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In the heat of battle

ENERGY PRICE WARS

The latest announcements of price cuts by the major domestic energy suppliers in Britain have been hailed as the opening shots in a price war. This may prove to be an exaggeration, but history tells us that customers switch more in volatile markets. Suppliers tempted to seize this opportunity to grab market share via aggressive customer acquisition strategies should be aware that winning a price war requires a bit of luck and a deep understanding of different customer segments.

In early March, British Gas announced its first major price cuts for almost 7 years. Electricity retail prices fell by 17%, with gas prices down by 11%, both on the back of falling wholesale prices. Some of British Gas's competitors, including npower, Powergen and SSE, were quick to follow. One even claimed it would blow the British Gas offer "out of the water".

This is, at last, some good news for customers, since Energywatch figures indicate that between 2003 and 2006, average household prices increased by 95%

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for gas and 53% for electricity. It is still too early to tell whether the aggressive talk will lead to an all-out price war, but customers are switching (see below) and history suggests they only do so sporadically. Some industry commentators have argued that now is the perfect time for suppliers to push aggressive customer acquisition strategies, the aim being to catch customers when they are most likely to hunt around and then wait for them to fall back into inertia.

The big uncertainties about such a strategy, however, are how low prices will eventually fall, and what the long-run profit position will look like. Winning new customers with aggressive pricing today only pays if you can recoup the cost tomorrow. In other words, customer acquisition is an investment decision, and as with all such decisions that they take, successful investors are those who most carefully consider the future. The key for Britain's domestic energy suppliers is to understand why customers switch, how to retain them in the future, and how rivals will react.

STICKERS AND SWITCHERS

As in many markets, energy customers are often reluctant to switch provider, even in the face of apparently attractive price savings. Customer inertia, uncertainty about the options, a lack of interest in the underlying product, and a perception of questionable sales techniques discourage many people from switching.

These switching costs introduce an important dynamic into the competitive process. To overcome switching resistance, suppliers need to work hard to acquire customers, often by offering big discounts. The only way to earn a return on these customer acquisition costs is by holding on to customers for a long time, and/or by increasing the average profitability of each customer (either by future price rises, or by selling them additional products and services).

In designing a strategy, suppliers also have to be aware that while energy is the same whoever buys it, its customers are not. The most obvious distinction to make is between those customers who have never switched from their incumbent supplier (currently about 45% of the market) and those who have done so at least once. Even within the switching group, behaviour may vary by different types of customer. The cost of an acquisition strategy will depend critically on the kind of customers you are seeking to acquire.

Focusing price cuts on the right customers (and protecting the value of other customers) is critical to maximising the potential returns on investment in your acquisition strategy. Each domestic energy supplier has a different customer base, with different proportions of each type of customers. As if that did not introduce enough complexity, a further critical point to note is that the behaviour of each group of customers tomorrow may not be the same as its behaviour in the past (see our previous bulletin, *The theory of evolution – capturing the benefits of customer lifetime value models,* August 2006).

An increase in the level of switching in a market tends to be driven by events. When the market is quiet, switching levels tend to be low, but when the events pick up, switching levels also rise.

The kind of events that have an impact include changes in government policy (such as market liberalisation), events that trigger concerns about the characteristics of the product (such as its environmental impact) or the reputation of a supplier, or, of course, sharp movements in price. Price events fall into two types – a change in the prices offered by all retailers, or a change in the prices offered by some retailers relative to others.

When the domestic electricity and gas markets were liberalised, customers shopped around in large numbers. By the end of 2001, some two years after electricity market liberalisation, around 40% of customers had switched away from their regional electricity supplier – the former monopolist in the region. Over that period, switching averaged 449,000 customers a month.

From the end of 2001 to the middle of 2005, however, there were few significant events in the electricity market. Prices were stable, both in absolute terms and in terms of the relative offerings of the retailers. Rates of customer switching dropped substantially, falling to below 300,000 in some months.

This pattern was broadly repeated in the residential gas market, and since electricity and gas is sold under dual-fuel deals, the fact that both markets were relatively event-free served to reinforce these patterns.

WAKE-UP CALLS

However, since early 2005, there have been significant price shifts in the market.

- **General industry-wide price movements.** Beginning in early 2005, retailers increased their prices, largely in response to higher wholesale prices. Retail prices rose by an average of 10% in 2005 and a further 27% in 2006 – indeed, in March 2006 alone, British Gas increased its price by 22%. More recently, of course, British Gas was the first to cut its prices.
- **A widening of price differentials between suppliers.** Until late 2005, British Gas's rivals tracked its retail prices fairly closely. However, in October 2005, British Gas opened up a significant price differential relative to its rivals. This was widened further in March 2006. Whilst prices on the whole were rising, customers suddenly had a lot to gain from shopping around. This remains the case as retailers evaluate their best response to British Gas's price reductions.

Switching during this period increased significantly. From March to October 2006, switching averaged 417,000 per month – the highest sustained level of switching since 2002, and more than 11% higher than in the 2002-05 period. The most recent Ofgem data for 2007 confirms that switching remains high. The question for suppliers now is: what degree of switching can be encouraged by aggressive pricing?

Their answers may result in either an industry-wide price war, or a sharp divergence in supplier behaviour. Some suppliers may remain cautious: others may either achieve worthwhile increases in market share or destroy significant amounts of value. Over-aggressive pricing, with unrealistic assumptions about future retention patterns or cross-sale opportunities, can be a recipe for disaster. Domestic energy suppliers, like other retailers, need to have a good idea of the likely returns before taking the gamble.

Experience from similar situations suggests that it is essential to avoid panic reactions to competitor announcements. If there are to be winners from this battle, they will be those with the coolest heads. Five tips might help.

- **Get a good handle on your customer base.** Which customers are the most sensitive to price cuts, and how do the proportions of these customers vary between you and your rivals? How do they vary by geography? What customer segmentation can you do, and where do your vulnerabilities lie?
- **Look at the customer economics.** Even if it is difficult to place accurate values on future retention periods and average customer profitability, it is necessary to take a view before being sucked into increased acquisition costs.
- **Look for alternative proposition designs.** Competing solely on price, even in the price war, is rarely the best strategy. Look for the middle-of-the-road customers (those who might switch but who are not the most price-sensitive) and find out what else they value. Do they want improved service, green tariffs, better information? Think also about propositions that may attract new customers without risking existing sales.
- **Build a retention plan now.** In a period of all-out price cuts, it can be too easy to focus only on acquisition. However, in the end, good retention policies are at least as important.
- **Begin now to map out what the end-game looks like.** What is a reasonable lower level for average prices, how many customers are likely to end up switching, and what might final market shares look like? Scenarios can be constructed and flexed, and a realistic check on the possible end-game will bring structure to short-term decision-making.

In short: re-analyse the market before you start. Relying on the competitive patterns and tactics of the past may not deliver the best strategy for the future.

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