Appendix 10.6: Retail profit margin comparators

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Introduction

1. This appendix sets out our assessment of potential comparators for competitive benchmark profit margins in retail energy supply.

2. Many of the parties to this investigation pointed to the difficulty of calculating a return on capital employed (ROCE) for retail energy and encouraged us to focus our profitability assessment on profit margins. Parties submitted a range of evidence, including potential comparators, which they told us, could be used to infer a competitive benchmark margin, or at least its upper or lower bound.

3. This appendix considers the evidence on comparators based on:

   (a) profit margins in other retail sectors;

   (b) precedent regulatory price-control determinations in energy retail;

   (c) international energy retailers; and

   (d) profit margins for certain segments within the energy retail markets in Great Britain (GB), within which our reference markets falls, namely the profit margins generated: (i) by independent energy retailers; (ii) on non-standard tariffs (NSTs); and (iii) on large industrial and commercial (I&C) customers (a segment of the market outside our terms of reference due to lower competition concerns).

4. We first set out an overview of the parties' key arguments and our consideration of these, in paragraphs 5 to 19, before setting out their evidence in more detail.

Overview of key arguments

5. We turn to the key arguments and issues raised by the parties on each of the main types of comparators we reviewed, before setting out our consideration and preliminary views.

Comparators drawn from outside the GB energy retail markets

6. The Six Large Energy Firms put forward a range of comparators which they said could be used to indicate a reasonable level of EBIT margins in GB energy supply, ranging from around 2 to 25% (with appropriate adjustments). Parties favoured comparators drawn from other retail sectors, international energy retailers and precedent regulatory price controls. We set out an overview of their key arguments in relation to each of these in turn below, before turning to their views on comparators drawn from within GB retail energy:

   (a) **Other retail sectors***:* this category of comparators captures a wide range of different industries such as supermarkets, telecoms and water, and the results of benchmarking margins across a wide range of retail sectors yielded a wide range, with profit margins of up to around 25%. Whilst parties generally acknowledged that differences in risk characteristics and capital employed levels in other sectors would affect their comparability with our reference markets, some argued that we should control for these factors, with one party suggesting that we could (to some extent) control for differences in capital intensity, by benchmarking margins across a smaller sample of asset-light FTSE 100 companies. Other parties did not provide us with an alternative approach to quantifying these differences.

   (b) **International comparators***:* in relation to international comparators, one party cited the US energy retail markets as a potential comparator, although it added that differences in business models and market conditions between the US and GB retail energy markets should be controlled and adjusted for, if we were to infer a competitive margin from the US markets. Parties however were more in favour of drawing on past regulatory determinations in energy retail outside GB than from international energy retailers.

   (c) **Regulatory precedents***:* in relation to precedents drawn from regulatory price controls in energy retail, parties generally argued that a price-

regulated firm faced less risks than a firm operating in a competitive market (eg regulators allowed greater cost pass-through) and therefore regulated EBIT margins in Northern Ireland (eg around 2% for Power NI) and Australia (around 4.5% in New South Wales) represented an absolute lower bound for the competitive level in a more risky and competitive GB retail market.

Comparators drawn from within GB energy retail

7. We also considered the following comparators drawn from certain segments within the GB energy retail markets, namely:

   (a) Profit margins generated by mid-tier suppliers: given that the mid-tier suppliers were not endowed with a large legacy customer base when their retail operations commenced, they had each competed for all of their customers. Moreover, these firms operate in the same sector as the Six Large Energy Firms and therefore were likely to face similar systematic risks and (proportionately) similar capital requirements to those faced by the larger energy retailers. Some mid-tier energy retailers also operate on a stand-alone basis (see paragraph 57).

   (b) Profit margins generated on NSTs: given that: (i) energy retailers tended to acquire new customers on their fixed tariff prices; and (ii) our analysis of tariff profitability showed that gross margins were significantly lower on their NSTs than on their standard variable tariffs (SVT) (see Appendix 10.2: Retail energy supply profit margin analysis).

   (c) Profit margins generated on I&C customers: given that: (i) this retail segment fell outside our terms of reference due to lower competition concerns; and (ii) as set out in Appendix 10.2: Retail energy supply profit margin analysis, profit margins for the Six Large Energy Firms were generally lower in the I&C segment compared with our reference markets.

8. The Six Large Energy Firms argued that comparators drawn from within the GB energy retail markets were not meaningful comparators citing significant differences in risks and capital requirements to those in our reference markets, and told us that these comparators would only represent a lower bound:

   (a) In relation to mid-tier energy retailer margins, some parties argued that as recent market entrants, the mid-tier suppliers adopted a strategy to grow market share rapidly at the expense of short-term margins, which would depress their historic margins (ie due to a combination of offering discounted tariffs and incurring high upfront costs to acquire customers),

and reduce their comparability with the more steady-state and mature growth profiles of the Six Large Energy. One party also argued that some of the mid-tier suppliers used trading intermediaries to hedge their wholesale energy costs that ultimately reduced their capital requirements, and in turn justify lower gross and net margins compared with those generated by the Six Large Energy Firms which did not outsource these functions.

(b) In relation to profit margins generated on NSTs, some parties argued that these were largely customer acquisition tools, and therefore margins on these tariffs should not be treated as representative of a benchmark for the industry.

(c) Finally, in relation to I&C customers, parties cited differences in risk characteristics between I&C customers and domestic and SME customers, which undermined their comparability, including differences in the levels of risks assumed by the supplier to serve I&C and other customers, eg that I&C customers operated on more bespoke contracts with their energy suppliers, including greater pass-through of certain non-commodity costs, and greater control exercised by some I&C customers in relation to their wholesale energy hedging strategies.

9. We set out our consideration and preliminary views below. Further details of the parties' evidence and their arguments are set out later in this appendix and its supporting annexes.

Preliminary views

10. In our view, for this type of comparator margin analysis to be meaningful, the comparators need to exhibit similar cost structures and risk profiles to GB energy retailers. This is because profit margins on their own are an incomplete descriptor of profitability.[1] Many of the comparators proposed by parties were in different industries where both cost structure and risks were likely to differ considerably from GB energy retail. Parties did not put forward a proposal for how such differences should be measured and adjusted for.

11. In relation to comparators from other retail sectors, we considered that significant differences in risk characteristics and levels of capital requirement would render other retail sectors as weaker comparators, and therefore unlikely to yield robust conclusions. Different market structures (ranging from competitive to regulated monopolies) and cost and balance sheet structures

[1] Where profitability is defined as return on assets. Return on assets can be decomposed into sales margin x asset turnover (the Du Pont equation).

would affect the required margin in different sectors and jurisdictions. For example, general retail and telecoms are fundamentally different to retail energy: general retailers may have retail property and stock on their balance sheets, and likewise telecoms retailers may have significant infrastructure and stock on their balance sheets. As we would expect from a profit margin benchmarking exercise across different retail sectors, this yielded a significantly wide range of profit margins, from which little can be inferred in relation to what level might be appropriate for GB retail energy supply.

12. Comparators drawn from markets outside GB are also affected by differences in the national regimes that affect their risk characteristics and capital requirements. For example, differences in national tax regimes and regulatory frameworks, including any obligations placed on energy retailers, as well as differences in wholesale energy prices, would have an impact on costs and capital requirements that ultimately have an impact on profit and margins. These differences also undermine the relevance of regulatory determinations outside GB.

13. In relation to regulatory precedents, our view is that it is not automatic that a supplier in a competitive market would be more exposed to revenue and cost fluctuations relating to economic conditions than a regulated firm would be as this could depend on the regulatory arrangements and the extent to which suppliers in both types of market were exposed to risk. We note that GB energy retailers appear to have some ability to pass through wholesale energy and network costs to consumers (see Appendix 8.4: Price discrimination). In addition we were not persuaded that the cost and capital structures of Power NI or the energy retailers in New South Wales were sufficiently comparable to that of GB suppliers to enable a like-for-like margin comparison, eg network charges accounts for a much more significant proportion of domestic electricity bills in New South Wales than in GB, where wholesale energy accounts for the largest cost component.

14. The parties' rejection of comparators drawn from within the GB retail energy supply markets would also suggest that considerable measurement and comparability issues arise even when certain differences are controlled for. For example:

    (a) E.ON told us that our concerns that other retail comparators were characterised by different risk profiles, also applied to comparators within the GB energy retail markets; and

    (b) RWE told us that whilst making adjustments to use I&C profit margins as a benchmark was theoretically possible, data did not exist to make the

necessary adjustments, and therefore we could not take I&C margins as a meaningful benchmark.

15. Such limitations, which we discuss above, however do not render the use of all comparators as meaningless, and we considered that profit margins generated from various segments exposed to greater competitive pressures within the GB energy retail markets could be used as one piece of evidence by which we can triangulate the results of our various strands of profitability analysis, including our ROCE analysis (see Appendix 10.3: Analysis of retail supply profitability), and as we discuss later, our own analysis and determination of a competitive benchmark set out in Appendix 10.5: Assessment of the competitive benchmark in retail energy supply.

16. Based on our review of the evidence on comparator margins, it is our preliminary view that comparators within the GB energy retail supply markets are likely to be more informative than those outside the GB energy retail markets. This is because profitability should take into account both the risk characteristics and level of capital employed, which are highly context specific, and therefore without controlling for such differences, a direct comparison of comparator profit margins with those generated in GB energy retail would not yield robust conclusions. We discuss the following comparators:

    (a) Margins of mid-tier suppliers.

    (b) Margins on I&C customers.

    (c) Margins on NSTs.

17. We set out a summary of our preliminary views below, and discuss the parties' arguments in further detail in the main body of this appendix:

    (a) In relation to EBIT margins, the above evidence from independent suppliers suggests to us that competitive EBIT margins in energy supply are relatively low and likely to be 3% or less depending on the level of investment and the level of cost efficiency.

    (b) I&C margins indicate that an EBIT margin of around 2% is reasonable, and possibly lower for a fully independent supplier once the costs of trading on the wholesale markets are factored in. On balance we consider that I&C EBIT margins are one possible indicator of the competitive margin in the domestic and SME markets. I&C margins indicate that an EBIT margin of around 2% is reasonable, and possibly lower for a fully independent supplier once the costs of trading on the wholesale markets are factored in.

(c) In relation to gross margins, the evidence from NST margins and from the mid-tier suppliers suggests that gross margins of around 12% may be regarded as one measure of the 'competitive benchmark'.

18. We consider that we can use profit margin comparators generated from within the GB energy retail markets as one piece of evidence we take in the round when triangulating and arriving at our preliminary conclusions on retail profitability.

19. The remainder of this appendix sets out the evidence and our consideration of each of the following areas in further detail:

(a) parties' views of the appropriate margin for energy retail;

(b) profit margins in other sectors;

(c) international energy retail comparators;

(d) regulatory precedents;

(e) the margins of independent energy retailers; and

(f) the margins generated on I&C and NST customers.

Parties' views on the appropriate margin

20. Some of the parties provided us with their estimates of the competitive margin for energy retail:

(a) EDF Energy told us that it believed that an EBIT margin of around 3% would represent a 'fair profit'.

(b) RWE believed that in the context of financial expectations over the relevant period (ie FY07 to FY13), an industry EBIT margin of 5% represented a reasonable profit margin. However, it added that due to the marked shifts in the risk profile faced by the industry in the period, it did not consider that this margin was necessarily representative of what a recommended future profit margin should be;[2]

(c) Scottish Power told us that analysis undertaken on its behalf by Oxera indicated that an EBIT margin towards 5% would be a suitable starting point for a competitive margin in energy retail;

[2] RWE told us that statistical analysis of market data over the period 2008 to 2012 suggested that a typical FTSE 100 company with limited tangible assets would still be expected to earn an EBIT margin of at least 5%.

(d) SSE told us that its target EBIT margin was 5% over the medium-term, and considered that the competitive margin would lie between [✂];

(e) Centrica told us that an appropriate competitive margin for energy retailing should be between 4 and 6% over the period FY09 to FY13;

(f) Ovo Energy estimated the competitive EBIT margin at between 3 and 4%, and added that an appropriate gross margin benchmark should be around 12% as customers were not well served if a highly inefficient business was generating a 4% EBIT margin. It added that whilst some of the Six Large Energy Firms were run reasonably well, others were run very badly, they should not be able to assume that they were all due a fair EBIT margin of 4 to 5%; and

(g) [✂] told us that 3% should represent a fair benchmark margin for the industry.

21. Some of the Six Large Energy Firms highlighted the relevance of taking into account the capital base when considering profitability, although they did not conclude that ROCE would be the most appropriate measure of profitability for energy retail. These views are set out below:

(a) EDF Energy told us that the equilibrium level of profit in a competitive market was at least equal to the risk-adjusted return necessary to remunerate the capital employed in a business, assuming efficient, competitive operations. It considered that a profit margin measure would not take into account a firm's risks and capital intensity and therefore would not represent a theoretically robust method for assessing profitability. It added that for a supply business, it was particularly concerned that profitability was not wholly driven by capitalised assets.

(b) Centrica considered a comparative analysis of EBIT margins provided a practical approach to assessing industry profitability but only provided that full consideration was given to differences between comparators over time and across markets and, especially, to the scale of cash flows necessary to sustain the financial viability of individual supply businesses given their specific levels of capital at risk (which may vary with different hedging strategies).

(c) SSE also made reference to profit margins being a reward to investors (in the context of being driven by competition and volumetric risks), a view, which we considered was consistent with a ROCE approach where we take into account a fair return on the capital invested into the business by investors.

22. The Six Large Energy Firms argued that profit margin comparators could be used to infer a competitive benchmark margin. We discuss some of these arguments below:

(a) Centrica told us that benchmarking margins could provide objective guidance on what the upper and lower bounds on a competitive return might be, and added that conversely ROCE analysis tended to be highly sensitive to estimations of capital and contingent capital requirements which would always be subject to a number of critical assumptions. However, it added that it was important to take account of the different business models, customer mix, operating costs and risks (and therefore capital requirements) underlying those comparator returns, as well as adjusting for unrepresentative conditions (eg extreme weather conditions). It explained that only by doing so could any comparison be considered 'like-for-like'.

(b) E.ON told us that an appropriate set of benchmark margins should be based on a sufficiently large sample, and therefore we should include margins from a range of sectors. However, it added that when interpreting margin comparisons, it was also 'crucial to take account of differing risk profiles, not only across firms in different sectors or countries, but also within the GB energy retail industry'. It considered that any benchmarking of competitive margins necessarily involved some level of judgement, and in that context, it was also important to consider this evidence alongside a range of other evidence, eg the evidence on cost improvements and efficiency programmes. Ultimately, in order to estimate a fair margin from benchmarking comparator margins, E.ON told us that this required adjustments to account for differences in the cost structure and risk profile of the firms. It added that this requirement did not invalidate the overall approach, and that adjustments to comparator margins was necessarily a requirement of any benchmarking exercise and therefore was not a sufficient rationale to dismiss the benchmarking approach.

(c) RWE told us that there was a wide range of evidence on profit margins, and whilst there was no perfect comparator, it considered that it was still possible to reach a robust conclusion on the range within which the competitive margin could be expected to lie. It told us that this could be achieved by looking at all of the available data, and observing the general direction of the evidence. For example, RWE told us that the average EBIT margin for the Six Large Energy Firms over the relevant period of 2.8% was below the competitive margin range suggested by Ofgem in its RMR report (ie a range of 3 to 8.9%), and below regulatory precedents of 4.4% (in New South Wales), which it noted provided an important sense check and formed the lowest possible bound for the competitive margin.

In the context of financial expectations over the relevant period, RWE told us that it tended to believe that a market profit of 5% represented a reasonable level of return. However it noted that the industry had faced marked shifts in its risk profile during the period, particularly in respect of political and regulatory risks, and therefore did not think this was necessarily representative of what a competitive margin would be in the future.

23. RWE also proposed that given the issues relating to the measurement of economic capital employed, we should undertake a 'properly conducted benchmarking exercise' which did not require an estimate of capital employed:

(a) It argued that adjustments to the data could had been made for known differences between the comparators (eg for capital intensity, cost pass through, volume and balancing risk, forward price risk and collateral).

(b) It explained that it did not consider it appropriate for the CMA to assess a competitive margin using the WACC given: *(a)* it required a robust estimate of capital employed which RWE did not consider could be achieved, and noted that the CMA's approach to valuing capital employed wrongly excluded or understated the value of key elements; and *(b)* it would effectively lead to the CMA using the same approach twice (in both its ROCE and profit margins analysis) and it would disregard valuable sources of independent evidence on what constituted a reasonable margin, in preference to alternative benchmarks. It added that independent evidence would include, for example, regulatory precedents, profit margins in other retail sectors and international energy retail benchmarks.

(c) It explained that a WACC approach to setting regulated prices was inappropriate for asset-light firms. It explained that regulators had considered whether the implied margins were consistent with the results of other approaches and, where it implied materially lower profit margins, they had allowed regulated margins substantially above the level implied by the WACC

(d) When explaining that the competitive level of profitability needed to be determined at the EBIT margin level rather than at the gross margin level, it referred to the 'theoretical link between the opportunity cost of capital and EBIT'.

24. Whilst RWE acknowledged the difficulty of identifying comparators, its view that we should nevertheless use profit margin comparators, appears to be

inconsistent with its rejection of the use of capital measures for ROCE. Furthermore, RWE told us that it did not consider I&C profit margins provided an appropriate competitive benchmark for profit margins in other retail segments, and that it would be essential to adjust for the material differences in risk between I&C and other segments. However, it added that the data did not exist to make these adjustments. We considered that this was internally inconsistent with its advocacy of international and inter-industry benchmarks.

25. Parties have argued that benchmarking margins and then calibrating them would yield a meaningful estimate or range for the competitive benchmark. As noted in this appendix, we considered that comparators drawn from within certain segments of the GB energy retail markets provided us with the most meaningful comparators, although we note that the parties have argued that these would also require adjustments. Parties have also pointed to the difficulty of adjusting comparator margins, and ultimately their conclusions from their review of comparators, are underpinned by subjective views on why for example, more weight should be given to margins generated in another retail sector than gross margins generated by mid-tier suppliers in the reference markets. The results of such exercise can only be expressed descriptively, and in our view, do not present us with a more robust approach than the ROCE approach, whose issues we consider and address in Appendix 10.3: Analysis of retail supply profitability.

26. In our view, profit margins on their own provide us with an incomplete picture of economic profitability because economic profitability should, in theory, be commensurate with the cost of capital employed in that business – which in turn depends on the level of capital requirement and the risks faced by investors in lending money to fund it. In arriving at an appropriate competitive margin, it is our preliminary view that the appropriate cost of capital is factored into its derivation.

Profit margins in other sectors

27. We first considered parties' submissions in relation to margins on other, non-energy, sectors. We summarise the parties' views below, and provide further details of their comments in Annex A to this appendix.

28. We noted that the competitive margin range of 3 to 8.9% in Ofgem's 2011 Retail Market Review (RMR) report was based on retail industry comparators, combined with various adjustments to account for risk profile differences

between energy retail and comparator retail industries.[3] We summarise Ofgem's competitive margin analysis in Annex A.

29. However, the majority of parties told us that comparators from non-energy retail and utility sectors in GB would not provide an appropriate basis for assessing the competitive margin given their lack of comparability to retail energy. Differences that were commonly highlighted included input price volatility, regulatory risks and asset intensity. Furthermore, parties argued that any reliance on profit margins generated in other retail and utility sectors for the purposes of determining the competitive margin would require making profit margin adjustments whose estimations would invariably be subjective and arbitrary. We set out a selection of these views below, with other parties' views set out in Annex A.

30. E.ON considered that an industry's risk profile had a significant impact on the levels of profit margins generated, and therefore any comparator industry should share a similar risk profile to energy retail. However, we noted that even for retail industries that shared some, but not all of the risk factors to energy retail, EBITDA margins ranged from nearly 6 to just over 20% (with a simple average of 14%) based on E.ON's benchmarking analysis.[4]

31. E.ON illustrated that profit margins from other sectors could be used to feed into a larger sample of potential proxies. For example, it told us that an EBITDA margin of 15.5% for TalkTalk (telecoms) could be one relevant comparator, given that its sector shared many of the risk characteristics of GB energy retail, eg TalkTalk used BT's network for transmission purposes, much in the same way that energy retailers used the National Grid. In relation to Power NI, an energy retailer in Northern Ireland, it considered the allowed margin of 2.2% represented an 'absolute floor' for a fair margin in GB energy retail given that Power NI faced substantially fewer risks (eg regulatory, political and volume risks and input cost volatility) than GB energy retailers. In the case of Power NI's allowed margin, E.ON told us that 'material risk premiums' would need to be added before arriving at a fair margin for GB energy retail.

32. RWE cited a 2013 benchmarking study of EBIT margins of various retail sectors, which yielded a similarly wide range, from 4.5% (for food retail) to 21.1% (utilities). RWE considered that returns observed in a broad range of

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[3] Ofgem (March 2011), *The Retail Market Review – Findings and Initial Proposals*, Appendix 9 – Trends in profits and costs, Figure 4.
[4] E.ON considered the following risk factors faced by energy retailers: *(a)* input price volatility; *(b)* revenue uncertainty based on retail customer demand; *(c)* use of a third-party regulated network; *(d)* political and regulatory uncertainty; and *(e)* asset base.

retailers (such as food and apparel) were likely to be the most relevant benchmarks for energy retail, although it acknowledged that there was no perfect set of comparable margins for retail energy firms given their different characteristics, such as risks, product differentiation and capital requirements.[5] RWE also told us that we should consider margin benchmarks based on a wider market index, such as the FTSE 100 and/or the FTSE 250, given that they provided an indication of the level of profits generated in other competitive markets.

33. In response to our preliminary view that the comparability of other retail sectors might be restricted by the fact that these sectors could have different levels of capital intensity, SSE told us that this could be addressed by limiting the comparator set to asset-light companies with a relatively low level of capital intensity. It told us that a high-level analysis of FTSE 100 companies revealed that, within the period from 2008 to 2013, companies with the 5th and 10th percentile lowest capital intensity made an average margin of around 5% and 6%, respectively. It told us that this was an example of a practical and evidence-based step that could be taken to adjust for differences in risk and improve the comparability of the benchmark group. It disagreed that such adjustments would be subjective and arbitrary.

34. However, such an approach would not account for other specific risk characteristics which would need to be accounted for, eg even within the GB energy retail markets where asset intensity would be broadly similar, parties highlighted differences in risk characteristics which, they said undermined, for example, the use of I&C margins as a meaningful comparator. Whilst differences between GB retail energy and other retail and utility sectors may readily be identified, we did not consider that they could be reliably measured as an EBIT margin adjustment, to increase the comparability of profit margins generated in other sectors with those generated in retail energy.

35. More critically however, we considered that sectors outside GB energy retail, would face different risks and have different capital requirements – these differences yield a wide range of profit margins, and we considered that such comparisons were therefore unlikely to yield robust conclusions. We noted that whilst parties supported making adjustments to comparators, none of the parties provided us with how such adjustments could be measured, but instead used these results as an indicative upper or lower bound.

[5] RWE cited a 2013 study carried out by CEPA on behalf of Power NI, which benchmarked EBIT margins for FTSE 350 firms in retail industries for 2006 to 2012. CEPA looked at the following retail sectors: utilities, apparel, telecoms, food retailers, specialty retailers and home retailers

International energy retail comparators

36. We considered parties' submissions in relation to international energy retailer comparators comprising past regulatory determinations in energy retail in international jurisdictions and international energy retailers. The details of the parties' submissions in relation to international energy retail comparators are set out in detail in Annex B.

37. SSE was in favour of international comparators. SSE told us that international comparisons involving international energy retailers would appear to be reasonably good comparators, depending on the similarity of the institutional characteristics of the market to those observed in the UK. It considered that regulatory determinations in the Australian retail energy supply markets (in particular for New South Wales) provided the most relevant comparators given that energy retailers in Australia faced similar wholesale market purchase and volume risks, and competition as in GB.[6] Based on SSE's submission, it considered the competitive margin to lie [✂]. We summarise SSE's submission in Annex B.

38. Whilst we noted that SSE limited its international comparator benchmarking to New South Wales in order to select a market that shared similar wholesale market purchase and volume risks, and competition as in GB, this is necessarily subjective, and the differences would remain unaccounted for in these comparator margin figures. In particular, unlike the GB energy retail market, the regulatory pricing determinations in New South Wales are used for the purposes of setting a regulatory tariff, which energy retailers have to offer customers alongside their own unregulated tariffs. In relation to this point, EDF Energy highlighted that in Australia, the retail energy supply context was different from GB given the use of these price controls.

39. However, similar to the parties' views on non-energy industry comparators, the vast majority of parties highlighted the areas of differences in retail energy between GB and international jurisdictions, which reduced the relevance of international energy retail comparators for the purposes of determining a competitive margin.

40. We set out a selection of these views below, with other parties' views set out in Annex B.

[6] SSE commissioned Frontier Economics to review the available evidence on retail margins from authorities in various countries. It told us that the resulting range of retail margins was then restricted to margin estimates for retailers exposed to risk, eg due to competition or absence of regulation. It considered these criteria would yield the most relevant comparators for GB retail energy supply

41. Centrica told us that the profit margins of energy retailers outside GB might be indicative of the competitiveness of GB margins, but added that it would be difficult to make adjustments for differences between market and regulatory conditions across retail energy supply markets. Centrica told us that the US energy markets should be included within our benchmarking exercise, and that we should take into account the 'competitive returns' generated there, where EBIT margins ranged from 1 to 14% for retail gas, and 9 to 11% for retail electricity (for the period 2009 to 2011). However, it added that adjustments would still need to be made to account for differences, eg differences in business models and market conditions.

42. However, in our view, where wholesale energy costs were likely to result in differences in capital requirement, in addition to the different cost and capital impact of tax and regulatory regimes, even if cost recovery was identical, this would still result in differences in profit margins.

43. E.ON also echoed this by stating that any comparisons with international comparators would need to take into account, and control for, the differences in the political, regulatory and economic environment compared with GB.

44. We also noted that in 2012, London Economics performed an international EBIT margin benchmarking exercise for energy retail (see Annex B).[7] The report however concluded that given sample size and data reliability issues, its results on profitability benchmarking should only be interpreted as providing a broad indication of jurisdictional profitability.[8] For example, given the difficulty of isolating energy supply profits for a vertically integrated company, London Economics highlighted that this was too few to allow benchmarking between other countries and regions.[9] However, for the reasons mentioned above, we do not rely on these results.

45. RWE told us that energy suppliers from other countries in the EU could potentially provide a suitable benchmark because they operated in the same industry and faced some of the same risks as the larger GB energy suppliers. It accepted that there would be differences between the GB market and international comparators, but considered that the CMA could seek to adjust the data for these differences. It added that even on an unadjusted basis,

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[7] London Economics carried out a study comparing prices, competition and profitability in the UK electricity and gas retail markets with those in other countries. Its EBIT margin benchmarking exercise was based on a total sample of 163 companies across 44 jurisdictions (including GB). GB comprised 12 companies (London Economics report prepared for DECC (April 2012), *Energy Retail Markets Comparability Study*).
[8] For information only, London Economics found that the weighted average EBIT margin for GB was 4.3% over 2003 to 2010, and that this was the fourth lowest of the 44 jurisdictions covered (source: London Economics report prepared for DECC (April 2012), *Energy Retail Markets Comparability Study*).
[9] London Economics report prepared for DECC (April 2012), *Energy Retail Markets Comparability Study*.

these international benchmarks could still be used as an important sense check of the competitive margin.

46. RWE also argued that in relation to the London Economics international benchmarking study, whilst it accepted that there were limitations given the difficulty of separating energy retail results from more vertically integrated energy firm results, it told us that in relation to sample size, this was less of an issue given that there were a total of 163 energy companies in the London Economics Study's sample.

47. Again, the issues of comparability and the need to make adjustments, would not suggest that benchmarking international energy retailer margins offers a robust approach. In relation to the London Economics study, the relevant issue in our consideration was not the sample size, but the sample quality given that the benchmarking study conducted by London Economics considered a wide range of firms operating in different markets and regimes.

48. Similar to our view on comparators from sectors outside the GB energy retail markets, international energy retailers would also face different capital and cost structures which would yield different margin requirements.

Regulatory precedents

49. In relation to past regulatory pricing determinations in energy retail in GB (and also Northern Ireland), many of the parties commented on their limitations as a comparator for the purposes of determining a competitive margin, arguing that firms faced far greater risks in a competitive market than in a regulated environment, and therefore should be rewarded accordingly with a higher profit margin.

50. Some parties also commented on the significant changes that had taken place in the market since market liberalisation that undermined the relevance and applicability of past determinations that had been made in a different market context. For example, Scottish Power suggested that additional risks arising from exposure to wholesale energy price movements and retail competition since market liberalisation, would undermine the relevance of these determinations for determining a competitive margin against which to compare recent profitability in energy retail.[10]

[10] Scottish Power adopted 1.5% as a minimum EBIT margin, which would cover the costs and working capital associated with engaging in retail activities where there was no risk from competition (eg regulated monopoly retailers) and no risk from wholesale price movements. It considered that 1.5% was broadly consistent with regulatory precedents, including for British Gas Trading when it retained significant market power in retail.

51. Parties suggested that regulatory precedents provided a lower bound for the competitive margin, eg Centrica told us that allowed margins in Northern Ireland for Power NI of 2.2% and in North South Wales, Australia of 4.5% allowed for greater cost pass-through and therefore represented lower risks, which would decrease the capital required resulting in lower margins, compared to the GB energy retail markets.

52. SSE told us that the Australian (New South Wales) precedent was particularly relevant given that it told us that the most recent price control in New South Wales recognised the strength of competition in energy retail and recommended that price controls be phased out over time as a result. It added that energy retailers in New South Wales potentially faced competition and volumetric risks similar to that faced by GB suppliers, and that these risks were an important driver of the retail margin that must be earned to reward investors, supporting the position that this allowed EBIT margin provided a potentially relevant benchmark and a useful point of comparison in present circumstances.

53. Centrica told us that there would be clear differences between regulated and competitive markets, and that in general these differences would leave lower costs but also higher risk (and therefore higher EBIT returns) in competitive markets. Therefore, it told us that regulated margins might provide a useful lower bound for what competitive margins could be (ie competitive margins should not be lower than a reasonable margin for an otherwise comparable but regulated and therefore lower risk business).

54. RWE told us that regulatory precedent of margins up to 4.4% provided an important sense check to the CMA's findings, as it expected regulated retail supply businesses to have lower margins than the competitive margin for retail energy supply, due to lower risks and regulatory safeguards around financial viability. Therefore, it considered that regulated margins formed the lowest possible bound for the competitive margin.

55. In our view, whilst the Six Large Energy Firms argued that in a competitive market one would require higher margins to compensate for higher risks, and therefore regulated EBIT margins should be seen as a lower bound (eg 0.5 to 2.2%). Our view is that it is not automatic that a supplier in a competitive market will be more exposed to revenue and cost fluctuations relating to economic conditions than a regulated firm would be as this could depend on the regulatory arrangements and the extent to which suppliers in both types of market were exposed to risk. We note that GB energy retailers appear to have significant ability to pass through costs to customers (see Appendix 7.2: Cost pass-through and Annex B to Appendix 10.5: Assessment of the competitive benchmark in retail energy supply). In addition we were not persuaded that

the cost structure of Power NI or the New South Wales suppliers was sufficiently comparable to that of GB suppliers to enable a like-for-like margin comparison. Since, for an asset-light business, the required margin is sensitive to small absolute changes in capital employed, this latter point is important.

Independent energy retailers

56. We considered the profit margins generated by independent energy retailers, which operated in the reference markets but did not have any of the potential incumbency advantages of the Six Large Energy Firms, eg in terms of a legacy customer base. The margins earned by independent suppliers are potentially relevant to our assessment of a competitive benchmark because:

    (a) they are not vertically integrated and therefore do not benefit from any cost savings that might arise as a result;

    (b) achieve lower revenues per customer and have fewer customers on SVTs; and

    (c) there is evidence that some mid-tiers are more efficient.

57. Of the four 'mid-tier' suppliers for which we gathered financial data, we considered First Utility and Ovo Energy as particularly relevant in regards to point (a) because they were independent stand-alone operations. As such, the prices they charge must be sufficient to ensure that they can cover the costs of a fully independent stand-alone operator. We did not regard Co-op Energy and Utility Warehouse as fully independent due to Co-op Energy's status as a part of a wider group, ie The Midcounties Co-operative Ltd, and Utility Warehouse's long term supply agreement with RWE.[11]

58. In relation to the profitability of First Utility and Ovo Energy as potential comparators, there are a number of considerations to take into account:

    (a) Impact of rapid growth on earnings: for First Utility and Ovo Energy, we found that their EBIT margins over the period FY09 to FY13 were depressed by relatively significant customer acquisition expenditure.

    (b) Impact of different business models: we would need to consider the extent to which differences in the business models adopted by First Utility and

[11] Utility Warehouse's gross margin performance over the period FY09 to FY13, was to a large extent driven by its supply agreement with RWE, under which Utility Warehouse could achieve [✂]. More importantly, Utility Warehouse told us that when its supply agreement with RWE was first drawn up in 2005/6, it was based on giving Utility Warehouse [✂].

Ovo Energy would reduce their comparability with those of the Six Large Energy Firms, in particular the absence of vertical integration on their costs and levels of risk exposure.

(c) *Differences in customer mix:* unlike the Six Large Energy Firms, First Utility and Ovo Energy predominantly serve domestic customers, with little, or no, exposure to the non-domestic retail segment.[12] For First Utility, its customer mix changed from being SME-focused until FY09, to being domestic customer focused thereafter.[13]

(d) *Absence of a legacy customer base:* a large number of parties suggested that the Six Large Energy Firms were generating higher profit margins on their legacy customer base, which some parties explained accounted for the highest proportion of their disengaged customer base.

(e) *Differences in costs:* one of the commonly cited differences in relation to the independent suppliers' cost structures with those of the Six Large Energy Firms, related to social and environmental obligation exemptions on smaller suppliers. For example, over the period FY09 to FY13, First Utility told us that it became liable for costs in relation to 'small-scale' Feed-in Tariff, Energy Companies Obligation (ECO) and Warm Home Discount (WHD) for the first time in FY13, and Ovo Energy told us that it did not meet the thresholds for ECO and WHD over the period considered.

59. Based on the above, we considered that:

(a) Profitability comparisons between independent suppliers and the Six Large Energy Firms need to take account of differences in customer acquisition costs.

(b) The absence of a significant non-domestic customer base for independents means that comparisons with the Six Large Energy Firms may be limited to the profitability of their respective domestic supply businesses, and for only certain periods of time.

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[12] In relation to the retail customers served by each of the mid-tier suppliers: *(a)* Co-op Energy told us that since it commenced trading in December 2010, it only supplied energy to domestic customers; *(b)* First Utility commenced operations targeting niche SME customers (eg new build), but told us that it had stopped serving the SME retail segment by December 2013; *(c)* Ovo Energy told us that it focused on domestic supply, with SME supply being a relatively new area of its business; and *(d)* Utility Warehouse told us that its business was focused on the domestic market with a non-domestic exposure that was effectively an extension of the domestic market. In relation to its non-domestic customers, it categorised all of its non-domestic customers as 'microbusinesses'

[13] [✂].

(c) The absence of a legacy customer base for independent suppliers may suggest lower profitability. We consider this point further when we discuss our proposed approach to the competitive margin in the next section.

(d) Whilst smaller independent energy suppliers may face lower obligation costs, the Six Large Energy Firms may face cost advantages in terms of wholesale energy procurement or economies of scale benefits. As we consider later, the efficient level of costs will be relevant to our proposed approach to the competitive margin.

60. A comparison of profit margins between independent suppliers and the Six Large Energy Firms may be instructive because independent energy retailers generally offer lower tariffs, have fewer customers on SVTs, and there is some evidence that they are more efficient. However, independent energy retailers are diverse; operate different strategies; are at different stages of growth; and target different retail segments.

61. We considered that comparisons of gross margins would be more instructive than EBIT margins for the following reasons:

(a) rapid customer growth over the period FY09 to FY13 meant that these suppliers had incurred disproportionately large customer acquisition costs in comparison to the Six Large Energy Firms; and

(b) upfront investments in staff costs and facilities required to support future growth were likely to distort operating costs.

62. Figure 1 below sets out the gross margins of the mid-tier suppliers.

Figure 1: Mid-tier supplier gross margins (FY09 to FY13, period*)

[✂]

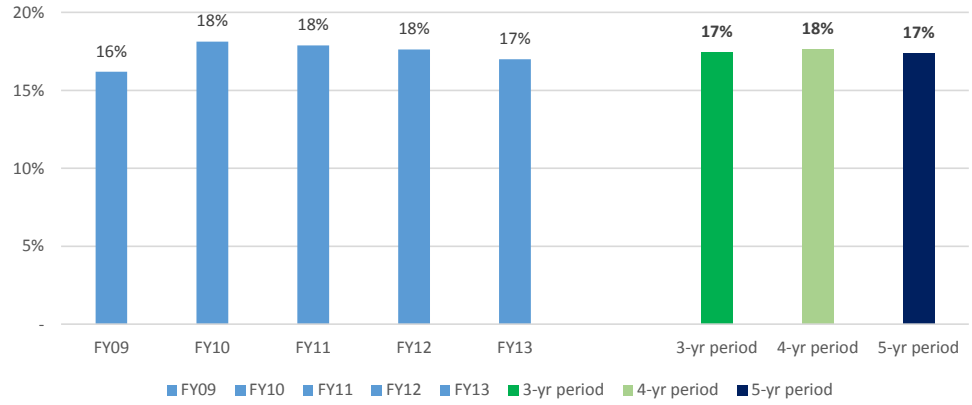
Source: CMA analysis of P&L information submitted by the mid-tier suppliers.
* The period total profit margin was calculated as the sum of an individual firm's profits over the period under consideration, divided by the sum of its relevant revenues over the same period.

63. Based on Figure 1, we noted a wide range of reported gross margins for the mid-tier suppliers from [✂] to [✂]%. We discounted the lower end of this range as the supplier in question [✂]. The remaining mid-tier suppliers [✂] had earned average gross margins over the period of between [✂] and [✂]%. The period average of the Six Large Energy Firms' gross margins were 17% and 18% in domestic electricity and gas respectively (see Figure 2).

64. In Figure 2 below, we set out the annual and period domestic supply gross margins for the Six Large Energy Firms combined. Given the differences in the time periods covered by the P&L information of each of the mid-tier

suppliers, we calculated the Six Large Energy Firms' period gross margins based on three-, four- and five-year period totals.

Figure 2: Six Large Energy Firms combined domestic annual and period gross margins (three-, four- and five-year period total basis)



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

65. We also calculated that over the period, indirect costs as a percentage of domestic revenues was on average 16% of revenues for the Six Large Energy Firms (based on domestic revenues only). Based on this, the period total gross margins for First Utility and Ovo Energy of [✂].

66. However, the above analysis does not take into account what level of indirect costs might be appropriate for an efficient energy retailer of the size comparable to the Six Large Energy Firms. We found that indirect costs in domestic supply ranged from 9 to 23% of revenues across the Six Large Energy firms over the period FY09 to FY13, and therefore a lower assumed level of indirect costs would have a significant impact on the implied EBIT margins resulting from this analysis.

67. Utility Warehouse criticised other 'mid-tier' suppliers for exploiting: *(a)* short-term wholesale and retail price divergence; *(b)* small supplier exemptions; and *(c)* apathetic customers to grow an unsustainable and non-profit making business. It added that the fixed term tariffs offered by independent suppliers had been consistently and substantially cheaper than those offered by the Six Large Energy Firms, and that the majority of these simply reflected price undercutting as a result of a short-term favourable environment that facilitated the independent suppliers to do this.

68. However, in relation to Utility Warehouse's argument that 'mid-tier' independent suppliers were operating unsustainable or non-profit making businesses, we did not believe that this would apply to the mid-tier suppliers

we looked at given the importance of credit worthiness (whether measured by an external credit scoring agency or monitored through minimum financial performance targets) when dealing with trading counterparties to access the wholesale markets or posting collateral with network operators. In particular:

(a) [✂].

(b) [✂].

69. However, the impact of customer acquisition costs creating losses at an earnings level did not appear to be limited to the mid-tier suppliers. For example, [✂].

70. Some of the Six Large energy Firms queried why 'true independence' was necessary for comparability, eg Centrica argued that Utility Warehouse's agreement with RWE would likely be comparable to that between [✂] and [✂], and Co-op Energy's access to its parent company's balance sheet strength would seem to make it more comparable to the Six Large Energy Firms than [✂].

71. RWE told us that less weight should be placed on independent energy retailers as potential comparators (eg based on their gross margins) because of: *(a)* differences between the independent firms and the Six Large Energy Firms in terms of strategy and operational practice; *(b)* significant differences between the independent firms and the Six Large Energy Firms in terms of life-cycle, risk and cost, which would impact comparisons at both a gross margin and EBIT margin level; and *(c)* the small sample size, ie two firms could distort our analysis.

72. RWE told us that with a sample of only two mid-tier suppliers (Ovo Energy and First Utility), the specific performance and operating models of the two firms could materially influence our results, eg EBIT margins could be distorted by start-up costs and higher marketing costs. It added that with small sample sized, any averages that were calculated could be materially distorted by these factors.

73. Centrica told us that whilst we could look at gross margins rather than net margins of the mid-tier suppliers to eliminate the effects of high customer acquisition costs, it would still not address the mid-tier suppliers' strategy to sacrifice gross margin to build their market shares.

74. However, it was not necessarily clear that the mid-tier suppliers have been sacrificing their gross margins, and we would note that none of the mid-tier suppliers have told us that their gross margins were unsustainable, eg under [✂].

75. Centrica told us that it should have a higher competitive margin than that of independent energy retailers which contracted out their risks. It argued that it supported its own hedging and trading activities, and therefore had higher capital requirements than suppliers (such as First Utility, [✂] and Utility Warehouse) which outsourced this to third-parties (eg [✂]), and therefore suppliers who contracted out their risk management should not expect to make returns similar to an integrated business.

76. Centrica also told us that there were substantial differences in the business strategy, customer mix, capital requirements, wholesale market risks, bankruptcy risk appetite and costs of the smaller suppliers which meant that in reality, their gross margins would be lower than should be expected for a stand-alone retailer in a competitive market managing its own risk position. For example, Centrica told us that other differences in the stage of development (eg low margins investing in customer growth); exposure to the risk of ECO delivery and customer mix (eg gas and SME customers require larger capital support and the supply of cash cheque and pay as you go customers drive a higher operating cost and therefore gross margin), were also important to take into account.

77. E.ON told us that any comparability issues concerning non-energy sectors, also applied to comparators within GB energy. It told us that comparisons to mid-tier firms necessarily required the same degree of subjectivity, regarding adjustments for differing risk profiles and cost structures, as for comparisons to other retailers. It added that the mid-tier suppliers were also in early stages of the business cycle, making their margins unrepresentative of a steady state competitive margin. It also told us that it had reservations with the sample size used (ie Ovo Energy and First Utility being selected over other firms) and the selection process, as well as the completeness and accuracy of adjustments to their underlying data. It disagreed that the gross margins of the mid-tier suppliers represented an upper bound for a competitive margin, as other risk and cost factors were not taken into account. For example, it considered that the risk of regulatory change was materially higher for the larger energy retailers, eg in relation to social obligation costs. It argued that this increased regulatory risk and other differences would need to be factored into any assessment of a competitive margin.

78. We considered the EBIT margins of the mid-tier suppliers over the period. These were generally negative, reflecting the substantial customer acquisition costs incurred by these suppliers to support their rapid growth. Considering EBIT margins before customer acquisition costs, we noted a wide range of

period average EBITC2A[14] margins from [✂]% (see Appendix 10.2: Retail energy supply profit margin analysis). As to whether the two mid-tier suppliers that we have looked at will need to generate higher margins to survive, we consider that EBIT margins for many mid-tier suppliers have been very low or negative largely because of high customer acquisition costs. Having added back these costs, we note a wide range of EBITCA margins.

79. Whilst we recognise that the current EBIT margins generated by mid-tier suppliers would be impacted by higher acquisition costs and upfront investment as they expanded their customer base and business, we consider that the mid-tier suppliers face sufficiently similar cost structures and risks to those of large suppliers as to provide useful information as to likely levels of competitive margins. Ovo Energy told us that 3% was a fair margin (based on 12% gross margins and efficient costs).

80. The Six Large Energy Firms told us that comparisons with mid-tier suppliers were not appropriate because: *(a)* their customer bases were different to those of the mid-tier suppliers and were higher cost; and *(b)* mid-tier suppliers would accept lower margins in the short term to gain market share, but in the longer term would need to generate higher returns.

81. We are not persuaded that energy retailers have such different customer bases as would warrant significantly higher returns on capital employed and by implication higher EBIT margins. Whilst we accept that standard credit customers and prepayment meter customers are more costly to serve and acknowledge that the larger suppliers have significant numbers of such customers, we are not persuaded that such customers require substantially higher levels of capital employed or have materially higher systematic risk such as would justify higher returns than those of the independent suppliers.

82. The evidence from the mid-tiers suggests that ‘competitive’ gross margins are likely to be around 12%. Actual EBIT margins are difficult to interpret due to customer acquisition costs and high growth. We consider that the target EBIT margins of 3% mentioned by some suppliers may indicate an aspirational margin for a supplier operating with an efficient level of capital employed and operating costs. A supplier who had not invested in systems to the same degree or had not achieved comparable efficiencies could not expect to realise the same level of profitability.

[14] Earnings before interest, tax, depreciation and customer acquisition costs.

Margins on I&C customers

83. We considered profit margins generated on I&C customers, a market segment which was excluded from our investigation due to limited competition concerns. Our analysis showed that I&C EBIT margins based on a five-year period total basis were 2%; lower than those generated in the domestic and SME retail segments of 3.3 and 8.4% respectively.[15]

84. Haven Power also told us that the I&C retail electricity market was highly competitive, which resulted in very competitive prices. It told us that this retail segment provided a good example of a well-functioning market which might serve as a benchmark to assess any adverse effects on competition.[16]

85. In relation to profit margins generated on I&C customers, RWE told us that it did not consider that I&C profit margins provided an appropriate competitive benchmark for profit margins in other retail segments. It added that the data to adjust for the material differences in risk did not exist, but given the nature and magnitude of these differences, it would expect that, over the long run, the profit margins in other segments would be materially higher than the profit margins in the I&C segment. RWE explained that there were a number of material differences in the levels and types of risks faced by retailers in supplying I&C customers in relation to domestic customers, including: *(a)* the use of bespoke contracts in I&C; *(b)* fixed contract lengths in I&C; *(c)* the impact of seasonal weather on demand (ie RWE told us that the I&C segment had a demand profile that was less sensitive to seasonal weather which resulted in lower risk; *(d)* lower operating costs in I&C; and *(e)* consumption volumes per customer – RWE told us that the higher consumption volumes per customer in the I&C segment resulted in lower risk to the supplier because operating costs could be absorbed over much higher volumes.

86. RWE also suggested, when commenting on whether margins on non-standard products provided a suitable benchmark, that past hedging decisions in relation to wholesale energy prices meant that wholesale costs in respect of SVTs did not necessarily fall at the same rate as spot prices when these fell (meaning that suppliers might reduce SVT prices more slowly than they were able to launch new non-standard products), which would suggest to us that the pricing volatility in domestic supply may not be significantly greater than for I&C supply.

87. SSE argued that I&C customers carried less shape risk, greater cost pass-through, lower bad debts, and signed by site for a fixed term, and therefore

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[15] CMA working paper – Profitability of retail energy supply: profit margin analysis, Table 1.
[16] Haven Power is a non-domestic electricity supplier to SME and I&C customers.

the exposure to macroeconomic shocks was reduced for I&C customers. It therefore considered that supplying domestic and SME customers exposed retailers to substantially greater risks than supplying I&C customers, and accordingly, any assessment of I&C margins for the purposes of considering the competitive margin associated with supplying domestic and SME customers must take these significant differences into account. It also told us that this meant that the competitive benchmark margin associated with serving domestic and SME customers must be considerably higher than the 2% margin earned over the relevant period in the supply of I&C customers.

88. E.ON told us that both the risk profile and cost structure of the I&C segment was entirely different to both the SME and domestic segments, and therefore any margins derived from the I&C segment would need to be considered in the context of these differing risks and costs, to provide a meaningful reference point for a fair margin in GB. It told us that it considered the SME segment was also significantly exposed to the economic cycle as evidenced by high bad debt write-offs, but considered that the I&C segment held substantially less margin risk than the SME and domestic segments, eg I&C customers could choose to take certain price risks, including variable cost fluctuations, and therefore, I&C margins would need to be materially uplifted for some form of risk premium to arrive at a competitive margin.

89. Centrica told us that EBIT margins on I&C customers represented a lower bound for the competitive margin given that I&C customers assumed greater procurement risks, eg automatic pass-through of several elements of non-commodity costs. It added that whilst it agreed that the I&C segment was ‘highly competitive’, it did not agree that profits earned in this market were a useful direct benchmark for either domestic or SME profits. It explained that there were fundamental differences in the way the I&C market operated compared to both the SME and domestic markets, which resulted in a lower level of business risk (offset by a higher level of customer risk). As a result, without adjustment, it considered that profit comparisons between these markets were not appropriate.

90. We considered the parties’ arguments that I&C was a less risky business due to having more scope for cost pass through, less shaping risk, and lower bad debt costs. In relation to bad debt risk, we note that I&C is likely to be more correlated with the economy than is domestic supply, but possibly less so than SME. On balance, it was not clear to us that bad debt risk was clearly lower in I&C than for the combined SME and domestic business, such as would justify a lower margin on I&C. In relation to shaping risks and wholesale energy cost risks, we accept that a significant proportion of I&C customers are on tariffs which vary with wholesale prices to a greater extent than domestic and SME tariffs. This may increase suppliers’ domestic and SME wholesale

energy costs due to increased hedging, balancing, and demand forecasting costs. However, we do not consider that this justifies higher EBIT margins on domestic and SME tariffs, than on I&C.

91. Further, we note that I&C margins reported by the Six Large Energy Firms must be sufficient to remunerate the group for the costs of any implicit guarantee at group level. All things equal, the EBIT margin would be lower if the firm had properly accounted for the implicit benefit of the VI structure, which we have approximated as less than or [✂].

92. On balance we consider that I&C EBIT margins are one possible indicator of the competitive margin in the domestic and SME markets.

Profit margins on non-standard tariff customers

93. We considered domestic electricity and gas tariffs of the Six Large Energy Firms over the recent period, and examined the relative gross profit margins of SVTs compared with other tariff types (including fixed tariffs).

Margins on non-standard tariffs

94. In Appendix 10.2: Retail energy supply profit margin analysis, we found that:

    (a) Firms generated a significant proportion of their domestic gas and electricity revenues from SVTs (up to around 80%).

    (b) Suppliers earned significantly higher gross margins on SVTs than they earned on other NST types. The gross margins on SVTs were between 3 and 19 percentage points higher than on NSTs.

    (c) Average gross margins on were 20% on SVTs, and 10% on NSTs.

95. In relation to profit margins generated on NSTs, RWE told us that it did not consider that an estimated margin for an individual tariff type provided evidence as to the appropriate competitive margin benchmark. It argued that the CMA has provided no evidence to support the assumption that a particular tariff type is at a competitive level. It also told us that there were a number of problems in trying to estimate profit margins for individual tariff types. Therefore, it considered that comparisons between the profit margins of different tariffs were not meaningful and did not provide any evidence for the competitive margin. RWE also suggested that it was possible that margins on NST tariffs could be below the competitive benchmark. This may suggest that if returns were adequate, then SVTs were cross-subsidising other tariffs.

96. Centrica told us that it did not recognise our results showing higher margins on SVT than NST customers, and argued that not adjusting for differences in commodity costs and the inclusion of subsidised ‘social tariffs’ in its NST results were distorting our results.

97. SSE told us that the RMR reforms prevented discounted SVTs, and in practice, any investment into customer acquisitions had to be made through fixed tariffs, which were typically the cheapest tariffs in the market. It added that given that suppliers were often making an investment in customer acquisition when offering fixed tariffs, it was to be expected that the unit revenues and gross margins for fixed tariffs should be lower than those for SVTs.

98. E.ON told us that any meaningful gross margin comparisons between SVT and NSTs would need to take into account differences in pricing risk and customer behaviour within the two product groups, which would lead to differences in their average gross and EBIT margins. For example, it told us that a key difference between SVT and NST lay in the frequency with which the supplier felt able to make price adjustments in response to changes in wholesale price movements: while new NST products could be launched routinely in response to market changes, the decision to change SVT attracted significant media and political interest resulting in changes being made much less frequently. It told us that this reduced ability to change the prices of the SVT offering, to reflect changes in the costs incurred by E.ON, exposed E.ON to a greater margin risk on the SVT product.

99. Suppliers said that our analysis tended to overstate the difference between gross margins because we had not factored in the extent to which energy costs varied by tariff type due to different purchasing and hedging strategies.

100. We accepted that in theory the costs of purchasing energy for SVT customers could have been higher depending on the time that it was purchased however suppliers did not supply any data to support this point. As a matter of principle we did not consider that the risks of buying energy for SVT customers were significantly greater than those for other tariff customers. As discussed above, we considered that it was unlikely to explain the wide differential in margins by tariff type. Our analysis suggests that SVT gross margins are approximately twice as high as NST margins, with differences in costs to serve unlikely to be significant to justify such high margin differentials (see also Appendix 10.2: Retail energy supply profit margin analysis).

Annex A: Great Britain non-energy industry comparators

Introduction

1. This annex sets out the parties' submissions in relation to the relevance of GB non-energy retail and utility industry comparators.

Non-energy retail sector comparators

2. Centrica told us that whilst regulators and consultants supporting regulatory determinations commonly prepared benchmarks from a range of retail sectors engaged in mass-market activities, it was not possible to draw any robust conclusions from these benchmarks given that no adjustments were made to account for differences in the levels of capital intensity or systematic risk relative to retail energy.

3. E.ON considered that an industry's risk profile would have a significant impact on its level of profit margins, and told us that any comparator industry should share a similar risk profile to that of retail energy. E.ON told us that for retail industries which shared some of the risk factors faced by energy retailers, EBITDA margins ranged from nearly 6 to just over 20%, with a simple average of 14%. E.ON also assessed the extent to which these industries shared the risk factors faced by GB energy retailers. E.ON concluded however that even where there was some level of comparability in a specific risk factor, there could be variability in the nature of the risk and its impact on profit margins.[17] It believed that identifying relevant comparators would involve a significant degree of subjectivity, and that it would also not always be possible to control perfectly for differences in risk factors.

4. EDF Energy told us that any attempts to resolve differences in risks between energy retailers and other retailers in general would require adjustments that were arbitrary and subjective, and therefore would likely result in a wide range of plausible benchmarks. It told us that simple profit margin comparisons between industries were necessarily artificial and misleading, and relied on these industry participants facing similar risks and having similar levels of capital intensity.[18]

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[17] E.ON's EBITDA margin benchmarking exercise was based on 2009 to 2013 data, and included the following industries: airlines (eg EasyJet and Ryanair); fixed-line and broadband providers (eg TalkTalk); online retail (eg ASOS and N Brown); mail delivery (UK Mail); and B2B manufacturers (A.G. Barr, Britvic, Fenner and Rexam)

[18] EDF Energy told us that comparing levels of capital intensity was difficult given the intangible nature of much of the capital employed in retail energy supply. For example, EDF Energy told us that energy retailers required significant credit support and risk capital to manage their exposure to market risk, which must be remunerated through the profits they generated. EDF Energy also told us that regulated networks through their natural

5. RWE cited a 2013 study which found that EBIT margins in other retail industries ranged from 4.5% (for food retailers) to 14.5% (for apparel retailers) and 21.1% for utilities. RWE considered that returns observed in a broad range of retailers (such as food and apparel) were likely to the most relevant benchmarks for energy retail, although it acknowledged that there was no perfect set of comparable margins for retail energy firms given their different characteristics, such as risks, product differentiation and capital requirements.[19] RWE also told us that we should consider margin benchmarks based on a wider market index, such as the FTSE 100 and/or the FTSE 250, given that they provided an indication of the level of profits generated in other competitive markets.

6. Ovo Energy told us that whilst a comparison with the groceries sector was often cited, retail energy had lower capital requirements, and therefore should be expected to generate lower profit margins.

7. In its 2011 RMR report, Ofgem considered a range of non-energy retail and utility sectors as part of its analysis of the competitive margin for energy retail. Based on this analysis:[20]

   (a) Ofgem considered that supermarket and high street retailers were more reasonable comparators for retail energy supply than telecoms.[21] Based on these comparators, it estimated a generic retail benchmark EBIT margin of 5.8%. Ofgem identified the following differences between energy retail and these non-energy comparators, namely that retail energy supply involved: (i) lower fixed capital (eg premises); (ii) more pass-through items in the retail price, eg network charges; and (iii) significant risk capital and collateral requirements associated with forward purchasing energy in volatile energy markets.

   (b) Ofgem quantified the impact of the differences identified in *(b)* above, and adjusted its estimated generic retail margin of 5.8% to arrive at a competitive margin figure. Based on these adjustments, it concluded that a competitive margin would be 3%for a vertically integrated retail energy

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monopoly and guarantee of regulated returns, were exposed to risks that were qualitatively different from, and significantly lower than, the risk exposure of an energy retailer

[19] RWE cited a 2013 study carried out by CEPA on behalf of Power NI, which benchmarked EBIT margins for FTSE 350 firms in retail industries for 2006 to 2012. CEPA looked at the following retail sectors: utilities, apparel, telecoms, food retailers, specialty retailers and home retailers.

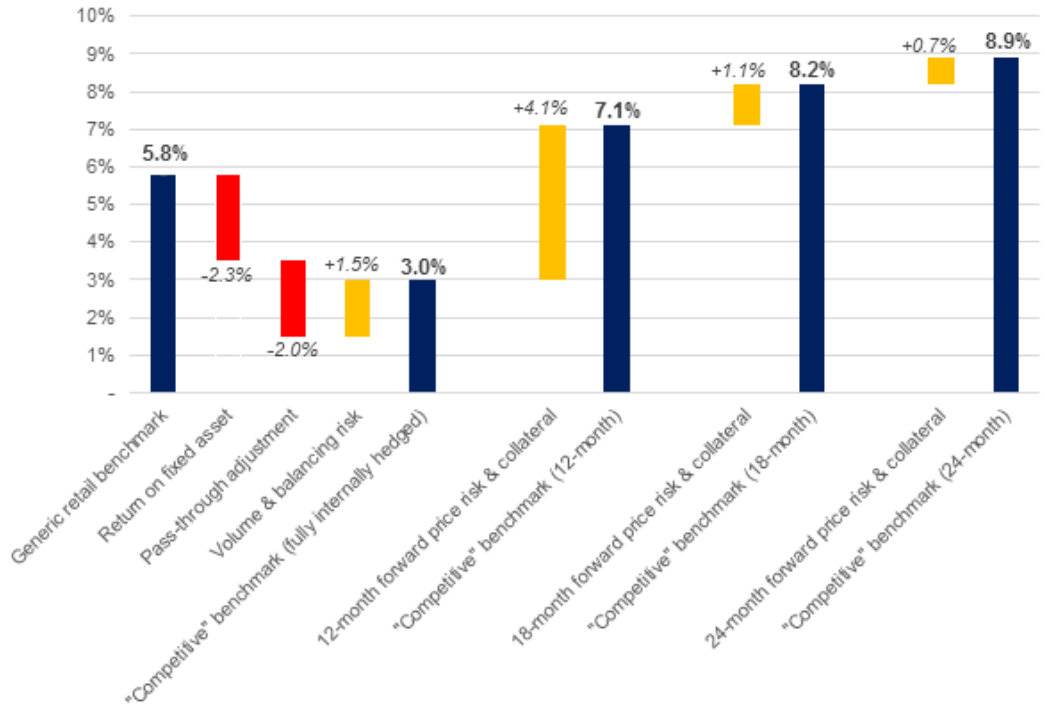
[20] Ofgem (March 2011), *The Retail Market Review – Findings and Initial Proposals*, Appendix 9 – Trends in profits and costs, paragraphs 1.6 and 1.9 and Figures 2 and 4.

[21] Ofgem found that the average FY10 EBIT margin of 4.2% for retail energy supply was lower the EBIT margins generated by supermarket and high street retailers and telecoms of around 5, 7 and 10% respectively. Ofgem said that most telecom businesses were capital intensive; had a large part of their cost base that was 'sunk' and therefore 'at risk'; and had higher profit margin variability than the other retail industries it had considered (source: ibid).

supplier that was fully internally hedged in relation to its wholesale energy requirement, absent which, the competitive margin could be as high as 8.9% for a retail energy supplier with a 24-month forward purchasing hedging strategy.

8. Ofgem's 2011 RMR analysis of the competitive margin is illustrated in Figure A.1 below.

Figure 1: Ofgem 2011 RMR competitive margin analysis*



Source: Ofgem (March 2011), *The Retail Market Review – Findings and initial proposals*, Appendix 9 – Trends in profits and costs, Figure 4.
*Ofgem's calculation of 5.8% as a generic retail benchmark EBIT margin was based on the 2010 EBIT margins for supermarket and high street retailers.
Note: We have made slight alterations to the original presentation of this chart.

Non-energy utility sector comparators

9. In relation to the relevance of regulated and unregulated GB utilities as potential comparators, E.ON told us that there may be significant limitations in drawing comparison with other utilities in the UK, eg water, telecoms and postal services, given their lower risk profile relative to energy retail. It considered that it was likely to be difficult to control for the impact of these factors on the level of returns.[22]

[22] E.ON told us that UK utilities generated lower returns given their lower risk profile relative to energy retail, mainly that: (i) the other utilities did not share its highly volatile cost base; (ii) the price or rate of return was often

10. RWE told us that regulatory precedents would not provide a suitable benchmark for the competitive margin in energy retail, given the fundamentally different risks faced by regulated businesses, and may only provide some indication of the lower bound of the competitive benchmark.[23]

11. Scottish Power told us that the extent to which profit margins generated by other GB utility companies were relevant comparators depended on their respective capital intensity. It told us that most utility businesses, especially those that were regulated, were relatively asset-heavy and would tend to generate much higher profit margins (eg double digit margins) in order to provide investors with an appropriate return on the assets.

12. SSE told us that it expected the profit margins allowed on regulated UK businesses to be lower than in energy retail given the lower risks faced by these regulated firms.

13. Ovo Energy told us that whilst other utility companies (both regulated and unregulated) may be highly relevant as a reference point for determining a competitive margin, care should be taken when comparing markets with different characteristics, eg differences in fixed asset costs.

highly regulated; (iii) the other utilities often had a higher asset base; and (iv) there was much more uncertainty around political and regulatory change and its impact on future earnings in energy supply.

[23] RWE explained that energy retailers faced higher risks than firms in regulated markets, including: *(a)* the higher degree of competition and choice of supplier; *(b)* input price volatility; *(c)* inability to pass-through costs; *(d)* volume uncertainty (eg weather impact); *(e)* political and regulatory uncertainty. RWE told us that although regulated businesses faced risks from the process of regulatory redeterminations on a periodic basis, they benefited from lengthy periods of stability in between regulatory reviews. It added that this contrasted with the frequency of political and regulatory interventions in the energy supply.

Annex B: International energy retail comparators

Introduction

1. This Annex sets out the parties' submissions in relation to the relevance of international energy retail comparators. We first set out the views of parties in relation to international energy retailers, before turning to their views on international regulatory precedent decisions concerning energy retail.

International energy retailers

2. Centrica told us that profitability measures needed to allow for different market and regulatory conditions given that markets in which supply businesses faced or took on more risks than in other markets (eg in relation to commodity volatility, regulatory regimes and competitive dynamics), and as a result required higher levels of capital, needed to generate higher levels of returns in order to satisfy investor requirements. It added that regulatory conditions outside GB varied considerably, ranging from markets with limited commodity risk faced by suppliers due to cost pass through protection (such as Northern Ireland) to markets more similar to GB (such as in Texas).

3. Centrica told us that the profit margins of energy retailers outside GB could be used to provide an indication of the competitiveness of GB margins. It added that this was only indicative given that it was difficult to make adjustments for differences between market and regulatory conditions across retail energy supply markets. Centrica referred to its experience in the US with its own subsidiary, Direct Energy, which it told us operated in competitive markets in 46 US States, and [✂].

4. E.ON told us that whilst including price or margin benchmarks from international comparators in different industries would have the benefit of extending the sample size and limiting the noise introduced by the inherent drawbacks of benchmarking, consideration needed to be given to the comparability of the political, regulatory and economic environment of the relevant jurisdiction to the UK, and controlled for, for a meaningful comparison to be made.

5. Although E.ON told us that there may a number of similarities between overseas and UK suppliers (eg energy retailers face input price volatility and volume uncertainty based on retail customer behaviour), when considering international comparators, it highlighted several potential differences which would need to be adjusted for or taken into consideration:

(a) *Different models to approaching electricity and gas price volatility risk, which would give rise to different returns:* E.ON told us that whilst UK energy suppliers tended to buy energy forward in order to reduce the level of uncertainty, which it told us allowed it to minimise the number of price changes customers were exposed to, many overseas suppliers did not adopt this strategy.

(b) *Different countries were at different stages of deregulation:* E.ON told us that there were different stages of unbundling from networks and generation, which increased the limitations of benchmarking due to the different risk profiles arising from a supply business that had its own network assets and/or a fully integrated generation business, which might have different transfer pricing models to the UK.

(c) *Degree of change, complexity and consequence of regulation in the UK supply market is observed to be greater than that of other European regions:* E.ON told us that this could be seen in the length of the supply licence, the amount of obligations on supply companies and the scale of fines available to the regulator.

(d) *Short and long run factors impacting customer demand are different:* E.ON told us that there were different rules and regulations around customer switching, differing climates and therefore consumption patterns and different economic environments, amongst other factors.

(e) *Differing generation mix and wholesale market structures:* which E.ON told us would have an impact on the magnitude and volatility of input costs.

6. EDF Energy told us that it was difficult to compare the profitability of energy retailers equitably across different jurisdictions without taking into account, and then adjusting for, jurisdictional differences in their risk adjusted ROCE.[24] For this reason, EDF Energy considered European and North American energy retailers were unlikely to be appropriate comparators given the significantly different institutional structures in their respective jurisdictions.[25]

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[24] EDF Energy told us that comparing profit margins between energy retailers in GB and in other jurisdictions would need to take into account a number of jurisdictional differences, including (but not limited to): the extent to which each market was open to competition; differences in ownership patterns of energy retailers; taxation regime differences; and the mix of domestic and non-domestic loads which drove differences in overall consumption patterns. For example, EDF Energy told us that municipal energy retailers may not have profitability as a primary objective, and taxation differences could affect prices where it was used to subsidise energy retailers or wholesale energy costs to meet public policy objectives.

[25] EDF Energy told us that many European markets had a more recent history of end user price controls as well as a culture of state ownership or state control, whilst North American markets often had vertically integrated distribution and supply models.

7. RWE told us that UK comparators were more likely to provide better evidence on the competitive market, and cited a number of factors that reduced the comparability of international energy supply with GB retail energy supply: *(a)* differences in the political, legal and regulatory frameworks; *(b)* structural market differences; *(c)* differences in input costs; *(d)* cultural differences in consumer habits and demands; *(e)* quality of service; and *(f)* differences in accounting treatment and access to the relevant disaggregated data.[26]

8. In relation to European energy retailers, Scottish Power told us that their comparability with GB energy retailers depended on whether they faced similar wholesale energy price and demand risks to energy retailers in GB, and whether data could be obtained on their retail profitability. It also told us that retail profitability within integrated businesses could be subject to a range of different cost allocation assumptions, which whilst generally transparent and well-understood for the Six Large Energy Firms, the same conclusion could not be confidently drawn for European counterparts. It therefore told us that it would attach less weight to retail profitability of international retailers, but added that initial analysis by Oxera indicated that some European energy retailers were generating EBIT margins of around 5%.[27]

9. Utility Warehouse told us that comparisons involving international prices or profit margins were 'wholly irrelevant', as were comparisons with other utility companies, which operated in fundamentally different markets.

10. First Utility told us that international price or profit margin comparisons could be distorting unless a detailed assessment was undertaken on the comparability and relevance of each international market to GB, including the policy and regulatory frameworks, market structures, levels of market liquidity and different business and operating models, including the degree of vertical integration.

11. Ovo Energy told us that international comparators should be treated with caution given that other national energy markets were often very different, eg in terms of market structure, and not many were as liberalised as the UK.

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[26] RWE told us that whilst energy retailers in the EU could potentially provide a suitable benchmark, the following differences across jurisdictions needed to be taken into account and adjusted for in determining a competitive margin: *(a)* the regulatory requirement and legal framework; *(b)* the degree of liberalisation; *(c)* different fuel mix, and whether the country was a net importer or exporter of energy; *(d)* differences in the network and distribution structure; *(e)* differences in a retailer's electricity and gas mix and differences in customer mix (eg domestic and non-domestic); and *(f)* weather and climatic differences. It added that there would also be difficulties of obtaining energy supply company only data.

[27] Average across the set of European comparators which published financial statements for their supply businesses separately in 2013. This included RWE, Gas Natural, Fortum, Enel and EnBW. Data was obtained from 2013 annual reports of the companies without any additional adjustments.

12. The following parties referred to a 2012 study conducted by London Economics, which looked at, among other things, benchmarking EBIT Margins of energy retailers in different countries:[28]

(a) E.ON told us that based on the London Economics study, for the period 2003 to 2010, the UK average EBIT margin was around 4%, resulting in the UK having the fourth lowest EBIT margin profitability out of the 15 EU countries reviewed.

(b) RWE mentioned the 2012 London Economics study, but told us that it did not have access to the underlying data to assess the basis on which any comparisons were made.

(c) Centrica noted that London Economics highlighted that very few companies in the dataset could be classified as pure suppliers, and therefore it considered this sample to contain too few firms to allow benchmarking between GB and other countries and regions.

International regulatory precedents in energy retail

13. EDF Energy told us that in Australia, some of the state energy regulators based their regulated margin determinations using a ROCE approach, and therefore Australian energy retailers may be the most appropriate and relevant international comparators, or at least relation to their regulators' approach to assessing profitability. However, EDF Energy added that even in Australia, the retail energy supply context was different from GB given the use of retail price controls in many states.

14. Scottish Power told us that Northern Ireland Electricity was allowed a retail EBIT margin of 1.7%, which similar to the 1999 determination for Centrica Trading and for ESB Customer Supply prior to deregulation (which had an allowed margin of 1.3% for its regulated tariffs), did not include compensation for wholesale price risk and was set in an environment with lower market share risk. Scottish Power told us that the present GB energy retail market required suppliers to cover a wider range of risks (including wholesale price and market share risks), and therefore the competitive margin would be expected to be higher.[29]

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[28] London Economics carried out a study comparing prices, competition and profitability in the UK electricity and gas retail markets with those in other countries. Its EBIT margin benchmarking exercise was based on a total sample of 163 companies across 44 jurisdictions (including GB). GB comprised 12 companies (source: London Economics report prepared for DECC (April 2012), *Energy Retail Markets Comparability Study*.
[29] Utility Regulator for Northern Ireland, 'NIE Energy Supply Price Control 2010/11, Decision Paper', March 2010.

15. Outside GB, SSE believed that the Australian retail energy market was the only regulated market where the regulated businesses faced similar wholesale energy purchase and volume risks and effective competition as in GB, although it added that other risks were reduced compared to GB due to the provision of a cost pass-through mechanism. It considered that the determinations for New South Wales were the most relevant comparators given that not all states were exposed to the same level of competition as New South Wales.[30]

16. SSE told us that in New South Wales, the allowed EBITDA margin on domestic and small business customers was set at 2% for the period 2004 to 2007, which increased to 5.7% (around 4.5% EBIT margin based on the latest 2014 determination. It told us that this increase coincided with an increase in competition as the market had recently and gradually been opened up to competition, and SSE believed that this increase was set to provide new entrants with some headroom to compete against the incumbents. SSE therefore considered an EBIT margin of 4.5% to be towards the upper bound of what might result in a competitive market in Australia, but added that the competitive level would be unlikely to be materially below the allowed margin, given that a material proportion (around 40%) of customer in New South Wales were paying regulated prices.

17. In responding to the CMA's Profitability Approach Paper, SSE provided further information regarding the comparability of the Australian and GB markets. SSE noted that the Australian regime for the price control provided a cost pass-through mechanism for any unforeseen costs incurred during the regulatory period and that were outside the control of the retailers, which SSE told us suggested that Australian energy retailers faced less risk than those in GB. Further, it added that the price control in New South Wales recommended that price regulation should be phased out, in part due to concerns that the allowed margin set could be too low and could hinder effective competition in the future. SSE stated that this implied that the allowed margin set in New South Wales could provide one of a number of useful benchmarks (rather than an upper estimate).

18. In relation to Northern Ireland, SSE told us that price-controlled electricity retailers were allowed to earn an EBIT margin of 1.7% on their domestic and small business customers for the price control period to 2014, which was increased to 2.2% for the next three years based on the most recent

[30] For example, SSE told us that the Australian state energy regulator for Tasmania allowed a lower profit margin to its retail energy supplier given that it did not face material volume risk or competition in its small customer market.

determination in 2014.[31] However, SSE told us that the allowed margin in Northern Ireland was not a relevant benchmark given the different risk and competition characteristics of Northern Ireland and GB energy markets, eg energy retailers there did not face volume or price risks.

19. SSE concluded that it was reasonable to assume that a competitive margin for GB retail energy suppliers would lie materially above the 2.2% set by the recent price control in Northern Ireland, and would more likely be in the region of the allowed margin in New South Wales, Australia. It noted however that whilst regulators in Australia and Northern Ireland both set out their final determinations as an allowed profit margin, these margins were both informed by an estimate of retail WACC (alongside other factors) to estimate profits.

[31] SSE told us that the increase in the allowed margin reflected the recent and gradual opening up of the market to competition, and was not increased to allow headroom for small suppliers, but to constrain prices to the level needed to cover costs.

Annex C: Great Britain energy retail comparators

Introduction

1. This Annex sets out the details of the parties' evidence concerning past regulatory determinations in GB retail energy as a relevant comparator for our competitive margin analysis. We first set out their views on the relevance of precedent regulatory determinations in GB, before turning to more recent examples within the GB energy retail market.

Past regulatory determinations in Great Britain retail energy

2. RWE told us that regulatory determinations were unlikely to provide any evidence on a suitable competitive margin given the business risks and price control regimes that applied at the time of these determinations. It explained that the regulatory decisions made by Ofgem and the Monopolies and Mergers Commission (MMC) during the 1990s were made:

   (a) for regulated businesses which effectively acted as monopoly service providers; before competition had fully developed; and before any evidence emerged on what might be the appropriate profit margin in a competitive market environment; and

   (b) in a very different wholesale market context, where the regulatory authority did not need to take into account the risk capital and collateral requirements which were now associated with forward purchasing of energy in a liberalised wholesale electricity market.

3. In relation to the latter, RWE pointed out that when Ofgem presented its competitive margin analysis in its 2011 RMR report, it took into account the significant risk capital and collateral requirements associated with forward purchasing energy in volatile energy markets.

4. Scottish Power told us that the regulated EBIT margin precedent of 1.5%[32] would only serve as an indication of the base minimum margin level that would be required by a retailer not exposed to significant input price or market share risks. It considered that 1.5% would not represent a reasonable margin in any current view of the market given the low-risk market environment at the time of these determinations, when: *(a)* the costs of wholesale electricity and

[32] As part of their retail price controls in the late 1990s, British Gas Trading and the domestic electric retailers had an allowed EBIT margin of 1.5% (Ofgem (November 1999), *Review of British Gas Trading's Price Regulation, Initial Proposals*).

gas were explicitly passed through as a separate item in the regulated price; and *(b)* competitors had a relatively low market share.

5. Scottish Power considered that an EBIT margin towards 5% would be a suitable starting point for a competitive margin, based on:[33]

   (a) a base minimum EBIT margin of 1.5%;

   (b) a 'retail competition risk premium' of around 0.5 to 2.5% to take into account the incremental risks associated with operating in a competitive retail environment;[34] and

   (c) a further risk premium (which it did not quantify) to account for the incremental risks of exposure to wholesale energy price movements, which required energy retailers to hold an additional (and notional) risk capital to manage these other market risks.

6. SSE told us that Ofgem's past determinations for the allowed EBIT margin of 1.5% would be too low an estimate for the competitive margin given that the retail energy markets had not been opened up to effective competition at the time of these determinations.[35]

7. In its 2012 published report, the Institute for Public Policy Research, a UK think-tank, said that an appropriate EBIT margin for a price-regulated energy retailer would range from 1 to 1.5% (based on UK regulatory precedents), but would increase to around 3% (or slightly more) if an energy retailer was exposed to 'full competitive risk'. It considered the higher profit margins typical of a competitive market to be a cost to consumers as a direct result of having competition.[36]

8. In relation to some of these precedent regulatory determinations, Ofgem said in its 2008 Probe report, that:[37]

   (a) the 0.5% allowed EBIT margin in the MMC's 1995 decision on Scottish Hydro was determined at a time when supply was still a monopoly activity, and therefore it would expect the current relevant margin to be higher to reflect the increased risks associated with a competitive environment; and

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[33] Scottish Power adopted 1.5% as a minimum EBIT margin, which would cover the costs and working capital associated with engaging in retail activities where there was no risk from competition (eg regulated monopoly retailers) and no risk from wholesale price movements. It considered that 1.5% was broadly consistent with regulatory precedents, including for British Gas Trading when it retained significant market power in retail.
[34] Scottish Power told us that this 'competition risk premium' was based on analysis of comparator data carried out by Oxera on its behalf.
[35] Based on Ofgem's pricing decisions over the period 1998 to 2002.
[36] IPPR (April 2012), *The True Cost of Energy*, pp7 & 35.
[37] Ofgem (October 2008), *Energy Supply Probe – Initial Findings Report*, paragraph 8.19.

(b) in 1998, Offer and Ofgas considered a 1.5% EBIT margin to reflect adequately the increased risks associated with the competitive environment. It added that this was at a time when the revenues per customer were less than half of 2008 levels.

9. In relation to some of these regulatory EBIT margin determinations, EDF Energy noted that ROCE was used by the MMC in 1995 in its Scottish Hydro price control review to assess the required margin for energy retail, as well as by the regulator in Northern Ireland in the context of Power NI's retail energy pricing determination.[38]

More recent examples potential comparators in Great Britain energy retail

10. Co-op Energy told us that given the limited availability of suitable comparators for the determination of a competitive margin, the most appropriate comparator would be the profit margins generated by independent energy retailers, and more ideally, energy retailers of a similar size to the Six Large Energy Firms. It considered that any comparisons based on independent energy retailers would need to take into account their growth over the period given the significant impact of customer acquisition costs on their profit margins.[39]

11. RWE however considered that the profit margins of the smaller independent GB energy retailers would not provide an appropriate benchmark. It told us that smaller energy retailers did not provide a consistent comparator set, comprising companies at various stages of maturity, with different business models, product portfolios (eg fuel mix), and customer bases with differing profiles (eg domestic and non-domestic mix), and with some firms operating in niche segments.

12. We also noted [✂].[40]

13. We also considered some of the evidence we received in relation to individual firms' target profit margins:

(a) RWE told us that in the context of financial expectations over the Relevant Period, it believed that an industry EBIT margin of 5% represented a reasonable profit margin. However it added that, due to the marked shifts

[38] EDF Energy told us that in relation to the Scottish Hydro decision, the capital employed was based on the working capital used by the vertically-integrated distribution and supply businesses. EDF Energy told us that in a competitive context, the capital requirement would likely be higher.
[39] Co-Op Energy also told us that it did not consider international prices, non-GB energy retailers or other utility companies to be appropriate comparators
[40] SSE's projected EBIT margins were calculated on a forward-looking basis based on cost projections at the time of sale.

in the risk profile faced by the industry in the period, it did not consider that this margin was necessarily representative of what a recommended future profit margin should be. RWE also noted that statistical analysis of market data over the period 2008 to 2012 suggested that a typical FTSE 100 company with limited tangible assets would still be expected to earn an EBIT margin of at least 5%.

(b) SSE told us that its target EBIT margin was 5% over the medium-term, although it added that it had not met this target in any year over the last five years (FY09 to FY13), although it achieved just under 5% in FY10.

(c) Ovo Energy told us that its Ovo Communities business[41] fixed energy retail EBIT margins at 3% to underline its view that this represented a fair benchmark profit margin for the industry.

14. Centrica told us that city analyst estimates suggested a range of 4 to 6% for the EBIT margins that were required in its retail supply business:

(a) Liberum Capital estimated that Centrica's supply business required an EBIT margin of 6% to cover a pre-tax WACC of 10% on a notional capital employed estimate of around £5 billion.[42]

(b) Morgan Stanley assumed in its base projections for Centrica Group's valuation, that an energy retail EBIT margin of 5% would be sustainable in the long term. Morgan Stanley estimated that reducing the retail supply EBIT margin to 3% for the Six Large Energy Firms would reduce their ROCE (on a vertically integrated basis) to 'even less acceptable levels'.[43]

(c) UBS estimated that at 4% EBIT margin for energy retail, Centrica Group would be at risk of a credit downgrade given that it would come close to breaching a threshold on one of its key credit metrics, namely funds from operations to net debt, in the event that there were further adverse regulatory developments.[44]

15. Two parties pointed to the lack of market entry from certain high street retailers as a possible indication that the available profit margins were too low:

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[41] Ovo Energy told us that its Ovo Energy Communities business offered support services to local authorities and community groups wanting to set up new energy companies
[42] Liberum Capital report, 'Centrica –Vertically challenged', 23 January 2012, p.27.
[43] Morgan Stanley Research Europe (March 2014), *UK Utilities – Returns Create a Case for the Defence – Buy SSE*, pp7 and 17.
[44] UBS Global Research (February 2014), *Centrica: Retail Strategy Unsustainable and Political Risk Now Higher*, p16.

(a) Utility Warehouse told us that it would expect many more high street retailers would have entered the market if profit margins were attractive. It told us however that this had not been the case, which may be an indication that profit margins were insufficient to offer satisfactory returns.[45]

(b) Scottish Power told us that the relatively low levels of profitability, combined with the political and regulatory uncertainty and regulatory risks, may be significant factors that explained why retailers with strong brands and systems had not chosen to extend their reach into retail energy.[46]

[45] Utility Warehouse cited the following types of market entrants: supermarkets (as principals, ie not under a white label arrangement); other utility companies (eg water companies or telecoms providers); and 'consumer champion' brands (eg Virgin or Easy).
[46] Scottish Power referred to certain telecoms or pay-TV providers as 'brand extenders', ie retailers with strong brands and customer relationship management systems and processes.