

## Appendix 10.1: Domestic retail detriment direct approach – adjustments to competitive benchmark prices

### Contents

	<i>Page</i>
Introduction .....	1
Parties' views .....	2
Our assessment .....	6

### Introduction

1. In our provisional decision on remedies, we set out the 'direct' approach which we adopted to assess the extent to which prices were excessive (ie have exceeded those we would expect in a well-functioning market). Under this approach, we calculated the average prices offered by different suppliers to their customers and compared these to a 'competitive benchmark price', which was constructed on the basis of the average prices offered by the most competitive suppliers, who we considered to be First Utility and Ovo Energy. We controlled for those exogenous differences in each supplier's customer base that were likely to affect costs, notably network charges and the costs associated with different payment methods.
2. This analysis indicated that the prices charged by the Six Large Energy Firms may have exceeded the competitive level by around £1.7 billion on average between 2012 and 2015, with an increasing trend over time (and a £2.5 billion difference in 2015).
3. In response to our provisional decision on remedies, we received submissions from a number of parties on this analysis. In particular, parties made various submissions on the appropriateness of using the prices of First Utility and Ovo as the competitive benchmark against which to assess detriment.
4. In this appendix we set out the analysis that we have undertaken to understand the likely impact on First Utility and Ovo Energy of operating at a larger scale and in a steady state, ie with a stable number of customers. This analysis forms the basis of the adjustments that we have applied to First Utility's and Ovo Energy's prices in order to give our estimate of the competitive benchmark price against which we have assessed detriment and which forms the basis of our price cap remedy.<sup>1</sup>

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<sup>1</sup> We consider parties' views on other elements of our direct detriment analysis in Section 10 of our Final Report.

## Parties' views

5. The Six Large Energy Firms and Mid-tier Suppliers made a range of submissions on our use of First Utility's and Ovo Energy's prices as the competitive benchmark.
6. Centrica and RWE told us that First Utility and Ovo were investing in growing their customer base as opposed to earning sustainable profits, such that their prices could not be seen as representing a stable competitive outcome which would be sustainable over the long term. In particular Centrica highlighted that Ovo made losses in 2011, 2012 and 2014, while First Utility had not consistently made returns that were in line with the CMA's view of competitive EBIT margins of just under 1.5%.<sup>2</sup> RWE told us that, even if an EBIT margin of 1.5% were sufficient (which it disputed), there was no evidence from the profitability analysis that either Ovo or First Utility had achieved this level of return or was likely to do so in the future.<sup>3</sup> Furthermore, RWE told us that these Mid-tier Suppliers were hoping that they would benefit from a larger flow of customers onto SVTs in the future and that a move towards the customer mix of the Six Large Energy Firms would increase benchmark bills by between 6% and 12%.<sup>4</sup>
7. SSE told us that the available evidence clearly indicated that Ovo's prices were unsustainable during the period of study, noting that Ovo had been making sustained losses over these years, including a loss of £33 million in 2014. It submitted that our view that Ovo's pricing was sustainable in spite of these losses because customer acquisition costs were likely to fall in the next few years demonstrated unsound reasoning. SSE noted that the CMA had selected its 'benchmark' suppliers on account of their share of active customers but that this reasoning assumed that Ovo's customer base would become less active as it grew, meaning that Ovo would have to fight less hard to retain existing customers. SSE submitted that either this would not be the case in the well-functioning market that the CMA was applying as its benchmark, or that this would make Ovo unsuitable for benchmarking purposes in the CMA's view.<sup>5</sup>
8. SSE told us that we should scale up Ovo's prices to a level that would have been sustainable during the period of study. Frontier (on behalf of SSE) set out an analysis which sought to estimate the appropriate price uplift to apply.

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<sup>2</sup> Centrica response to the PDR, paragraph 83. Brattle made a similar point, noting that between 2012 and 2014, First Utility and Ovo earned a combined EBIT margin of [ ] %, which was well below the long-term equilibrium level of profit in an efficient market. Brattle CR Report, submitted on behalf of EDF Energy, paragraph 37.

<sup>3</sup> FTI, CR report, prepared on behalf of RWE, paragraph 83.

<sup>4</sup> FTI, CR report, prepared on behalf of RWE, paragraph 10.

<sup>5</sup> Frontier Economics CR report, prepared on behalf of SSE, paragraphs 2.3.3 to 2.3.5.

It did this by replacing Ovo's and First Utility's actual customer acquisition costs with the average amortised customer acquisition costs of the Six Large Energy Firms (in order to understand the financial performance of Ovo absent the effect of its rapid growth in customer numbers), and then estimating the revenue uplift that Ovo would need to achieve in order for its EBIT margin over the period 2011 to 2014 to be at a similar level to First Utility's. The results of this analysis indicated that Ovo's revenue would need to increase by at least 8.3% in order for it to achieve an EBIT margin of 2% over the period.<sup>6</sup>

9. E.ON's advisers submitted that a well-functioning energy market was likely to be characterised by some degree of switching costs, such that suppliers could be expected to offer lower prices in order to attract new customers (to compensate them for switching costs). Subsequently, the prices that these customers paid would increase over time, with the result that the average prices of suppliers with a large number of newly acquired customers would be lower than the average price for more established suppliers. E.ON's advisers stated that this difference in prices was not evidence of a lack of competition but rather the competitive outcome in a market with switching costs. On this basis, E.ON's advisers told us that benchmarking the Six Large Energy Firms' tariffs to the average current tariffs of First Utility and Ovo Energy was inappropriate since it was not a like-for-like comparison.<sup>7</sup> It submitted that in order to accurately measure a competitive benchmark price, the CMA would need to consider what was the long-run equilibrium tariff mix and tariff level for a mature energy supplier in a competitive, well-functioning market.<sup>8</sup>
10. Scottish Power told us that by using First Utility and Ovo Energy, which were either loss making or making a profit that is below the benchmark that is considered reasonable by the CMA in its indirect benchmarking analysis, with no adjustments for profitability, the CMA was implicitly assuming that established firms will make losses or sub-par profits for a prolonged period without a corresponding period of super-profits in other years. Scottish Power submitted that this was not a reasonable approach to proxy for prices in a well-functioning market and that the CMA should adjust the benchmark tariffs to a level that is consistent with a 'reasonable' profit as estimated by the CMA in its ROCE analysis. It estimated that this would increase profitability (and, therefore, benchmark prices) by around £19 per customer on average.<sup>9</sup>

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<sup>6</sup> Frontier Economics CR report, prepared on behalf of SSE, paragraphs 2.3.6 to 2.3.8.

<sup>7</sup> KPMG CR report (on behalf of E.ON), paragraph 1.1.6.

<sup>8</sup> KPMG CR report (on behalf of E.ON), paragraph 3.2.6.

<sup>9</sup> Oxera CR submission on behalf of Scottish Power, 'Critique of CMA direct benchmarking analysis', 8 April 2016, paragraphs 24 to 29. Oxera noted that this increase in profitability would be expected to come about, at

11. Centrica, Scottish Power, EDF and RWE told us that the CMA's analysis did not appropriately reflect a range of differences in suppliers' costs. These costs included:

- (a) ECO and other social and environmental costs<sup>10</sup> – for various schemes, [redacted] and [redacted] were only fully obligated from April 2015 but were not obligated, or only partially obligated in previously years. In addition, given that CERT/CESP/ECO/WHD costs<sup>11</sup> for the year starting in April 2015 are set by reference to customer numbers at the end of December 2014, and the two Mid-tier Suppliers have been growing rapidly, these Mid-tier Suppliers will have incurred a lower cost per customer than the Six Large Energy Firms. [redacted] Scottish Power (Oxera) estimated that the total difference in CERT, CESP, ECO and WHD costs between the Six Large Energy Firms and the benchmark companies was £[redacted] per customer in 2012, £[redacted] per customer in 2013, and £[redacted] per customer in 2014.<sup>12</sup> EDF (Brattle) estimated that during 2012 to 2014, the average obligation costs of the Six Large Energy Firms were around £35 per customer account more than for Ovo Energy and First Utility, for both gas and electricity.<sup>13</sup> RWE (FTI) recalculated the EBIT margins of Ovo Energy and First Utility under the assumption that they incurred the same level of obligation costs per customer as the Six Large Energy Firms and estimated that both First Utility and Ovo Energy would have been loss-making throughout the period.<sup>14</sup>
- (b) Bad debt costs – Centrica told us that the level of bad debt per customer for First Utility and Ovo was considerably smaller than for many other suppliers as they had so few customers paying by quarterly cash or cheque. Centrica stated that customers who had a preference to pay in arrears by cash/cheque were more expensive to serve (around £10 per dual fuel account).<sup>15</sup>

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least in part, by the Mid-tier Suppliers increasing their proportion of customers on SVTs, rather than acquisition tariffs, as their rate of growth slowed over time and their customer base moved towards steady state. Oxera estimated that the average level of dual fuel, direct debit bills for customers of Mid-tier Suppliers might increase by around £14 per customer due to this effect. Paragraphs 40 to 49.

<sup>10</sup> See Appendix 8.1 for an overview of the various social and environmental schemes in GB. Over the relevant period, suppliers with more than 250,000 customers on any one fuel (2,000 GWh of gas supply, or 400GWh of electricity supply) as of 31<sup>st</sup> December, were partially obligated as of 1<sup>st</sup> April of the following year. Suppliers with more than 500,000 customers on any one fuel were fully obligated. These schemes specify a total level of obligation which is split between suppliers based on their market shares.

<sup>11</sup> CERT is the Carbon Emissions Reduction Target; CESP is the Community Energy Saving Programme; ECO is the Energy Companies Obligation; and WHD is the Warm Home Discount. CERT and CESP ran until the end of 2012 and were replaced with the ECO scheme.

<sup>12</sup> Oxera CR submission on behalf of Scottish Power, 'Critique of CMA direct benchmarking analysis', 8 April 2016, paragraph 10.

<sup>13</sup> Brattle CR Report, submitted on behalf of EDF Energy, paragraph 34.

<sup>14</sup> FTI, CR report, prepared on behalf of RWE, paragraphs 87 to 91.

<sup>15</sup> Centrica response to the PDR, paragraph 85.

- (c) Smart meter roll out – Centrica noted that it had taken the lead in the roll-out of smart meters, incurring greater relative metering costs than its competitors. It told us that the Mid-tier Suppliers used for benchmarking had a base of smart, not dumb, prepayment meters and fewer prepayment customers joining them by moving into a property they serve, leaving them with minimal embedded debt repayment in their prepayment base. Centrica stated that, although not of great impact during 2012 to 2014, as the roll-out of smart meters gathers pace this will have a major impact on the future calculation of “detriment” following the CMA’s methodology. [✂]
12. EDF told us that there were differences in customer characteristics between the customer bases of the Six Large Energy Firms and those of the Mid-tier Suppliers and submitted that these differences explained a large portion of the differences in costs. In particular, EDF noted that customers of the Six Large Energy Firms were more likely to be on the Priority Services Register, while those of the Mid-tier Suppliers were more likely to pay by direct debit. The Mid-tier Suppliers were also likely to have lower IT costs as they did not have legacy IT systems and were able to use off the shelf packages. Brattle estimated that if the Six Large Energy Firms had the same proportion of direct debit customers as Ovo and First Utility, their indirect costs would have been as much as £20 lower per customer in 2014.<sup>1617</sup>
13. RWE submitted that the CMA should assess the sustainability of the Mid-tier Suppliers based on the expected profitability of their current tariffs offered going forward, rather than their historic financial performance. RWE suggested that such an assessment should be based on the firms’ strategy documents, pricing models, tariff NPV forecasts and business plans.<sup>18</sup>
14. RWE put forward the view that the available evidence on economies of scale did not support the sustainability of Ovo’s pricing. It told us that the degree to which economies of scale can be enjoyed was dependent on the level of fixed and variable costs and that, although some economies of scale will be enjoyed due to their fixed / stepped nature (eg indirect costs), the majority of costs are variable (eg wholesale and network costs) and, therefore, cannot be expected to fall on a unit basis.<sup>19</sup>
15. Ovo told us that during 2014 the customers that it was acquiring were profitable and that its overall financial losses were due to a combination of the

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<sup>16</sup> Brattle CR Report, submitted on behalf of EDF Energy, paragraphs 23 to 25.

<sup>17</sup> We consider EDF’s submission regarding the relative proportion of customers on the PSR in section 10.

<sup>18</sup> FTI, CR report, prepared on behalf of RWE, paragraphs 70 to 72.

<sup>19</sup> FTI, CR report, prepared on behalf of RWE, paragraphs 85 to 86.

costs of scaling up its management function and those of acquiring a large number of customers over a relatively limited period of time. [✂]

## Our assessment

16. Our analysis seeks to identify the level of prices that could be expected to obtain in a well-functioning market and to benchmark the current prices of the energy suppliers against this level. We consider that this benchmark should reflect the prices that an efficient firm, having exploited the benefits of economies of scale, was able to charge to active or engaged customers. Taking into account parties' submissions, we reasoned that our benchmark should be a firm that incurred all the costs associated with operating in the GB domestic retail energy markets, ie all social and environmental obligations, and that had a steady state customer base, ie was neither growing nor shrinking significantly year on year. We also considered that the prices of such a firm would, due to its active / engaged customer base, reflect the opportunity cost of wholesale energy, which might be either higher or lower than the historic cost of wholesale energy, depending on the dynamics of the wholesale market.
17. We observed that there are no firms active in GB which currently exhibit all of these characteristics. In particular, we note that the Six Large Energy Firms all have a significant proportion of customers who are on SVTs and who have been with their supplier for an extended period of time, both of which we consider demonstrate lower levels of engagement.<sup>20</sup> In addition, our analysis indicates that several of these firms have indirect cost bases which are higher than we would expect for an efficient firm (see Appendix 9.11). In the case of the Mid-tier Suppliers, we observed that they have generally grown very rapidly in recent years and/or have only recently passed the volume thresholds to be fully obligated for the various social and environmental schemes currently in place. These factors can be expected to have an impact on their financial performance, which need to be taken into account in when considering the extent to which the prices of these suppliers represent a reasonable competitive benchmark (or need to be adjusted).
18. In order to come to a view on an appropriate competitive benchmark price, we have sought to make a number of adjustments to the financial results of First Utility and Ovo Energy to assess whether their prices might change if these firms were large, stand-alone businesses, with a stable customer base, incurring all the relevant social and environmental costs and earning profits that allowed them to cover their cost of capital. In carrying out this analysis,

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<sup>20</sup> See section 8 for our discussion of customer engagement.

we have taken into account the various submissions we received in response to our PDR, as well as further information that we have collected from First Utility and Ovo Energy. We note that it is not possible to quantify precisely all the likely changes in costs that these firms would experience as they continue to grow and move towards a stable customer base in the future. However, we have sought to quantify and make adjustments for the principal differences to come to a view on an appropriate competitive benchmark based on a hypothetical supplier of scale in a steady state.

19. We considered RWE's suggested approach of evaluating the expected profitability of current tariffs rather than considering historic financial performance information. In this respect, we note that Ovo Energy told us that (both in 2014 and 2015) it considered each customer it acquired to be profitable but that it had made losses overall for various reasons associated with the growth of the business.<sup>21</sup> This indicates that Ovo Energy considered its tariffs to be profit-making at the point of introducing them. However, we have received a number of submissions putting forward the view that the cost base of the Mid-tier Suppliers is likely to change as they grow, eg due to incurring higher social and environmental costs. We observed that such changes might be expected to have an impact on these firms' levels of profits in the future, such that their current assessment of profitability may be less relevant. Therefore, the analysis that we have carried out seeks to identify the level of profits that we would expect the Mid-tier Suppliers to have made over the 2012 to 2015 period, if they had been large firms with stable customer bases. We consider that this provides the most reliable means of assessing the extent of any changes to these firms' prices required to give a reasonable competitive benchmark against which to assess the tariffs of the Six Large Energy Firms.

### ***Financial performance of the Mid-tier Suppliers***

20. We collected information on the financial performance of First Utility and Ovo Energy between 2012 and 2015. This is set out in Table 1. It shows that both of these firms have grown considerably over the 2012 to 2015 period, with First Utility increasing its revenues by almost six times, and Ovo Energy increasing its revenues by five times. First Utility has earned relatively low but positive EBIT margins, on average, while Ovo Energy has generally made losses over the period. We compared these EBIT margins with the implied EBIT margin from our ROCE analysis (of 1.25%).<sup>22</sup> Neither firm earned a

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<sup>21</sup> Ovo Hearing with the CMA, Ovo submission to the CMA 29 April 2016.

<sup>22</sup> This is the margin that would have allowed the Six Large Energy Firms to earn a normal return on their capital employed over the 2007 to 2014 period. See paragraph 158 of Appendix 9.10.

margin that was consistent with this level over this period, with First Utility earning a weighted average EBIT margin of [✂] and Ovo Energy earning an average EBIT margin of [✂] over the period.

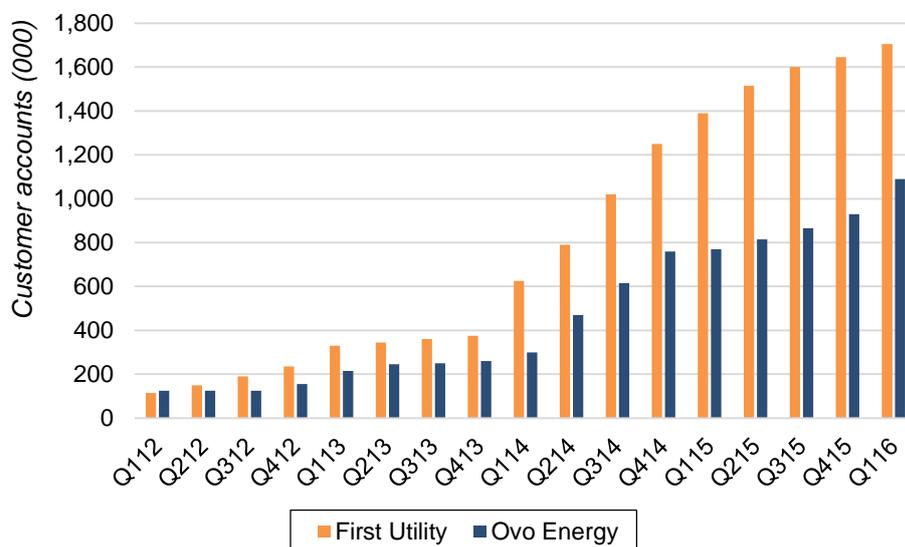
**Table 1: Financial performance of First Utility and Ovo Energy, 2012 to 2015**

	2012	2013	2014	£'m 2015
<b>First Utility</b>				
Revenues	145.0	282.7	561.6	[✂]
Gross Profit	25.5	32.9	67.1	[✂]
Gross margin	17.6%	11.7%	11.9%	[✂]
EBIT	0.9	0.3	10.6	[✂]
EBIT margin	0.6%	0.1%	1.9%	[✂]
<b>Ovo Energy</b>				
Revenues	102.9	171.7	319.3	[✂]
Gross Profit	12.6	20.2	23.6	[✂]
Gross margin	12.2%	11.8%	7.4%	[✂]
EBIT	(2.0)	0.3	(34.2)	[✂]
EBIT margin	(2.0)%	0.2%	(10.7)%	[✂]

Source: First Utility and Ovo Energy Financial Information  
 Note: 2015 figures for Ovo Energy are unaudited.

21. Figure 1 shows the growth in their customer numbers over this same period. At the beginning of 2012, these firms accounted for less than 1% of total customer accounts in GB, whereas their combined share had increased to around 5.5% by the beginning of 2016.

**Figure 1: First Utility and Ovo Energy, number of customer accounts (gas and electricity)**



Source: Cornwall Energy survey of market share, Q1 2016.

22. First Utility and Ovo Energy provided us with their business plans for the next three years, ie 2016 to 2018 (inclusive). These showed that [✂]

## ***Social and environmental obligations***

23. There were seven social and environmental schemes in operation over the 2012 to 2015 period: the Carbon Emissions Reduction Target (CERT); the Community Energy Saving Programme (CESP); the Energy Companies Obligation (ECO); the Warm Home Discount (WHD), Feed-in tariffs (FiTs), the Renewables Obligation (RO) and Levy Exemption Certificates (LECs). CERT and CESP ran until the end of 2012 and were replaced by ECO from 2013 onwards.
24. As set out in paragraph 11, CERT, CESP, ECO and the WHD do not apply to suppliers with fewer than 250,000 customers, with the obligation then tapered until the energy supplier reaches around 500,000 customers. In addition, the level of the obligation in each year commencing 1<sup>st</sup> April, is based on customer numbers as of 31<sup>st</sup> December of the previous year. We considered that the design of these schemes would reduce the costs of First Utility and Ovo Energy, compared with a large supplier with a stable customer base via two mechanisms. First, in the early years of the period, these Mid-tier Suppliers were fully or partially exempted from these obligations due to their low customer numbers. Second, the rapid growth of these Mid-tier Suppliers meant that, in any given year, the level of the obligation faced on a per customer basis would be lower for them than for a firm with a stable customer base.
25. Therefore, we considered how First Utility's and Ovo Energy's financial performance would have been affected by being both fully obligated under the various social and environmental schemes over the whole of the relevant period (ie assuming no small supplier exemptions), and by these schemes being based on average customer numbers in each year rather than the number of customers at the start of the year. In order to make this adjustment, we considered that the correct approach to adopt was that set out by FTI in paragraph 11(a), ie to compare the per customer level of social and environmental obligations incurred by the Six Large Energy Firms with those incurred by First Utility and Ovo Energy and to equalise these to the level incurred by the Six Large Energy Firms.
26. We collected data on all the social and environmental costs incurred by each firm. We noted that the information we had for Ovo Energy did not separate out the costs by scheme, ie it was not possible to distinguish the costs of renewable obligations from those of ECO, WHDs, FiTs etc. Therefore, we compared total costs across all categories for each firm, as set out in Table

2.23 For each firm, we also calculated the per customer costs of these schemes.<sup>24</sup>

**Table 2: Social and environmental costs by supplier, total and per customer**

	Total costs (£'m)				Per customer costs (£)			
	2012	2013	2014	2015	2012	2013	2014	2015
Centrica	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
EDF Energy	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
E.ON	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
RWE	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
Scottish Power	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
SSE	[X]	[X]	[X]	[X]	[X]	[X]	[X]	[X]
<b>Six Large Energy Firms average</b>								
<b>Six Large Energy Firms average (excl. RWE)</b>					<b>47.92</b>	<b>55.61</b>	<b>58.71</b>	<b>52.20</b>
First Utility	[X]	[X]	[X]	[X]	[20-30]	[30-40]	[30-40]	[35-45]
Ovo	[X]	[X]	[X]	[X]	[20-30]	[30-40]	[30-40]	[35-45]

Source: CMA analysis.

Note: The Mid-tier Suppliers' figures did not include AAHED costs.<sup>25</sup> Therefore, we have excluded these from the Six Large Energy Firms' social and environmental obligation costs where these costs were separately identified.<sup>26</sup>

27. We noted that RWE's financial statements did not show the WHD costs that it incurred. Therefore, we excluded RWE's data when calculating the average social and environmental costs to be used in our model for adjusting the financial performance of Ovo and First Utility. Using this information, we estimated the total social and environmental costs that First Utility and Ovo Energy would have incurred if they had the same level of costs per customer as the Six Large Energy Firms in each year over the period. The results of this analysis is set out in Table 3.

<sup>23</sup> We considered whether this aggregation might introduce any distortions in our analysis since only some of these costs were subject to the volume threshold and lag effects, while others applied to all firms equally depending only on the volume of gas / electricity sold. However, we concluded that the latter category of costs should effectively "fall out" of the figures when we looked at the difference between the average costs of the Six Large Energy Firms and those of the Mid-tier Suppliers. Moreover, by using averages across the large majority of the industry, we concluded that firm-specific differences in the proportion of gas and electricity supplied should not have a material effect on the numbers.

<sup>24</sup> For the Six Large Energy Firms, we used customer meter figures as set out in their Financial Statements (SQ response). For First Utility and Ovo Energy, we used their average number of customer accounts as recorded by Cornwall Energy in its market share survey. This survey gives customer numbers as of the end of January, April, July and October. Therefore, an average based on these figures should be a good proxy to the weighted average number of customers for the year as a whole, which would be measured as of mid-February, mid-May, mid-August and mid-November.

<sup>25</sup> [National Grid information on AAHED costs](#)

<sup>26</sup> To the extent that AAHED costs are included in some of the Six Large Energy Firms' figures, we note that this will slightly overstate the overall difference between their costs and those of First Utility and Ovo Energy and therefore overstate the adjustment to the Mid-tier Suppliers' cost bases.

**Table 3: Impact on First Utility and Ovo Energy of adjusted social and environmental obligation costs (£m)**

	2012	2013	2014	2015
Actual obligation costs incurred				
First Utility	[0-5]	[10-20]	[30-40]	[60-70]
Ovo	[0-5]	[5-10]	[20-30]	[30-40]
Adjusted obligation costs				
First Utility	[5-10]	[10-20]	[50-60]	[80-90]
Ovo	[5-10]	[10-20]	[30-40]	[40-50]
Difference in obligation costs				
First Utility	[0-5]	[5-10]	[20-30]	[10-20]
Ovo	[0-5]	[0-5]	[10-20]	[10-20]

Source: CMA analysis.

28. This analysis indicates that First Utility and Ovo Energy would have incurred around £30 million of additional social and environmental costs in 2014 and 2015 if they had been both fully obligated over that period and had incurred such obligations based on their average customer numbers (ie in a hypothetical scenario where full obligation costs could be incurred by a supplier with Ovo’s and First Utility’s average customer numbers). We observe that this estimate is likely to be slightly conservative, ie to over-state the difference in the costs that would have been incurred by Ovo and First Utility in this hypothetical scenario, as the social and environmental costs incurred by the Six large Energy Firms in 2014 and 2015 would have been reduced if these two Mid-tier Suppliers had been fully obligated on the basis of average customer numbers over the period.<sup>27</sup>

### **Customer acquisition costs**

29. As shown in Figure 1, First Utility and Ovo Energy have grown their customer numbers rapidly in recent years. This rapid growth is likely to have had an impact on their reported financial performance in a number of respects. For example, Ovo Energy told us that in 2015, it had experienced another period of exceptional growth, increasing its net customer numbers by over 150,000, with gross new customers of around 250,000. It incurred [redacted] of customer acquisition costs in this period. Furthermore, Ovo explained that over 45% of its customer growth occurred in the last quarter of 2015, which were unseasonably warm months, [redacted]
30. We observed that the financial performance of these two Mid-tier Suppliers, as reflected in their reported EBIT, was currently affected by the significant investments that they were making in acquiring customers, the income from

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<sup>27</sup> This is because the CERT, CESP and ECO schemes set out total obligations for the industry as a whole to achieve, with each firm’s specific obligations depending on its market share. If smaller suppliers had incurred a proportionate share of these costs, those imposed on the Six Large Energy Firms, which we use as our benchmark, would have been reduced.

which would, largely, be earned in future years. In order to match the costs of customer acquisitions with the period of time over which the profits from these customers will be earned, we have taken the same approach as for the Six Large Energy Firms in our ROCE analysis (see appendix 9.10, paragraph 74), ie we capitalised their customer acquisition costs as they were incurred and we amortised them over the average customer life observed in the industry (of six years). This ensures that, in our analysis, the level of customer acquisition costs that First Utility and Ovo Energy incur in their P&Ls is proportionate to their size and, thereby, approximates the level of customer acquisition costs that a firm with a stable customer base would incur (which would be proportionate to its revenues). The impact of this adjustment is set out in Table 4.

**Table 4: Impact of capitalising First Utility and Ovo Energy’s customer acquisition costs on EBIT**

	2012	2013	2014	£'m 2015
<b>First Utility</b>				
Add back customer acquisition costs	[X]	[X]	[X]	[X]
Incremental depreciation charge	[X]	[X]	[X]	[X]
<b>Net impact on EBIT</b>	[5-10]	[5-10]	[10-20]	[20-30]
<b>Ovo Energy</b>				
Add back customer acquisition costs	[X]	[X]	[X]	[X]
Incremental depreciation charge	[X]	[X]	[X]	[X]
<b>Net impact on EBIT</b>	[0-5]	[0-5]	[10-20]	[10-20]

Source: CMA analysis.

31. These adjustments do not imply an assumption that First Utility’s and Ovo Energy’s customer bases become less engaged over time, although a six year customer life may imply a lower level of switching activity than these two Mid-tier Suppliers currently experience. For example, [X] which is below the industry average of around six to eight years. In this context, we considered whether six years was the appropriate time period over which to amortise customer acquisition costs, or whether a shorter customer life assumption would be consistent with the tariffs we are using to form our competitive benchmark. In a well-functioning market, we would expect both a greater propensity to switch among customers as the actual or perceived costs of doing so would be lower. However, we would also expect smaller price differentials between tariffs, reducing customers’ incentives to switch. As a result, switching rates could be either higher or lower than currently. Ie, while we would expect customers to be engaged, this does not necessarily imply that they would switch more often than they do currently. In light of this uncertainty, we decided a six year average customer life would provide consistency between our treatment of the Mid-tier Suppliers and that of the

Six Large Energy Firms in our ROCE analysis. However, we note that the impact of using a shorter [£] customer life is relatively small.<sup>28</sup>

32. We considered that our approach was likely to be more accurate than that proposed by SSE (see paragraph 8) since we have used these two Mid-tier Suppliers' actual customer acquisition costs over the period, rather than basing the adjustment on the acquisition costs of the Six Large Energy Firms. We compared the implied acquisition costs per customer for the Six Large Energy Firms and for First Utility and Ovo Energy. In our ROCE analysis (see Appendix 9.10), our approach of capitalising customer acquisition costs gives an average customer valuation of between £[£] and £[£] for five of the Six Large Energy Firms, which equates to an acquisition cost of around £[£] to £[£] per customer account.<sup>29</sup> The figures for Centrica were lower, with an average customer valuation of £[£], implying an acquisition cost of around £[£] per customer (per fuel). In comparison, as of 2015, First Utility's customers were valued at £[£] each, while those of Ovo were valued at £[£] each. While these figures are consistent with the customer valuations of five of the Six Large Energy Firms, they imply lower average customer acquisition costs (and, therefore, a lower annual amortisation charge) since these suppliers' customer bases will be disproportionately composed of recently acquired customers, ie their customer assets will be less than half way through their average lives. As a result, the approach taken by SSE (of using the Six Large Energy Firms' average amortised customer acquisition costs) would overstate the Mid-tier Suppliers' cost bases and understate their steady state profits.<sup>30</sup>

### **Overhead costs**

33. As we set out in the PDR, Ovo told us that during 2014 the customers that it was acquiring were profitable and that its overall financial losses were due to a combination of the costs of scaling up its management function and those of acquiring a large number of customers over a relatively limited period of time. [£]. Furthermore, Ovo explained that it had spent the last two years investing in and building a smart meter business, which has involved significant

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<sup>28</sup> Using a [£] customer life would reduce the EBIT of First Utility by £1.2 million and of Ovo Energy by £0.3 million per year on average between 2012 and 2015.

<sup>29</sup> The implied customer acquisition costs are twice the average customer valuation. This is because the customer base of a firm in steady state will be composed of customers who are, on average, half way through the typical customer life. As a result, the capitalised customer acquisition costs will be 50% amortised.

<sup>30</sup> We have not made any assumptions as to how customer acquisition costs might change as firms grow. We considered that making assumptions about the development of such costs in the future would be speculative. Therefore, we have based our analysis on the evidence of actual costs incurred.

investment in people and IT. In February 2016, Ovo completed a sale and leaseback arrangement of this business.<sup>31</sup>

34. Therefore, we considered the potential impact on these two Mid-tier Suppliers' overhead cost base of operating with a stable number of customers and with overhead infrastructure proportional to that customer base, as well as in the absence of building a separate smart meter business. First, we collected information from both First Utility and Ovo Energy on their historic and forecast financial performance. In Table 5, we show each firm's revenues and their overhead costs less customer acquisition costs for the period between 2012 and 2018.<sup>32</sup>

**Table 5: First Utility and Ovo Energy revenues and overhead costs less customer acquisition costs, 2012 to 2015 actuals and 2016 to 2018 forecasts**

	2012	2013	2014	£'m 2015	2016	2017	2018
<b>First Utility</b>							
Revenues	145.0	282.7	561.6	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Overheads (less CA)	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
As % of revenues	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
<b>Ovo Energy</b>							
Revenues	102.9	171.7	319.3	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Overheads (less CA)	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
As % of revenues	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Source: First Utility & Ovo Energy submissions to CMA.

35. This shows that First Utility has achieved a lower average level of overhead costs as a proportion of revenue in recent years than Ovo Energy and that this level appears to have declined over time to around [REDACTED] in 2014 and 2015. First Utility expects to see these costs increase slightly (in 2016) before declining to [REDACTED] in 2018.
36. Ovo Energy's overhead costs have increased (relatively) in the last couple of years, which is consistent with its explanation of the expenses incurred in both scaling up their operations in expectation of continued growth in customer numbers and [REDACTED]. Ovo Energy's forecasts show that it expects to achieve significant relative reductions in its overhead costs over the next few years [REDACTED]
37. We reasoned that as these suppliers grew in size and stabilised their customer bases, such that their overhead costs reflected the business infrastructure for their actual customer base, rather than that targeted in the future, their overhead costs were likely to decline further as a proportion of revenue. The forecasts that we collected from the firms provide some indication of the potential extent of such declines, although we note that these

<sup>31</sup> Ovo Energy, CMA submission, 29 April 2016.

<sup>32</sup> We have discussed adjustments to customer acquisition costs separately in paragraphs 29 to 32.

cover a period when [X]. As a result, these figures may still overstate the overhead costs of a large, efficient supplier with a stable customer base.

38. In making our adjustments, we placed most weight on the evidence of the level of overhead costs already achieved by First Utility of around [X] of revenues. We noted that First Utility's financial results over the period were not affected by [X] in the way that Ovo Energy's financial results were and considered, therefore, that they were likely to provide a better indication of the level of such costs that an energy supplier could be expected to incur. We observed that this level of overhead costs is broadly consistent with the short-term forecasts of both of the Mid-tier Suppliers. Therefore, we have adjusted the overhead costs of First Utility and Ovo Energy to (a constant) [X] of revenues over the relevant period. Table 6 shows the results of this analysis.

**Table 6: Adjusted overhead costs of First Utility and Ovo Energy**

	2012	2013	2014	£'m 2015
<b>First Utility</b>				
Revenues	145.0	282.7	561.6	[X]
Actual overheads (less CA)	[X]	[X]	[X]	[X]
Adjusted overheads (less CA)	[X]	[X]	[X]	[X]
<i>Difference</i>	<i>[5-10]</i>	<i>[0-5]</i>	<i>[(0-5)]</i>	<i>[0-5]</i>
<b>Ovo Energy</b>				
Revenues	102.9	171.7	319.3	[X]
Actual overheads (less CA)	[X]	[X]	[X]	[X]
Adjusted overheads (less CA)	[X]	[X]	[X]	[X]
<i>Difference</i>	<i>[0-5]</i>	<i>[0-5]</i>	<i>[10-20]</i>	<i>[20-30]</i>

Source: CMA analysis.

39. This adjustment has a relatively minor impact on First Utility's cost base over the period, since it is based on its own achieved costs, whereas the impact on Ovo Energy's cost base is more significant. We note that this is consistent with the evidence provided by Ovo Energy on the costs that it has incurred in scaling up its business infrastructure and [X]. We consider that our approach to overhead costs is reasonably conservative as we have not taken into account the fact that overhead costs may decline as these two Mid-tier Suppliers grow further and are able to exploit economies of scale.

### **Customer characteristics and mix**

40. We noted EDF Energy's estimate that the Six Large Energy Firms' indirect costs might have been up to £20 per customer lower if they had the same proportion of direct debit customers as First Utility and Ovo Energy, as well as Centrica's submission on the additional costs (including due to bad debt) of supplying customers who pay quarterly by cash or cheque, as well as those prepayment customers with dumb meters. However, our analysis already controls for payment cost differentials between direct debit and standard

credit or (dumb meter) prepayment customers. Therefore, our view is that no further adjustment is required.<sup>33</sup>

41. Several suppliers put forward the view that our analysis should take into account the tariff mix of a large energy firm with a stable customer base, ie a typical mix of fixed-term and SVT tariffs. We consider that the adjustments that we have made to Ovo Energy's and First Utility's prices to ensure that they allow these firms to make a normal return (equivalent to an EBIT margin of 1.25%<sup>34</sup>) already take into account any such differences in the mix of tariffs, such that no further adjustments are required.<sup>35</sup>
42. Finally, we considered whether further adjustments should be made to reflect the varying proportions of customers on the Priority Services Register and / or the higher than average levels of consumption of First Utility and Ovo Energy customers for gas and electricity. However, we observed that while the Six Large Energy Firms may have more customers on the PSR, and / or have customers with (slightly) lower levels of consumption than the Mid-tier Suppliers, the Mid-tier Suppliers have a larger proportion of engaged customers, who are likely to be more costly to serve than those who have not switched either tariff or supplier for several years.<sup>36</sup> On this basis, we concluded that the exclusion of these factors from our quantitative analysis does not introduce a systematic bias into the results.

### **Overall conclusions**

43. We noted Ovo Energy's submission (see paragraph 15) that its customers were profitable and that its recent (accounting) losses were the result of the effects of growth. We consider that the analysis that we have undertaken in this Appendix is consistent with this view.
44. We combined all the various adjustments set out in this Appendix in order to provide an estimate of the financial performance of First Utility and Ovo Energy in the hypothetical scenario that they were large energy suppliers with

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<sup>33</sup> We noted that the smart meter roll-out programme should reduce the differential in cost to serve between direct debit customers and those on prepayment meters as many of the incremental costs result from the dumb prepayment meter infrastructure.

<sup>34</sup> See paragraph 158 of Appendix 9.10.

<sup>35</sup> Our analysis increases the average prices of the First Utility and Ovo Energy for the purposes of identifying a competitive benchmark. To the extent that such an increase may come about without list prices increasing but as a result of some customers moving from lower-priced to higher-priced tariffs, this effect is already accounted for in our adjustments.

<sup>36</sup> First Utility told us that the costs incurred by a supplier over the three-week period when a customer joined were [£]. We also note that the quantity of energy that customers demand is affected by the price charged. Therefore, some element of the difference in consumption levels between the customers of Mid-tier Suppliers and the Six Large Energy Firms may be due to differences in the prices charged. See section 8, paragraph 8.9.

stable customer bases over the 2012 to 2015 period. Table 7 shows their actual EBIT figures and the impact of each of the adjustments we have made.

**Table 7: Adjusted EBIT for First Utility and Ovo Energy, 2012 to 2015**

	2012	2013	2014	2015
<b>First Utility</b>				
Actual EBIT	0.9	0.3	10.6	[X]
Cost adjustments				
Social & environmental	[(0-5)]	[(5-10)]	[(20-30)]	[(10-20)]
Customer acquisition	[5-10]	[5-10]	[10-20]	[20-30]
Overheads (excl. CA)	[5-10]	[0-5]	[(0-5)]	[0-5]
<b>Adjusted EBIT</b>	<b>8.9</b>	<b>1.1</b>	<b>(1.4)</b>	<b>4.4</b>
<i>EBIT margin</i>	6.1%	0.4%	(0.2)%	0.5%
<b>Ovo Energy</b>				
Actual EBIT	(2.0)	0.3	(34.2)	[X]
Cost adjustments				
Social & environmental	[(0-5)]	[(0-5)]	[(10-20)]	[(10-20)]
Customer acquisition	[0-5]	[0-5]	[10-20]	[10-20]
Overheads (excl. CA)	[0-5]	[0-5]	[10-20]	[20-30]
<b>Adjusted EBIT</b>	<b>1.2</b>	<b>1.5</b>	<b>(13.8)</b>	<b>(5.0)</b>
<i>EBIT margin</i>	1.2%	0.9%	(4.3)%	(1.0)%

Source: CMA analysis.

45. This analysis suggests that if First Utility and Ovo Energy were large firms with a stable customer base, they might not make a return that was sufficient to cover their cost of capital at their current level of prices due to changes in their costs. Therefore, for the purposes of identifying a competitive benchmark, we concluded that these firms' prices should be uplifted to give a 1.25% EBIT margin, consistent with our estimate of the EBIT margin that would give an large standalone energy supplier a normal level of profits<sup>37</sup>. As a result, we have increased First Utility's 2015 prices by 0.8% and those of Ovo Energy by 2.3% in our competitive benchmark.
46. These adjustments are relatively small and are significantly lower than some of the parties suggested (eg see paragraph 8). However, for the reasons explained above concerning each of the adjustments considered in light of parties' responses, we found this outcome to be based on more accurate and/or proportionate adjustments to First Utility's and Ovo's cost bases than the views put forward by some of the Six Large Energy Firms.

<sup>37</sup> See paragraph 158 of Appendix 9.10.