

## Appendix 10.2: Retail energy supply profit margin analysis

### Contents

	<i>Page</i>
Introduction .....	1
Total supply business profit margins .....	5
Comparison of retail segmental profit margins .....	9
Domestic profit margins.....	23
Profit margins by domestic tariff type .....	34
Annex A: Domestic profit per customer account .....	38
Annex B: Mid-tier suppliers' financial performance .....	40
Annex C: Domestic supply unit revenues for the mid-tier suppliers .....	43
Annex D: Gross margins by fuel and tariff type for the Six Large Energy Firms.....	45

### Introduction

1. This appendix sets out our analysis of the profit margins and ratios generated by the retail energy supply businesses of the Six Large Energy Firms.
2. This profit margin analysis forms part of our retail profitability assessment, in conjunction with our analysis of retail profitability based on ROCE (see Appendix 10.3: Analysis of retail supply profitability); our bottom-up determination of the competitive benchmark price (see Appendix 10.5: Assessment of the competitive benchmark in retail energy); and our assessment of different comparator profit margins (see Appendix 10.6: Retail profit margin comparators).
3. In this appendix, we primarily focus on two profit measures: profit after direct costs (gross profit) and profit after direct and indirect costs (otherwise known as net profit or earnings before interest and tax (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.
4. We examined profit margins by fuel type, ie electricity and gas, and by customer segment type, ie residential (domestic), small and medium-sized enterprises (SMEs) and larger industrial and commercial (I&C) customers (the

retail segments).<sup>1</sup> 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.

5. We examined profit margins for the three retail segments combined (the total supply business), and for each individual retail segment. 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-operative Energy (Co-op Energy), First Utility, Ovo Energy and Utility Warehouse.
6. The period under consideration for our profit margin analysis covered the last seven financial reporting years, or financial year-ends (FYs), of the Six Large Energy Firms, ie FY07 to FY13 (the relevant period). We covered a shorter five-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 five-year period.<sup>2</sup>
7. We have structured the main body of this appendix under the following subjects:
  - (a) Total supply business profit margins: in paragraphs 17 to 25 below, 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 segments combined.
  - (b) Comparison of retail segmental profit margins: in paragraphs 26 to 65 below, we compare profit margins and ratios between the domestic, SME and I&C retail segments of the Six Large Energy Firms. In particular, we consider the reasons for the differences in profit margins between the domestic and SME retail segments.
  - (c) Domestic profit margins: in paragraphs 66 to 92 below, we examine profit margins and ratios for the domestic retail segment of the Six Large

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<sup>1</sup> 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.

<sup>2</sup> 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, FY13 means their FY ended 31 December 2013; (b) for firms with financial reporting years ending 31 March, ie SSE and Utility Warehouse, FY13 means their FY ended 31 March 2014; and (c) for Co-op Energy, its financial reporting year ends on the fourth Saturday in January, therefore FY13 means its FY ended 25 January 2014.

Energy Firms, and compare these with those generated by the mid-tier suppliers.

- (d) Profit margins by domestic tariff type: in paragraphs 93 to 105 below, we compare the relative profit margins of the Six Large Energy Firms' domestic standard variable tariffs (SVT) against their other tariff types, including fixed tariffs and other non-standard tariffs (NSTs). We have done this based on a stylised calculation of their gross margins by tariff type.
8. We briefly outline the key results of our analysis below together with a summary of parties' responses to our published working paper<sup>3</sup> of the analysis contained in this appendix, before discussing them in more detail over the remainder of this appendix.
  9. We found that whilst profit margins in retail supply for the Six Large Energy Firms combined had increased over the relevant period, ie between FY07 and FY13, 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 (ie five- and seven-year period totals), as well as for the Six Large Energy Firms combined, and highlight where the combined results are significantly affected by the inclusion of certain firms.
  10. We found that for the Six Large Energy Firms combined, EBIT margins were significantly higher on SME customers than on domestic and I&C customers, and that these were driven largely by lower unit costs for SME supply, rather than by higher prices. In their responses to our published working paper on retail profit margins,<sup>4</sup> some parties told us that these higher margins were justified based on the higher price and demand risks borne by suppliers to serve SME customers compared with domestic or I&C customers, eg in relation to higher risk of bad debts and greater exposure to the economic cycle. The SME markets would have to be much more exposed to systematic risk, or require a much higher level of capital employed than other markets, in order to justify the extent of the difference in EBIT margins. However, we have not seen any evidence to suggest that the risks of bad debts or greater exposure to the economic cycle were sufficient to justify such a large gap in EBIT margins between SME customers and other customer segments. For example, we did not consider that the risk of bad debts was intrinsically higher for SME than domestic customers, eg SME customers could be disconnected for non-payment in contrast to domestic customers. In addition, the relatively

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<sup>3</sup> [CMA working paper on retail profit margin analysis.](#)

<sup>4</sup> CMA working paper on retail profit margin analysis.

higher EBIT margins we observed on SME customers was also during a period of weak economic growth, a pattern that does not suggest cyclicity. However, we agreed that in theory the SME and I&C business was likely to be more exposed to the economic cycle than domestic customers and we took this into account in estimating the required WACC for the retail energy business as a whole (see Appendix 10.4: Cost of capital).

11. We also found that Centrica generated relatively higher margins, in particular on its gas supply business compared with the other Six Large Energy Firms. In its response to our published working paper on retail profit margins,<sup>5</sup> Centrica told us that its relatively higher margins on gas supply was driven by a combination of: (a) its dual fuel pricing strategy to acquire customers through lower electricity prices, and it believed that the reverse could often be seen from the electricity incumbent suppliers; and (b) greater risks in gas supply due to more volatility in wholesale gas input prices and greater volatility due to weather effects.
12. In our view, we found no clear cost or risk-related justification for the higher margins earned by Centrica on gas. For example, it generated a significantly higher EBIT margin on domestic gas than the other Six Large Energy Firms, generating an EBIT margin of 9.4% over the last five years compared with the next highest margin of 5.4%. We considered that wholesale price or weather risks were capable of management through hedging and forecasting, and did not justify a higher profit margin on gas, as would be the case for systematic risks (where they warranted a higher cost of capital).
13. 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 acquisition expenditure, generated EBIT margins over the period under consideration that were negative, and significantly lower than the Six Large Energy Firms combined. However, some parties told us that it would be inappropriate to compare them with the Six Large Energy Firms, citing material differences in their customer strategy, customer mix and stage of the business cycle, which undermined a meaningful comparison. We consider some of these comparability issues in more detail in Appendix 10.6: Retail profit margin comparators.
14. We estimated gross margins on SVTs, based on the assumption that direct costs (ie wholesale energy, network and obligation costs) could be allocated to each tariff type in proportion to their respective volumes. We found that

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<sup>5</sup> CMA working paper on retail profit margin analysis.

gross margins on SVTs were higher than on the other tariffs offered by the Six Large Energy Firms (excluding SSE for whom we did not have the relevant data). Whilst some of the Six Large Energy Firms agreed with our analysis, others disagreed and told us that our stylised assumptions on their wholesale energy costs did not reflect the different hedging strategies they adopted for their different tariff offerings. Some parties said that the higher costs to serve customers on SVTs justified the higher gross margins.

15. We did not find that the wide differential in prices and margins for SVT customers could be fully explained by differences in costs (see also Appendix 8.4: Price discrimination).
16. Our analysis and preliminary results are set out in more detail over the remaining sections of this appendix.

### **Total supply business profit margins**

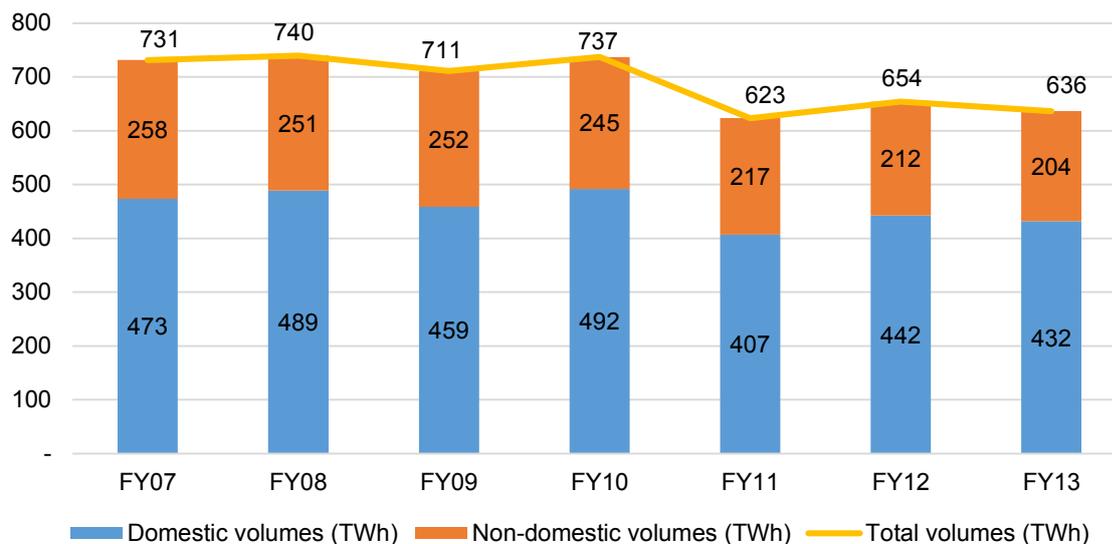
#### ***Section overview***

17. 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 three retail segments combined.

#### ***Total supply business performance***

18. 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.

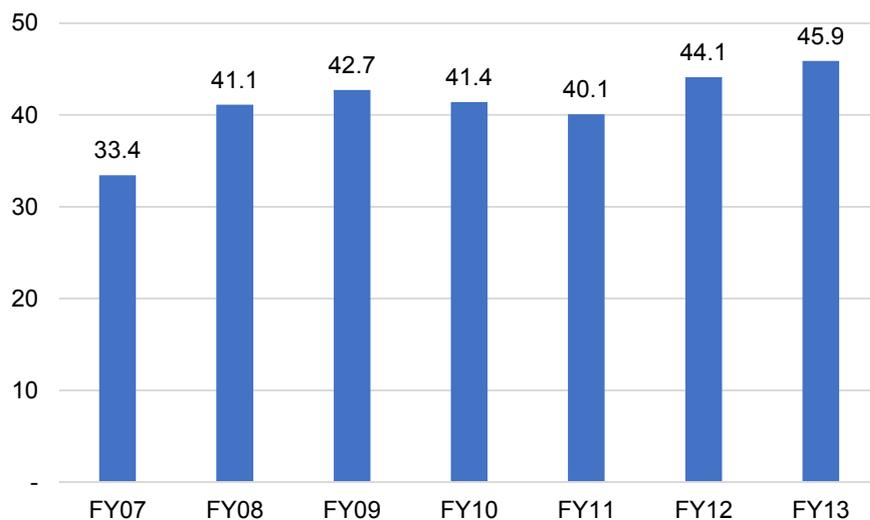
**Figure 1: Total supply business annual energy volumes (TWh) for the Six Large Energy Firms combined over the relevant period**



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.

19. Figure 1 shows that total volumes supplied by the Six Large Energy Firms declined by 13% from 731 TWh in FY07 to 636 TWh in FY13. 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.
20. Figure 2 below shows that annual revenues for the Six Large Energy Firms' total supply businesses increased by 37% over the relevant period from £33 billion to £46 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**

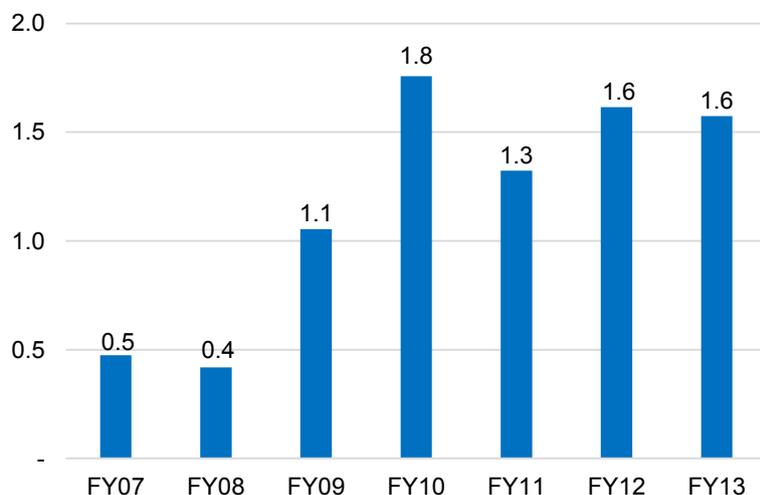


Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.

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

21. 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 FY13 (see Figure 3).

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



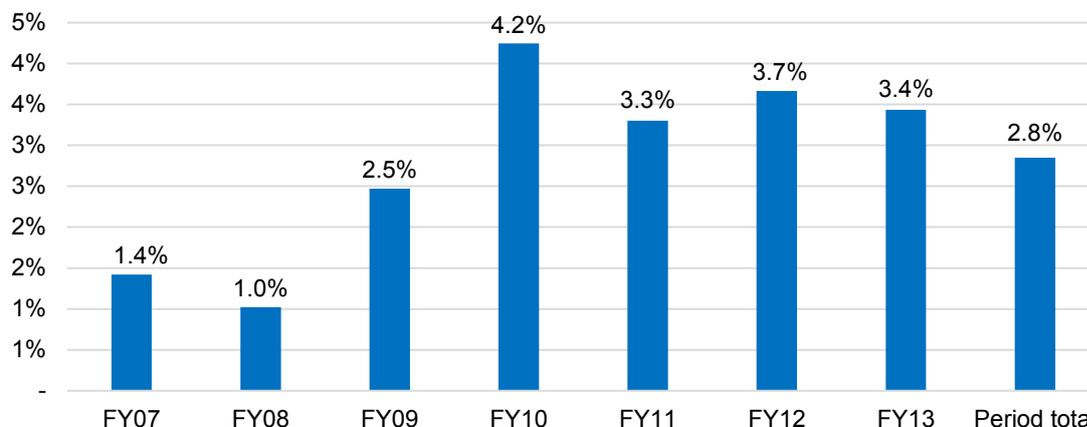
Source: CMA analysis of P&L information submitted by the Six Large Energy Firms.

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

22. 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 2.8% by FY13, with a period high of 4.2% in FY10.<sup>6</sup>

**Figure 4: Six Large Energy Firms' total supply business EBIT margins (FY07 to FY13)**



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).

23. 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 Appendix 10.6: Retail profit margin comparators.

24. We note that whilst the EBIT margins shown in Figure 4 above were relatively low in FY07 and FY08, we would note that 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 these differences highlight that FY07 and FY08 were

<sup>6</sup> 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.

not necessarily a period of low profit margins for some suppliers, for example: [✂].

25. 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**

### ***Section overview***

26. This section sets out our analysis of profit margins and ratios for each of the three retail segments, 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,<sup>7</sup> 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);<sup>8</sup> and (b) on an annual basis.

### ***Retail segmental profit margins on a period total basis***

#### ***Retail segmental profit margins for the Six Large Energy Firms combined***

27. On a five-year period total basis (ie period total EBIT divided by period total revenues),<sup>9</sup> the Six Large Energy Firms combined generated an EBIT margin of 3.4% at a total supply business level, and 4.0% for our reference market (ie approximated by the combination of the domestic and SME retail segments). When we examined profit margins at an individual retail segmental level, we found that EBIT margins varied considerably between the different retail segments.
28. In Table 1, we set out the revenues, EBIT and EBIT margin by retail segment and for the total supply business on a five-year period total basis. We present the figures for the Six Large Energy Firms on a combined basis.

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<sup>7</sup> eg, the FY13 EBIT margin for the Six Large Energy Firms combined (ie on an aggregated basis) would be calculated as the sum of the FY13 EBIT of the Six Large Energy Firms divided by the sum of their FY13 revenues.

<sup>8</sup> 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).

<sup>9</sup> 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 five years (FY09 to FY13) for which SME segmental P&L data was separately available for all of the Six Large Energy Firms.

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

	<i>Domestic</i>	<i>SME</i>	<i>I&amp;C</i>	<i>Total supply business</i>	<i>Reference market†</i>
<b>Period revenues (£bn)</b>	<b>132</b>	<b>21</b>	<b>61</b>	<b>214</b>	<b>153</b>
<i>Retail segment % split</i>	<i>62%</i>	<i>10%</i>	<i>28%</i>	<i>100%</i>	<i>72%</i>
<b>Period EBIT (£bn)</b>	<b>4.3</b>	<b>1.8</b>	<b>1.2</b>	<b>7.3</b>	<b>6.1</b>
<i>Retail segment % split</i>	<i>59%</i>	<i>25%</i>	<i>18%</i>	<i>100%</i>	<i>83%</i>
<b>Period EBIT margin (%)‡</b>	<b>3.3%</b>	<b>8.4%</b>	<b>2.0%</b>	<b>3.4%</b>	<b>4.0%</b>

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 segments 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.

29. Based on Table 1, the reference market,<sup>10</sup> as approximated by the combined domestic and SME retail segments,<sup>11</sup> accounted for a significant proportion of the revenues and EBIT generated by the total supply businesses of the Six Large Energy Firms combined, ie 72 and 83% of period revenues and EBIT respectively. For the Six Large Energy Firms combined, the reference market generated a higher EBIT margin of 4.0% on a five-year period total basis, compared with 3.4% for the total supply business.
30. Table 1 also shows that the SME retail segment generated a significantly higher period EBIT margin of 8.4% when compared with the lower period EBIT margin generated by the domestic retail segment of 3.3%. The I&C retail segment, which did not form part of our reference market, generated the lowest period EBIT margin of 2.0%.
31. In relation to the five-year period total segmental margins, EDF Energy told us that it considered a period total 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 Appendix 10.6.

<sup>10</sup> 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](#).

<sup>11</sup> 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.

32. We examine the key revenue and cost drivers behind the difference in profit margins between the domestic and SME retail segments in paragraphs 40 to 65 below.

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

33. Based on five-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 segment and fuel type. For each firm, we have highlighted the two retail segments (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 five-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&amp;C energy</i>	<i>Total supply business</i>	<i>Reference market†</i>
<i>Period revenue split</i>							
Centrica	27	48	[X]	[X]	[X]	100	[X]
E.ON	34	24	[X]	[X]	[X]	100	[X]
EDF Energy	28	16	[X]	[X]	[X]	100	[X]
RWE	29	24	[X]	[X]	[X]	100	[X]
Scottish Power	43	32	[X]	[X]	[X]	100	[X]
SSE	35	27	[X]	[X]	[X]	100	[X]
<b>Combined*</b>	<b>31</b>	<b>30</b>	<b>8</b>	<b>2</b>	<b>28</b>	<b>100</b>	<b>72</b>
<i>Period EBIT margin</i>							
Centrica	2.8	9.4	[X]	[X]	[X]	7.0	[X]
E.ON	4.9	-2.5	[X]	[X]	[X]	3.1	[X]
EDF Energy	-3.3	-6.5	[X]	[X]	[X]	-0.6	[X]
RWE	0.7	0.0	[X]	[X]	[X]	1.5	[X]
Scottish Power	0.4	4.6	[X]	[X]	[X]	3.1	[X]
SSE+	4.7	5.4	[X]	[X]	[X]	3.6	[X]
<b>Combined‡</b>	<b>2.2</b>	<b>4.4</b>	<b>7.9</b>	<b>10.1</b>	<b>2.0</b>	<b>3.4</b>	<b>4.0</b>

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 five-year time period.

†We have assumed that the domestic and SME retail segments 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.

+ [X].

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

34. Based on Table 2, we summarise the key preliminary 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 segment generated the highest EBIT margin for both fuel types: 7.9% for SME electricity and 10.1% for SME gas supply. These EBIT margins were significantly higher than in any of the other retail segments. 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).<sup>12</sup> For the other five 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 40 to 65 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] generated their two highest period EBIT margins in both SME electricity and gas supply.
- (c) Centrica and gas supply: [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 43% 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 -3.3% for EDF Energy (see (e) below) to 4.9% 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 -3.3 and -6.5% respectively, [REDACTED] its loss-making domestic supply business accounted for 44% of period total revenues. As we set out in Annex C of Appendix 10.5, [REDACTED].
- (f) I&C profit margins: the I&C retail segment 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 segments, eg [REDACTED].

35. 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

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<sup>12</sup> For SSE, its EBIT margin on gas [REDACTED].

was driven by its dual fuel conversion strategy and the higher risks it faced in supplying gas.

36. 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.
37. In relation to its argument 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.  
[✂] Centrica explained that with demand for gas impacting wholesale gas

prices, these consumption variations could have a significant impact on its profitability.<sup>13</sup>

38. Relevant to Centrica's argument above concerning its dual fuel conversion strategy was Ofgem's comment that our preliminary findings concerning the domestic gas segment 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.
39. We found no clear cost or risk-related justification for 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 9.4% over the last five 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 RWE and Scottish Power generated higher margins on domestic gas than electricity over the five-year period. We also 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).

### ***Comparison of SME and domestic profit margins***

40. We now turn to examine the key revenue and cost drivers behind the relatively higher profit margins in SME compared with domestic supply.
41. 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 the two retail segments based on a breakdown of prices (as measured by unit revenues) into its constituent cost and profit elements, ie a 'cost stack' for prices.

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<sup>13</sup> 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%.

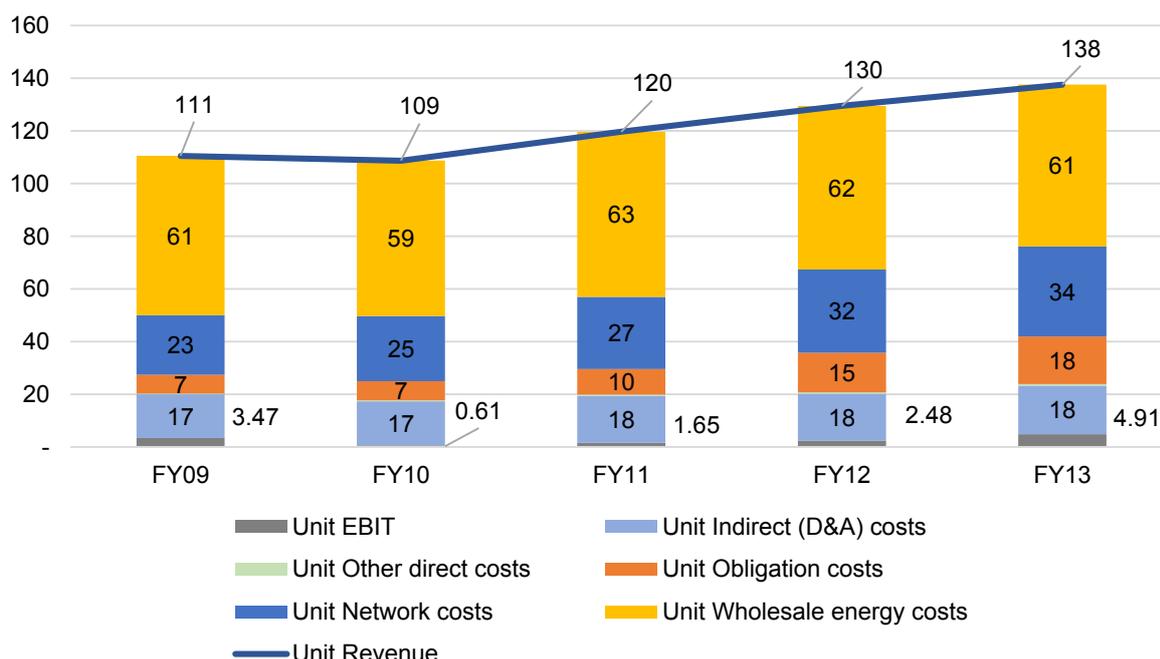
42. We first compare the unit revenues, unit costs and unit EBIT for domestic and SME electricity supply for the Six Large Energy Firms on a combined basis. We then compare these ratios for their domestic and SME gas supply.

*Comparison of domestic and SME electricity price-cost stacks*

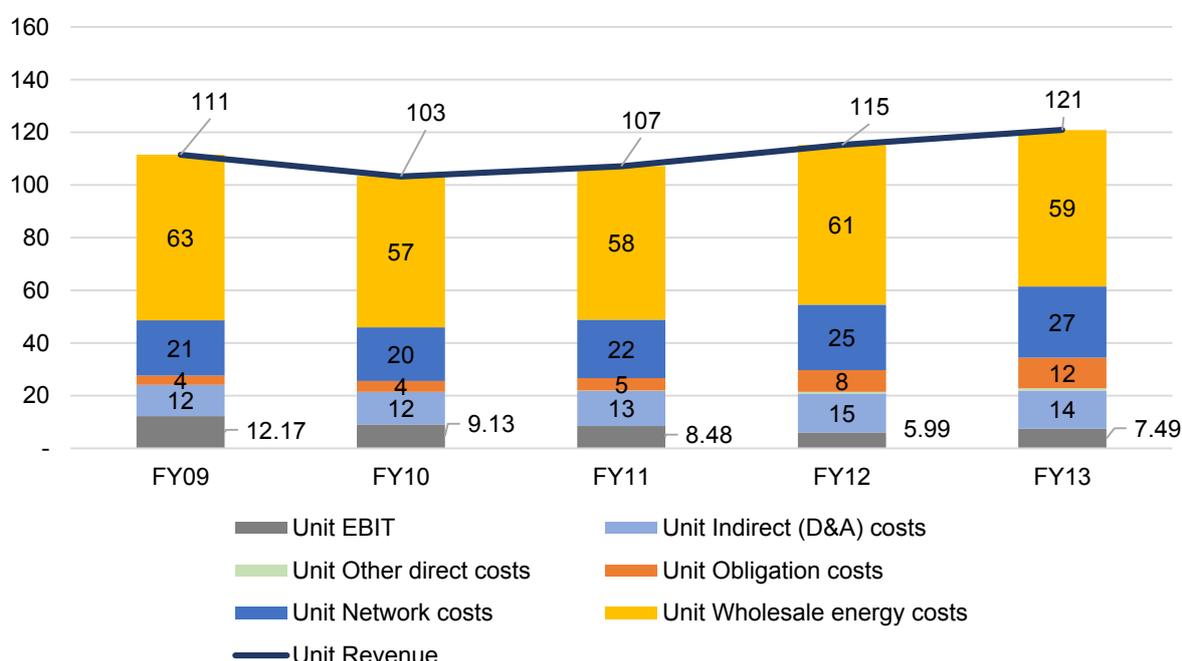
43. Figure 5 illustrates how annual unit revenues for domestic and SME electricity supply for the Six Large Energy Firms combined are broken down into their various costs and profit components.

**Figure 5: Comparison of unit revenue breakdown (£ per MWh) for domestic and SME electricity supply for the Six Large Energy Firms combined (FY09 to FY13)**

**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.

44. 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.

45. To accompany Figure 5, we set out in Table 3, the annual gross and EBIT margins between FY09 and FY13 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
<i>Gross margin</i>					
Domestic electricity	18	16	16	16	17
SME electricity	22	21	20	18	18
<i>EBIT margin</i>					
Domestic electricity	3.1	0.6	1.4	1.9	3.6
SME electricity	10.9	8.8	7.9	5.2	6.2

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.

46. Based on Figure 5 and Table 3 above, in each year over the period FY09 to FY13, unit EBIT, gross margin and EBIT margin in SME electricity supply consistently exceeded their respective measures in domestic electricity supply. Table 3 also shows that gross and EBIT margins in SME electricity have generally declined year-on-year over the five-year period, although they have remained ahead of their respective measures for domestic electricity.
47. 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.
48. 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 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 £3 to £9 per MWh each year.

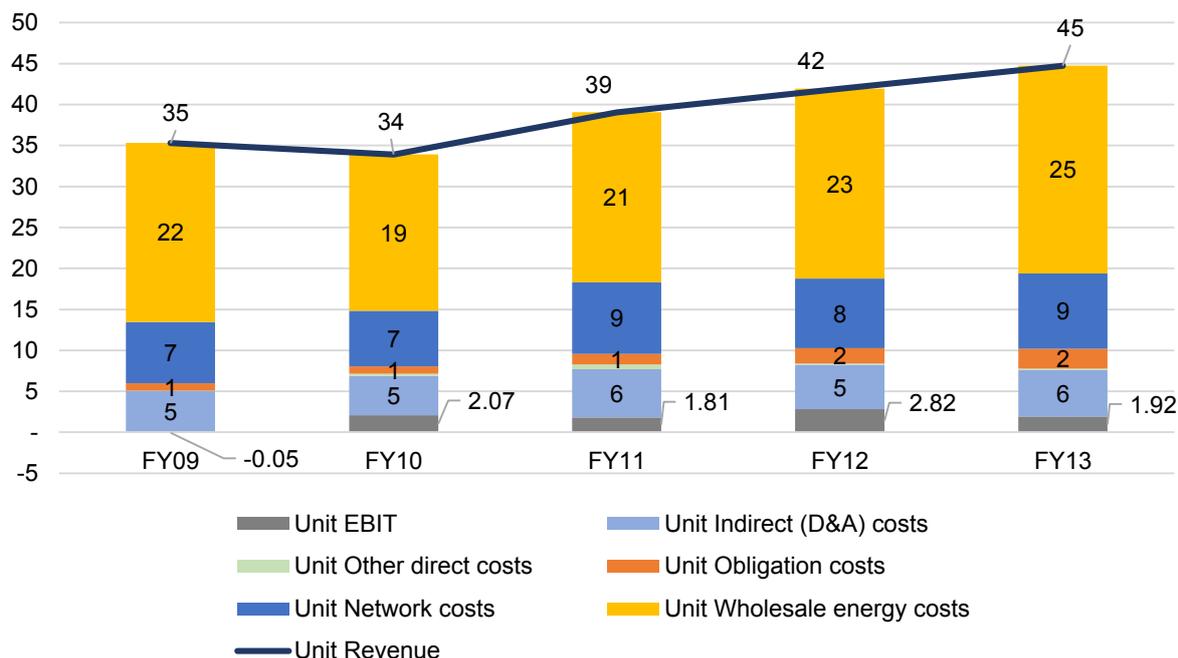
49. In relation to the differences in unit network costs between SME and domestic supply, Ofgem told us that whilst it was difficult to do a proper comparison of distribution network operator (DNO) tariffs without knowing the distribution of DNO customer classes among SME customers, in general it believed 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*

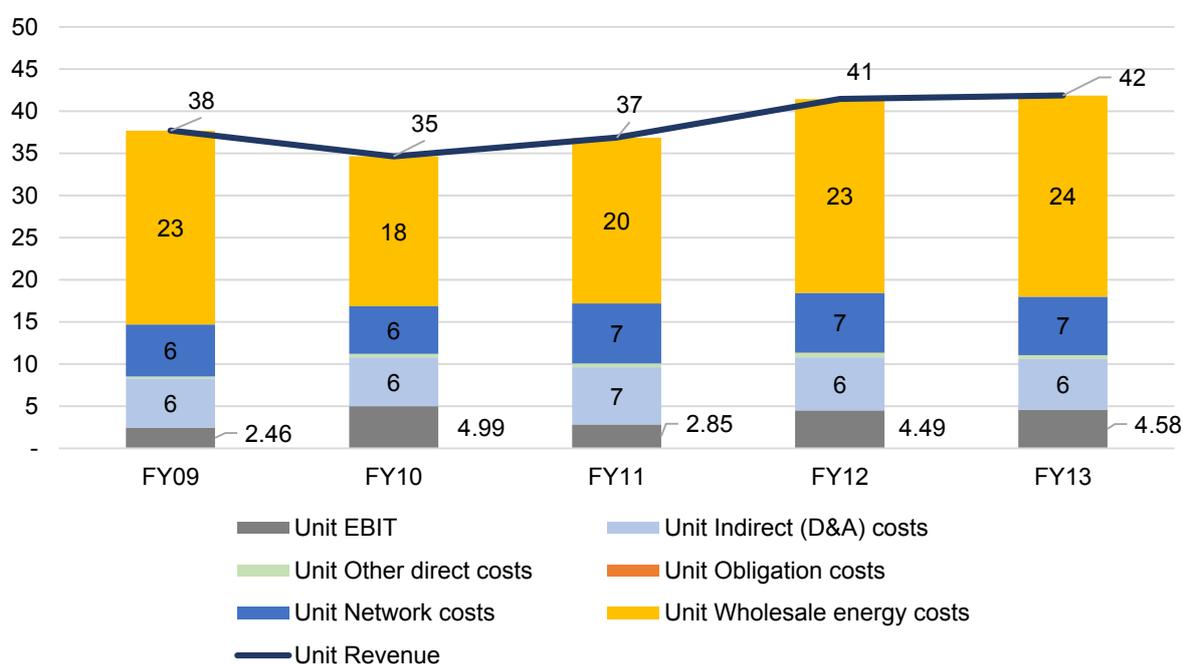
50. Similar to Figure 5 above, we compare the breakdown of unit revenues for domestic and SME gas supply over the period FY09 to FY13 (see Figure 6 below).

**Figure 6: Comparison of unit revenue breakdown (£ per MWh) for domestic and SME gas supply for the Six Large Energy Firms combined (FY09 to FY13)**

**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.

51. 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.

52. Similar to Table 3, Table 4 sets out the annual gross and EBIT margins between FY09 and FY13 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
<i>Gross margin</i>					
Domestic gas	14	20	20	20	17
SME gas	22	31	26	26	25
<i>EBIT margin</i>					
Domestic gas	-0.1	6.1	4.6	6.7	4.3
SME gas	6.5	14.4	7.7	10.8	10.9

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.

53. 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 FY13. 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.
54. 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,<sup>14</sup> were significant as a proportion of unit EBIT in gas in relative terms, eg FY13 unit EBIT for SME gas was around £5 per MWh.
55. Figure 6 also shows that these cost differentials between domestic and SME gas supply had generally widened over the period, eg while FY07 network

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<sup>14</sup> For example, network costs were around £2 per MWh lower in SME gas than domestic gas supply.

costs were around £1 per MWh lower in SME gas than domestic gas, this differential increased to over £2 per MWh by FY13.

56. 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 and FY13.
57. Despite the mixed picture mentioned above in relation to domestic and SME gas supply unit revenues (and also compared with the unit revenue trends for electricity supply), 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, which was also the case for SME electricity supply.

#### *Parties' views on the relative performance of SME profit margins*

58. We set out below the comments of the Six Large Energy Firms in relation to the higher EBIT margins we found on SME customers.
59. EDF Energy told us that differences in market risks between the different retail segments (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]. 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].<sup>15</sup>
60. 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.

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<sup>15</sup> 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.

61. 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 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.
- (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) **Less 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].

62. 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 taken into account when considering E.ON's actual levels of return, including:<sup>16</sup>

- (a) greater variation across the base due to different customer sizes but similar costs to serve;

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<sup>16</sup> E.ON response to the CMA updated issues statement.

- (b) higher debt risk than other sectors, with debt write-offs accounting for between [X] of revenues;
- (c) around [X]% 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; and
- (d) [X].

63. [X].

64. 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*

65. 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 markets (see Section 10). However, we have not seen any evidence to suggest that the risks of bad debts or greater exposure to the economic cycle were sufficient to justify such a large gap in EBIT margins between SME customers and other customer segments. For example, we did not consider that the risk of bad debts was intrinsically higher for SME than domestic customers, eg SME customers could be disconnected for non-payment in contrast to domestic customers. In addition, the relatively higher EBIT margins we observed on SME customers was also during a period of weak economic growth, a pattern which does not suggest cyclicity. However, we agreed that in theory the SME and I&C business was likely to be more exposed to the economic cycle than domestic customers and we took this into account in estimating the required WACC for the retail energy business as a whole (see Appendix 10.4).

#### **Domestic profit margins**

66. 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	% change
<i>EBIT (£m)</i>								
Domestic electricity	489	354	396	70	179	270	523	7%
Domestic gas	-379	-360	-17	781	539	942	624	N/A
<b>Domestic supply</b>	<b>110</b>	<b>-6</b>	<b>379</b>	<b>852</b>	<b>718</b>	<b>1,211</b>	<b>1,148</b>	<b>945%</b>
<i>EBIT margin (%)</i>								
Domestic electricity	4.5%	2.7%	3.1%	0.6%	1.4%	1.9%	3.6%	-22%
Domestic gas	-4.1%	-3.1%	-0.1%	6.1%	4.6%	6.7%	4.3%	N/A
<b>Domestic supply</b>	<b>0.6%</b>	<b>0.0%</b>	<b>1.5%</b>	<b>3.4%</b>	<b>2.9%</b>	<b>4.3%</b>	<b>3.9%</b>	<b>613%</b>
<i>Unit EBIT (£/MWh)</i>								
Domestic electricity	4.21	2.99	3.47	0.61	1.65	2.48	4.91	17%
Domestic gas	-1.06	-0.97	-0.05	2.07	1.81	2.82	1.92	N/A
<b>Domestic supply</b>	<b>0.23</b>	<b>-0.01</b>	<b>0.83</b>	<b>1.73</b>	<b>1.76</b>	<b>2.74</b>	<b>2.66</b>	<b>1,044%</b>
<i>EBIT per customer (£)†</i>								
Domestic electricity	18.89	13.47	15.09	2.67	6.72	10.21	19.89	5%
Domestic gas	-17.57	-16.35	-0.71	35.39	24.18	42.50	28.28	N/A
<b>Domestic supply</b>	<b>2.31</b>	<b>-0.13</b>	<b>7.86</b>	<b>17.57</b>	<b>14.68</b>	<b>24.90</b>	<b>23.71</b>	<b>925%</b>

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.

67. 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 £1.1 billion in FY13, primarily driven by domestic gas supply, which increased from an EBIT loss of -£0.4 billion in FY07 to £0.6 billion in FY13. 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).
68. 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.
69. 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.

70. 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 FY13.
71. We would also highlight that the inclusion or exclusion of certain firms has a particularly significant impact on the annual and period total EBIT margins generated in domestic electricity and gas. For example:
- (a) The exclusion of Centrica from Table 5 above would show that for the other five firms combined, their domestic gas annual EBIT margins were – 5.8% in FY09 and 0.9% in FY13, compared with the figures shown in Table 5 of –0.1% in FY09 and 4.3% in FY13. Domestic electricity EBIT margins for the other five firms would be 1.9% in FY09 and 4.5% in FY13 (compared with 0.6% and 3.6% respectively in Table 5 for the Six Large Energy Firms combined).
  - (b) The exclusion of both Centrica and EDF Energy (for example, due to its persistent EBIT losses in its domestic supply business over the period) from Table 5 would mean that for the remaining four firms, annual EBIT margins in FY07 would be 3.1% for domestic electricity and –4.8% for domestic gas. In FY13, the annual EBIT margin would be 5.7% for domestic electricity and 2.0% for domestic gas.
72. In relation to domestic gas supply, in Table 2 above, we showed that:
- (a) British Gas generated around half its five-year period total supply business revenues from domestic gas, which [redacted] generated [redacted] period EBIT margins of 9.4% [redacted];
  - (b) out of the Six Large Energy Firms, SSE and Scottish Power respectively generated the second and third highest period EBIT margins in domestic gas with 5.4 and 4.6%, with domestic gas accounting for around 30% of their respective period total supply business revenues; and
  - (c) over the same period, both E.ON and EDF Energy generated negative EBIT margins in domestic gas on a period total basis, while RWE generated a period EBIT margin of nil.
73. To the extent that these variations in period EBIT margin performances for each of the Six Large Energy Firms in relation to their respective domestic

gas and electricity supply (as shown earlier in Table 2) may be driven by differences in profitability at a tariff type level is considered in more detail in the next section (see paragraphs 93 to 105 below).

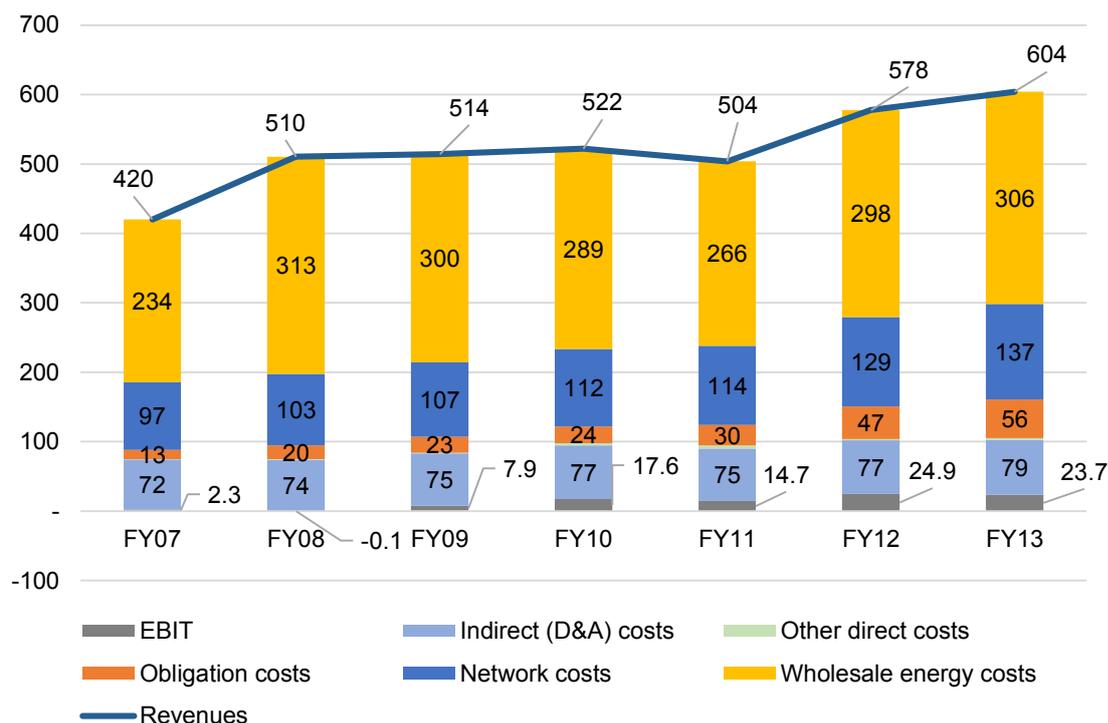
*Domestic supply profit ratios on a per customer account basis*

74. In Table 5, we introduced the profit ratio based on a per customer account basis, ie EBIT per domestic customer account. Figure 7 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.<sup>17</sup>

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<sup>17</sup> 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 7: Breakdown of annual revenues per domestic energy customer account (£ per domestic energy account) for the Six Large Energy Firms combined (FY07 to FY13)**



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.

75. Based on Figure 7:

- (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 £604 in FY13, an increase of 44% over the period. When considering the last five 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 £604 in FY13, an increase of 18%; 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 £23.71 by FY13. However, for the last five years only, the increase was 3 times (from £7.86 in FY09 to £23.71 in FY13).

76. We note that the revenues, costs and EBIT per customer account shown in Figure 7 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.

77. 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.
78. Based on the approach described in paragraph 77(b) above and the charts in Annex A, we compared for the Six Large Energy Firms combined their annual revenues in FY13 for each domestic electricity account, domestic gas account and the combined total, with those for FY07 (seven-year period) and FY09 (five-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 FY13 comparisons)\***

	FY07	FY09	FY13	7Y % change	5Y % change
<i>Annual revenues per account†</i>					
Domestic electricity	415	481	557	34%	34%
Domestic gas	426	554	660	55%	55%
	<b>841</b>	<b>1,035</b>	<b>1,217</b>	<b>45%</b>	<b>45%</b>
<i>Annual EBIT per account†</i>					
Domestic electricity	18.89	15.09	19.89	5%	5%
Domestic gas	-17.57	35.39	28.28	N/A	N/A
	<b>1.32</b>	<b>50.48</b>	<b>48.16</b>	<b>3,555%</b>	<b>3,555%</b>

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.

79. 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 FY13, the annual electricity bill increased by 34% and the annual gas bill increased by 55%. 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 45% from £841 in FY07 to £1,217 in FY13. However, when considering a shorter five-year period, the annual bill increased by 18% from £1,035 in FY09 to £1,217 in FY13.

- (b) Regarding EBIT per customer account – when looking at the entire seven-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 £48.16 in FY13, driven entirely by the increase in the EBIT generated on domestic gas. The EBIT generated on domestic electricity in FY13 remained broadly in line with FY07 levels. When considering a shorter five-year period however, EBIT per customer account actually decreased slightly by 5% from £50.48 to £48.16.

#### *Domestic profit margin comparisons with the mid-tier suppliers*

80. We now turn to introduce the mid-tier suppliers and consider their profit margins for comparison purposes against the profit margins of domestic supply for the Six Large Energy Firms.<sup>18</sup> We noted that over the period FY09 to FY13 only Utility Warehouse<sup>19</sup> and First Utility had traded for the full five-year period. In relation to 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 Energy commenced trading in September 2009. However, we only received full 12-month P&L information for Ovo Energy down to EBIT for FY11 to FY13 based on a common December FY.<sup>20</sup>
81. Over the period FY09 to FY13, 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 8 below shows the number of domestic electricity and gas customer accounts for each of the mid-tier suppliers over the period FY09 to FY13.

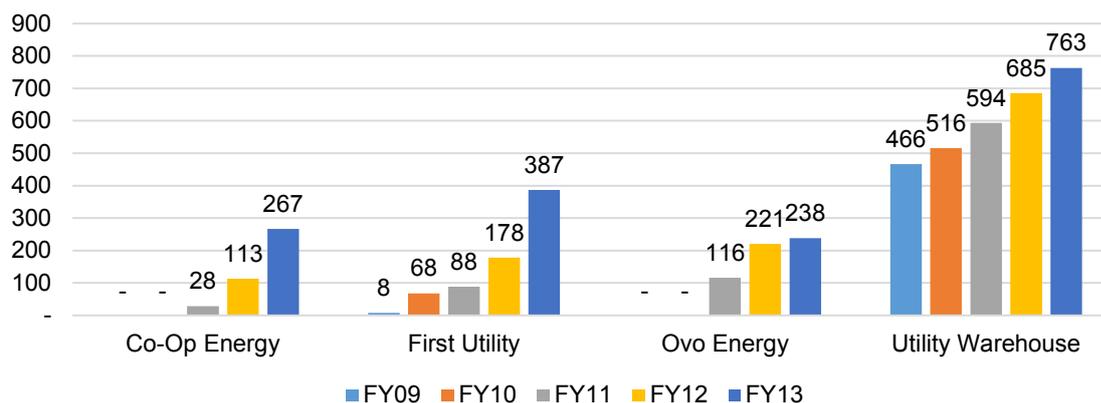
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<sup>18</sup> The mid-tier suppliers predominantly serve the domestic retail segment. Therefore any comparisons of their profit margins with those of the Six Large Energy Firms should be made against the Six Large Energy Firms' domestic supply operations.

<sup>19</sup> 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.

<sup>20</sup> In relation to the P&L information we received from First Utility and Ovo Energy: (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 FY13; and (ii) only provided a retail segmental split down to gross profit.

**Figure 8: Mid-tier suppliers' domestic customer accounts ('000s) from 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 Energy commenced trading during FY09 and therefore we have its P&L information for four full years of trading, ie FY10 to FY13.

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

82. 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 FY13. 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).

83. 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 to 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*

84. In Figure 9, 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 FY13.

**Figure 9: Mid-tier suppliers' annual and period gross margins (FY09 to FY13)**



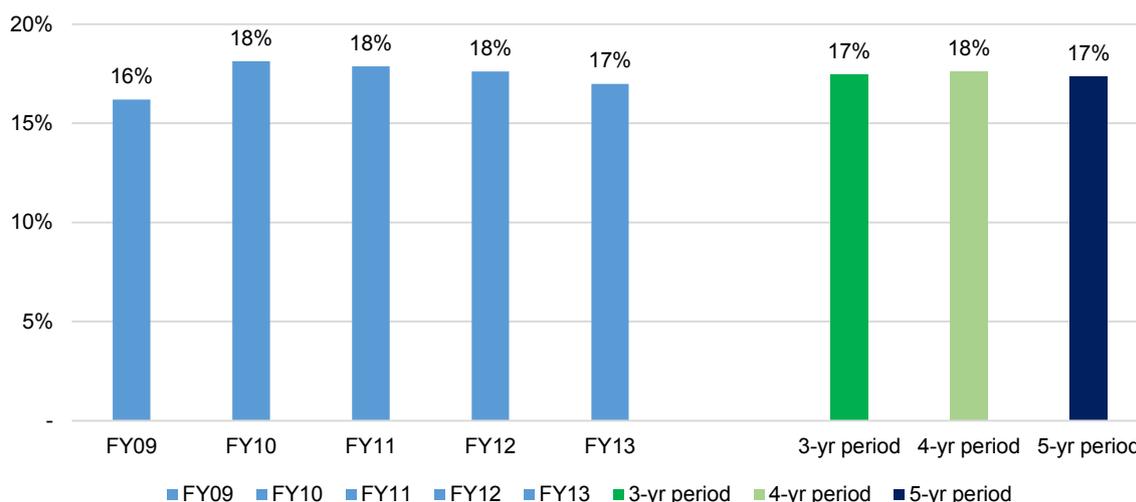
Source: CMA analysis of P&L information submitted by the mid-tier suppliers.

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 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 Energy commenced trading during FY09 and therefore we have its P&L information for four full years of trading, ie FY10 to FY13.

85. In Figure 10, we set out the annual and period domestic supply gross margins for the Six Large Energy Firms combined. Given the differences in the time periods covered by the P&L information of each of the mid-tier suppliers, we calculated the Six Large Energy Firms' period gross margins based on three-, four- and five-year period totals.

**Figure 10: 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.

86. Based on Figures 9 and 10, the period gross margins for the Six Large Energy Firms ranged from 17 to 18% based on three-, four- and five-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] compared with a three-year period gross margin of [redacted] for the Six Large Energy Firms combined.

87. Based on this preliminary comparison, the mid-tier suppliers (with the exception of [REDACTED]) appeared to generate 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.<sup>21</sup> 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 Energy told us that it did not meet the thresholds for ECO and WHD over the period considered.

88. A number of parties highlighted a number of 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.

89. 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

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<sup>21</sup>Some 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.

the Six Large Energy Firms,<sup>22</sup> and therefore this would necessitate the higher gross margins for the Six Large Energy Firms to recover their higher indirect cost base.

(b) SSE also told us that 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.

90. 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:<sup>23</sup>

(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

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<sup>22</sup> 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 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.

<sup>23</sup> Centrica response to the CMA working paper on retail energy supply profit margin analysis.

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

91. 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.
92. In Appendix 10.6, we address the issue 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. Whilst we note that gross margins do not take into account the total costs of the energy retailer to supply its customers, as we set out in Appendix 10.6, we considered that any meaningful assessment of economic profitability should also take into account the level of capital employed to generate the return, and the appropriate rate of return on that invested capital (ie based on the WACC).

## **Profit margins by domestic tariff type**

### ***Section overview***

93. This section sets out the preliminary results of our analysis to assess profit margins by tariff type. Our analysis focused on the domestic electricity and gas tariffs of the Six Large Energy Firms over the relevant period comparing the relative profit margins of their SVTs (by fuel type), ie their standard variable default tariffs, with their NSTs, which will include other variable and fixed tariff types.
94. This section is structured under the following headings:
  - (a) Methodology: in paragraphs 95 to 98 below, we discuss our methodology for this analysis, in particular we explain how we overcame data limitations to calculate stylised profit margins by tariff type.

(b) Preliminary results: in paragraphs 99 to 105 below, we set out the preliminary results of our analysis.

## **Methodology**

95. As part of our initial request for information, we requested the Six Large Energy Firms to provide us with their domestic supply revenues and direct costs split by tariff type on a monthly basis. However, we were told by the Six Large Energy Firms that they did not routinely record or segment their information in this manner, and any allocation would not be to the accuracy we would require. The information we were able to receive showed their monthly revenues and volumes split by standard variable and non-standard variable tariff types. The time period over which this information could be provided by each of the Six Large Energy Firms also varied (as we set out later).<sup>24</sup>
96. Given that for each of the Six Large Energy Firms we had a complete set of annual P&L information for domestic electricity and gas, including their relevant annual direct and indirect cost figures covering the relevant period, we used the percentage breakdown of monthly revenues and volumes data by tariff to allocate the annual P&L information by tariff type. We briefly explain our methodology below, and summary tables of our results can be found in Annex D:
- (a) Calculating revenues by tariff type: for each firm we calculated the percentage split of revenues by tariff type from the monthly data for both electricity and gas. We then applied these percentages to annual total revenues in the P&L data to derive annual revenues by tariff type.
  - (b) Calculating gross profit and margin by tariff type: for each firm and for each of its fuel type, we calculated the percentage split of volumes by tariff type based on monthly data, and applied these percentages to annual direct costs to derive annual direct costs by tariff type. Together with the annual revenues we calculated in (a) above, we were able to calculate a stylised gross margin by tariff type for each fuel type.

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<sup>24</sup> 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.

97. This methodology was based on two key assumptions:
- (a) we can overlay trends from a monthly data set onto annual P&L information; and
  - (b) when calculating gross margin, the major direct cost items, ie wholesale energy, network and obligation costs, do not vary by tariff type.
98. We now turn to the results of our profit margin analysis by tariff type.

## Results

99. Table 7 sets out the average gross margins by tariff type for the Six Large Energy Firms (with the exception of SSE) over the period for which we were able to calculate each firm's gross margins by tariff type. In this appendix, we set out the differences between SVTs and NSTs.

**Table 7: Average gross margin by tariff type**

			%			
			Average electricity gross margin	Average gas gross margin	2013 Proportion of revenue (electricity)	2013 Proportion of revenue (gas)
<i>Tariff types</i>						
Scottish Power	FY 2011–2013	Standard variable	[X]	[X]	[X]	[X]
		Non-standard	[X]	[X]	[X]	[X]
Centrica	FY 2011–2013	Standard variable	[X]	[X]	[X]	[X]
		Non-standard	[X]	[X]	[X]	[X]
RWE	FY 2011–2013	Standard variable	[X]	[X]	[X]	[X]
		Non-standard	[X]	[X]	[X]	[X]
E.ON	FY 2011–2013	Standard variable	[X]	[X]	[X]	[X]
		Non-standard	[X]	[X]	[X]	[X]
EDF Energy	FY 2011–2013	Standard variable	[X]	[X]	[X]	[X]
		Non-standard	[X]	[X]	[X]	[X]

Source: CMA analysis of P&L and monthly finance data provided by the Six Large Energy Firms (excluding SSE).

\*EDF Energy's figures exclude month-end adjustments, the impact of which are not material.

Notes:

1. Proportion of revenue by tariff type in 2013 is provided to demonstrate the relative importance of each tariff type.

2. Some suppliers provided tariff information prior to 2011 but others could not so information shown is only to 2011 so the supplier's figures are comparable.

100. In Table 7, the tariff type with the highest average gross margins for each of the relevant firms' electricity and gas tariff types is always the SVT tariff. Our findings, based on these preliminary results, were as follows:

- (a) Significance of SVT's contribution to revenues: each of the five firms generated a significant proportion of their domestic revenues from SVTs. For example, in 2013 these tariff types accounted for at least 60% of each firm's total domestic electricity revenues (and up to 80% for some firms). In domestic gas, SVTs accounted for the highest proportion of revenues

for three of the suppliers, between 60-75% and for two of the suppliers the split of revenues between SVT and NST was relatively even.

- (b) Domestic electricity tariffs: for domestic electricity, all five firms had a higher gross margin on their SVTs compared with their NSTs.
  - (c) Domestic gas tariffs: for domestic gas all five firms generated a higher gross margin on their standard variable gas tariffs. We found that there were variations, between these firms in relation to the extent to which their SVT gross margins were higher than their gross margins on their NSTs.
101. From this analysis, all of the five major firms generated higher gross margins on their SVTs than on their other NSTs combined. Based on the figures in Table 7 above, for the five firms combined, their period total gross margin for the period FY11 to FY13 was 20% for SVTs and 10% for their NSTs.
102. It should be noted that all the suppliers have told us that energy costs can 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.
103. The Six Large Energy Firms were not able to allocate their indirect costs by tariff type to any degree of certainty.
104. Therefore, in summary, based on our tariff profit margin analysis above:
- (a) When apportioning direct costs by volumes, all the firms covered by our analysis generated higher gross margins on their SVT customers for each fuel type compared to their NST customers.
  - (b) While the costs to serve may be higher for SVT customers than for NST customers, the size of the differences in gross margins would mean that the costs to serve SVT customers would likely need to be significantly higher than for NST customers to explain fully the higher gross margins that we found for SVT customers. A commonly cited reason for fixed tariffs having a lower margin was that fixed tariffs were used as a customer acquisition tool.
105. In Appendix 8.4, we observe that there are significant disparities in the tariffs charged by the Six Large Energy Firms that cannot fully be explained by differences in costs.

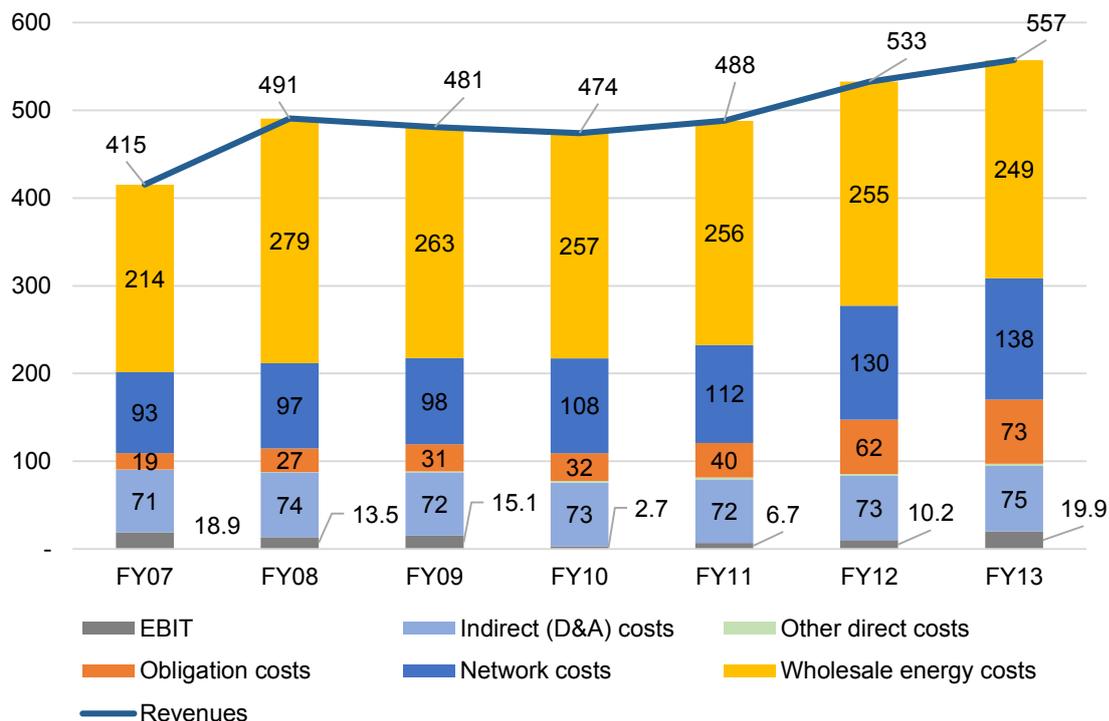
## **Annex A: Domestic profit per customer account**

### **Breakdown of domestic revenues per customer account (by fuel)**

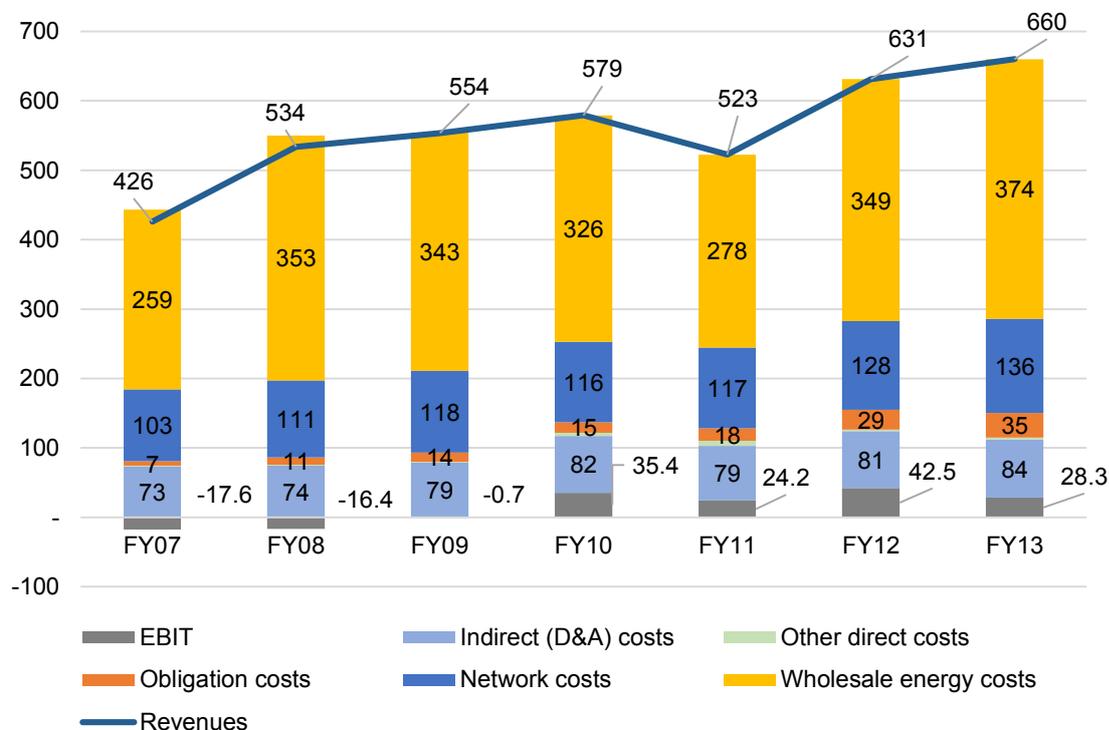
1. Figure 1 shows for domestic electricity the revenues per domestic electricity customer account broken down into its constituent cost and EBIT components. The figures presented represent the revenues, costs and profits for domestic electricity supply for the Six Large Energy Firms combined. Below the 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 FY13)**

**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 FY13. 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 FY13.

**Figure 1: Mid-tier suppliers' total supply business revenues, gross profit and EBIT (FY09 to FY13)**

#### 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 three full years of its trading information, ie from FY11 to FY13; and (b) Ovo Energy commenced trading during FY09 and therefore we have its P&L information for four full years of trading, ie FY10 to FY13.

3. Based on the figures above, each of the mid-tier suppliers saw their revenues increase year-on-year over the period FY09 to FY13, but EBIT profitability was only achieved in the latter years:
  - (a) Co-op Energy's [~~ⓧ~~].
  - (b) First Utility and Ovo Energy [~~ⓧ~~].
  - (c) Utility Warehouse [~~ⓧ~~].

### 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.

**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 Energy‡	[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 Energy 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.

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

[REDACTED]

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)**

[REDACTED]

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 Energy 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 [X], 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 Energy 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**

£

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

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

	Domestic electricity unit ratios					Domestic gas unit ratios				
<i>Six Large Energy Firms combined</i>	FY09	FY10	FY11	FY12	FY13	FY09	FY10	FY11	FY12	FY13
Revenues	111	109	120	130	138	35	34	39	42	45
Wholesale energy costs	61	59	63	62	61	22	19	21	23	25
Network costs	23	25	27	32	34	7	7	9	8	9
Obligation costs	7	7	10	15	18	1	1	1	2	2
Other direct costs	0	0	1	1	1	0	0	0	0	0
<b>Gross profit</b>	<b>20</b>	<b>17</b>	<b>19</b>	<b>20</b>	<b>23</b>	<b>5</b>	<b>7</b>	<b>8</b>	<b>8</b>	<b>8</b>

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\***

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

### Introduction

1. In this annex, we set out the figures used to calculate the revenues, direct costs and indirect costs by tariff type for each of the Six Large Energy Firms (with the exception of SSE).
2. The percentages for revenue and direct costs by tariff type was based on their monthly revenue and volume information, which were overlaid onto their respective annual P&L information to provide us with stylised annual revenues and direct costs by tariff type.

### Centrica

3. In relation to Centrica, Table 1 sets out the average gross margins over the financial years 2011 to 2013. The percentage revenue split by fuel is calculated from monthly financial data. The percentage split by direct costs is based on delivered volumes by tariff type and is used to apportion direct costs by tariff type.

**Table 1: Centrica: average tariff profit margins (FY11 to FY13) £m**

P&L information	FY11-13			
	Electricity %	Gas %	Electricity £m	Gas £m
Domestic electricity revenue			[X]	
Domestic gas revenue			[X]	
Domestic electricity direct costs			[X]	
Domestic gas direct costs			[X]	
Gross profit			[X]	
<hr/>				
	Electricity %	Gas %	Electricity £m	Gas £m
<b>Revenues</b>				
Standard variable	[X]	[X]	[X]	[X]
Non-standard	[X]	[X]	[X]	[X]
<b>Direct costs</b>				
Standard variable	[X]	[X]	[X]	[X]
Non-standard	[X]	[X]	[X]	[X]
<b>Gross margins</b>				
Standard variable	[X]	[X]		
Non-standard	[X]	[X]		

Source: CMA analysis based on Centrica P&L information.  
\*Figures rounded.

### E.ON

4. In relation to E.ON, Table 2 sets out simple average gross margins (by tariff type) from 2011 to 2013.

**Table 2: E.ON: average tariff profit margins (FY11 to FY13) £m**

<b>P&amp;L information</b>		<b>FY11-13</b>			
Domestic electricity revenue		[X]			
Domestic gas revenue		[X]			
Domestic electricity direct costs		[X]			
Domestic gas direct costs		[X]			
Gross profit		[X]			
		<i>Electricity %</i>	<i>Gas %</i>	<i>Electricity £m</i>	<i>Gas £m</i>
<b>Revenues</b>					
Standard variable		[X]	[X]	[X]	[X]
Non-standard		[X]	[X]	[X]	[X]
<b>Direct costs</b>					
Standard variable		[X]	[X]	[X]	[X]
Non-standard		[X]	[X]	[X]	[X]
<b>Gross margins</b>					
Standard variable		[X]	[X]		
Non-standard		[X]	[X]		

Source: CMA analysis based on E.ON P&L information.

\*Figures rounded.

## EDF Energy

5. In relation to EDF Energy, Table 3 sets out the average gross margins (by tariff type) based on financial years 2011 to 2013.

**Table 3: EDF Energy: average tariff profit margins (FY11 to FY13) £m**

<b>P&amp;L information:</b>		<b>FY11-13</b>			
Domestic electricity revenue		[X]			
Domestic gas revenue		[X]			
Domestic electricity direct costs		[X]			
Domestic gas direct costs		[X]			
Gross profit		[X]			
		<i>Electricity %</i>	<i>Gas %</i>	<i>Electricity £m</i>	<i>Gas £m</i>
<b>Revenues</b>					
Standard variable		[X]	[X]	[X]	[X]
Non-standard		[X]	[X]	[X]	[X]
<b>Direct costs</b>					
Standard variable		[X]	[X]	[X]	[X]
Non-standard		[X]	[X]	[X]	[X]
<b>Gross margins</b>					
Standard variable		[X]	[X]		
Non-standard		[X]	[X]		

Source: CMA analysis based on EDF Energy P&L information.

\*Figures rounded.

## RWE

6. In relation to RWE, Table 4 sets out simple average gross margins (by tariff type) from 2011 to 2013.

**Table 4: RWE: average tariff profit margins (FY11 to FY13) £m**

<b>P&amp;L information:</b>		<b>FY11-13</b>			
Domestic electricity revenue		[X]			
Domestic gas revenue		[X]			
Domestic electricity direct costs		[X]			
Domestic gas direct costs		[X]			
Gross profit		[X]			
		<i>Electricity %</i>	<i>Gas %</i>	<i>Electricity £m</i>	<i>Gas £m</i>
<b>Revenues</b>					
Standard variable		[X]	[X]	[X]	[X]
Non-standard		[X]	[X]	[X]	[X]
<b>Direct costs</b>					
Standard variable		[X]	[X]	[X]	[X]
Non-standard		[X]	[X]	[X]	[X]
<b>Gross margins</b>					
Standard variable		[X]	[X]		
Non-standard		[X]	[X]		

Source: CMA analysis based on RWE P&L information.  
\*Figures rounded.

## Scottish Power

7. In relation to Scottish Power, Table 5 sets out simple average gross margins (by tariff type) based on financial years 2011 to 2013.

**Table 5: Scottish Power: average tariff profit margins (FY11 to FY13) £m**

<b>P&amp;L information:</b>		<b>FY11-13</b>			
Domestic electricity revenue		[X]			
Domestic gas revenue		[X]			
Domestic electricity direct costs		[X]			
Domestic gas direct costs		[X]			
Gross profit		[X]			
		<i>Electricity %</i>	<i>Gas %</i>	<i>Electricity £m</i>	<i>Gas £m</i>
<b>Revenues</b>					
Standard variable		[X]	[X]	[X]	[X]
Non-standard		[X]	[X]	[X]	[X]
<b>Direct costs</b>					
Standard variable		[X]	[X]	[X]	[X]
Non-standard		[X]	[X]	[X]	[X]
<b>Gross margins</b>					
Standard variable		[X]	[X]		
Non-standard		[X]	[X]		

Source: CMA analysis based on Scottish Power P&L information.  
\*Figures rounded.