

Appendix 9.13: Retail profit margins

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Introduction

1. This appendix sets out our analysis of the profit margins¹ and ratios generated by the retail energy supply businesses of the Six Large Energy Firms and the Mid-tier Suppliers, as well as our discussion of the 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. We noted, however, that when seeking to make comparisons of margins between different customer types (eg comparing the margins earned on domestic customers with those earned on SMEs), or between energy suppliers and other 'comparable' firms, the parties suggested that it was

¹ Profit margins include both gross profit margins and EBIT margins.

necessary to take into account differences in the risks, capital employed or cost structures associated with different activities in order to make meaningful comparisons. We agree that a robust profitability analysis should take into account these factors and we note that our ROCE analysis set out in Appendix 9.10 – with the results benchmarked against an industry WACC – seeks to do this, which is why it is our preferred means of assessing profitability. However, we consider that the profit margins of suitable comparator firms can provide a useful cross-check on this ROCE analysis. Therefore, in this appendix, we set out our analysis of profit margins and our discussion of the potential comparators. We have concluded that the most relevant comparators were those taken from within the GB energy markets due to similarities in cost structures, risks and capital employed, rather than other retail sectors or international comparators. These comparators indicate that a firm operating in a competitive market, could expect to earn an EBIT margin of around 2% on average over time.

Summary

Profit margins

3. We found that the Six Large Energy Firms earned an average EBIT margin of 2.9% between 2007 and 2014 across all customer types. Between 2009 and 2014, this return was higher at 3.5% on average. For our reference market of domestic and microbusiness customers,² EBIT margins were higher at 4.1% per year over the last six years.
4. Whilst total profits for the Six Large Energy Firms combined had increased over the relevant period, ie between FY07 and FY14, there were significant variations year on year, as well as between the different firms, and between retail segments and fuel type. As a result of these variations, we have looked at profit margins on both an annual and period total basis, as well as for the Six Large Energy Firms combined.
5. We found that for the Six Large Energy Firms combined, EBIT margins were significantly higher on SME customers (8.0%) than on domestic (3.5%) and I&C (1.9%) customers, and that these were driven largely by lower unit costs for SME supply, rather than by higher prices.³ Some parties told us that these higher margins were justified based on the greater risks borne by suppliers in serving SME customers and the higher level of capital employed, as compared with domestic or industrial and commercial (I&C) customers. For

² In order to estimate the returns on microbusiness customers, we used SME returns as a proxy. We recognise that the returns on microbusinesses may have been slightly different.

³ These figures are all for the six-year period from 2009 to 2014.

example, suppliers pointed to higher risk of bad debts and greater exposure to the economic cycle, as well as the greater working capital requirements. In the first instance, we noted that these arguments supported the use of ROCE, rather than margins, to assess profitability since ROCE takes account of such differences in capital employed and the WACC benchmark (with which ROCE is compared) takes into account the impact of systematic risks on returns.

6. We concluded that there was some evidence that serving business customers required a higher level of capital than domestic customers but that the evidence did not support the view that there were significantly larger systematic risks associated with serving SMEs. We consider the apportionment of capital between customer types further in Appendix 9.10. This analysis shows that, even when we take into account a reasonable range of estimates of a higher capital base for SMEs, the Six Large Energy Firms have earned relatively higher returns on these customers than on domestic and I&C customers.
7. We also found that Centrica generated relatively higher margins, in particular on its gas supply business, compared with the other Six Large Energy Firms. For example, Centrica earned an EBIT margin of 9.1% on domestic gas over the last six years compared with the next highest EBIT margin of 5.4%. Centrica told us that its relatively higher margins on gas supply in comparison with electricity was driven by a combination of: (a) its dual fuel pricing strategy to encourage gas only customers to also purchase their electricity from Centrica through lower electricity prices, and it believed that the reverse would be expected to be seen from the electricity incumbent suppliers; and (b) greater risks in gas supply due to more volatility in wholesale gas input prices, greater volatility due to weather effects and the seasonality of gas demand.
8. In our view, we found no clear cost or risk-related justification for the higher margins earned by Centrica on gas. We considered that wholesale price or weather risks were capable of management through hedging and forecasting, and that, to the extent that such factors increased volatility in an energy supplier's profits on gas (relative to electricity), such volatility was not correlated with the economic cycle and therefore did not justify a higher profit margin on gas, as would be the case for systematic risks.⁴
9. In relation to our analysis of the profit margins generated by the Mid-tier Suppliers, we found that they generated lower gross margins than the Six Large Energy Firms combined, and given their substantial customer

⁴ Systematic risks are those that are correlated with the broader market.

acquisition expenditure, generated EBIT margins over the period under consideration that were negative, and significantly lower than the Six Large Energy Firms combined.

Comparators

10. 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:
 - (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 EBIT 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 submitted 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 submitted that a price-regulated firm faced fewer 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.

11. Several parties told us that it would be inappropriate to compare the Six Large Energy Firms' performance with that of the Mid-tier Suppliers, citing material differences in their customer strategy, customer mix and stage of the business cycle, which undermined a meaningful comparison. Similarly, parties told us that I&C was a less risky business and should, therefore, earn lower margins than domestic and SME, due to a combination of having more scope for cost pass-through to customers, lower shaping cost and risk, and lower bad debt costs.
12. We concluded that, to the extent that comparators are used to identify a competitive benchmark margin, the most relevant comparators were those taken from within the GB energy markets due to similarities in cost structures, risks and capital employed, rather than other retail sectors or international comparators. For example, we observed that a retailer in a different market, such as a supermarket or a telecoms provider, would have both a very different cost structure and a very different level of capital employed. Similarly, energy suppliers operating in other countries are likely to be subject to different proportions (and absolute levels) of network charges, social and environmental obligations and wholesale energy costs.
13. We found that:
 - (a) The evidence from independent suppliers was difficult to interpret due to the rapid growth of these suppliers in recent years. However, it tends to suggest 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) The evidence from the I&C market indicates that an EBIT margin for the domestic and SME markets of around 1.9 to 2.4% is reasonable.
 - (c) The evidence from previous GB regulatory determinations indicated EBIT margins of between 0.5 and 1.5%, while that from Power NI suggested a margin of just over 2% and that from New South Wales suggested up to 4.5%.
14. We consider that greatest weight should be placed on evidence from the GB energy market itself, ie on the margins earned serving I&C customers and on previous GB regulatory determinations (recognising that regulated firms may face fewer risks). On this basis, we consider that an appropriate benchmark EBIT margin is around 2%.
15. We note that this figure is higher than the competitive EBIT margin implied by our ROCE analysis (of 1.25%). However, the level of the appropriate EBIT margin will depend on the choice of operating model of an individual firm. Our

ROCE analysis is based on a relatively asset-light model under which a firm pays an intermediary a trading fee, rather than holding capital for the purposes of trading collateral, and uses letters of credit rather than cash to meet regulatory collateral requirements. A firm that chose to hold capital rather than pay such fees would, other things being equal, earn a higher EBIT margin.⁵ We estimated the competitive EBIT margin implied by our ROCE analysis under the assumption that an equivalent amount of capital was held for trading and regulatory collateral purposes. This indicated a competitive EBIT margin of around 1.9%, which is broadly consistent with a 2% benchmark (see Appendix 9.10).⁶

Profit margin analysis

16. We focused primarily on two profit measures: profit after direct costs (gross profit) and profit after direct and indirect costs (otherwise known as net profit or EBIT). Based on these profit measures, we looked at a range of profitability ratios, in particular profit margins (ie gross or net profit as expressed as a percentage of sales), profit per MWh (unit profit) and, when appropriate to do so, profit per customer account.
17. We examined both profit margins by fuel type, ie electricity and gas, and by customer segment type, ie residential (domestic), SMEs and larger I&C customers (the retail segments).⁷ Our analysis was based primarily on the annual profit and loss (P&L) account information submitted to us in response to our financial information requests by the Six Large Energy Firms.
18. We examined profit margins for all retail markets combined (the total supply business), and for each individual retail market. We also compared our results for the domestic supply businesses of the Six Large Energy Firms with those of the next four largest independent domestic energy suppliers in GB (the Mid-tier Suppliers), namely Co-op Energy, First Utility, OVO and Utility Warehouse.
19. The period under consideration for our profit margin analysis covered the last eight financial reporting years, or financial year-ends (FYs), of the Six Large

⁵ This higher margin would result from not paying these fees. However, the increase in margin would be offset by the need to remunerate a higher level of capital employed at its WACC.

⁶ In order to do this analysis, we capitalised the trading and letters of credit fees paid at the firms' estimated WACC (of 10%) and calculated the EBIT margin that a firm would need to make in order to earn its 10% WACC on its overall capital base.

⁷ For the purpose of our analysis, we have assumed that the domestic and SME retail segments combined, as reported in the Six Large Energy Firms' P&L information, most closely represented the retail markets that were defined by our terms of reference. There was also a broad consensus from the Six Large Energy Firms that these 'smaller business' customers that formed part of our terms of reference would most appropriately be categorised under their SME customer category.

Energy Firms, ie FY07 to FY14 (the relevant period). We covered a shorter six-year time period for the Mid-tier Suppliers, noting that Utility Warehouse and First Utility were the only Mid-tier Suppliers that had traded for the full six-year period.⁸

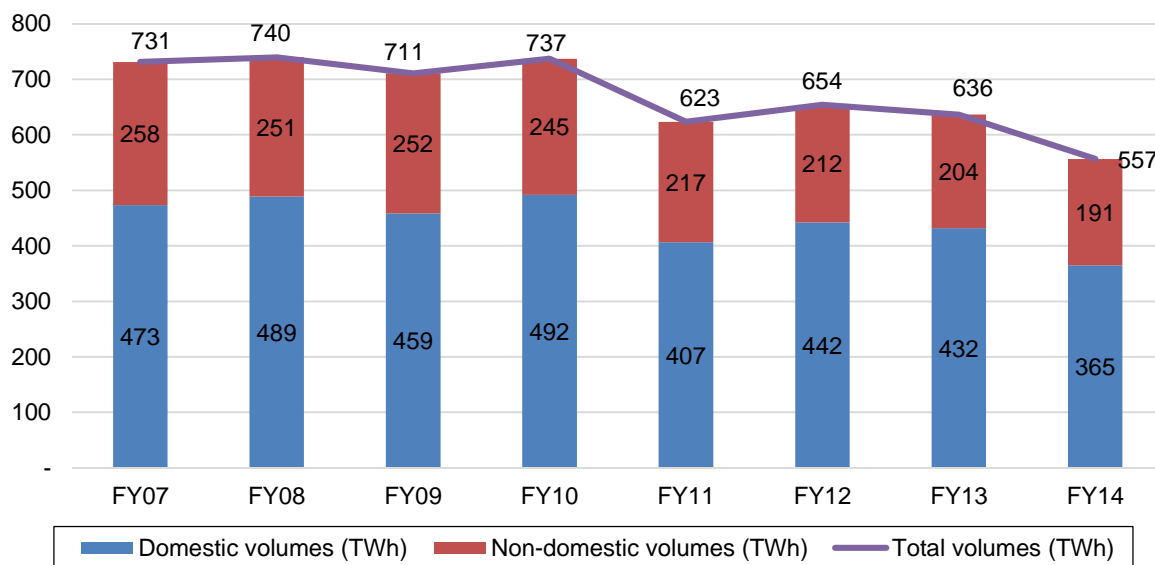
20. We have structured the main body of this section of the appendix under the following subjects:
- (a) Total supply business profit margins: we begin our analysis by looking at profit margins and ratios at the total supply business level for the Six Large Energy Firms, ie for the domestic, SME and I&C retail markets combined.
 - (b) Comparison of retail segmental profit margins: we compare profit margins and ratios between the domestic, SME and I&C retail markets of the Six Large Energy Firms. In particular, we consider the reasons for the differences in profit margins between the domestic and SME retail markets.
 - (c) Domestic profit margins: we examine profit margins and ratios for the domestic retail segment of the Six Large Energy Firms' businesses, and compare these with those generated by the Mid-tier Suppliers.

Total supply business profit margins

21. This section sets out our analysis of the profit margins and ratios generated by the Six Large Energy Firms on their total supply businesses, ie for their retail activities combined.
22. Figure 1 shows the total annual energy volumes (ie including both electricity and gas volumes) supplied by the Six Large Energy Firms over the relevant period on a combined basis, split by domestic and non-domestic supply.

⁸ We adopted a convention to match a firm's own financial reporting year as closely as possible to the calendar year (ie ending 31 December), such that the FY refers to the calendar year in which the majority of its months fell into. To illustrate how we applied this convention, and for the avoidance of doubt: (a) for firms with financial reporting years ending 31 December, ie Centrica, E.ON, EDF Energy, RWE, Scottish Power, First Utility and Ovo Energy, FY14 means their FY ended 31 December 2014; (b) for firms with financial reporting years ending 31 March, ie SSE and Utility Warehouse, FY14 means their FY ended 31 March 2015; and (c) for Co-op Energy, its financial reporting year ends on the fourth Saturday in January, therefore FY14 means its FY ended 24 January 2015.

Figure 1: Total supply business annual energy volumes (TWh) for the Six Large Energy Firms combined over the relevant period

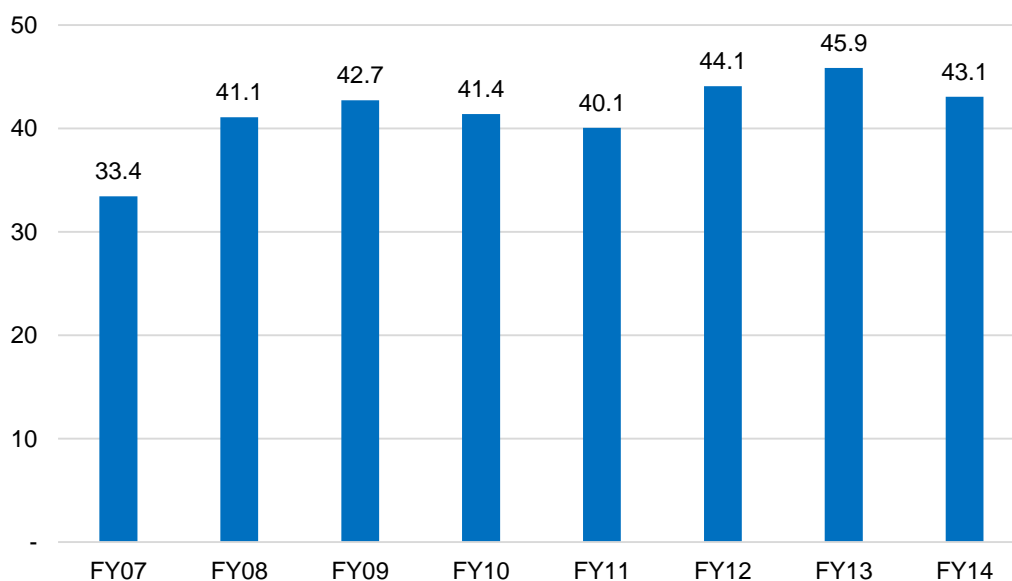


Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.

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

23. Figure 1 shows that total volumes supplied by the Six Large Energy Firms declined by 24% from 731 TWh in FY07 to 557 TWh in FY14. The sharpest single year fall in volumes occurred in FY11 for both domestic and non-domestic volumes, when they declined by 17 and 12% respectively.
24. Figure 2 below shows that annual revenues for the Six Large Energy Firms' total supply businesses increased by 29% over the relevant period from £33 billion to £43 billion. The largest annual increase over the relevant period occurred in FY08, when revenues increased by 23%.

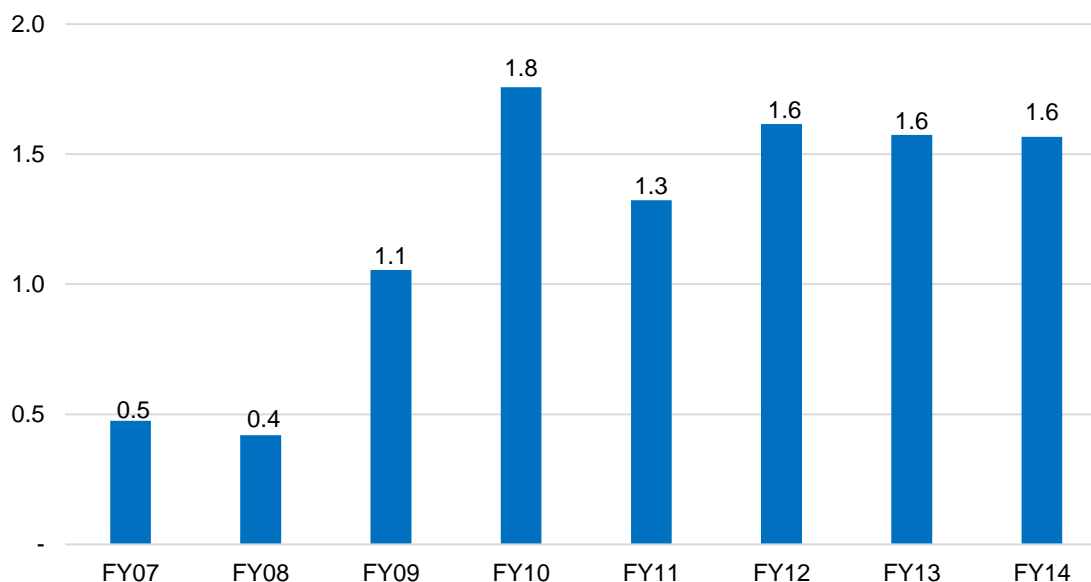
Figure 2: Total supply business revenues (£ billions) over the relevant period for the Six Large Energy Firms combined



Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.
 Note: Total energy revenues relate to both electricity and gas supply for all three retail segments, ie domestic, SME and I&C.

25. Over the relevant period, EBIT in energy retail increased for the Six Large Energy Firms combined from £0.5 billion in FY07 to £1.6 billion in FY14 (see Figure 3).

Figure 3: Total supply business EBIT (£ billions) over the relevant period for the Six Large Energy Firms combined

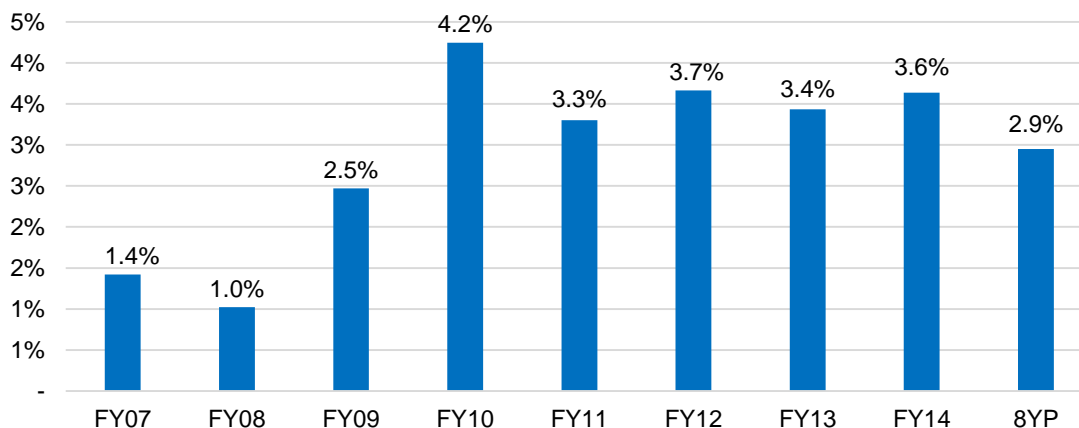


Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.
 Note: Total energy EBIT relate to both electricity and gas supply for all three retail segments, ie domestic, SME and I&C.

26. Figure 4 sets out the annual total supply business EBIT margins for the Six Large Energy Firms combined over the relevant period, and shows that EBIT

margins for the total supply businesses of the Six Large Energy Firms combined increased over the relevant period, from 1.4 and 1.0% in FY07 and FY08 respectively to 3.6% by FY14, with a period high of 4.2% in FY10 and an average of 2.9% for the period as a whole.⁹

Figure 4: Six Large Energy Firms' total supply business EBIT margins (FY07 to FY14)



Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.

Note: Profit margins for the Six Large Energy Firms combined have been calculated by dividing the sum of the numerator values (eg EBIT for EBIT margin) for each of the Six Large Energy Firms, by the sum of the denominator values (eg revenues for EBIT margin).

27. In relation to the increase in total supply business EBIT margins over the relevant period, Centrica told us that whilst profit margins had increased over this period, the context of the observed increase was key to understanding whether this was reflective of a well-functioning market. It told us that it was important to recognise that EBIT margins in FY07 and FY08 for domestic suppliers were less than 1%, with several industry participants incurring losses and a number choosing to exit the market. It therefore considered that from this starting point, it was reasonable to expect industry profits to increase to more sustainable rates of return. In relation to a possible 'fair return', Centrica pointed to Ofgem's RMR estimate of 3 to 9% for the competitive EBIT margin benchmark, and the 2013 regulated EBIT margin of between 4 and 6% in the Australian energy supply market. We consider these points in more detail, below.
28. We note that whilst the EBIT margins shown in Figure 4 above were relatively low in FY07 and FY08, these figures were based on the total EBIT and revenues generated by the Six Large Energy Firms on a combined basis, and therefore disguise the different performances across individual firms. Some of

⁹ Annual total supply business EBIT margins for the Six Large Energy Firms combined were relatively higher between FY10 and FY12 than in any other year over the relevant period, ranging from 3.3% in FY11 to 4.2% in FY10.

these differences highlight that FY07 and FY08 were not necessarily a period of low profit margins for some suppliers, for example: [X].

29. We now turn to retail segmental profit ratios, which underpin the profit ratios above for the total supply business.

Comparison of retail segmental profit margins

30. This section sets out our analysis of profit margins and ratios for the retail markets, ie domestic, SME and I&C. We first set out the segmental profit ratios of the Six Large Energy Firms on a combined aggregated basis,¹⁰ before setting out their individual ratios. For certain areas of our analysis, we have presented our ratios on two different bases: (a) calculating profit margins and ratios based on aggregated figures over a given period (period total);¹¹ and (b) on an annual basis.

Retail segmental profit margins for the Six Large Energy Firms combined

31. For FY07 and FY08, SSE was unable to provide a split of its non-domestic P&L information between its SME and I&C retail segments. We have therefore focused our analysis on the last six years (FY09 to FY14) for which SME segmental P&L data was separately available for all of the Six Large Energy Firms.
32. On a six-year period total basis (ie period total EBIT divided by period total revenues), the Six Large Energy Firms combined generated an EBIT margin of 3.5% at a total supply business level, and 4.1% for our reference market (ie approximated by the combination of the domestic and SME retail markets). When we examined profit margins at an individual retail segmental level, we found that EBIT margins varied considerably between the different retail segments.
33. In Table 1, we set out the revenues, EBIT and EBIT margin by retail segment and for the total supply business on a six-year period total basis. We present the figures for the Six Large Energy Firms on a combined basis.

¹⁰ Eg, the FY14 EBIT margin for the Six Large Energy Firms combined (ie on an aggregated basis) would be calculated as the sum of the FY14 EBIT of the Six Large Energy Firms divided by the sum of their FY14 revenues.

¹¹ Eg, the EBIT margin on a period total basis would be calculated based on the sum of the EBIT generated over the period (ie period EBIT), divided by the sum of the total revenues generated over the period (ie period revenues).

Table 1: Six-year period total revenues, EBIT and EBIT margins for the Six Large Energy Firms combined*

	<i>Domestic</i>	<i>SME</i>	<i>I&C</i>	<i>Total supply business</i>	<i>Reference market†</i>
Period revenues (£bn)	159	25	73	257	184
<i>Retail segment % split</i>	<i>62%</i>	<i>10%</i>	<i>29%</i>	100%	<i>71%</i>
Period EBIT (£bn)	5.5	2.0	1.4	8.9	7.5
<i>Retail segment % split</i>	<i>62%</i>	<i>22%</i>	<i>16%</i>	100%	<i>84%</i>
Period EBIT margin (%)‡	3.5%	8.0%	1.9%	3.5%	4.1%

Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.

*When calculating figures for the Six Large Energy Firms on a combined basis, we have taken a simple sum of their individual figures.

†We have assumed that the domestic and SME retail markets combined represent the closest proxy to the 'reference markets' based on the available P&L information of the Six Large Energy Firms.

‡Period EBIT margin was calculated by dividing period EBIT by period revenues.

Note: Period total is calculated based on a simple sum of the relevant annual figures over the stated time period.

34. Based on Table 1, the reference market,¹² as approximated by the combined domestic and SME retail markets,¹³ accounted for a significant proportion of the revenues and EBIT generated by the total supply businesses of the Six Large Energy Firms combined, ie 71 and 84% of period revenues and EBIT respectively. For the Six Large Energy Firms combined, the reference market generated a higher EBIT margin of 4.1% on a six-year period total basis, compared with 3.5% for the total supply business.
35. Table 1 also shows that the SME retail market generated a significantly higher period EBIT margin of 8.0% when compared with the lower period EBIT margin generated by the domestic retail market of 3.5%. The I&C retail market, which did not form part of our reference market, generated the lowest period EBIT margin of 1.9%.
36. In relation to the FY09 to FY13 period total margins, EDF Energy told us that it considered an EBIT margin of 3.3% for domestic supply (for the Six Large Energy Firms combined) to be within the range of a 'fair margin' for the industry as a whole, but noted that there was likely to be a wide range behind the period total margin figure, with some firms and products generating EBIT margins that were well below or above the period total level. In relation to the above, we consider parties' views concerning the competitive benchmark margin in further detail in the next section of this appendix.

¹² Ofgem's terms of reference for the CMA's investigation define the reference markets as the economic markets for the supply and acquisition of energy in GB, where for this purpose 'energy' means both electricity and gas, and both the wholesale and retail activities are included in the reference (with the exception of retail supply to larger businesses). Ofgem's terms of reference are set out [here](#).

¹³ We noted from our discussions with each of the Six Large Energy Firms that the threshold of what categorised 'larger businesses' from our terms of reference was not a definition they used to segment their financial reporting. There was also a broad consensus from the Six Large Energy Firms during these discussions that these 'smaller business' customers that formed part of our terms of reference would most appropriately be categorised under their SME customer category.

37. We examine the key revenue and cost drivers behind the difference in profit margins between the domestic and SME retail markets in paragraphs 45 to 71 below.

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

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

Table 2: Breakdown by individual firm of six-year period total revenues and EBIT margins

	%						
	<i>Domestic electricity</i>	<i>Domestic gas</i>	<i>SME electricity</i>	<i>SME gas</i>	<i>I&C energy</i>	<i>Total supply business</i>	<i>Reference market†</i>
<i>Period revenue split</i>							
Centrica	27	48	[REDACTED]	[REDACTED]	[REDACTED]	100	[REDACTED]
E.ON	33	23	[REDACTED]	[REDACTED]	[REDACTED]	100	[REDACTED]
EDF Energy	28	16	[REDACTED]	[REDACTED]	[REDACTED]	100	[REDACTED]
RWE	29	24	[REDACTED]	[REDACTED]	[REDACTED]	100	[REDACTED]
Scottish Power	44	32	[REDACTED]	[REDACTED]	[REDACTED]	100	[REDACTED]
SSE	36	26	[REDACTED]	[REDACTED]	[REDACTED]	100	[REDACTED]
Combined*	31	30	8	2	29	100	71
<i>Period EBIT margin</i>							
Centrica	2.5	9.1	[REDACTED]	[REDACTED]	[REDACTED]	6.7	[REDACTED]
E.ON	5.0	-1.3	[REDACTED]	[REDACTED]	[REDACTED]	3.2	[REDACTED]
EDF Energy	-2.4	-5.9	[REDACTED]	[REDACTED]	[REDACTED]	-0.4	[REDACTED]
RWE	0.9	0.7	[REDACTED]	[REDACTED]	[REDACTED]	1.6	[REDACTED]
Scottish Power	1.9	4.2	[REDACTED]	[REDACTED]	[REDACTED]	3.4	[REDACTED]
SSE+	4.9	5.4	[REDACTED]	[REDACTED]	[REDACTED]	3.7	[REDACTED]
Combined‡	2.5	4.5	7.4	9.9	1.9	3.5	4.1

Source: CMA analysis of P&L information submitted by the Six Large Energy Firms. 'N/A' means 'not applicable'.

*When calculating period revenues for the Six Large Energy Firms on a combined basis, we have taken a simple sum of their individual revenue figures over the stated six-year time period.

†We have assumed that the domestic and SME retail markets combined represented the closest proxy to the 'reference markets' based on the available P&L information of the Six Large Energy Firms.

‡Period EBIT margin was calculated by dividing period EBIT by period revenues.

+ [REDACTED].

Note: Period total is calculated based on a simple sum of the relevant annual figures over the stated five-year time period.

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

- (a) Higher profit margins in SME supply: we found that for the Six Large Energy Firms on a combined basis, the SME retail market generated the highest EBIT margin for both fuel types: 7.4% for SME electricity and 9.9% for SME gas supply. These EBIT margins were significantly higher than in any of the other retail markets. This pattern of higher margins in SME supply for the Six Large Energy Firms combined was consistent across most of the Six Large Energy Firms (with one exception; SSE in SME gas supply). For the other five of the Six Large Energy Firms, we

found that the EBIT margin on SME supply was consistently greater than the EBIT margin on domestic supply for the same fuel type. We examine the key drivers behind the relatively higher EBIT margins in SME supply compared with domestic supply in paragraphs 45 to 70 below.

- (b) SME electricity supply: at an individual firm level, SME electricity supply generated the highest or second highest period EBIT margin for all the Six Large Energy Firms, with the exception of [REDACTED]. [REDACTED] generated their two highest period EBIT margins in both SME electricity and gas supply.
 - (c) Centrica and gas supply: Centrica generated its [REDACTED].
 - (d) Domestic electricity supply: for each of the Six Large Energy Firms, revenues from domestic electricity accounted for the highest or second highest percentage of its total supply business revenues, and ranged from 27% for Centrica to 44% for Scottish Power. However, profit margins on domestic electricity supply varied considerably across the Six Large Energy Firms, with EBIT margins on a period total basis ranging from -2.4% for EDF Energy (see (e) below) to 5.0% for E.ON.
 - (e) EDF Energy and non-domestic profit margins: EDF Energy generated a negative EBIT margin on a period total basis at a total supply business level, and was the only firm out of the Six Large Energy Firms to have generated an EBIT loss on this basis. On a retail segmental level, EDF Energy generated negative period EBIT margins in both its domestic electricity and gas supply with -2.4 and -5.9% respectively, [REDACTED] its loss-making domestic supply business accounted for 44% of period total revenues. As we set out in Appendix 9.11, [REDACTED].
 - (f) I&C profit margins: the I&C retail market accounted for the highest or second highest percentage of period revenues for [REDACTED] of the Six Large Energy Firms, namely [REDACTED], for whom I&C revenues accounted for between [REDACTED] of period revenues. I&C accounted for a relatively smaller proportion of period revenues for [REDACTED]. At an individual firm level, the highest period EBIT margin in I&C supply was generated by [REDACTED], which was significantly lower than the highest period EBIT margins generated by any of the other Six Large Energy Firms across all the other retail markets, eg [REDACTED].
40. In relation to its relatively high profit ratios on gas compared with the other Six Large Energy Firms or its own electricity customers, Centrica told us that this was driven by its dual fuel conversion strategy and the higher risks it faced in supplying gas.

41. In relation to its dual fuel conversion strategy, Centrica told us that the GB energy market operated predominantly on a dual fuel proposition basis, and therefore it had structured its gas and electricity offerings to ensure a competitive dual fuel proposition. It added that it continually reviewed the balance between its gas and electricity prices and margins to ensure that it had a competitive position in the market. Centrica also told us that it sought to optimise the balance between its gas and electricity prices in order both to convert its existing single fuel gas customers to dual fuel and also to acquire new to brand dual fuel customers. It explained that this had resulted in a lower than average electricity price, a slightly higher gas price and a competitive dual fuel offering. It believed that its competitors had done the opposite: using lower gas prices to try and win its gas customers, and convert their electricity to dual fuel. Therefore, as a consequence of these pricing strategies, Centrica told us that its gas margins had generally been higher than its competitors, although occasionally lower than SSE and Scottish Power, whilst its electricity margins had been significantly lower than the market average. However, it told us that its overall dual fuel margin had been between 3 and 6% (based on its CSS results from FY11 onwards), within the range of most of its competitors.
42. In relation to its submission concerning the differences in the risks between supplying gas and electricity driving higher margins in gas, Centrica told us that there was greater pricing and demand volatility for gas than for electricity:
- (a) In relation to pricing volatility, Centrica told us that in its experience, forward gas prices were more volatile than forward electricity prices, which was a reflection of the fact that gas was a primary commodity whereas electricity was a secondary one (ie electricity prices were influenced by a number of different commodity costs, including gas, coal and carbon). Therefore, it told us that the variation in the price of a single commodity impacting electricity prices did not have the same relative impact as it did on the underlying gas price, as it was dampened by movements in the price of other fuels making up the electricity price.
- (b) In relation to demand or consumption volatility, Centrica told us that it faced significant volatility in gas demand due to weather factors, and that the impact of weather was greater on gas than electricity consumption. [REDACTED]. Centrica explained that with demand for gas impacting wholesale

gas prices, these consumption variations could have a significant impact on its profitability.¹⁴

43. Relevant to Centrica's argument above concerning its dual fuel conversion strategy was Ofgem's comment that our findings concerning the domestic gas market suggested that single fuel gas customers could be particularly disadvantaged, in particular given that a large majority of these customers were with Centrica (around 75%). Ofgem added that it could be important to assess how margins in the single fuel gas segment compared with dual fuel rates, and in particular whether there was evidence that single fuel margins were significantly higher than dual fuel margins.
44. We considered that wholesale price or weather risks were capable of management through hedging and forecasting, and therefore should not justify a higher profit margin on gas, as only systematic risks would do so (ie as reflected in its cost of capital).¹⁵ As noted in Appendix 9.10, we considered that the retail supply of gas might require slightly higher capital to be employed (in the form of risk capital and working capital). However, we did not consider that this was sufficient to justify the higher margins earned by Centrica on gas. For example, in Table 2 of this appendix, Centrica generated a significantly higher EBIT margin on domestic gas than the other Six Large Energy Firms, generating an EBIT margin of 9.1% over the last six years compared with the next highest margin of 5.4%. In addition, Centrica was not the only firm generating higher margins on gas than electricity over this period, eg SSE and Scottish Power generated higher margins on domestic gas than electricity over the six-year period.

Comparison of SME and domestic profit margins

45. We now turn to examine the key revenue and cost drivers behind the relatively higher profit margins in SME compared with domestic supply.
46. We divided the Six Large Energy Firms' P&L information by the volume of energy supplied to arrive at unit revenues, unit costs and unit EBIT. This enabled us to compare domestic and SME retail markets based on a

¹⁴ Centrica told us that during warmer periods (compared with the seasonal norm), it could result in excess commodity volumes being sold back to the market at a loss in warm periods (further lowering profits in gas already hit by reduced demand). Conversely, it told us that during unpredicted cold spells, it faced the risk of having to purchase additional gas volumes at a premium, eg in March 2013, when volumes were around 60% higher than the previous March, and day ahead prices rose by more than 50%.

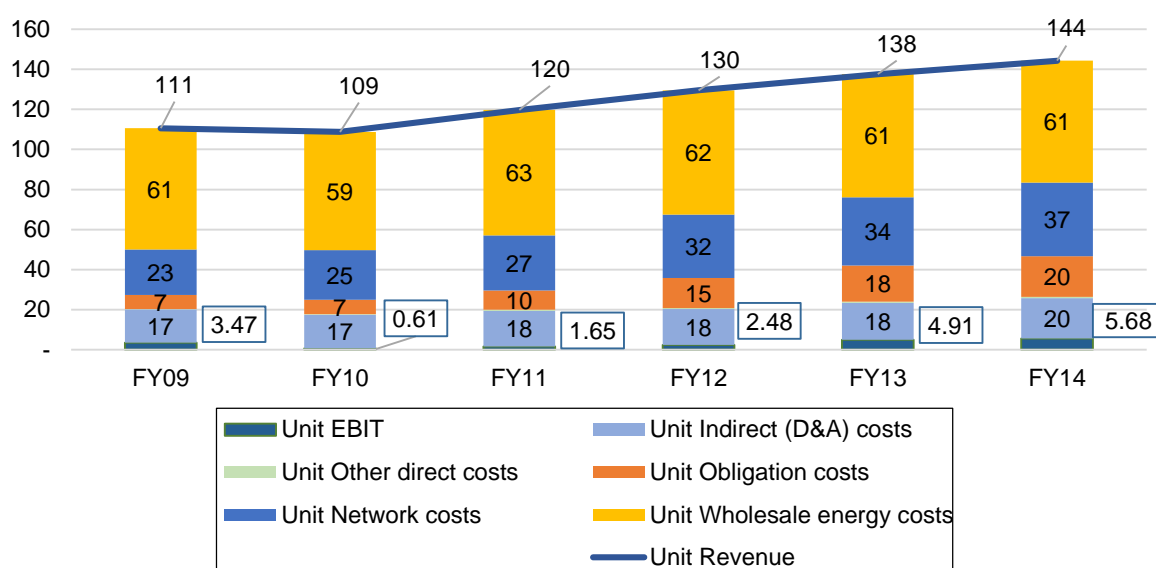
¹⁵ While the profitability of gas supply may be more volatile than that of electricity supply, this volatility is created by weather conditions that are not correlated with the economic cycle, ie are not 'systematic'. As a result, we would not expect investors to require a higher return for holding shares in a company that exhibited this type of volatility.

breakdown of prices (as measured by unit revenues) into its constituent cost and profit elements, ie a 'cost stack' for prices.

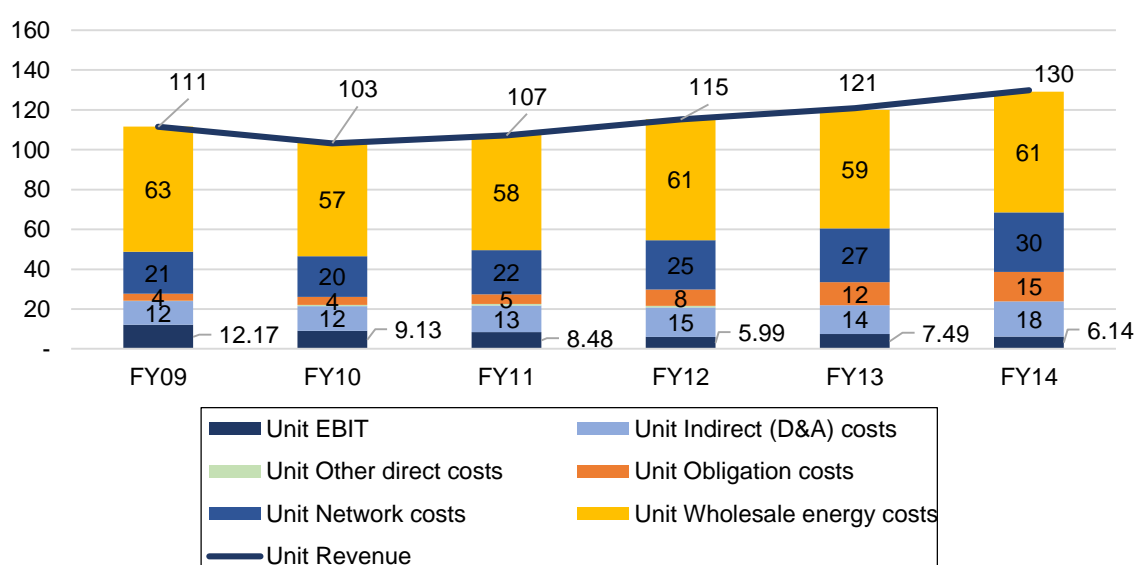
47. We first compared the unit revenues, unit costs and unit EBIT for domestic and SME electricity supply for the Six Large Energy Firms on a combined basis. We then compared these ratios for their domestic and SME gas supply.
48. Figure 5 illustrates how annual unit revenues for domestic and SME electricity supply for the Six Large Energy Firms combined are broken down into their various costs and profit components.

Figure 5: Comparison of unit revenue breakdown (£ per MWh) for domestic and SME electricity supply for the Six Large Energy Firms combined (FY09 to FY14)

Domestic electricity supply unit revenue breakdown



SME electricity supply unit revenue breakdown



Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.
 Note: Line and bar height both equal annual unit revenues. Indirect costs include D&A costs.

49. For information, Table 3 of Annex C sets out for domestic electricity supply the percentage of unit revenues accounted for by each unit cost item down to unit gross profit. This table provides a link between unit profits and profit margins, eg by definition, unit gross profit divided by unit revenues is equivalent to the gross margin, and the same is the case for gross profit per customer divided by revenues per customer.
50. To accompany Figure 5, we set out in Table 3, the annual gross and EBIT margins between FY09 and FY14 for domestic and SME electricity supply for the Six Large Energy Firms on a combined basis.

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

	%					
	FY09	FY10	FY11	FY12	FY13	FY14
<i>Gross margin</i>						
Domestic electricity	18	16	16	16	17	18
SME electricity	22	21	20	18	18	18
<i>EBIT margin</i>						
Domestic electricity	3.1	0.6	1.4	1.9	3.6	3.9
SME electricity	10.9	8.8	7.9	5.2	6.2	4.7

Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.

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

51. Based on Figure 5 and Table 3 above, in each year over the period FY09 to FY14, unit EBIT, gross margin and EBIT margin in SME electricity supply consistently exceeded their respective measures in domestic electricity supply.¹⁶ Table 3 also shows that gross and EBIT margins in SME electricity have generally declined year-on-year over the six-year period, although they have remained ahead of their respective measures for domestic electricity.
52. The differentials we found in EBIT margins and unit EBIT between domestic and SME supply did not appear to be driven by higher SME prices. Figure 5 shows that in FY09 unit revenues (a proxy for unit prices) were the same in both domestic and SME electricity at around £111 per MWh. However, since then, unit revenues for electricity have been consistently higher in domestic than in SME supply, with the gap widening year-on-year, eg in FY10 unit revenues in domestic electricity were around 5% higher than those in SME electricity. This price differential increased to around 12% in FY11 and FY12, and reached around 14% by FY13, before declining to around 11% in FY14.
53. Figure 5 shows that the key driver behind the higher profit margins and unit EBIT in SME electricity appeared to be due to lower costs in SME supply in all

¹⁶ The one exception is for gross margins in FY14, where these were the same for SME and domestic electricity.

the main cost categories for each year over the period. In absolute terms, the biggest cost differences arose in relation to network and obligation costs, where the gap between domestic and SME supply generally widened year-on-year. For example, unit network costs were around £2 per MWh lower in SME electricity than in domestic electricity supply in FY07. By FY13, this gap had increased by more than three times to a difference of around £7 per MWh. Indirect costs per MWh were also lower for SME electricity by around £2 to £5 per MWh each year.

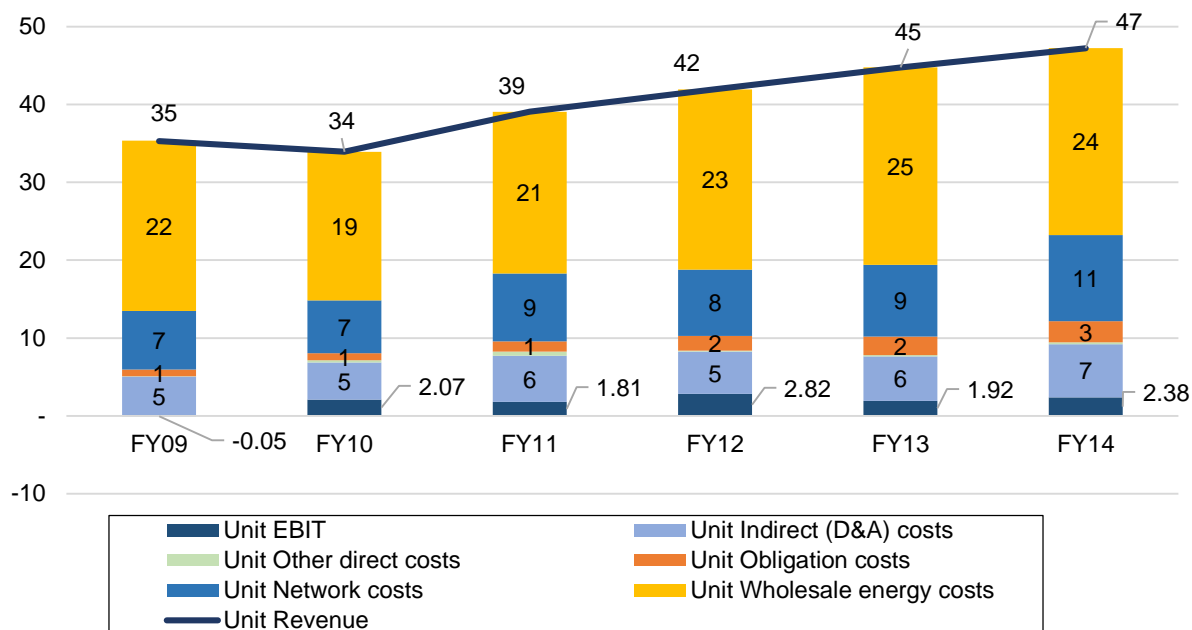
54. In relation to the differences in unit network costs between SME and domestic supply, Ofgem told us that whilst it was difficult to do a proper comparison of distribution network operator (DNO) tariffs without knowing the distribution of DNO customer classes among SME customers, in general it believed that the differences (for domestic and SME electricity unit network costs) were largely driven by the different load coefficients for domestic and SME customers.

Comparison of domestic and SME gas price-cost stacks

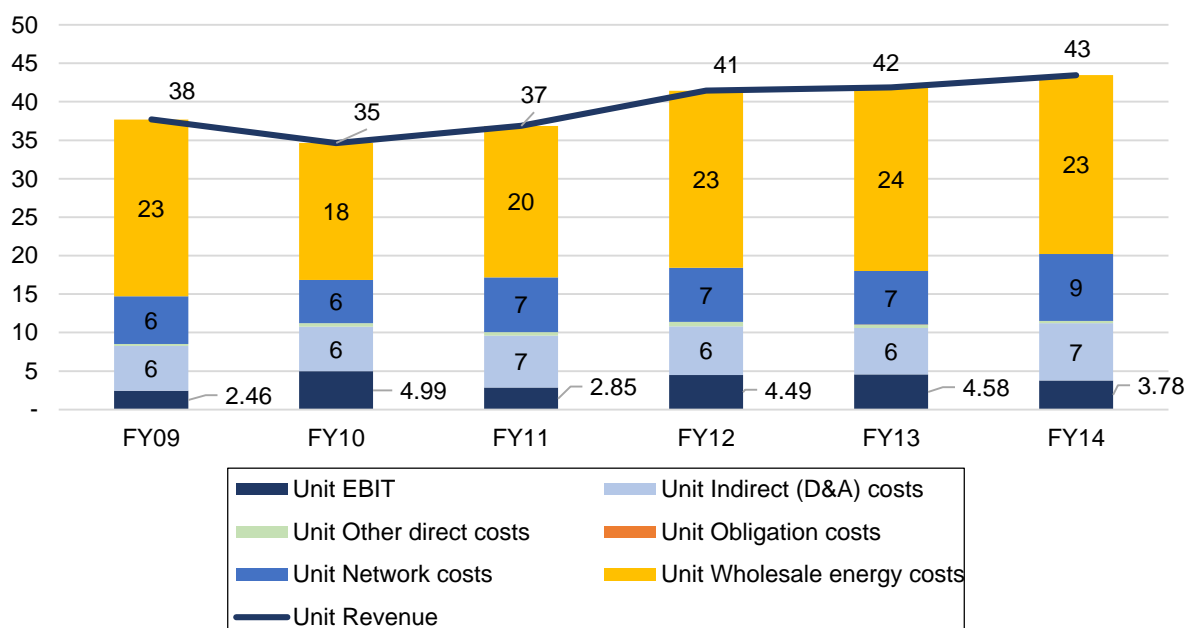
55. Similar to Figure 5 above, we compared the breakdown of unit revenues for domestic and SME gas supply over the period FY09 to FY14 (see Figure 6 below).

Figure 6: Comparison of unit revenue breakdown (£ per MWh) for domestic and SME gas supply for the Six Large Energy Firms combined (FY09 to FY14)

Domestic gas supply unit revenue breakdown



SME gas supply unit revenue breakdown



Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.
 Note: Line represents unit revenues. Indirect costs include D&A costs.

56. As the unit ratios in Figure 6 show, these are smaller in absolute £ per MWh terms for gas supply than their respective unit ratios for electricity supply. Therefore, when considering unit ratio trends and comparisons, we considered it more meaningful to look at these separately for electricity and gas supply, rather than for electricity and gas combined.

57. Similar to Table 3, Table 4 sets out the annual gross and EBIT margins between FY09 and FY14 for domestic and SME gas supply for the Six Large Energy Firms on a combined basis. As for domestic electricity, we provide for information purposes, in Table 3 of Annex C, the percentage of domestic gas unit revenues accounted for by each unit cost item down to unit gross profit. As mentioned above, this table provides a link between unit profit and profit margins.

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

	%					
	FY09	FY10	FY11	FY12	FY13	FY14
<i>Gross margin</i>						
Domestic gas	14	20	20	20	17	19
SME gas	22	31	26	26	25	26
<i>EBIT margin</i>						
Domestic gas	-0.1	6.1	4.6	6.7	4.3	5.0
SME gas	6.5	14.4	7.7	10.8	10.9	8.7

Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.

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

58. Similar to electricity supply, gross and EBIT margins and unit EBIT were higher in SME gas than domestic gas supply, and this pattern was consistent for every year over the period FY09 to FY14. These differences were relatively significant, eg over this period EBIT margins in SME gas were around 3 to 8 percentage points higher than in domestic gas.
59. As for electricity supply, we focus our comparison of domestic and SME gas profit ratios based on a £ per MWh unit ratio. When examining the key drivers for the differences in the profit margins between domestic and SME gas supply, Figure 6 shows that there was a consistent pattern of lower direct costs per MWh for SME gas than domestic gas supply. For example, network and obligation costs per MWh were lower in SME gas than domestic gas for every year over the period considered, and all but one year for wholesale energy costs. These differences, while small in absolute per MWh terms,¹⁷ were significant as a proportion of unit EBIT in gas in relative terms, eg FY14 unit EBIT for SME gas was around £4 per MWh.
60. Figure 6 also shows that these cost differentials between domestic and SME gas supply had generally widened over the period, eg while FY07 network costs were around £1 per MWh lower in SME gas than domestic gas, this differential increased to over £2 per MWh by FY14.

¹⁷ For example, network costs were around £2 per MWh lower in SME gas than domestic gas supply.

61. However, in contrast to what we found when we compared SME and domestic profit ratios in electricity supply above, we found that for gas supply:
- (a) indirect costs were higher in SME than in domestic gas supply on a per MWh basis, which was the reverse of what we found for electricity supply; and
 - (b) unlike electricity supply, there was a mixed picture in relation to unit revenues for domestic and SME gas. For example, unit revenues in domestic gas supply were: (i) lower than SME gas in FY09 and FY10; (ii) broadly the same as SME gas in FY12; and (iii) higher than SME gas in FY11, FY13 and FY14.
62. Despite the mixed picture mentioned above in relation to domestic and SME gas supply unit revenues, these were relatively immaterial when compared with the cumulative effect of lower direct costs in SME gas, which primarily drove the higher unit EBIT and EBIT margins in SME gas supply.

Parties' views on the relative performance of SME profit margins

63. We set out below the comments of the Six Large Energy Firms in relation to the higher EBIT margins we found on SME customers.
64. EDF Energy told us that differences in market risks between the different retail markets (ie domestic, SME and I&C) needed to be taken into account when comparing their relative profit margins. Whilst it acknowledged that its electricity [redacted] (noting that it had negligible SME gas sales), EDF Energy told us that its SME pricing took into account [redacted], eg [redacted]. EDF Energy told us that given that I&C customers tended to take on a much higher level of risk than by either SME or domestic customers, [redacted].¹⁸
65. Centrica told us that over the FY09 to FY13 period, its [redacted]. It added that it anticipated that the increased switching at renewal would mean that the differential between acquisition and renewal prices would reduce.
66. Centrica also told us that whilst it agreed that there were differences in unit costs for environmental obligations and network charges (or network charging structures) between SME compared with domestic supply, there were a

¹⁸ EDF Energy agreed that it [redacted] between SME and domestic electricity within its own business, and that [redacted] SME electricity than domestic electricity. However, it noted that this equated to [redacted] (based on a five-year period total basis). It also told us that it had split the financial results of its non-domestic business to provide the CMA with a separate EBIT figure for SME and I&C, and that this made the 'relativity' of EBIT margins between SME and I&C highly sensitive to the chosen fixed-cost allocation method.

number of commercial reasons why SME gross margins should be higher than those in domestic supply:

- (a) **Higher demand risk:** Centrica told us that whilst its B2B business (business-to-business, ie non-domestic) and residential supply business both faced weather risks, its B2B business faced the risk of greater variations in demand across the economic cycle, including a greater economic exposure to the impact of recession, in particular in the high street sector, where its B2B had a strong presence. Centrica stated that these risks were not diversifiable by shareholders as they were correlated with broader economic conditions that affect all investments.¹⁹
- (b) **Higher bad debt risk:** it also told us that its B2B business faced a much higher level of bad debt risk than its residential business with bad debt charges accounting for [REDACTED].
- (c) **Fewer benefits of scale:** Centrica told us that its B2B business did not benefit from the same economies of scale as large residential supply businesses due to the smaller number of accounts over which to spread their fixed costs.
- (d) **Non-commodity price risks:** Centrica told us that for its longer-term SME contracts where customers' prices were fixed, it was exposed to changes in non-commodity prices over the term of the contract, eg arising from unexpected changes in its feed-in-tariff (FiT) and Renewables Obligations costs. [REDACTED].
- (e) **Higher capital requirements:** finally, Centrica told us that longer-term SME contracts required more capital to support potential margin calls (compared with residential contracts), [REDACTED]. In addition, Centrica told us that there were significant differences in the debtor profiles of their business and residential customer segments. In particular, Centrica noted that its business customers had average debtor days of [REDACTED], compared with [REDACTED] for domestic customers. The additional debtor days period gives rise to additional working capital requirements to supply business customers.²⁰

67. The above views were also echoed by E.ON when it told us that whilst it was the case that the profitability of its SME business was higher, the SME business carried a number of significant risks, which needed to be properly

¹⁹ Centrica response to provisional findings, Appendix, paragraph 169.

²⁰ Centrica response to provisional findings, Appendix paragraph 115.

taken into account when considering E.ON's actual levels of return, including:²¹

- (a) greater variation across the base due to different customer sizes but similar costs to serve. In particular E.ON highlighted that some SME customers used less energy than domestic customers but had similar costs in terms of payment type, indebtedness and debt collection to those SME customers who are many times larger (up to 100MWh);
- (b) higher debt risk than other sectors, with E.ON noting that between 2007 and 2013 the average SME debt write-offs accounted for [redacted]% of total revenues, compared with [redacted]% for I&C customers and [redacted]% for domestic customers;²²
- (c) around [redacted]% of SME volumes being on fixed-term fixed-price contracts, which resulted in it facing significant risk in terms of commodity risk, third-party costs and regulatory costs;
- (d) higher working capital requirements for SME customers compared with I&C customers due to the different payment terms offered to SME customers; and²³
- (e) [redacted].

68. E.ON submitted analysis of the difference between the returns earned by 'small'²⁴ listed companies and those earned by the market portfolio as a whole in the UK (between October 1980 and September 2014). This analysis indicated that small firms returned around 6.3% more per year over the period than the wider market. E.ON stated that, on the assumption that markets were efficient (such that a group of firms could only earn persistently higher returns as compensation for a greater level of risk), this implied that microcaps were twice as risky as 'the market'. E.ON told us that this implied that the SME customers of energy suppliers were inherently riskier than I&C customers and, as a result the CMA should rationally expect energy suppliers to earn higher EBIT margins on SME customers.²⁵

69. [redacted].

²¹ E.ON response to the CMA updated issues statement.

²² E.ON response to provisional findings, paragraphs A.49 to A.51.

²³ E.ON response to provisional findings, paragraph A.52. E.ON told us that its working capital requirements for SME customers were three times higher than for its I&C customers, when expressed as a percentage of total turnover.

²⁴ E.ON noted that these firms had a market capitalisation of up to £21.96 million in 2010 and were, therefore, relatively large by SME standards.

²⁵ E.ON response to provisional findings, paragraphs A.53 to A.68.

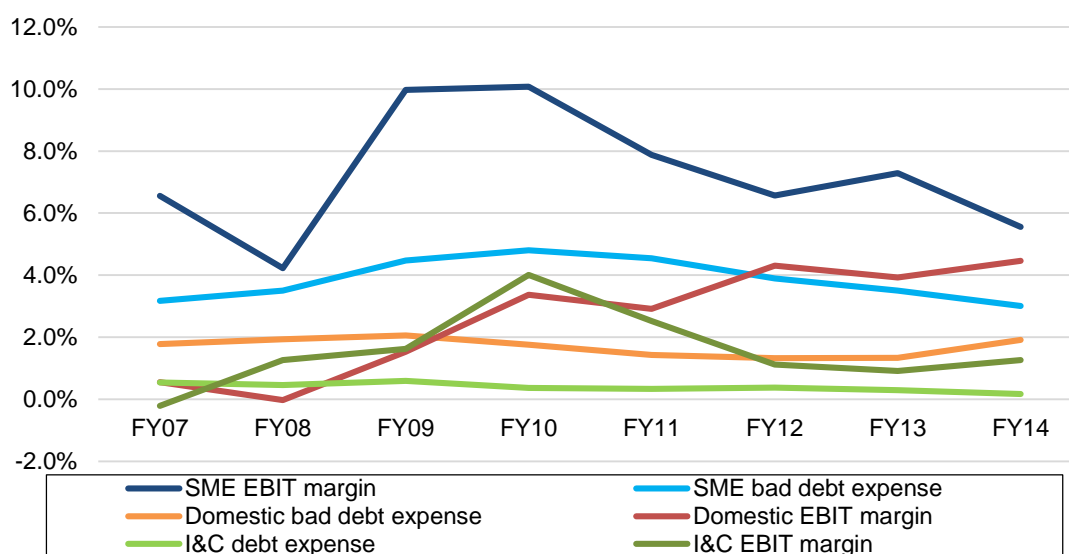
70. SSE told us that the difference between its own SME and domestic EBIT margins (by fuel) was significantly narrower than the difference we calculated for the Six Large Energy Firms combined. It also told us that there were certain differences in the costs to serve SME and domestic customers, which we had not taken into account.

Our views on the relative performance of SME profit margins

71. In the first instance, we observed that higher costs to serve a particular customer type, arising for example due to higher bad debt costs, higher indirect costs (on a per MWh basis), or fewer economies of scale, can be expected to be reflected in the prices charged to those customers and would not justify a higher EBIT margin. That is, prices would be higher than for domestic customers to offset the higher costs but EBIT margins would not need to be higher.
72. In order to justify the extent of the difference in EBIT margins between SME customers and other customer segments, the SME markets would have to be much more exposed to systematic risk, or require a much higher level of capital employed than other energy retail markets. We noted that both these types of consideration suggest that the relevant approach to assessing profitability is to use a ROCE analysis, which benchmarks the returns on capital employed against the WACC for the relevant activity. There is, therefore, an inconsistency between the Six Large Energy Firms' views that margins are the appropriate means of assessing profitability (and that ROCE is inappropriate for an asset-light business) and their submissions that we should take into account differences in the level of capital employed or risk incurred in serving different types of customer.
73. We have, therefore, taken these submissions into account in (i) assessing the appropriate WACC for a retail energy supplier active in GB, and (ii) apportioning ROCE between different customer types (see Appendix 9.10). In summary, we considered the two broad arguments put forward to explain higher returns on SME customers. The first was that the risks of serving these customers are greater than those of serving domestic and I&C customers. The second was that greater capital is required to serve SME customers.
74. While we noted that the average level of bad debts did not have an impact on the risks of serving SME customers, we considered that a greater correlation between the returns on serving SME customers with returns on the market as a whole, which could be caused by movements in bad debts (or other factors), would make serving SME customers more risky. We compared the average level of bad debt expense for the Six Large Energy Firms with their average EBIT margins over the period for both domestic and SME customers. Figure 7

shows that as SME bad debt expense increased between 2008 and 2010, the margins earned by the Six Large Energy Firms on SME customers also increased. From 2010 onwards, both bad debt expense and SME EBIT margins declined. This indicates that movements in bad debt expense, although broadly correlated with the economic cycle, do not appear to result in returns which are correlated with the economic cycle. For domestic and I&C customers, the movements in bad debt expense were slight and did not appear to be correlated with the economic cycle, while margins on both these customer types increased between 2008 and 2010. I&C margins then declined, while margins on domestic customers continued to increase.

Figure 7: Domestic and SME EBIT margins and bad debt expense



Source: SME analysis.

Note: Bad debt expense and EBIT margins are calculated on a weighted average basis across the Six Large Energy Firms. For FY07 and FY08, SSE's SME and I&C data is excluded from the averages as SSE was unable to separate out its financial results for these two customer groups.

75. On this basis, we concluded that the evidence did not support the parties' views that serving SMEs resulted in significantly greater exposure to the economic cycle, justifying a significant gap in EBIT margins between SME customers and other customer segments.
76. In the case of the level of capital employed, we noted that the evidence put forward by Centrica and E.ON²⁶ suggested that there were differences in the working capital requirements associated with serving different customer types. We have considered a number of scenarios for allocating capital between domestic, SME and I&C customers in Appendix 9.10. We note that increasing the working capital allocated to SMEs reduces the returns on those customers

²⁶ Centrica's evidence compared debtor days for business customers (SME and I&C together) with those for domestic customers, while E.ON's evidence compared the working capital requirements of SME with those of I&C customers.

and increases the returns on domestic and/or I&C customers. However, on our base case estimate (15% capital reallocation), the level of economic profits earned on SMEs (at £220 million per year on average total revenues of just under £5 billion) is still proportionately significantly higher than that earned on domestic customers (£300 million of economic profits earned on just over £25 billion of average revenues per year).

Domestic profit margins

77. Table 5 below sets out the annual EBIT for domestic supply (split by fuel type) over the relevant period, together with a range of different profit ratios. The figures in Table 5 were based on the figures for the Six Large Energy Firms combined.

Table 5: Domestic supply profit ratios for the Six Large Energy Firms combined*

	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
<i>EBIT (£m)</i>								
Domestic electricity	489	354	396	70	179	270	523	556
Domestic gas	-379	-360	-17	781	539	942	624	637
Domestic supply	110	-6	379	852	718	1,211	1,148	1,193
<i>EBIT margin (%)</i>								
Domestic electricity	4.5%	2.7%	3.1%	0.6%	1.4%	1.9%	3.6%	3.9%
Domestic gas	-4.1%	-3.1%	-0.1%	6.1%	4.6%	6.7%	4.3%	5.0%
Domestic supply	0.6%	0.0%	1.5%	3.4%	2.9%	4.3%	3.9%	4.5%
<i>Unit EBIT (£/MWh)</i>								
Domestic electricity	4.21	2.99	3.47	0.61	1.65	2.48	4.91	5.68
Domestic gas	-1.06	-0.97	-0.05	2.07	1.81	2.82	1.92	2.38
Domestic supply	0.23	-0.01	0.83	1.73	1.76	2.74	2.66	3.27
<i>EBIT per customer (£)†</i>								
Domestic electricity	18.89	13.47	15.09	2.67	6.72	10.21	19.89	21.99
Domestic gas	-17.57	-16.35	-0.71	35.39	24.18	42.50	28.28	30.25
Domestic supply	2.31	-0.13	7.86	17.57	14.68	24.90	23.71	25.74

Source: CMA analysis of P&L information submitted by the Six Large Energy Firms. N/A means 'not applicable' for calculating a percentage change given the negative starting figure in FY07.

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

†EBIT per customer was based on total annual EBIT generated by the Six Large Energy Firms divided by the number of domestic customer accounts.

78. Based on Table 5, for the Six Large Energy Firms combined, total domestic supply EBIT increased over the relevant period from £0.1 billion in FY07 to £1.2 billion in FY14, primarily driven by domestic gas supply, which increased from an EBIT loss of -£0.4 billion in FY07 to £0.6 billion in FY14. However, during the relevant period, we found considerable year-on-year variations. For example, annual EBIT margins (for the Six Large Energy Firms combined) ranged from 0.6% (FY10) to 4.5% (FY07) for domestic electricity, and from a negative 4.1% (FY07) to a positive 6.7% (FY12) for domestic gas.
79. In relation to the trends in domestic profit ratios over the relevant period, SSE told us that the period before FY09 was not an appropriate comparator for gas, given that the growth in domestic gas supply EBIT over the relevant

period reflected the unsustainably low margins in the years preceding FY09. It explained that a series of significant unanticipated wholesale cost shocks resulted in a number of energy retailers (including SSE) to sustain losses during these years (eg since tariffs could only be adjusted periodically to reflect these pressures). It added that this could be seen by negative EBIT in domestic gas during this period for the Six Large Energy Firms combined, which were clearly not sustainable in the longer term.

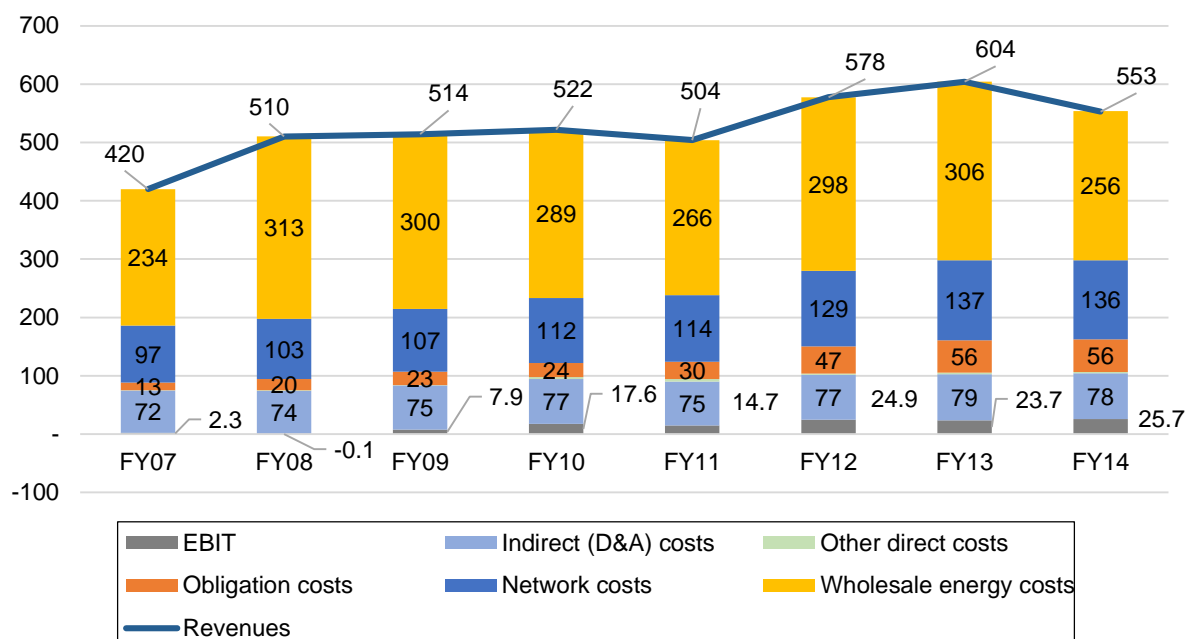
80. SSE also highlighted that it was important to note that increases in domestic profit ratios over the relevant period were almost entirely driven by gas rather than electricity. In relation to domestic electricity profit ratios, SSE told us that there was considerable year-on-year volatility over this period, which it told us was due to the inherent volatility in input prices and consumption. Therefore, SSE told us that for these reasons, it would be more appropriate to focus on profit ratios for the relevant period as a whole rather than comparing its starting and ending years.
81. Given the year-on-year variations we have found over the relevant period for both domestic electricity and gas, we see merit in considering profitability on a period total basis, as set out earlier in this appendix. We also considered that there was merit in considering period profit ratios for FY07 and FY08 separately, from the period FY09 to FY14.

Domestic supply profit ratios on a per customer account basis

82. In Table 5, we introduced the profit ratio based on a per customer account basis, ie EBIT per domestic customer account. Figure 8 sets out the revenues per domestic energy customer account (including both fuel types) broken down by their constituent cost and profit components. We calculated these based on dividing total domestic supply revenues and costs (for both fuel types combined) by the total number of domestic electricity and gas customer accounts for the Six Large Energy Firms on a combined basis. The resulting ratios show the revenues, costs and EBIT generated from each domestic customer account. We also set these per customer account ratios separately for domestic electricity and gas in Annex A, eg unit revenues per domestic electricity account represent a proxy for the annual electricity bill per domestic electricity account.²⁷

²⁷ In relation to revenues, costs or profit per customer account, we noted that year-on-year movements in these ratios may be sensitive to consumption levels, which in turn could be affected by a number of different factors, including the impact of prices, customer gains and losses, unseasonal weather and greater household energy efficiency. In order to control for changes in consumption levels affecting these per customer account ratios, one method is to calculate unit ratios that, to a large extent, control for changes in consumption levels. For the purposes of looking at the impact of changes in prices and costs on profitability, unit ratios and profit margins may therefore be more appropriate measures than per customer account ratios.

Figure 8: Breakdown of annual revenues per domestic energy customer account (£ per domestic energy account) for the Six Large Energy Firms combined (FY07 to FY14)



Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.

Note: Line represents revenues per domestic customer account. Indirect costs include D&A costs.

83. Based on Figure 8:

(a) annual revenues per customer – based on adopting revenues per customer account as a proxy for annual energy bills (without the VAT element which is levied on to customers’ bills), the average annual single fuel energy bill (ie either electricity or gas, but not dual fuel) per customer increased from £420 in FY07 to £553 in FY14, an increase of 32% over the period. When considering the last six years only (assuming profit margins were unsustainably low in FY07 and FY08 as argued by some parties), an average annual single fuel energy bill increased from £514 in FY09 to £553 in FY14, an increase of around 7.5%; and

(b) annual EBIT per customer – an average single fuel bill generated an EBIT for the Six Large Energy Firms (on a combined basis) of £2.31 in FY07, which increased to £25.74 by FY14. For the last six years only, the increase was just over 3 times (from £7.86 in FY09 to £25.74 in FY13).

84. We note that the revenues, costs and EBIT per customer account shown in Figure 8 represents the annual electricity or gas revenues per domestic customer account, ie on a single fuel basis. A dual fuel customer would be counted as two customer accounts.

85. Therefore, an estimate of a dual fuel bill based on revenues per customer could either be:

- (a) the annual revenues per domestic energy customer account multiplied by two; or
- (b) more preferably, the sum of: (i) the annual revenues per domestic electricity customer account; and (ii) the annual revenues per domestic gas customer account. As mentioned above, the charts setting out the 'cost stack' for revenues per customer account in domestic electricity and domestic gas separately are set out in Annex A.

86. Based on the approach described in paragraph 85(b) above and the charts in Annex A, we compared for the Six Large Energy Firms combined their annual revenues in FY14 for each domestic electricity account, domestic gas account and the combined total, with those for FY07 (eight-year period) and FY09 (six-year period). We also set out their annual EBIT per account figures. These calculations are set out in Table 6.

Table 6: Annual revenues and EBIT per domestic account by fuel and dual fuel (FY07/FY09 and FY14 comparisons)*

	FY07	FY09	FY14	8Y % change	6Y % change
<i>Annual revenues per account†</i>					
Domestic electricity	415	481	559	35%	16%
Domestic gas	426	554	599	41%	8%
	841	1,035	1,158	38%	12%
<i>Annual EBIT per account†</i>					
Domestic electricity	18.89	15.09	21.99	16%	46%
Domestic gas	-17.57	35.39	30.25	N/A	-15%
	1.32	50.48	52.24	3,724%	3%

Source: CMA analysis of P&L information submitted by the Six Large Energy Firms. N/A means 'not applicable' for calculating a percentage change given the negative starting figure in FY07.

*These figures have been calculated for the domestic electricity and gas supply businesses of the Six Large Energy Firms combined.

†Per customer account ratios was based on the sum of the annual figures generated by the Six Large Energy Firms divided by the number of domestic customer accounts.

87. Based on Table 6, and under our assumption that the annual revenue per customer account represents a proxy for the annual bill (but without the VAT element):
- (a) Regarding revenues per customer account – when comparing FY07 and FY14, the annual electricity bill increased by 35% and the annual gas bill increased by 41%. For a dual fuel customer therefore, the annual bill (as estimated by the sum of the annual revenue per domestic customer account for electricity and gas) increased by 38% from £841 in FY07 to £1,158 in FY14. However, when considering a shorter six-year period, the annual bill increased by 12% from £1,035 in FY09 to £1,158 in FY14.
- (b) Regarding EBIT per customer account – when looking at the entire eight-year period, the annual EBIT per customer account generated by the Six Large Energy Firms on a dual fuel customer increased from £1.32 in

FY07 to £52.24 in FY14, driven almost entirely by the increase in the EBIT generated on domestic gas. The EBIT generated on domestic electricity in FY14 was only slightly above FY07 levels. When considering a shorter six-year period however, EBIT per customer account increased only marginally, by 3.5% from £50.48 to £52.24.

Domestic profit margin comparisons with the Mid-tier Suppliers

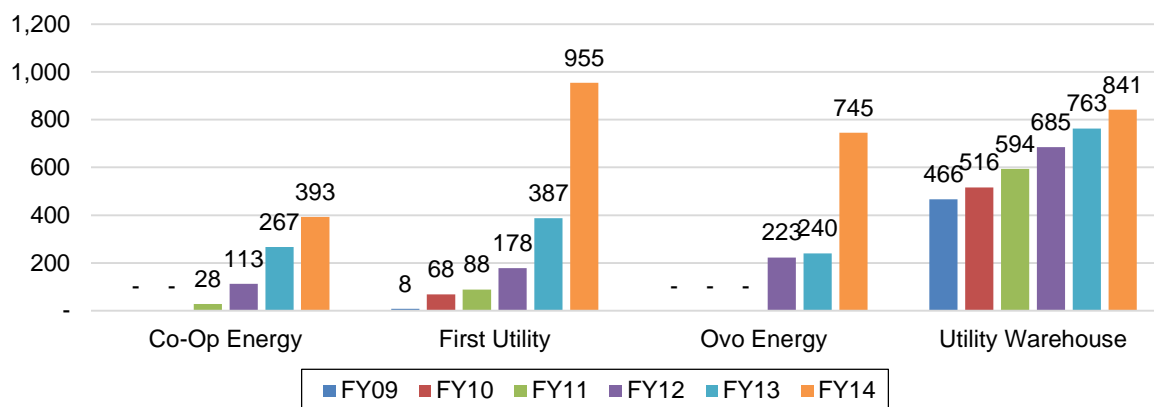
88. We now consider the financial performance of the Mid-tier Suppliers and compare their profit margins with those earned by the Six Large Energy Firms from domestic supply.²⁸ We noted that only Utility Warehouse²⁹ and First Utility had traded for the full six-year period from FY09 to FY14. In relation to the other Mid-tier Suppliers: (a) Co-op Energy commenced trading in December 2010, and therefore we have four full years of its trading information, ie from FY11 to FY14; and (b) OVO commenced trading in September 2009. However, we only received full 12-month P&L information for OVO down to EBIT for FY11 to FY14 based on a common December year end.³⁰
89. Over the period FY09 to FY14, all the Mid-tier Suppliers saw considerable growth in their domestic customer base, which translated into year-on-year growth in their respective revenues and gross profit over the period. Figure 9 below shows the number of domestic electricity and gas customer accounts for each of the Mid-tier Suppliers over the period FY09 to FY14.

²⁸ The Mid-tier Suppliers predominantly serve the domestic retail segment. Therefore any comparisons of their profit margins with those of the Six Large Energy Firms should be made against the Six Large Energy Firms' domestic supply operations.

²⁹ Because of its integrated multi-utility business model, Utility Warehouse told us that it was unable to identify separately all the indirect costs associated with the supply of energy on an objective basis from the total indirect costs it incurred. It also told us that the data for Utility Warehouse's total supply business was prepared on the basis that certain of their indirect costs were incurred pro-rata to the sales revenues generated on each of the services it supplied. Therefore, it told us that care should be taken when comparing its figures with those of other suppliers.

³⁰ In relation to the P&L information we received from First Utility and OVO: (a) First Utility was only able to provide us with a retail segmental split of its P&L information down to gross profit, with its indirect costs, D&A costs and EBIT reported at a total supply business level only; and (b) OVO commenced trading in September 2009, and changed its financial reporting year-end from 30 June to 31 December for its annual results to 31 December 2012. This resulted in OVO's P&L information being reported to different year-ends over the period. We therefore adopted OVO's pro forma P&L information, which while reporting to a 31 December year-end for FY10 to FY13: (i) only reported down to EBIT for FY11 to FY14; and (ii) only provided a retail segmental split down to gross profit.

Figure 9: Mid-tier Suppliers' domestic customer accounts ('000s) from FY09 to FY14



Source: CMA analysis of P&L information submitted by the Mid-tier Suppliers.

Notes:

1. Only Utility Warehouse and First Utility traded for the full six-year period. For the other Mid-tier Suppliers: (a) Co-Op Energy commenced trading in December 2010, and therefore we have three full years of its trading information, ie from FY11 to FY13; and (b) OVO commenced trading during FY09 and therefore we have its P&L information for four full years of trading, ie FY10 to FY14.

2. Domestic customer accounts include both domestic electricity and gas customer accounts.

90. However, with the costs of acquiring customers accounted for within their respective indirect cost base, this growth had a significant impact on their respective EBIT figures over the period. Annex B to this appendix shows the annual revenues, gross profit and EBIT generated at a total supply business level for each of the Mid-tier Suppliers over the period FY09 to FY14. We also set out in the same appendix the impact of adding back customer acquisition costs to EBIT, to calculate EBIT before costs to acquire customers (EBITC2A).

91. However, we note that there are issues with the comparability of EBITC2A measures given the differences in each firm's definition and interpretation of which items should be included in its calculation of customer acquisition costs (see Annex B of this appendix for their individual definitions). We therefore considered whether it was more meaningful to make comparisons between the Six Large Energy Firms and the Mid-tier Suppliers based on their gross margins. We address this issue below.

Comparison of Six Large Energy Firms' and Mid-tier Suppliers' gross margins

92. In Figure 10, we set out the annual and period gross margins for each of the Mid-tier Suppliers at a total supply business level over the period FY09 to FY14.

Figure 10: Mid-tier Suppliers' annual and period gross margins (FY09 to FY14)



Source: CMA analysis of P&L information submitted by the Mid-tier Suppliers.

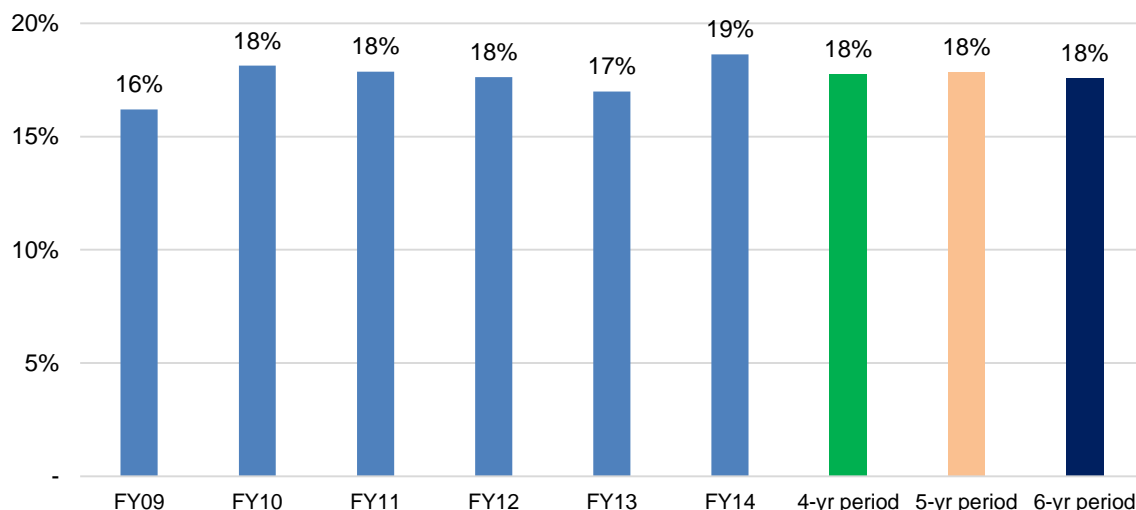
Notes:

1. The period total profit margin was calculated as the sum of an individual firm's profits over the period under consideration (including any FY where a firm did not trade for the full 12 months) divided by the sum of its relevant revenues over the same period.

2. Only Utility Warehouse and First Utility traded for the full six-year period. For the other Mid-tier Suppliers: (a) Co-Op Energy commenced trading in December 2010, and therefore we have four full years of its trading information, ie from FY11 to FY14; and (b) OVO commenced trading during FY09 and therefore we have its P&L information for five full years of trading, ie FY10 to FY14.

93. In Figure 11, 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 four-, five- and six-year period totals.

Figure 11: 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.

94. Based on Figures 9 and 10, the period gross margins for the Six Large Energy Firms were 18% based on four-, five- and six-year period totals. Only [redacted] generated a period gross margin that was higher than that of the Six Large Energy Firms combined, with a period gross margin (based on [redacted]) of [redacted].

95. Based on this comparison, the Mid-tier Suppliers (with the exception of [redacted]) generated lower gross margins on a period total basis than the Six Large Energy Firms combined. However, we noted that the Mid-tier Suppliers incurred lower obligation costs than the Six Large Energy Firms. In Annex C,

we set out the unit revenue breakdown for each of the Mid-tier Suppliers' domestic electricity and gas businesses, and compare these with the unit revenue breakdown for the Six Large Energy Firms' domestic electricity and gas businesses. Based on Annex C, one of the primary drivers behind the differences in the unit ratios of the Mid-tier Suppliers and the Six Large Energy Firms related to the lower unit obligation costs of the Mid-tier Suppliers. These differences arise because obligations are based on the number of customer accounts, and become mandatory once a firm exceeds a certain customer account size threshold, typically 250,000 customer accounts.³¹ We noted that out of the four Mid-tier Suppliers, only Utility Warehouse exceeded the threshold for obligations to be mandatory for the whole period:

- (a) Co-op Energy told us [redacted].
- (b) First Utility told us that it became liable for costs in relation to 'small-scale' FiT, Energy Companies Obligation (ECO) and Warm Home Discount (WHD) for the first time in FY14.
- (c) OVO told us that it did not meet the thresholds for ECO and WHD over the period considered. However, OVO was fully obligated from FY15 onwards.³²

96. A number of parties highlighted various issues concerning the comparability of the profit margins generated by the Mid-tier Suppliers with those of the Six Large Energy Firms. We consider these views below.

97. SSE told us that such a comparison was inappropriate and that the gross margins of the Mid-tier Suppliers would not provide a comparable benchmark for the profit margins generated by the Six Large Energy Firms:

- (a) SSE told us that gross margins did not take into account 'efficiently-incurred' indirect costs, and therefore EBIT margin was the more appropriate profit margin measure. It told us that it would expect the indirect costs of the Six Large Energy Firms to be higher than those for the Mid-tier Suppliers given the 'different mixes' of customers served by the Six Large Energy Firms,³³ and therefore this would necessitate the

³¹Some of these obligations such as the ECO and WHD become mandatory when electricity and gas customer accounts reach 250,000, while the FiT becomes mandatory from 250,000 electricity customers.

³² See Appendix 8.1: Social and Environmental Obligations.

³³ For example: (a) SSE told us that it expected a large majority of the Mid-tier Suppliers' customers to pay by direct debit, for whom the costs to serve were typically lower than for customers on other payment types. Therefore, it told us that in a competitive market, energy retailers like SSE, which had a lower proportion of customers on direct debit than the Mid-tier Suppliers, would require a higher gross margin to recover the higher costs to serve their customers; and (b) SSE also told us that gross margins ignored the costs of metering which

higher gross margins for the Six Large Energy Firms to recover their higher indirect cost base.

- (b) SSE also told us that the Six Large Energy Firms were at a different stage of their business cycles to those of the Mid-tier Suppliers, and that it would expect to see variations in the gross margins generated over the course of each business cycle. It told us that based on its analysis of the Mid-tier Suppliers' profits in FY12 and FY13, the Mid-tier Suppliers (combined) had made a negative EBIT margin of -1.7% in FY12, and a positive EBIT margin of 0.3% in FY13. It considered that the negative or negligible EBIT margins of the Mid-tier Suppliers was due to discounting to attract customers, and charging the full costs of building up the customer base to their P&Ls. SSE told us that it had pursued a similar strategy in the 'noughties' to grow its gas supply business, when it reported significant EBIT losses over this period, but added that this was not sustainable over the long term and should not be used as a benchmark for the whole industry.

98. Centrica told us that a comparison of gross margins (and indirect costs) between the Six Large Energy Firms and smaller suppliers would not be appropriate due to the following reasons:

- (a) Centrica told us that differences in commercial strategies would impact on an energy retailer's short-term profit aspirations. For example, it considered it likely that smaller suppliers would accept lower margins in the short term in order to gain market share. However, it believed that over a longer period, smaller suppliers would need to generate higher returns, and therefore a comparison of profits generated by the Mid-tier Suppliers with the longer term profitability of the more established suppliers, would not be appropriate.
- (b) Centrica told us that its (and the larger suppliers') more diverse customer mix would result in higher costs compared with those for the smaller suppliers. For example, Centrica argued that smaller and Mid-tier Suppliers focused almost exclusively on dual fuel, direct debit customer acquisitions through online channels, and therefore would have a lower average cost to serve than larger suppliers, which supplied a more diverse range of customers, eg Centrica told us that the majority of its bad debt costs was accounted for by its standard credit customers, and that

formed part of indirect costs, and were substantially higher for prepayment customers than for standard credit customers. It told us that the Six Large Energy Firms had a significant number of customers on prepayment meters, around 15% for SSE, whilst the Mid-tier Suppliers generally did not serve these customers.

18% of its customers were on prepayment meters (compared with less than 1% for most of the smaller suppliers).

99. EDF Energy told us that it believed Mid-tier Suppliers benefited from lower pension-related costs; lower IT costs (with the ability to experiment with new technology without the burden of legacy systems); and a simpler to serve customer base, eg it considered it likely that (compared with an incumbent) smaller suppliers had a higher proportion of 'self-serve' customers, fewer prepayment customers, and a higher uptake of dual fuel accounts and direct debit payment methods.
100. We address the issues raised by parties above in relation to the comparability of profit margins generated by the Mid-tier Suppliers and the Six Large Energy Firms when we consider the Mid-tier Suppliers' profit margins as a potential source for a competitive benchmark margin (see Retail profit margin comparators section, below).

Profit margins by domestic tariff type

101. In Appendix 10.2 of our provisional findings, we set out an analysis of profit margins by tariff type. This analysis focused on the domestic electricity and gas tariffs of five of the Six Large Energy Firms³⁴ over the relevant period comparing the relative profit margins of their SVTs (by fuel type), ie their standard variable default tariffs, with their non-standard tariffs (NSTs), which will include other variable and fixed tariff types. This analysis indicated that for the FY11 to FY13 period, the five energy suppliers analysed had earned significantly higher gross margins on their SVTs than on their NSTs across both gas and electricity. The firms' period total gross margin for FY11 to FY13 was 20% for SVTs and 10% for their non-SVTs.
102. 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.
103. In contrast, 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

³⁴ SSE was unable to provide us with a reliable breakdown of its revenues and volumes by tariff type to the level of accuracy required. We have therefore excluded SSE from our analysis.

revenues and gross margins for fixed tariffs should be lower than those for SVTs.

104. 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.
105. 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. The suppliers told us that energy costs could vary significantly by tariff type due to different purchasing and hedging strategies for different customer types. Therefore, they told us that the gross margins we had calculated were not reflective of actual gross margins and our analysis was likely to overstate the difference.
106. RWE told us that it [✂].
107. As a matter of principle we did not consider that the risks of buying energy for SVT customers, or providing a variable contract, were significantly greater than those for other tariff customers, eg fixed tariffs. Therefore, we concluded that such differences were unlikely to explain the wide differential in margins by tariff type. However, we recognise that energy suppliers may, in certain cases, use NSTs as a tool for acquisition, with the expectation that a certain proportion of customers will later move onto the SVT. As a result, the margins earned on these tariffs may not be capable of interpretation separate from the margins earned on SVTs. On this basis, while we note the substantial differences, we do not place weight on this analysis in coming to a view on a competitive benchmark profit margin.

Retail profit margin comparators

108. In this section of the appendix, we consider 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; and (ii) on large industrial and commercial (I&C) customers (a segment of the market outside our terms of reference due to lower competition concerns).

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

Overview of key arguments

Comparators drawn from outside the GB energy retail markets

110. 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 EBIT 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 submitted 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 submitted that a price-regulated firm faced fewer 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

111. We also considered the following comparators drawn from certain segments within the GB energy retail markets, namely:
- (a) EBIT margins generated by the 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.
- (b) EBIT margins generated on I&C customers: given that: (i) the I&C retail market fell outside our terms of reference due to lower competition concerns; and (ii) as set out above, profit margins for the Six Large Energy Firms were generally lower in the I&C market compared with our reference market.
112. The Six Large Energy Firms told us 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 the Mid-tier Suppliers' margins, some parties submitted 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 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.

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

Our views

114. In our view, for this type of comparator margin analysis to be meaningful, the comparators need to exhibit similar cost structures, levels of capital employed and risk profiles to GB energy retailers. This is because profit margins on their own are an incomplete descriptor of profitability.³⁵ 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.

115. 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 would affect the required margin in different sectors and jurisdictions. For example, general retail and telecoms are fundamentally different to retail

³⁵ Where profitability is defined as return on assets. Return on assets can be decomposed into sales margin x asset turnover (the Du Pont equation).

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, even among comparator firms that had been selected on the basis of having similar beta values to an energy retailer and being similarly 'asset-light', from which little can be inferred in relation to what level might be appropriate for GB retail energy supply.

116. 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.
117. In relation to regulatory precedents, we considered that a supplier in a competitive market may be more exposed to revenue and cost fluctuations relating to economic conditions than a regulated firm would be, although the extent to which this was the case would depend on the regulatory arrangements and the extent to which suppliers in both types of market were exposed to risk. In this respect, we noted that both the 1998 GB regulatory decisions, and the recent Northern Ireland and NSW regulatory decisions had made an allowance for increasingly competitive market conditions and the associated risks for regulated firms. Therefore, we did not agree with the parties that these decisions should necessarily represent a lower bound for an appropriate competitive margin.
118. We concluded that previously regulatory decisions in GB could be informative, although we recognise that these decisions were made a number of years ago. We noted that the 1998 decisions had been reached at a time when costs and revenues were significantly lower.³⁶ This suggests that the competitive EBIT margin might be lower if the current cost base of the firms were taken into account. We observed that the various regulatory decisions (from GB and overseas) gave a relatively broad range of potentially 'competitive' margins. We were not persuaded that the cost structure of Power NI or the New South Wales suppliers were sufficiently comparable to

³⁶ See Section 2, Figure 2.11 for details of the change in energy prices in real terms between 1996 and 2014. This shows that prices, and by implication total costs of supply increased significantly between 1998 and 2007, as well as between 2007 and 2014. As such expenses increase, a smaller EBIT margin is required to give the same return on capital (assuming that the capital employed remains constant).

that of GB suppliers to enable a like-for-like margin comparison. In particular, we noted that network charges account 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. As a result, we have placed most weight on the previous GB regulatory decisions, while also placing some weight on the Power NI EBIT margin of 2.2%.

119. 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.
120. While we agree with the parties that such limitations need to be taken into account in interpreting the results of our analysis, we do not consider that they make such comparisons meaningless. Moreover, we considered that comparators within the GB energy retail supply markets were 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 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. In the case of independent suppliers in GB, we observed that their profit margins over the last few years were difficult to interpret as they were around zero and had been affected by the rapid growth of the firms, resulting in relatively high customer acquisition costs. This has limited the usefulness of these firms as comparators. In the case of I&C margins, we consider that appropriate adjustments could be made and we have focused on these comparators in our assessment of profit margins. I&C margins indicate that an EBIT margin of around 1.9% to 2.4% is reasonable, and possibly lower for a fully independent supplier once the costs of trading on the wholesale markets are factored in.
121. We note that our ROCE/WACC analysis does control for both the level of capital employed and the risks associated with operating in the GB energy market, and therefore provides an alternative view of an appropriate

competitive EBIT margin, taking into account the factors that several parties suggested should be controlled for in our analysis.

Parties' views on the appropriate margin

122. 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, 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;³⁷
 - (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;
 - (d) SSE told us that its target EBIT margin was 5% over the medium-term, and considered that the competitive margin would lie between [REDACTED];
 - (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, and they should not be able to assume that they were all due a fair EBIT margin of 4 to 5%; and
 - (g) [REDACTED] told us that 3% should represent a fair benchmark margin for the industry.
123. Some of the Six Large Energy Firms highlighted the relevance of taking into account the capital base when considering profitability, although they did not

³⁷ 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%.

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.

124. The Six Large Energy Firms submitted that profit margin comparators could be used to infer a competitive benchmark margin. We discuss some of these submissions 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.

125. 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 submitted 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'.
126. 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 inconsistent with RWE's advocacy of international and inter-industry benchmarks.
127. Parties have submitted 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 submitted 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 9.10.

128. 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 view that the appropriate cost of capital should be factored into its derivation.

Profit margins in other sectors

129. 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 D to this appendix.
130. 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.³⁸ We summarise Ofgem's competitive margin analysis in Annex D.
131. 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 D.
132. 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

³⁸ Ofgem (March 2011), *The Retail Market Review – Findings and Initial Proposals*, [Appendix 9 – Trends in profits and costs](#), Figure 4.

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.³⁹

133. 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.
134. 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 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.⁴⁰ 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.
135. E.ON suggested an approach that we might adopt to identify suitable comparator firms, based on their exposure to systematic risks (asset betas) and their capital structure. This analysis produced four 'comparable' firms (Next plc, ASOS, Dixons Retail, and UK Mail), with a mean EBIT margin of 7.5% (and a mean ROCE of 32.6%).⁴¹
136. 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

³⁹ 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.

⁴⁰ 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.

⁴¹ E.ON response to provisional findings, paragraphs A.112 to A.123.

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.

137. We noted that the approaches put forward by E.ON and SSE provided fairly crude means of controlling for differences in asset intensity across firms and yielded a broad range of potential margins. For example, the set of four potential comparators identified by E.ON had EBIT margins ranging from 1.7 to 16.7%, with an average of 7.5%. We found the breadth of this range to be problematic for an analysis that sought to control for the principal differences in risks and asset intensity across the firms and we considered that an average of such a broad range was unlikely to be meaningful.
138. In addition, SSE's and RWE's approaches did 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.
139. We concluded that sectors outside GB energy retail, 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.

International energy retail comparators

140. 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 E.

141. 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.⁴² Based on SSE's submission, it considered the competitive margin to lie [X]. We summarise SSE's submission in Annex E.
142. 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 markets, 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.
143. 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. We set out a selection of these views below, with other parties' views set out in Annex E.
144. 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

⁴² 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.

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.

145. 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.
146. 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.
147. We also noted that in 2012, London Economics performed an international EBIT margin benchmarking exercise for energy retail (see Annex B).⁴³ 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.⁴⁴ 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.⁴⁵ However, for the reasons mentioned above, we do not rely on these results.
148. 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, these international benchmarks could still be used as an important sense check of the competitive margin.
149. RWE also submitted 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

⁴³ 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*).

⁴⁴ 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*).

⁴⁵ London Economics report prepared for DECC (April 2012), *Energy Retail Markets Comparability Study*.

Economics Study's sample. In response to our provisional findings, RWE told us that, although adjustments would be required to directly compare margins between jurisdictions, it nevertheless considered that a large sample across a large number of jurisdictions provides a valuable sense check for the CMA's assessment of what is a reasonable margin. RWE stated that the study found that the weighted average EBIT margin of 4.2% for Great Britain was the fourth lowest EBIT margin across the 44 countries and regions measured. Therefore, RWE disagreed with the CMA's basis for disregarding this evidence, submitting that, in defining a range for the competitive EBIT margin that is below the level of achieved EBIT margins across a range of other competitive retail energy supply markets in the EU, the CMA had not made a balanced assessment of all the evidence.⁴⁶

150. As discussed previously, 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. Similar to our view on comparators from sectors outside the GB energy retail markets, international energy retailers may also face different capital and cost structures which would yield different margin requirements. We did not agree with RWE's view that we have not made a balanced assessment of the evidence. We have sought to identify relevant evidence to inform our assessment of a reasonable competitive margin for GB energy retailers. However, where we do not find the evidence submitted to be reliable or relevant for the purpose of our analysis, we consider that it would be inappropriate to place weight on such submissions.

Regulatory precedents

151. 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.
152. 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

⁴⁶ RWE response to provisional findings, paragraph 187.

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.⁴⁷

153. 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 New 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.
154. 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.
155. 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. In particular, it noted that in order to remain as competitive as possible, it always sought to delay any price increases and that, even when it did choose to raise prices, it was required to provide residential energy customers with 30 days advance notice. Conversely many regulated businesses such as Power NI, could rely on formal mechanisms within their regulatory price control to pass through under- or over-recoveries of costs in previous years as a result of either weather/demand variations or cost fluctuations. Furthermore, in setting Power NI's latest regulated return at 2.2%, UREGNI accepted that the effects of competition (even with only 22% of the residential market supplied by rivals as at November 2013) justified a higher return than had been set in the previous price review, and a level which

⁴⁷ 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.

was above the 1.3% EBIT margin implied by the CMA's ROCE analysis. Finally, Centrica stated that both the Power NI and the NSW regulatory benchmarks related to electricity and that it would expect higher competitive EBIT returns in gas.⁴⁸ Therefore, Centrica 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).

156. 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.
157. We noted that previous regulatory decisions in GB had allowed margins of between 0.5% (Monopolies and Mergers Commission's (MMC) 1995 decision on Scottish Hydro) and 1.5% (Offer/Ofgas decision, 1998), with the 1.5% margin reflecting the increased risks associated with the newly competitive environment. Recent regulatory decisions in Northern Ireland and NSW allowed EBIT margins of 2.2% and around 4.5% (respectively). The Six Large Energy Firms submitted that in a competitive market, a supplier would require higher margins to compensate for higher risks, and therefore regulated EBIT margins should be seen as a lower bound. We recognise 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, although the extent to which this is the case will depend on the regulatory arrangements and the extent to which suppliers in both types of market were exposed to risk. However, we note that the 1.5% margin set in GB in 1998, UREGNI's 2.2% margin for Power NI and the NSW 4.5% EBIT margin all took into account the fact that suppliers would be operating in an increasingly competitive (and therefore, uncertain) market. Moreover, the 1998 price regulation was also set on a cost base which was significantly lower than that of the Six Large Energy Firms during the relevant period.⁴⁹ (This suggests that the competitive EBIT margin might be lower if the current cost base of the Six

⁴⁸ In addition, Centrica told us that in its last regulatory pricing review for electricity in June 2013, IPART in New South Wales, Australia set the regulated EBITDA at 5.7% of total cost. This was based on evidence on both 'bottom up' calculations of necessary returns and profitability benchmarking across countries and sectors. This level of profits reflected a significant level of competition (which has since resulted in retail price caps being lifted) – but even today the largest three electricity suppliers in New South Wales control 93% of the domestic electricity market. Centrica response to provisional findings, Appendix, paragraphs 172 to 175.

⁴⁹ See Section 2, Figure 2.11 for details of the change in energy prices in real terms between 1996 and 2014. This shows that prices, and by implication total costs of supply increased significantly between 1998 and 2007, as well as between 2007 and 2014. As such expenses increase, a smaller EBIT margin is required to give the same return on capital (assuming that the capital employed remains constant).

Large Energy Firms was taken into account.) We observed that these different regulatory decisions gave a relatively broad range of 'competitive' or 'near-competitive' margins. 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. In particular, we noted that network charges account 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. As a result, we have placed most weight on the previous GB regulatory decisions, while also placing some weight on the Power NI EBIT margin of 2.2%.

Independent energy retailers

158. We considered the profit margins generated by independent energy retailers, active in GB. The margins earned by independent suppliers are potentially relevant to our assessment of a competitive benchmark because these firms do not have a large base of legacy customers who have not switched in a number of years. As a result, we consider that their margins are likely to be more representative of those that a retail energy supplier could expect to earn on engaged customers.
159. Of the four 'mid-tier' suppliers for which we gathered financial data, we considered First Utility and Ovo Energy as particularly relevant because they were independent stand-alone operations, however, we have also considered the profit margins earned by Co-op Energy and Utility Warehouse.⁵⁰
160. In relation to the profitability of the Mid-tier Suppliers 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 FY14 were depressed by relatively significant customer acquisition expenditure.
 - (b) *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 markets.⁵¹ For First Utility,

⁵⁰ 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 [redacted]. 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 [redacted].

⁵¹ 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

its customer mix changed from being SME-focused until FY11, to being domestic customer focused thereafter.⁵² Mid-tier Suppliers generally also have (proportionally) fewer prepayment and standard credit customers than the Six Large Energy Firms.

- (c) *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.
- (d) *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, 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 became liable for these costs for the first time in FY15.

161. Based on the above, we considered that:

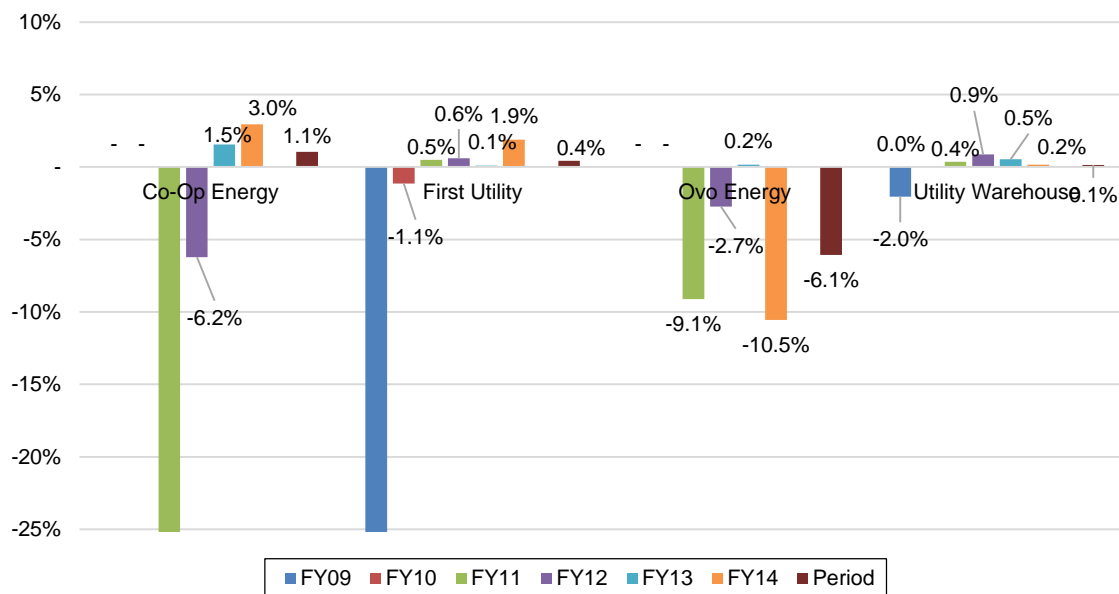
- (a) Profitability comparisons between independent suppliers and the Six Large Energy Firms need to take account of differences in customer acquisition costs.
- (b) The absence of a significant non-domestic customer base for independent suppliers means that comparisons with the Six Large Energy Firms may be limited to the profitability of their respective domestic supply businesses, and for only certain periods of time.
- (c) The absence of a legacy customer base for independent suppliers may suggest lower profitability.
- (d) Whilst smaller independent energy suppliers may face lower obligation costs, the Six Large Energy Firms may face cost advantages in terms of economies of scale benefits.

162. Figure 12 shows the EBIT margins earned by the Mid-tier Suppliers between 2009 and 2014.

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'.

⁵² [REDACTED].

Figure 12: EBIT margins for Mid-tier Suppliers, FY09 to FY14



Source: CMA analysis.

163. This analysis indicates that the Mid-tier Suppliers had very mixed performance over the relevant period, with all of them making losses in at least one year and, in the years where they made profits, earned EBIT margins of between 0.1 and 3.0%. In light of the very rapid growth of these firms between 2009 and 2014, we considered that it was difficult to use these EBIT figures for benchmarking purposes. In Annex B, we add back the costs incurred by these firms in acquiring customers, which are likely to be higher than they would be in steady state due to their rapid growth in customer numbers. This analysis gives a wide range of period average EBITC2A⁵³ margins from []%. We observed both that this range of potential competitive margins made interpretation difficult and that these margins could not readily be compared with Six Large Energy Firms' EBIT margins since the latter included customer acquisition costs.
164. The parties made a number of submissions in relation to any comparisons between the margins earned by Mid-tier Suppliers and the Six Large Energy Firms.
165. 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

⁵³ Earnings before interest, tax, depreciation and customer acquisition costs.

undercutting as a result of a short-term favourable environment that facilitated the independent suppliers to do this.

166. 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.
167. 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; and (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.
168. RWE told us that it was inappropriate to place weight on the stated 'target' EBIT margins of some Mid-tier Suppliers. It stated that these constituted 'unverifiable assertions from suppliers with limited experience of operating in the market' and, as such, were not relevant or reliable evidence for the competitive benchmark. RWE also told us that the CMA should explain why it describes the target margins of 3.0% stated by some mid-tier firms as 'aspirational'.⁵⁴
169. Centrica told us that it should have a higher competitive margin than that of independent energy retailers which contracted out their risks. It stated that it supported its own hedging and trading activities, and therefore had higher capital requirements than Mid-tier Suppliers (such as First Utility, [redacted] and Utility Warehouse) who outsourced this to third-parties (eg [redacted]), and therefore suppliers who contracted out their risk management should not expect to make returns similar to an integrated business.
170. 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

⁵⁴ RWE response to provisional findings, paragraph 172.

customers drive a higher operating cost and therefore gross margin), were also important to take into account.

171. 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 Suppliers 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 submitted that this increased regulatory risk and other differences would need to be factored into any assessment of a competitive margin.
172. In the first instance, we agreed with the view that a comparison of the gross margins earned by the Mid-tier Suppliers with those of the Six Large Energy Firms was unlikely to be reliable due to differences in the customer bases of the firms and the associated (indirect) costs to serve. Therefore, we have focused on comparisons of EBIT margins.
173. We noted the various submissions about the 'sustainability' of the Mid-tier Suppliers' prices and we have considered these in more detail in relation to the use of Ovo and First Utility as a competitive benchmark in Section 10 (and associated Appendices). We have also considered the potential impact of different business models on competitive EBIT margins (ie the use of trading arrangements versus the holding of capital) in paragraph 15.
174. We noted the other submissions on the differences between the Mid-tier Suppliers and the Six Large Energy Firms which would make comparisons problematic. While we did not necessarily agree with these submissions, we observed that the EBIT margins generated by Mid-tier Suppliers have been around zero (on average) in recent years, which is due (at least in part) to their incurring higher acquisition costs and upfront investment as they expanded their customer bases and businesses. We consider that this makes it difficult to interpret this information for the purposes of identifying a competitive benchmark. Therefore, we have not explored these issues in greater detail.

175. In our provisional findings, we noted that the EBIT margin of 3% mentioned by some Mid-tier Suppliers, including Ovo Energy and Co-op Energy, may indicate an aspirational margin for a supplier operating with an efficient level of capital employed and operating costs. As set out in paragraph 168, RWE questioned our view that this margin was ‘aspirational’ and our focus on this margin rather than that put forward by the other energy suppliers. We observed that the Mid-tier Suppliers have achieved significantly lower margins than this in recent years but have continued to invest in growing their businesses with a view to earning this margin in the future. This suggests that this margin (3%) is likely to be above the minimum acceptable return for remaining in the industry. However, given the difficulties associated with interpreting the Mid-tier Suppliers’ EBIT margins, we have not placed significant weight on this figure.

Margins on I&C customers

176. We considered profit margins generated on I&C customers, markets that were excluded from our investigation due to limited competition concerns. Our analysis showed that I&C EBIT margins based on a six-year period total basis were 1.9%; this is lower than those generated in the domestic and SME retail markets of 3.5 and 8.0% respectively.⁵⁵

177. 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 market provided a good example of a well-functioning market which might serve as a benchmark to assess any adverse effects on competition.⁵⁶

178. 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 markets would be materially higher than the profit margins in the I&C markets. 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 fewer risks); (d) lower operating costs in I&C; and (e) consumption

⁵⁵ CMA working paper – [Profitability of retail energy supply: profit margin analysis](#), Table 1.

⁵⁶ Haven Power is a non-domestic electricity supplier to SME and I&C customers.

volumes per customer – RWE told us that the higher consumption volumes per customer in the I&C markets resulted in lower risk to the supplier because operating costs could be absorbed over much higher volumes.

179. 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.
180. SSE submitted 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 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.
181. SSE submitted that it was not the case that price and volume risk (on non-I&C customers) could be eliminated by hedging since, when hedged, a supplier opened itself up to volume risk (customers do not wish to purchase all the energy procured). SSE told us that the supplier was still exposed to volatile wholesale markets, in particular falling wholesale costs. This could lead to a situation of increased customer churn, as the supplier found it could not sell the energy procured to customers at the price that it expected to be able to charge when it fixed the wholesale price.⁵⁷
182. E.ON told us that both the risk profile and cost structure of the I&C markets were entirely different to both the SME and domestic markets, and therefore any margins derived from the I&C markets 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 markets were also significantly exposed to the economic cycle as evidenced by high bad debt write-offs, but considered that the I&C markets held substantially

⁵⁷ SSE response to Provisional Findings, paragraphs 1.50 to 1.51.

less margin risk than the SME and domestic markets, 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.

183. 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. In addition, it told us that it was able to pass through all transmission and distribution (T&D) cost changes to I&C customers more readily than to its residential or SME customers. Centrica also submitted that the profits it earned from supply to I&C customers were not as exposed to weather risk. It added that whilst it agreed that the I&C markets were 'highly competitive', it did not agree that profits earned in these markets were a useful direct benchmark for either domestic or SME profits. It explained that there were fundamental differences in the way the I&C markets 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.
184. We considered the parties' submissions that I&C was a less risky business due to having more scope for cost pass through, less shaping and wholesale energy cost risk, and lower bad debt costs. In relation to bad debt risk, as set out in paragraphs 71 to 74, we do not consider that the level of such costs should have an impact on competitive margins.⁵⁸ In addition, as shown in Figure 7, we observed that movements in margins across all customer types (domestic, SME and I&C) did not demonstrate any clear correlation with the economic cycle. This suggests that differences in bad debts do not create higher risks in serving non-I&C customers. In relation to 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 and/or capital requirements due to increased hedging, balancing, and demand forecasting costs. To the extent that such costs are reflected in the P&L of the Six Large Energy Firms (eg shaping or balancing costs), we do not consider that this justifies higher EBIT margins on domestic and SME tariffs, than on I&C. However, to the extent that the Six Large Energy Firms choose to manage such risks by holding capital, we recognise that a higher margin may be required. As set out in Appendix 9.10, the

⁵⁸ The same reasoning applies to any other costs of serving domestic and SME customers that are predictably higher than for I&C customers.

evidence suggests that such capital costs equate to around [~~✂~~] of wholesale energy costs, ie the level of the trading fee. This would suggest that a competitive benchmark for domestic and SME customers might be around 0.4 to 0.5 percentage points higher than the same benchmark for I&C customers, ie it would increase from around 1.9% to around 2.4%.

185. Finally, we noted SSE's submission that supplying domestic and SME customers exposed suppliers to greater volumetric risk than supplying I&C customers, even once they have hedged. However, we observed that such risk was driven largely by (unexpected) weather conditions, rather than the broader economic cycle.⁵⁹ As a result, we would not expect firms to earn a higher margin to compensate for such (diversifiable) risks.

⁵⁹ While unexpected weather conditions can result in firms having to purchase/sell energy at short notice (a matter of days or a couple of weeks), changes in demand as a result of changing economic conditions can be accommodated in energy suppliers' existing hedging strategies. For example, as energy suppliers purchase forward under either a rateable strategy, or to match sales of fixed term contracts, they can adjust total volumes purchased to reflect changing economic conditions, including overall levels of demand and customer churn rates.

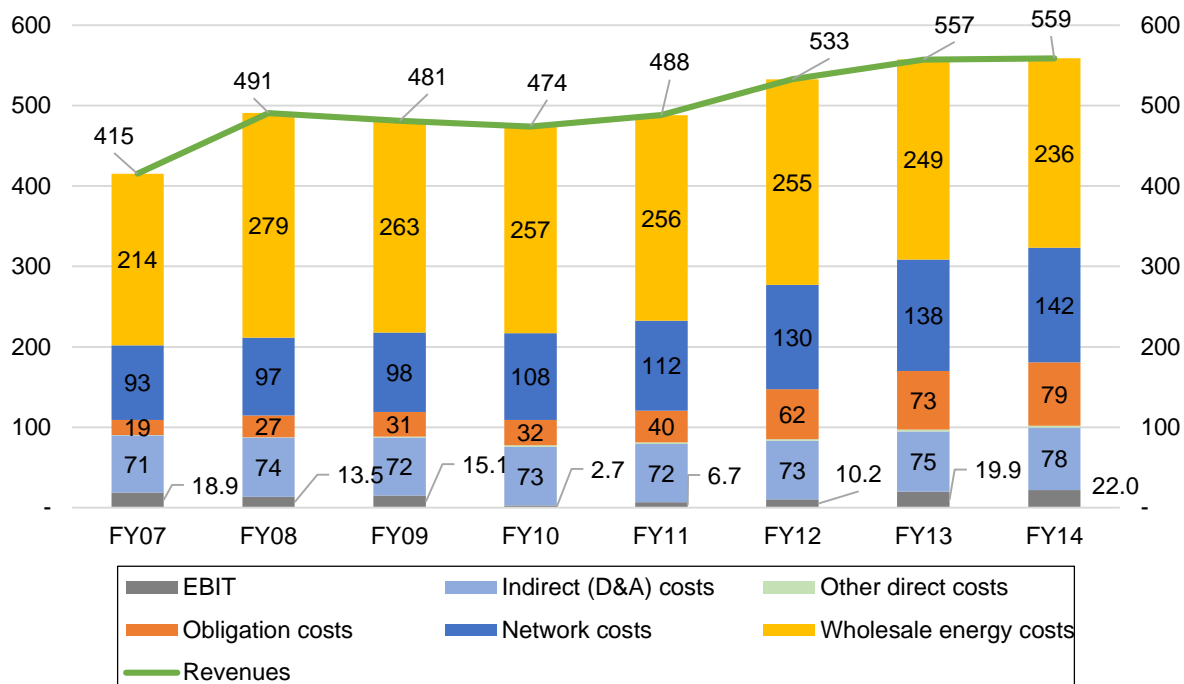
Annex A: Domestic profit per customer account

Breakdown of domestic revenues per customer account (by fuel)

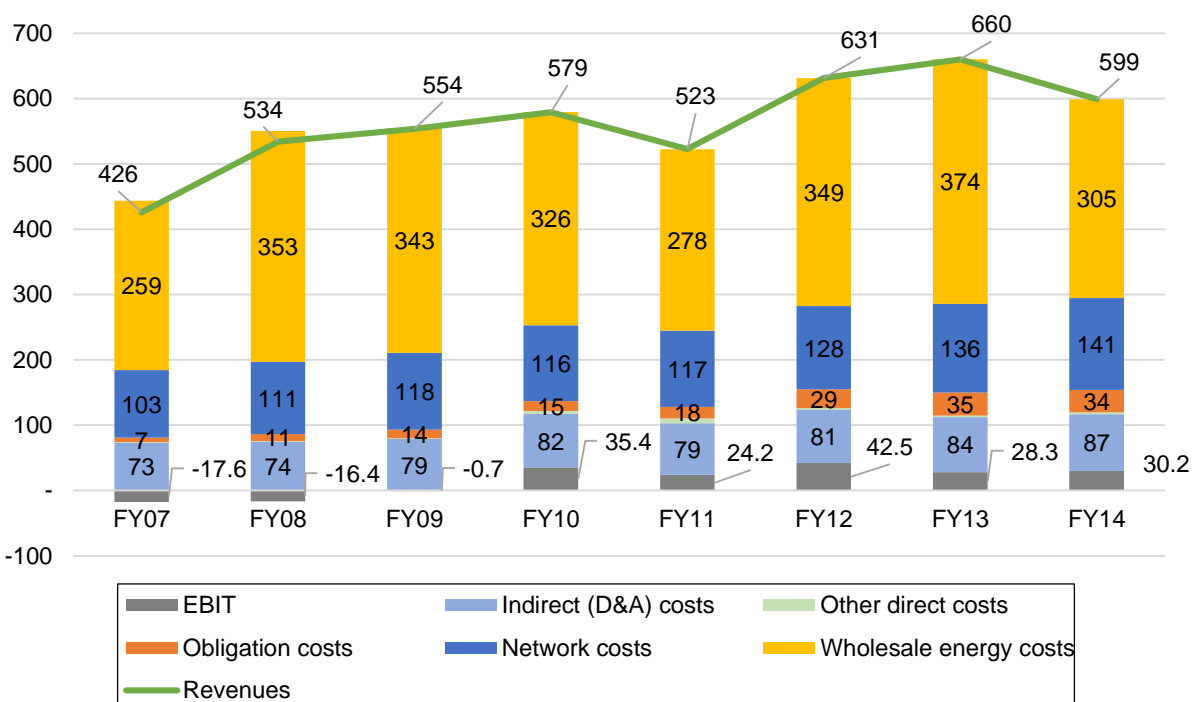
1. Figure 1 shows for domestic electricity the revenues per domestic electricity customer account broken down into its constituent cost and EBIT components. The figures presented represent the revenues, costs and profits for domestic electricity supply for the Six Large Energy Firms combined. Below the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

Figure 1: Breakdown of annual revenues per domestic customer account (by fuel type) for the Six Large Energy Firms combined (FY07 to FY14)

Domestic electricity (£ per customer account)



Domestic gas (£ per customer account)



Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.
 Note: Line represents revenues per domestic customer account. Indirect costs include D&A costs.

Annex B: Mid-tier Suppliers' financial performance

Introduction

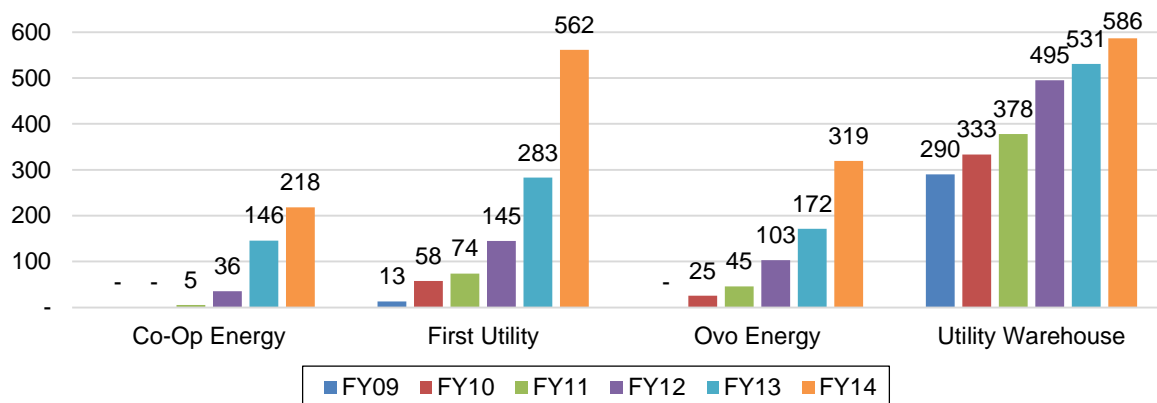
1. This annex sets out the annual revenues, gross profit and EBIT for each of the Mid-tier Suppliers based on their available P&L information for the period FY09 to FY14. We also set out their annual customer acquisition costs, which we used to calculate their EBITC2A measures (defined as EBIT adjusted for the add-back of customer acquisition costs).

Revenues, gross profit and EBIT

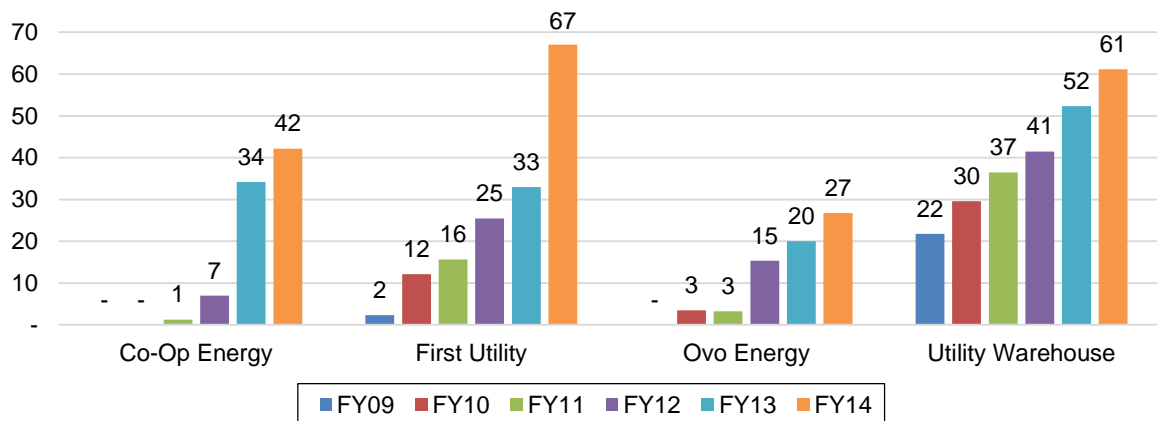
2. Figure 1 below shows the annual revenues, gross profit and EBIT generated at a total supply business level for each of the Mid-tier Suppliers over the period FY09 to FY14.

Figure 1: Mid-tier Suppliers' total supply business revenues, gross profit and EBIT (FY09 to FY14)

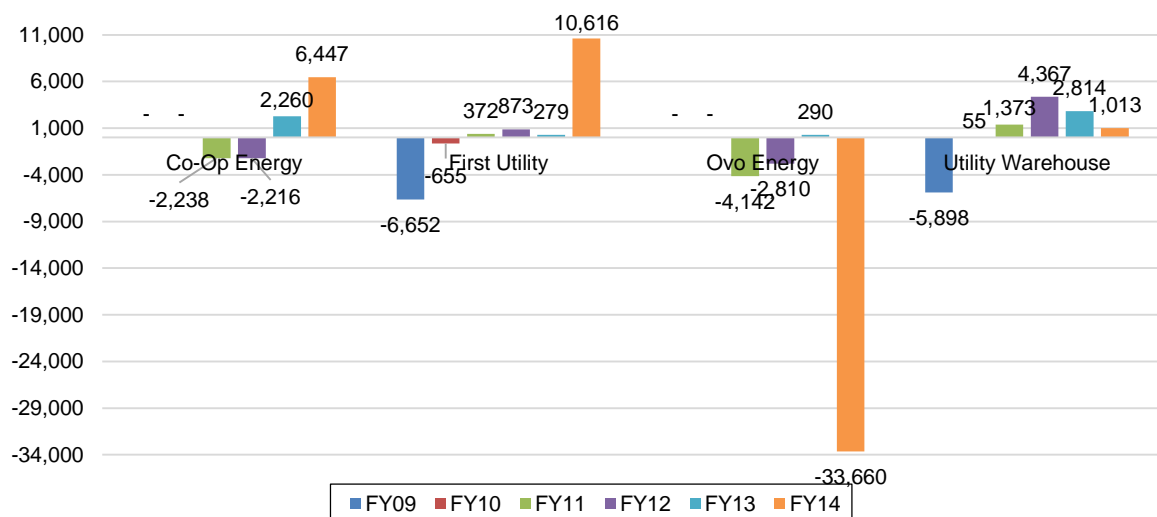
Annual revenues (£m)



Annual gross profit (£m)



Annual EBIT (£'000s)



Source: CMA analysis of P&L information submitted by the Mid-tier Suppliers.
 Note: Only Utility Warehouse and First Utility traded for the full five-year period. For the other Mid-tier Suppliers: (a) Co-Op Energy commenced trading in December 2010, and therefore we have four full years of its trading information, ie from FY11 to FY14; and (b) OVO commenced trading during FY09 and therefore we have its P&L information for five full years of trading, ie FY10 to FY14.

3. Based on the figures above, each of the Mid-tier Suppliers saw their revenues increase year-on-year over the period FY09 to FY14, but EBIT profitability was only achieved in the latter years:

(a) Co-op Energy's [REDACTED].

(b) First Utility and OVO [REDACTED].

(c) Utility Warehouse [REDACTED],⁶⁰[REDACTED].

Impact on EBIT of customer acquisition costs

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

5. Table 1 sets out each of the Mid-tier Suppliers' annual customer acquisition costs, and their definitions of these costs. We note that we only had customer acquisition costs for all these firms split out up to FY13.

Table 1: Annual customer acquisition costs for the Mid-tier Suppliers (FY09 to FY13)

	£'000				
	FY09	FY10	FY11	FY12	FY13
Co-op Energy*	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
First Utility†	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
OVO‡	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Utility Warehouse§	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: CMA analysis.

*Co-op Energy told us that its customer acquisition costs comprised the costs (including their salaries) of its field sales, telesales and marketing and advertising teams, as well as any marketing campaigns and switching site costs.

†First Utility told us that its customer acquisition costs comprised the departmental spend (eg pay and recruitment spend) related to new sales and acquisitions activity, as well as third-party customer acquisition fees, including fees charged by price comparison websites, cash-backs and commissions.

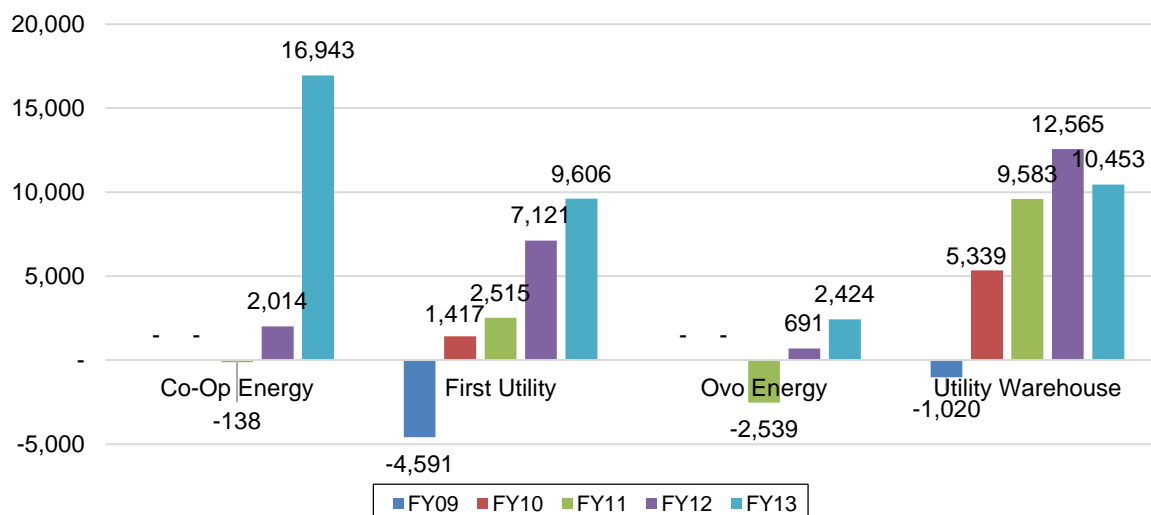
‡OVO defined its customer acquisition costs as commissions to third-party brokers (eg uSwitch) in relation to new customers coming on supply; and costs related to digital marketing activities aimed at directly acquiring new customers, eg display advertising.

§Utility Warehouse told us that its customer acquisition costs comprised: (i) the cost of promotional energy discounts for customers; (ii) distributor customer gathering commissions and marketing; (iii) distribution staff costs; and (iv) an allocation of administrative expenses to customer acquisition costs.

6. In Figure 2, we present the Mid-tier Suppliers' adjusted EBIT after adding back the costs to acquire customers, ie EBITC2A.

⁶⁰ Utility Warehouse generated a positive EBIT in FY08 of £3.8 million.

Figure 2: Mid-tier Suppliers' annual EBITC2A* (£'000s) (FY09 to FY13)

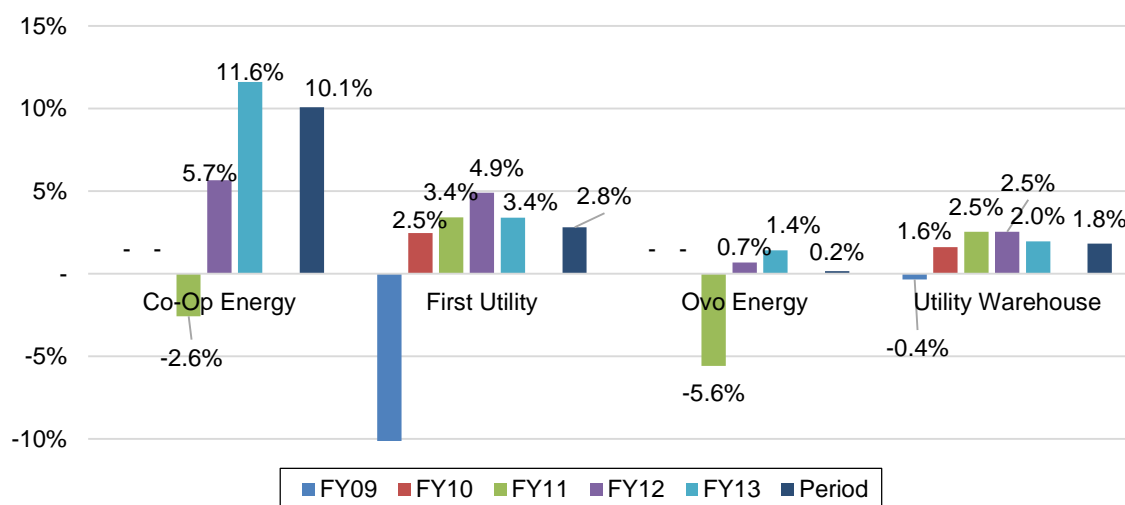


Source: CMA analysis.

*EBITC2A means EBIT before costs to acquire customers.

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

Figure 3: Mid-tier Suppliers' annual and period EBITC2A margins (FY09 to FY13)



Source: CMA analysis of P&L information submitted by the Mid-tier Suppliers.

Notes:

1. Only Utility Warehouse and First Utility traded for the full five-year period. For the other Mid-tier Suppliers: (a) Co-Op Energy commenced trading in December 2010, and therefore we have three full years of its trading information, ie from FY11 to FY13; and (b) OVO commenced trading during FY09, and therefore we have their P&L information for four full years of trading, ie FY10 to FY13. [redacted].

2. 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.

8. Based on the above, given the relative materiality of the level of customer acquisition costs for the Mid-tier Suppliers' EBIT figures, the add-back of customer acquisition costs had a material impact on their respective EBIT figures. With the exception of [redacted], the add-back of customer acquisition costs

resulted in EBIT profitability being achieved a year earlier than would otherwise have been the case.

Annex C: Domestic supply unit revenues for the Mid-tier Suppliers

Introduction

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

Unit revenue breakdown for the Mid-tier Suppliers

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

Table 1: Unit revenue (£ per MWh) breakdown for domestic electricity and gas for the Mid-tier Suppliers

£

	Domestic electricity unit revenues						Domestic gas unit revenues					
	FY09	FY10	FY11	FY12	FY13	FY14	FY09	FY10	FY11	FY12	FY13	FY14
<i>Co-op Energy</i>												
Revenues	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Wholesale energy costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Network costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Obligation costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Other direct costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Gross profit	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
<i>First Utility</i>												
Revenues	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Wholesale energy costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Network costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Obligation costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Other direct costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Gross profit	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
<i>Utility Warehouse</i>												
Revenues	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Contract payments*	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Other direct costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Gross profit	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]

Source: CMA analysis of P&L information submitted by the Mid-tier Suppliers.

*This relates to a payment made by Utility Warehouse to RWE over the period of review, which includes wholesale energy costs and other major direct cost items.

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

Unit revenue breakdown for the Six Large Energy Firms

3. Table 2 sets out the annual unit revenue breakdown for the domestic electricity and gas businesses for the Six Large Energy Firms on a combined basis over the period FY09 to FY14.

Table 2: Unit revenue (£ per MWh) breakdown for domestic electricity and gas for the Six Large Energy Firms*

£

Domestic electricity unit ratios

<i>Six Large Energy Firms combined</i>	<i>FY07</i>	<i>FY08</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>
Revenues	92	109	111	109	120	130	138	144
Wholesale energy costs	48	62	61	59	63	62	61	61
Network costs	21	22	23	25	27	32	34	37
Obligation costs	4	6	7	7	10	15	18	20
Other direct costs	0	0	0	0	1	1	1	1
Gross profit	20	19	20	17	19	20	23	26

£

Domestic gas unit ratios

<i>Six Large Energy Firms combined</i>	<i>FY07</i>	<i>FY08</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>
Revenues	26	32	35	34	39	42	45	47
Wholesale energy costs	16	21	22	19	21	23	25	24
Network costs	6	7	7	7	9	8	9	11
Obligation costs	0	1	1	1	1	2	2	3
Other direct costs	0	0	0	0	0	0	0	0
Gross profit	3	3	5	7	8	8	8	9

Source: CMA analysis of P&L information submitted by the Mid-tier Suppliers.

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

Comparison between Mid-tier Suppliers and Six Large Energy Firms

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

Table 3: Unit revenue components as a percentage of unit revenues (%) for the relevant firms*

	<i>Domestic electricity unit revenue split</i>						<i>Domestic gas unit revenue split</i>						%
<i>Six Large Energy Firms combined</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>	
Revenues	100	100	100	100	100	100	100	100	100	100	100	100	100
Wholesale energy costs	55	54	52	48	45	42	62	56	53	55	57	51	51
Network costs	20	23	23	24	25	26	21	20	22	20	21	23	23
Obligation costs	6	7	8	12	13	14	2	3	3	5	5	6	6
Other direct costs	0	0	0	0	0	1	0	1	1	0	0	0	0
Gross margin	18	16	16	16	17	18	14	20	20	20	17	19	19
<i>Co-op Energy</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>	
Revenues	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Wholesale energy costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Network costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Obligation costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Other direct costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Gross margin	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
<i>First Utility</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>	
Revenues	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Wholesale energy costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Network costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Obligation costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Other direct costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Gross margin	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
<i>Utility Warehouse</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12</i>	<i>FY13</i>	<i>FY14</i>	
Revenues	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Contract payments	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Other direct costs	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Gross margin	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]

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

*We restated the unit ratio for each cost item as a percentage of unit revenues. Unit gross profit as a percentage of unit revenues is also the gross margin.

Annex D: 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.⁶¹ 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.⁶² 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

⁶¹ 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.

⁶² 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).

these industry participants facing similar risks and having similar levels of capital intensity.⁶³

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 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.⁶⁴ 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:⁶⁵
 - (a) Ofgem considered that supermarket and high street retailers were more reasonable comparators for retail energy supply than telecoms.⁶⁶ 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)

⁶³ 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 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.

⁶⁴ 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 (source: CEPA study 'Power NI 2014 price review: Financeability and its implications for a required profit margin', March 2013, and.

⁶⁵ 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.

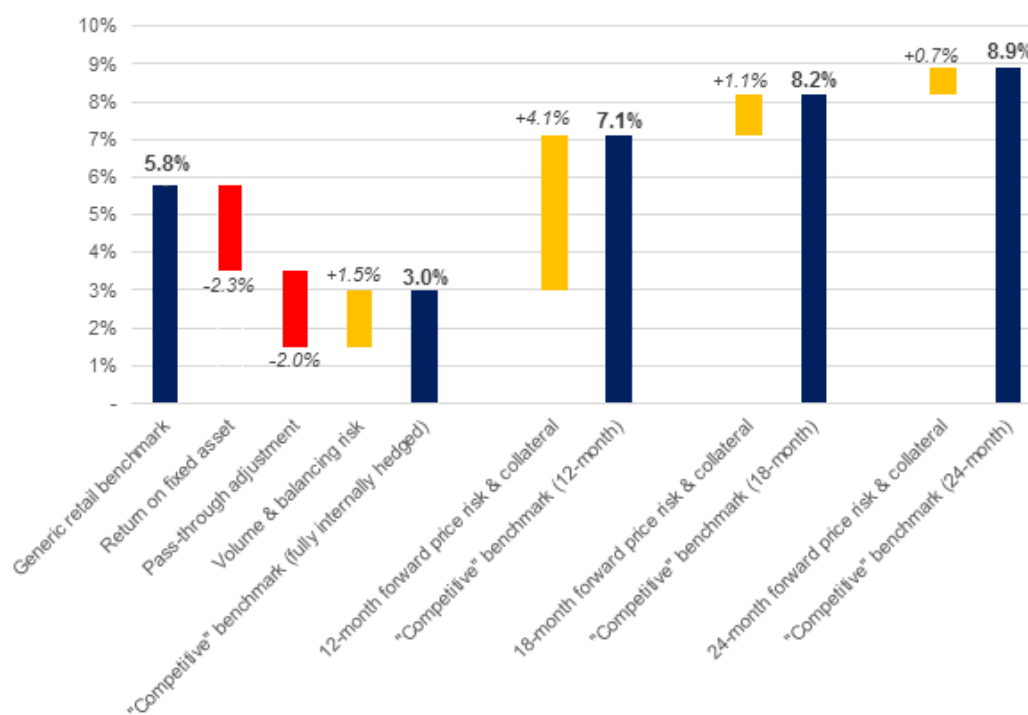
⁶⁶ Ofgem found that the average FY10 EBIT margin of 4.2% for retail energy supply was lower than the EBIT margins generated by supermarket and high street retailers and telecoms of around 5, 7 and 10% respectively. Ofgem said that most telecom businesses were capital intensive; had a large part of their 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*).

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 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 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.⁶⁷

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.⁶⁸
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.
14. In its response to our provisional findings, E.ON presented analysis which it stated showed there was no evidence to dismiss in principle comparisons to other industries but rather such firms could be used as part of a reliable margin benchmarking analysis for energy suppliers. It identified this set of appropriate comparator firms by:
 - (a) generating a sample of comparator firms, using the firms used by the CMA in its cost of capital analysis combined with some of the sample of asset-light firms that E.ON provided in response to the CMA's ROCE working paper;

⁶⁷ 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 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.

⁶⁸ 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 market.

- (b) evaluating the systematic risk in each of these firms using data on asset betas;
 - (c) evaluating the capital structure of the firms by using both the market to book value ratios and asset turnover ratios;
 - (d) using the empirical data on systematic risk and capital structure, E.ON then selected a sample of the most comparable firms to GB energy supply; and
 - (e) calculating the mean EBIT of this comparable sample and comparing it to E.ON's and the Six Large Energy Firm's EBIT.
15. E.ON told us that this analysis showed that the four comparator firms selected using this process (Next plc, ASOS, Dixons Retail, and UK Mail) had a mean EBIT margin of 7.5% (and a mean ROCE of 32.6%). It submitted that its EBIT margin of [redacted] over the 2007 to 2013 period (and the overall Six Large Energy Firms' margin of 2.8%), were low in this context.⁶⁹

⁶⁹ E.ON, response to provisional findings, paragraphs A.112 to A.123.

Annex E: 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 [REDACTED].
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.⁷⁰ 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.⁷¹

⁷⁰ 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.

⁷¹ 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.⁷²
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%.⁷³
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.

⁷² 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.

⁷³ 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:⁷⁴
- (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.⁷⁵

⁷⁴ 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*).

⁷⁵ 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.⁷⁶
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

⁷⁶ 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 2014.⁷⁷ 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.
20. E.ON told us that Power NI clearly faced less exposure to revenue and cost fluctuations relating to economic conditions as 70% of Power NI's revenue was guaranteed irrespective of volume changes. As a consequence, the margins for the Six Large Energy Firms should be higher than those in Northern Ireland to account for different levels of risk. E.ON submitted that the EBIT margin of 2.2% for Power NI, represented a minimum level of margin that would be expected for a GB energy supplier, operating in a competitive market rather than an absolute competitive benchmark.⁷⁸
21. RWE told us that the differences in the risks to which regulated firms were exposed and the risks to which firms in competitive markets were exposed were a factual and an empirical matter. It stated that retail energy suppliers operating in the competitive GB market faced significantly higher risks than a regulated business including the higher degree of competition driven by consumer choice of supplier and volatility in input prices, as well as their inability to fully pass through costs irrespective of the level of competition. RWE considered that there was clear evidence that the risk in retail energy supply was higher than in regulated industries from the variation in profitability between firms and over time. This variation, which included multiple firms periodically earning below the cost of capital, or even making losses, was far greater than such variations in regulated industries. On this basis, RWE disagreed with the CMA's view (as set out in its provisional findings) that regulated margins could represent more than the lowest bound for the competitive margin.⁷⁹

⁷⁷ 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.

⁷⁸ E.ON response to provisional findings, paragraphs A.106 and A.107.

⁷⁹ RWE response to provisional findings, paragraphs 189 to 194.

Annex F: 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 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%⁸⁰ 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

⁸⁰ 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:⁸¹
 - (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;⁸² 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.⁸³
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.⁸⁴
8. In relation to some of these precedent regulatory determinations, Ofgem said in its 2008 Probe report, that:⁸⁵
 - (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

⁸¹ 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.

⁸² Scottish Power told us that this 'competition risk premium' was based on analysis of comparator data carried out by Oxera on its behalf.

⁸³ Based on Ofgem's pricing decisions over the period 1998 to 2002.

⁸⁴ IPPR (April 2012), *The True Cost of Energy*, pp7 & 35.

⁸⁵ 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.⁸⁶

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.⁸⁷
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 [REDACTED].⁸⁸
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

⁸⁶ 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.

⁸⁷ 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.

⁸⁸ 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 business⁸⁹ 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.⁹⁰
 - (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'.⁹¹
 - (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.⁹²
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:

⁸⁹ 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.

⁹⁰ Liberum Capital report, 'Centrica –Vertically challenged', 23 January 2012, p.27.

⁹¹ Morgan Stanley Research Europe (March 2014), *UK Utilities – Returns Create a Case for the Defence – Buy SSE*, pp7 and 17.

⁹² 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.⁹³
- (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.⁹⁴

⁹³ 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).

⁹⁴ 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.