Appendix 10.1: Approach to profitability and financial analysis

Contents

<table>
<thead>
<tr>
<th>Contents</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Purpose and interpretation of profitability analysis</td>
<td>2</td>
</tr>
<tr>
<td>Scope of our profitability analysis</td>
<td>3</td>
</tr>
<tr>
<td>Selection of profitability measure and associated benchmark</td>
<td>7</td>
</tr>
<tr>
<td>Scope of relevant operating revenues, costs, assets and liabilities</td>
<td>8</td>
</tr>
<tr>
<td>Financial information: basis of preparation principles</td>
<td>9</td>
</tr>
<tr>
<td>Competitive benchmark prices and costs</td>
<td>15</td>
</tr>
</tbody>
</table>

Introduction

1. In this appendix we set out our approach to analysing profitability in this market investigation. We explain why we have undertaken this analysis and the generic approach adopted across the elements of the energy sector value chain we have analysed. The results of our analysis are set out in detail in the following appendices:

   (a) Cost of capital (Appendix 10.4);
   (b) Generation return on capital employed (Appendix 4.2);
   (c) Retail energy supply profit margin analysis (Appendix 10.2);
   (d) Retail profit margin comparators (Appendix 10.6);
   (e) Analysis of retail supply profitability (Appendix 10.3); and
   (f) Assessment of the competitive benchmark in energy retail supply (Appendix 10.5).

2. Most elements of our approach for analysing profitability, for example our chosen measure of profitability and the overarching approach to valuing a firm’s asset base, are common across the energy supply value chain and are set out in this appendix. However, where we have implemented our approach in a way specific to an individual piece of analysis, then we set out the detail of that implementation in the relevant appendix.

3. We supplemented our profitability analyses by conducting analysis of retail energy supply profit margins, considering the relevance of margin
benchmarks for retail energy supply and analysing the efficiency of the costs incurred by firms in retail energy supply.

4. The rest of this appendix is structured as follows:

(a) Purpose and interpretation of profitability analysis (paragraphs 5 to 9).

(b) Scope of our profitability analysis (paragraphs 10 to 22).

(c) Selection of profitability measure and associated benchmark (paragraphs 23 to 28).

(d) Scope of relevant operating revenues, costs, assets and liabilities (paragraphs 29 to 30).

(e) Financial information: basis of preparation principles (paragraphs 31 to 54).

(f) Competitive benchmark prices and costs (paragraphs 55 to 57).

Purpose and interpretation of profitability analysis

Purpose of profitability analysis

5. Our guidelines highlight that:

Firms in a competitive market would generally earn no more than a ‘normal’ rate of profit – the minimum level of profits required to keep the factors of production in their current use in the long run, i.e., the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity.¹

6. The purpose of conducting profitability analysis, therefore, is to understand whether the levels of profitability (and therefore prices) achieved by the firms in the reference markets are consistent with levels we might expect in a competitive market. If excess profits have been sustained over a relatively long time period, this could indicate limitations in the competitive process.

---

¹ Guidelines for market investigations: their role, procedures, assessment and remedies (CC3), April 2013, paragraph 116.
Interpretation of profitability analysis

7. In interpreting the results of our analysis, we take into account a number of factors. First, our guidelines recognise that at particular points in time the profitability of some firms may exceed what might be termed the 'normal' level. There could be several reasons for this, including cyclical factors, transitory price or other marketing initiatives, and some firms earning higher profits as a result of past innovation, or superior efficiency. We considered how these factors affected our interpretation of any observed gap between returns and the cost of capital, and how they affected our interpretation of differences in profitability between firms.

8. On the other hand, our guidelines highlight that a finding of low profitability does not necessarily signify that competition is working well, since low profitability may be concealing ineffective competition. For example, incumbent firms, despite being protected from new entry, may not earn high profits because they are inefficient and operate with higher costs than would be sustainable with stronger competition in the market. Therefore, in addition to considering whether prices are too high based on out-turn industry costs, we compared costs across firms in the supply sector to understand their relative efficiency. We further discuss this analysis in paragraphs 55 to 57.

9. We considered whether any trends in profits over the period of review indicated improvements or deteriorations in the competitive environment and/or the extent to which such trends may have been driven by factors other than the competitive dynamics of the sector, such as regulation or changing commodity prices. In general, where profitability has increased over a number of years, this may indicate a worsening of the competitive situation or weakening of competitive pressures in the reference markets. We also analysed the relative profitability of various different segments of the industry. For example, we estimated the profitability of different technologies for energy generation and different types of customers for energy retail supply.

Scope of our profitability analysis

10. In this section, we set out the scope of our profitability analysis and the relationship with our terms of reference, highlighting which business activities we consider to be relevant, which firms we analysed and the time frame over which we analysed their profitability.

---

2 CC3, paragraph 117.
3 CC3, paragraph 125.
The reference markets and the relevant business activities

11. Our terms of reference define the reference markets as the economic markets for the supply and acquisition of energy in Great Britain (GB), where for this purpose ‘energy’ means both electricity and gas, and both the wholesale and retail activities are included in the reference (with the exception of retail supply to larger businesses).  

12. Figure 1 shows the various stages of the energy supply chain, from the exploration and production of gas, coal and other inputs, to the supply of gas and electricity to customers. Gas is used both as an input to the production of electricity and as a product which is supplied directly to customers for their use. Gas is supplied to customers via a network of distribution pipelines, while electricity is supplied via a network of transmission (high voltage) and distribution (lower voltage) lines.

Figure 1: Energy supply chain

- Exploration and production of gas, coal, uranium etc (& gas storage)
- Generation of electricity (renewable and non-renewable technologies)
- Trading of electricity, gas and other commodities
- Retail supply of gas & electricity to domestic, SME and large business customers

Excluded activities | Included activities | partially included activities

Source: CMA analysis.

13. Our profitability assessment focused principally on the business operations engaged in: (a) the generation of electricity; and (b) the retail supply of electricity and gas to domestic and small and medium-sized enterprise (SME) customers. In the case of retail supply, we analysed the overall profitability of energy supply, as well as considering the margins earned on each type of customer (domestic, SME and larger business customers).

14. With respect to trading, we observe that the vertically integrated operators adopted different business models in terms of how they delineated their generation and retail supply activities from their trading activities. The impact of these different models is that certain activities which were undertaken by the ‘generation’ division or the ‘retail supply’ division in some firms were

---

4 Ofgem’s terms of reference for the CMA’s investigation are set out on the case page.
5 This approach reflects the reference markets set out in paragraph 11. We do not believe that it would be useful to seek to separate electricity generation activities according to whether the output is used by domestic and SME customers or by large businesses as the same asset base is used to produce all output.
undertaken by the ‘trading’ division in other firms. It was therefore important to us that the buying and selling of commodities for generation and retail supply typically undertaken by a vertically integrated firm’s trading division was appropriately and consistently reflected within the financial results for generation and retail supply (respectively) across each firm. We sought to make adjustments where we found this was not the case.

15. Our provisional view is that the trading activities undertaken by the vertically integrated firms for purposes other than the buying and selling on behalf of their generation or retail supply businesses, such as the trading of various commodities on a proprietary basis, were not directly relevant to our investigation. We therefore sought to exclude these from our analysis of the profitability of generation and retail supply.

16. We have not conducted a profitability assessment of the following activities:

(a) **Upstream gas production and storage** – where this activity is also carried out by a vertically integrated energy firm. The evidence collected during the assessment leading up to this market reference and during our inquiry, suggests that the wholesale gas market in GB does not share the potentially harmful features that were identified in wholesale electricity.⁶ As a result, we have not conducted a profitability analysis of the upstream gas operations.

(b) **Transmission and distribution networks** – where these are owned (or have been owned in the past) and operated by some of the major vertically integrated market participants, these operations are fully ring-fenced from the rest of their operations, and earn a regulated rate of return as determined by Ofgem. As a result, we decided not to investigate further the profitability of transmission and distribution network operations.

**The relevant firms**

17. Our profitability analysis focused on the Six Large Energy Firms in GB, namely Centrica, E.ON, EDF, RWE, Scottish Power and SSE, each of which has operations that are engaged in the generation of electricity and the retail supply of electricity and gas. In GB, these firms have a combined market share of 90% of the retail supply market in terms of domestic customer account numbers, and around 70% of electricity generation capacity.

---

⁶ We also said that the wholesale gas market is connected to other markets through import pipelines and liquefied natural gas import terminals, making it part of a wider international market for gas. Source: *issues statement*, paragraph 62. See Section 4: Nature of wholesale competition.
18. Of the Six Large Energy Firms, Centrica and SSE are also engaged in the production and storage of gas, while Scottish Power and SSE also currently own and operate distribution and transmission assets.\(^7\) Our treatment of these two areas of activities is covered in paragraph 16 above.

19. We also compared the financial performance of the largest firms’ relevant operations with those of the following medium-tier independent retail energy suppliers: Co-op Energy, First Utility, Ovo Energy and Utility Warehouse (together, the ‘Mid-tier Suppliers’). The Mid-tier Suppliers account for just under 10% of the retail electricity and gas supply market in terms of domestic customer account numbers.

**The relevant period**

20. We generally aim for a time period over which we can examine trends in profitability over a full business cycle, in order to provide a representative picture of profitability which is not unduly distorted by unusual macroeconomic conditions or one-off events.

21. In our draft financial information request, we consulted the Six Large Energy Firms on a ten-year time period over which to conduct our profitability analysis, from 1 January 2004 to 31 December 2013, or their corresponding (or closest matching) financial years (FY), ie FY04 to FY13.

22. However, in determining and agreeing the time period over which to request financial information and ultimately to conduct our profitability assessment, we took into account the ability of, and constraints faced by, the energy firms in providing the information to us in the form required for the purpose of our analysis, and:

   (a) for the Six Large Energy Firms, we decided to request annual financial information covering the seven-year period beginning 1 January 2007 and ending 31 December 2013, or FY07 to FY13 (the ‘Relevant Period’); and

   (b) for the Mid-tier Suppliers we decided on a shorter five-year time period beginning 1 January 2009 to 31 December 2013, or FY09 to FY13.

---

\(^7\) See Centrica website; SSE website; SP Energy Networks website.
Selection of profitability measure and associated benchmark

**Profitability measures**

23. There are a number of different ways of measuring profitability. Our guidelines primarily refer to the rate of return on capital, which can be based on cash flows (truncated internal rate of return (TIRR) or profits (return on capital employed (ROCE)). However, the guidelines also highlight that, in situations where capital employed cannot be reliably valued, we may consider alternative measures, such as the return on sales or other relevant financial ratios. In the case of energy generation, we observed that the capital-intensive nature of the industry meant that the most relevant profitability benchmark was likely to be return on capital. In the case of energy retail supply, we considered the arguments put to us that ROCE was not an appropriate measure of profitability due to difficulties with identifying and quantifying the capital base reliably. However, as explained Appendix 10.3, we did not agree with these arguments. In addition, we observed that return on capital is more informative than earnings before interest and tax (EBIT) margins since it has a clear economic interpretation. Therefore, we have also used return on capital as the principal measure of profitability for energy retail supply.

24. However, when analysing operating performance it can be instructive to split (pre-tax) ROCE in two. A measure of return on capital is the ratio of a profit number to an asset number. If we relate each of these to sales, the return on capital is the profit to sales ratio ('margin') times the sales to assets ratio, the asset turn. Therefore, we have also estimated EBIT margins – both by firm and by customer type – in order to understand the relative profitability of different customer types.

**Economic versus accounting profitability**

25. When estimating returns on capital, our approach was to start with accounting profits and the balance sheets for the operating units of the firms that undertook the relevant activities, and then to make adjustments to arrive at an economically meaningful measure of profitability. Economic profits can differ in important respects from accounting profits, with adjustments most commonly required to the value of capital employed in the business to: (a) ensure that all assets required for the operation of the business, including intangible assets, are recognised on the balance sheet; and (b) the value at which these assets are included in the capital base reflects the current

---

8 **CC3**, Annex A, paragraphs 9 and 15.
opportunity cost of owning the asset.\(^9\) We observe that, provided that these and a small number of other adjustments are applied to accounting profits to estimate ‘economic profits’, the TIRR and ROCE approaches to measuring profitability tend to converge.\(^{10}\)

**Benchmark for ROCE**

26. When measuring profitability on the basis of return on capital, we consider the weighted average cost of capital (WACC) to be the appropriate benchmark as this represents the opportunity cost of capital for the relevant activities. We used the capital asset pricing model to estimate the cost of equity, as we consider that this model has the strongest theoretical underpinnings. We estimated three different WACCs, one for a stand-alone generation business, one for a stand-alone retail supply business, and one for a vertically integrated firm. In Appendix 10.4 we set out in detail the approach we used to measure the cost of capital, and the results of applying that approach, for both generation and retail supply.

**Analysis based on our approach to analysing profitability and margins**

27. We set out the results of our analysis of ROCE in Appendix 4.2 (generation) and 10.3 (retail energy supply).

28. We set out the results of our analysis of margins in retail energy supply in Appendix 10.2. While there is no single appropriate benchmark for profit margins, we considered a number of comparators against which to assess the profit margins earned by the firms in retail supply. We set out the results of this work in Appendix 10.6.

**Scope of relevant operating revenues, costs, assets and liabilities**

29. We determine the ROCE using operating profits and net operating capital employed and then compare it to the relevant pre-tax weighted average cost of financing, the WACC. The general principle is therefore that all revenues, costs, assets and liabilities necessarily arising from the operation of the business in the areas analysed should be included.

\(^9\) **CC3**, Annex A, paragraphs 10 and 11; and **CC3**, paragraph 115.

30. In practice this means that the following items should be excluded:

(a) Financing costs both of a profit and loss and balance sheet nature, eg interest and sources of finance regardless of whether they are short- or long-term.

(b) Taxation on income and any associated corporation tax or deferred tax.\(^\text{11}\)

Financial information: basis of preparation principles

31. All the firms whose profitability we analysed routinely prepare financial information under the historical cost accounting (HCA) rules in accordance with UK or international accounting standards. Some firms have revalued some of their assets in which case the basis of preparation is described as modified HCA.

32. We are however interested in economic (or continuing) costs. Economic costs\(^\text{12}\) are the costs of resources used at a price they would be traded at in a highly competitive market, where entry to and exit from the market is easy. Here, the value of resources consumed and assets utilised should reflect their current value to the business, not their historical cost or a restated amount reflecting an historical revaluation as explained in the following paragraphs.

The accounting conventions underpinning the ROCE approach to analysing profitability

33. The ROCE approach is grounded in the CMA’s guidelines which in turn refer to the analysis of Edwards, Kay and Mayer (1987) (EKM),\(^\text{13}\) particularly Chapter 4, section 4.4 onwards. EKM discuss the application of their approach to the identification of monopoly power.\(^\text{14}\) They demonstrate that a particular measure of the ex post accounting rate of return (ARR), which we call ROCE, is suitable for comparison with the cost of capital, for this purpose. However, they stress the importance of separating monopoly profits from the consequences of unfulfilled expectations (of which impairment losses are an example). They also acknowledge other measurement difficulties.

34. EKM’s ARR is based upon two critical accounting conventions. First, all assets (and, where relevant, liabilities) are measured on a value to the owner

\(^{11}\) The Byatt Report. Volume I, paragraph 123, notes taxation on income forms part of the distribution of total returns, in this case to the government. Specific, or other indirect taxes, or taxes on economic rent should be treated as operational costs.

\(^{12}\) The Byatt Report, volume 1, page 5.


\(^{14}\) See EKM, pp58 & 59.
basis (often referred to as deprival value or value to the business) in the
balance sheet.\textsuperscript{15} Second, all gains and losses recorded in the balance sheet
(other than transactions with owners, such as dividend payments) are
included in the profit measure. Thus, the income measure is ‘comprehensive
income’ and the income statement ties in with the balance sheet, the income
in the former reconciling with the change in net assets in the latter.\textsuperscript{16}

35. The balance sheet comprising all assets deployed in the business less
liabilities incurred should be complete. Assets are defined as rights or other
access to future economic benefits controlled by an entity as a result of past
transactions or events. Liabilities are obligations of an entity to transfer
economic benefits as a result of past transactions or events.\textsuperscript{17} From the
perspective of a new entrant, assets would also need to be able to be
purchased separately from purchasing the business as a whole, ie only the
separable assets are relevant here. The only possible exception to this
approach would relate to the start-up costs\textsuperscript{18} and the like inevitably incurred
by a new entrant. To the extent that these costs need to be recovered over
future periods, they create an inseparable intangible asset, the cost of which
would need to be recovered over future periods.

\textit{Implementing these accounting conventions}

36. In practice we considered the following aspects of their financial information in
particular to assess whether it has been prepared in accordance with
principles appropriate to determining economic profitability, as explained
below:

(a) Transfer pricing (paragraphs 37 to 40).

(b) Capital employed determined on a deprival value basis (paragraphs 41
to 51).

(c) Profits determined on the basis of comprehensive income (paragraphs 52
to 54).

\textit{Transfer pricing}

37. In order to separately assess the economic performance of a vertically
integrated firm in: (a) the generation of electricity; and (b) the retail supply of

\textsuperscript{15} We explain deprival valuation principles in paragraphs 41 to 49.
\textsuperscript{16} We discuss the comprehensive income basis further in paragraphs 52 to 54.
\textsuperscript{17} As defined in the \textit{Statement of Principles for Financial Reporting} (1999), UK Accounting Standards Board.
\textsuperscript{18} Examples of these costs relate to assembling and training a workforce, devising working practices, and
possibly a commissioning period when a plant is below full capacity.
electricity and gas to domestic and SME customers, the information needs to be prepared as if these activities had been undertaken by the firm on a standalone basis.

38. In practice, this means that any transactions between the segments analysed and other segments of the firm must reflect transactions undertaken in a (competitive) market and be priced on an arm’s length basis. If transactions were reflected in the financial information provided to us on a basis other than reflecting market transactions priced on an arm’s length basis, the results of our analysis may not be meaningful as profits could have been transferred from one business segment to another.

39. In the energy sector, Ofgem has requested that the vertically integrated firms report their profit and loss results separately for their generation and retail supply operating divisions in statements called the consolidated segmental statements (CSS). As a result, the firms have told us that they have well-established procedures in place to ensure that transactions are priced on an arm’s length basis.

40. We considered the scope for transfer pricing to have distorted the profits reported in generation and retail supply as we carried out our analysis as explained in the relevant appendices.¹⁹

Net operating capital employed determined on a deprival value basis

Measurement basis for valuation of assets²⁰

41. The current value of an asset (or a liability) could be determined by reference to entry value (replacement cost), exit value (net realisable value) or value in use (discounted present value of the cash flows expected from continuing use and ultimate sale by the present owner). For some assets (for example, investments in actively traded securities), these three alternative measures of current value produce very similar amounts, with only small differences due to transaction costs. However, for other assets (for example, fixed assets specific to the business), differences between the alternative measures can be material.

42. Assets utilised should reflect their current value to the business, which is the loss the entity would suffer if it was deprived of the asset involved. That measure, which is also referred to as the deprival value, or value to the

¹⁹ Appendix 4.2 and Appendix 10.5, Annex A.
owner, will depend on the circumstances involved. Deprival value reflects the opportunity cost to the firm of owning that asset in a competitive market as explained below.

43. In most cases, as the entity will be putting the asset to profitable use within its current operations, the asset’s value in its most profitable use (in other words, its recoverable amount) will exceed its replacement cost. In such circumstances, the entity will, if deprived of the asset, replace it, and the current value of the asset will be its current replacement cost.

44. An asset will not be replaced if the cost of replacing it exceeds its recoverable amount. In such circumstances, the asset’s current value is determined as follows:

(a) When the most profitable use of an asset is to sell it, the asset’s recoverable amount will be the amount that can be obtained by selling it, net of selling expenses; in other words, its net realisable value (NRV).

(b) When the most profitable use of an asset is to consume it – for example, by continuing to operate it – its recoverable amount will be the present value of the future cash flows obtainable and cash flows obviated as a result of the asset’s continued use and ultimate disposal, net of any expenses that would need to be incurred; in other words, its value in use.

45. This can be portrayed diagrammatically as shown in Figure 2.

**Figure 2: Establishing which valuation basis for an asset gives its value to the business**

![Diagram](image)


46. Application of these valuation principles consistently across all assets is also called current cost accounting (CCA).

47. An implication of valuing, for example, generation plants of a particular type consistently on the basis of their value to their owner from one period to the next is that should give rise to the same expected ROCE across the plants.
Under this approach, differences in profitability, other than that reflecting windfall profits or losses, should in principle reflect superior or inferior management, rather than the locked-in relative inefficiencies associated with, for example, an individual plant’s technology. A further implication of this approach is that up until the point when the owner of the plant believes it is about to finally stop generating electricity for good, the owner is expecting to recover not only its ongoing (cash) costs but also the remaining economic value of the plant (which might well be quite small compared to its original cost if it is a marginal plant).

48. Such an approach to valuation also implies that the full cost of the original investment would be charged to the profit and loss over the plant’s lifetime, primarily through depreciation charges. Depreciation reflects the expected loss in value of a plant. This can be contrasted with other sources of loss over time in economic value embodied in plants. The losses arising from these other sources are normally described as impairment losses. Impairment can occur because something has happened to the economic environment in which the fixed assets are operated such that the carrying value (here the value of the business as determined on CCA principles) falls below the recoverable amount\(^2\) for that asset.\(^2\) One example of a change of economic circumstances would be an unexpected permanent slump in demand leading to excess capacity within the industry. Another example could be a sharp unexpected change in input costs relative to the input costs of competing plants which makes the plant not worthwhile to operate.

49. Thus either through depreciation (the expected loss in economic value in any period) or through impairment losses (the unexpected loss in economic value in any period) the full original cost is expensed in the profit and loss, consistent with the principle of determining profitability on the basis of financial capital maintenance (FCM).

*Estimation of replacement cost*

50. Where an asset is worth replacing, its value to the business will be its current replacement cost, or more precisely the replacement cost of a Modern Equivalent Asset (MEA) determined in a fully competitive market and allowing for the asset’s remaining useful life. The MEA value is the cost of replacing an old asset with a new one with the same service capability, allowing for any differences both in the quality of output and in operating costs. The fact that

---

\(^2\) The recoverable amount is the higher of NRV (‘exit’ value) and value in use.

\(^2\) Definition of impairment as per FRS11, paragraph 2, page 6.
markets are often not fully competitive does not alter the validity of the assumption of competition as a benchmark for measuring costs.

51. This approach is consistent with our guidelines, which state\(^{23}\) that the CMA considers MEA values to be the economically meaningful measure for the purpose of measuring profitability in most cases. The definition given in the guidelines emphasises that this valuation should be based on the most efficient technology available at the time and assumes that assets are optimally configured.\(^{24}\) This is the case even if the assets in question actually use legacy technology and are not ideally situated for current market conditions.

**Profits determined on the basis of comprehensive income**

52. When measuring the return being made on capital invested, it is important to identify in the measure of profits all gains and losses recorded in the balance sheet (other than transactions with owners, such as dividend payments). This measure of profits is known as ‘comprehensive income’ as it includes not only profits from day-to-day operations but also any exceptional profits earned or losses incurred as well as any gains or losses resulting from movements in asset values during a period. Because comprehensive income will also reflect any unexpected, temporary or otherwise unusual items accounted for in a period, it can be helpful to separately identify these items to aid the interpretation of profitability over time.

53. This approach to measuring profitability therefore means that the costs incurred, or revenues earned, in any one period will not necessarily reflect the levels of costs expected to be incurred, or revenue expected to be earned, in future years (at current cost levels). For example, one would not necessarily expect the unexpected losses in the value to the business of some generation plant deployed over the period of review to be repeated in the near future.

54. However, no commercial competitors would come into an industry if they did not expect to be able over the longer term to recover all their costs, including any unexpected decline in value of their assets, as well as earn a normal profit (the opportunity cost of capital) on their continuing operations. They would measure their return on investment after recovery of funds sufficient to maintain the real value of the financial capital they had invested. Therefore when assessing whether capital invested at the beginning of the period has in

---

24 The MEA value is the current cost of acquiring assets that yield equivalent services to those currently used by the firm, based on the most efficient technology and optimal configuration.
fact been maintained by the end of the period, it is important that all changes in the value to the business of its fixed assets have been charged to the profit and loss account. This system of accounting is called FCM.25

**Competitive benchmark prices and costs**

55. As part of our assessment of retail profitability, we took into account the impact on profitability of different levels of cost efficiency. We looked at operating capital employed as well as profit and loss costs. With respect to the latter we considered both direct costs, primarily wholesale energy costs, and indirect costs.

56. For the purposes of our cost-efficiency assessment of the supply business, we looked at the levels of indirect costs reported to us by the Six Large Energy Firms. These costs largely represented the supply business' costs of servicing customers, eg billing and customer service, and are the costs that are deducted from the gross profit to get to operating profit (EBIT). Indirect costs are, to a large degree, controllable by the supply business, and therefore were an appropriate area of focus for our efficiency assessment. We looked at these costs against a suitable metric such as per customer or per account to enable a comparison of their indirect costs, and relative levels of cost efficiency.

57. We set out the results of our analysis here in Appendix 10.5: Competitive benchmark prices and costs.

---

25 FCM is a system of accounting that regards the capital of the business as a fund attributable to the proprietors and profit as the surplus arising after that fund has been maintained. Assets are stated at their value to the business. This is the definition contained in The Byatt Report’s glossary on page 136. There it is defined in real terms, ie after allowing for changes in general purchasing power.