CMA analysis of data from RWE.
Note: Coverage is customers in consumption band E2.

Table 4: RWE average revenues and gross margins (conditional on payment) for medium microbusinesses (£/MWh), gas – Q4 2014

Tariff	*Average revenue*	*Gross margin*
Acquisition	[✂]	[✂]
Deemed	[✂]	[✂]
Default	[✂]	[✂]
Flexible	[✂]	[✂]
Retention	[✂]	[✂]
Rollover	[✂]	[✂]
Variable	[✂]	[✂]

Source: CMA analysis of data from RWE.
Note: Coverage is customers in consumption band G2.

11. [✂].

12. RWE provided annualised forecast data. Flexible customers can leave during a year – for those who do, the margins actually earned may be lower than those in the tables above.

SSE

13. SSE stopped automatically renewing customers in April 2014. Customers who would previously have been rolled over are now moved onto Variable Business Rates (which the customer can terminate at any time). This has published prices that are available online.[258] This tariff was already available to SSE customers (however, given that these prices are published, they should be similar[259] for existing customers on Variable Business Rates and for customers moving onto this tariff at the end of their fixed contracts).

[258] SSE's Variable Business Rate.
[259] SSE's Variable Business Rate is made up of different rates for different categories of customer. This means that the average revenues for existing customers and customers moving onto this tariff could be different, if there were different mixes of customers (eg different mixes of profile classes).

14. We look at the SSE's average revenues between Q2 2014 and Q4 2014. Table 5 below shows the results for electricity, while Table 6 shows the results for gas. SSE's Variable Business Rates make up the OOC tariff type (result in bold).

Table 5: SSE average revenues for medium microbusinesses (£/MWh), electricity – Q2 2014 to Q4 2014

Tariff type	*Average revenue*
Acquisition	[✂]
Retention and rollover	[✂]
Evergreen	[✂]
Deemed	[✂]
OOC	[✂]

Source: CMA analysis of data from SSE.
[✂]

Table 6: SSE average revenues for medium microbusinesses (£/MWh), gas – Q2 2014 to Q4 2014

Tariff type	*Average revenue*
Acquisition	[✂]
Retention and rollover	[✂]
Deemed	[✂]
OOC	[✂]

Source: CMA analysis of data from SSE.
[✂]

15. SSE could not separate out retention and rollover tariffs – we therefore cannot compare rollover tariffs against their replacements. We can observe that in electricity, the average OOC revenue was lower than on evergreen tariffs. In gas, the average OOC revenue was only slightly above the retention and rollover category.

Annex D: Outcomes: regional incumbency

1. This section looks at regional incumbency effects in electricity. We discuss the regional gross margin results, and then look at other evidence on incumbency.

Gross margins

2. As noted in paragraph 174 above, we found that the former electricity incumbents[260] generally had higher gross margins in their home regions than elsewhere.

3. This gross margin difference should not be the result of cost differences (the main costs that vary regionally are network charges, and these are deducted in the calculation of gross margin). We have not received clear evidence that indirect costs vary systematically on a regional basis. Even if certain indirect costs (such as metering or bad debt) might vary from region to region, this could not explain a general pattern of higher gross margins for former incumbents across regions.[261]

4. The gross margin result is partly driven by evergreen tariffs. Below we examine evidence on evergreen tariffs and then other tariffs.

Evergreen tariffs

5. We looked at this category separately because it included customers who had remained on the same tariff since privatisation. We observed two signs of incumbency:

   - in home regions, a high share by volume was supplied via evergreen tariffs compared to other regions (paragraph 6 below); and
   - higher gross margins (in most cases) on evergreen tariffs in home regions compared to other regions (paragraph 7 below).

6. All five of the former electricity incumbents supplied a [✂] proportion of their microbusiness volumes through evergreen tariffs in their home regions compared to other areas. Figure 1 below illustrates this. In some cases, over

[260] SSE was unable to provide information on gross margins. SSE's average revenues were higher in its home regions than elsewhere. However, one of SSE's home regions is Northern Scotland, which has higher network charges than many other regions. This means that higher average revenues in home regions could be the result of network charges, rather than incumbency.
[261] In relation to metering, if a former incumbent has a large number of customers in its home region, then it may be able to negotiate a cheaper rate for this service. Suppliers might therefore have lower metering costs in their home regions.

20% of a supplier's microbusiness volumes in its home region were supplied through evergreen tariffs, whereas evergreen tariffs never accounted for more than 10% of any of the former incumbent suppliers' volumes outside their home regions. As an overall mean, evergreen tariffs represented 13% of the volume supplied by the former incumbent suppliers to microbusinesses in their home regions. In contrast, evergreen tariffs only made up 2% of the volume supplied by these firms to microbusinesses in other regions. From our work elsewhere (paragraph 172(b) above), we saw that gross margins were generally higher on evergreen tariffs than on acquisition or renewal contracts. This means that a region with a higher proportion of volumes supplied through evergreen tariffs will tend to have a higher overall gross margin.

Figure 1: Evergreen tariffs as a proportion of microbusiness volumes, by region type

[✂]

Source: CMA analysis of data provided by suppliers.
Note: [✂].

7. The average unit gross margin on evergreen tariffs was also generally higher in former incumbents' home regions than elsewhere.[262] Figure 2 below shows the difference in average evergreen gross margins between home regions and other regions. For each supplier in the figure, the largest difference related to the smallest microbusinesses, where the gross margin was £[✂]/MWh higher in home regions.[263] The weighted average across the four[264] suppliers was £19/MWh for the smallest microbusinesses, £6 for medium microbusinesses, and £4 for the largest class of microbusinesses. For larger SMEs, there was no significant difference.

Figure 2: Difference in average unit gross margins on evergreen tariffs: home regions minus other regions

[✂]

Source: CMA analysis of data provided by suppliers.
Notes:
1. [✂].
2. [✂].

8. One potential explanation for higher evergreen gross margins in home regions compared to other regions is that evergreen customers in home regions may create higher indirect costs than evergreen customers in other regions. We did not receive evidence to indicate that this is the case.

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[262] Exceptions were [✂], and E.ON in band E4. In each case the average unit gross margin was a small amount lower in home regions.
[263] Meters with an annual consumption below 10 MWh (consumption band E1).
[264] SSE was unable to provide gross margin data.

9. Home area evergreen customers are a relatively small proportion of suppliers' microbusiness electricity volumes. For four of the former electricity incumbents, these customers represented between 3 and 6% of volumes supplied to microbusinesses. The exception was EDF Energy, where the proportion was [✂]%.[265] The overall average across the former electricity incumbents was 5%.

10. The number of home area evergreen customers may also be falling. RWE told us that the number of customers on its Tariff product (consisting of customers in its home regions who have not switched product since privatisation) fell from around [✂] in 2009 to around [✂] in 2014.

Other products

11. For products other than evergreen tariffs, the differences in average unit gross margins between home regions and other regions were mostly smaller than on evergreen tariffs, and were less consistently in the same direction. Table 1 compares the differences for medium microbusinesses.[266] This suggests that suppliers are not systematically receiving much higher gross margins on other tariffs in their home regions compared to elsewhere.

Table 1: Difference in average unit gross margins by tariff type: home regions minus other regions, medium microbusinesses (band E2)

	[✂]	[✂]	[✂]	[✂]	*Average*
Acquisition	[✂]	[✂]	[✂]	[✂]	–0.30
Retention	[✂]	[✂]	[✂]	[✂]	1.40
Rollover	[✂]	[✂]	[✂]	[✂]	1.15
Evergreen	[✂]	[✂]	[✂]	[✂]	5.84
Deemed	[✂]	[✂]	[✂]	[✂]	–1.05
OOC	[✂]	[✂]	[✂]	[✂]	–0.75

Source: CMA analysis of data provided by suppliers.
Notes:
1. Data is 2012 to 2014 for all suppliers except Scottish Power (2014 only).
2. Scottish Power retention category is retention and rollover.
3. Average is a volume weighted average across the four suppliers. Volume used is the annual average volume supplied to E2 customers on each tariff.

12. The idea that any regional differences in gross margins are unlikely to be the result of regional competition is supported by statements from suppliers.

    (a) EDF Energy told us that: '[our SME business] does not consider competitors, or its acquisition strategy, on a regional basis'.

    (b) E.ON said that it saw very little regional difference in competition for SME customers.

[265] CMA analysis of data provided by suppliers.
[266] Those with an annual electricity consumption between 10 and 30MWh.

Other indications of incumbency

13. We also saw some other indications that incumbency affected outcomes. Below we look at shares of supply by incumbents, and two measures of profitability (EBIT and NPV).

Shares of supply

14. As reported in Figure 8 in paragraph 35 of this appendix, the average share of the former electricity incumbent in each region has fallen over time. However, there is still some evidence from this chart that the former electricity incumbents are more important in their home regions than elsewhere. In July 2014, 34% of SME electricity meter points were supplied by the former electricity incumbent (in that region), which was only slightly less than the share of the other four electricity incumbents[267] put together (37%).

EBIT

15. Scottish Power provided SME EBIT figures from its management accounts, covering 2012 to 2014. [✂]. This EBIT information supports the case that customers are more profitable in incumbent regions.

Net Present Values

16. RWE provided us with an NPV model, which classified customers by [✂]. This provided information on customer NPVs [✂].[268] We report results from the most recent snapshot (February 2015). [✂]. The majority of RWE's Tariff customers were in a [✂] where this was the case. However, [✂]% of RWE's Tariff customers were in [✂].

17. RWE made a number of caveats about the NPV model. In particular, [✂], and the model had not been updated recently. [✂]. However, the model may at least provide a broad indication of NPVs on different tariffs.

18. E.ON also provided us with an NPV model.[269] This provided three-year customer NPVs split by tariffs and consumption bands. This showed that the 'BEP' (evergreen electricity tariff for profile classes [✂] and 'MD Tariff' (evergreen electricity tariff for profile classes [✂]) products had the [✂] for each consumption band above 5 MWh per year. For example, [✂].

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[267] ie firms that used to be electricity incumbents in other regions.
[268] [✂].
[269] We refer here to the latest version of E.ON's 'on supply' model (Q2 2014).

19. These values are not split by region. However, on average between 2012 and 2014, [✂] of E.ON's microbusiness evergreen volumes were supplied to customers in its former incumbent regions.[270] This suggests that there is some link between evergreen tariffs and incumbent regions.

Gas

20. We cannot look at incumbency on a regional basis in gas, because Centrica was the former national incumbent. However, Figure 7 of this appendix showed that Centrica still has the largest share of supply of gas. For meters with an annual consumption below 30 MWh, Centrica's share was two and a half times that of the next largest supplier.

21. Centrica has an evergreen product (named 'Tariff'). This product is not currently sold to new customers. In January 2015, [✂] of Centrica's SME gas sites were on this product, compared to [✂] of its SME electricity sites. However, the average gross margin on Centrica's evergreen gas product was generally similar to that of other suppliers on their evergreen gas products.[271,272]

22. This suggests that there may also be some residual effects of incumbency in microbusiness gas as well as electricity.

Summary on regional incumbency effects

23. We consider that regional incumbency in electricity is a sign of low engagement among certain customers. However, the data suggests that this may relate primarily to evergreen customers, who represent a small proportion of suppliers' microbusiness volumes. This limits the potential customer harm from incumbency. Therefore we have evaluated it as part of our overall view on engagement, rather than an issue in its own right.

24. There was only one former gas incumbent, so we cannot look at gas on a regional basis. However, evidence suggests that there may also be some residual effects of incumbency in microbusiness gas as well as electricity.

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[270] Based on annual average volumes. CMA analysis of data provided by E.ON. E.ON told us that this figure has been falling over time and fell by [✂] percentage points even within this period.
[271] For example, for medium microbusinesses (band G2), Centrica's average gross margin was £[✂]. The equivalent figures were: [✂] for E.ON, [✂] for RWE, and [✂] for Scottish Power.
[272] We were not able to compare Centrica's overall margins in gas with those of other suppliers, because Centrica did not provide a full view of its portfolio (Centrica only included fixed products at the point of sale).