Energy briefing

Energy Retail

MARCH 2008

Staying Power

KEEPING AHEAD OF THE GAME IN ENERGY RETAIL

Energy retailers are facing the most uncertain times since energy markets were fully opened up to competition ten years ago. A number of different forces are combining to squeeze profitability. More than ever, retailers need to look afresh at the markets in which they operate and the way they make decisions, drawing on experience from more mature markets, and thinking beyond the traditional "energy commodity" business model.

Energy retailers are facing the most uncertain times since energy markets were fully opened up to competition ten years ago. There are four key external forces that look set to put pressure on profitability now and in the future.

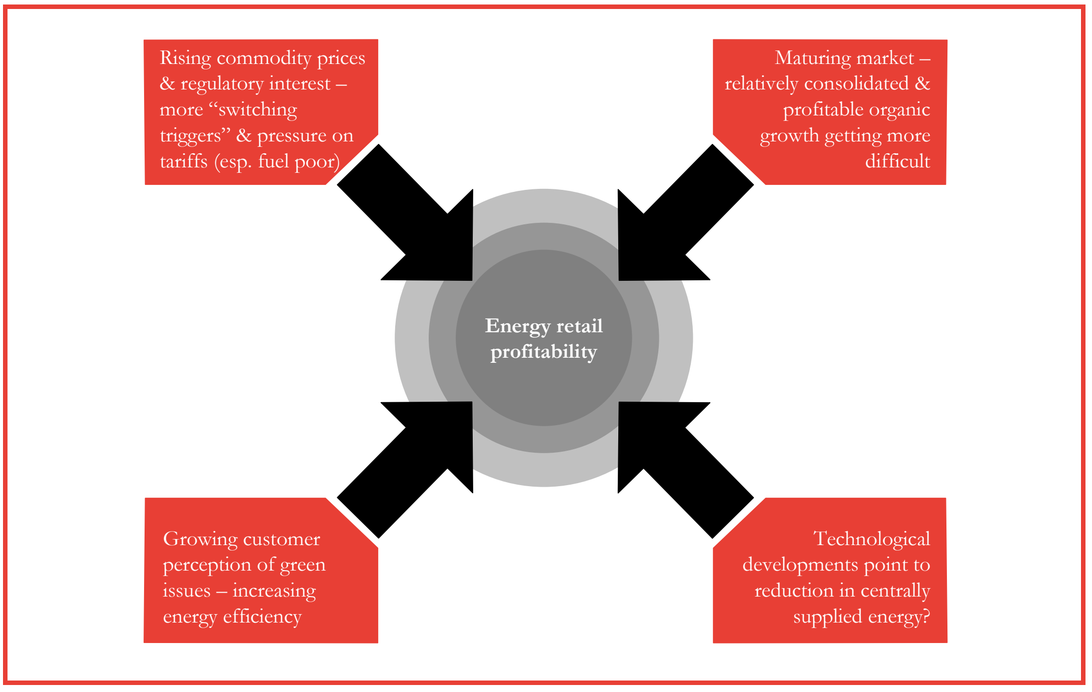

Figure 1: An uncertain outlook for retail profitability

Energy wholesale prices are rising and regulatory pressure is increasing. Energy prices are making up an increasing proportion of household expenditure. The increases in retail prices are triggering customers to search the market for the best offers, making it harder for retailers to retain customers. Last year, annual rates of switching were at the highest levels in four years, with 2.8 million customers switching supplier in the first seven months of 2007. Despite these high switching rates, political and regulatory interest in the market has increased, in part because rising prices have meant an increase in the number of customers falling within the definition of fuel poor.

The market is maturing, limiting growth opportunities. Once a customer has switched away, they are more likely to switch again in the future. This means that unless customers are carefully targeted, there is a high risk that new customers acquired are those most likely to move again in the face of potential savings. Unless acquisition strategies can target specific customer groups, they can be unprofitable in a market with such dynamics.

Customers are becoming more environmentally aware. Consumers are increasingly focused on energy efficiency measures – reducing retail volumes. According to the Co-operative Bank, spend on energy efficient appliances and energy efficiency services stood at £3.7bn in 2006, an increase of 10% on 2005. There is a reasonable probability that future growth in customer numbers will be offset by reductions in consumption per customer.

Technology will change the traditional energy supply model. In the future, it is highly likely that a material part of current customer energy demand is likely to be met locally, being "topped up" by centrally supplied resources. Econnect Consulting, in a report for the DTi in 2006, estimated that installed distributed generation could grow to 15GW by 2030, and recently Centrica have invested £20m (a 10% stake) in Ceres Power for the development of domestic combined heat and power ("CHP"). Smart metering should also provide opportunities for retailers to expand service offerings into energy services and energy management solutions.

All of these factors are placing pressure on the traditional energy retail model. Clearly the importance of each will vary over time. Currently, attention is focused on prices and switching rates, but in five years time it is likely that technological developments and environmental awareness will mean that energy efficiency is a major force for change. Consequently, energy retailers need to rethink their customer acquisition and retention strategies. It is potentially harder to acquire customers that will stay with you for the long haul. And, even if they do, chances are they will be worth less than they have been in the recent past. So, what to do?

VALUING RELATIONSHIPS

In energy retail markets, customer relationships have an important time dimension to them. The business model is based upon generating profits over the lifecycle of a customer relationship. Typically, this relationship has three components:

- customer **acquisition** and related costs;

- profits earned from customers during the **service** of the relationship; and
- customer **retention**.

It is, naturally, common for companies in new and growing markets to concentrate most on customer acquisition and establishing a footprint in their marketplace. In mature sectors, it tends to be more difficult to pursue a pure growth strategy. This is becoming the case in energy retailing: industry consolidation and low inherent market growth means profitable customers are becoming harder to acquire. But, in many cases, customers can still be inert. In some cases, customers may simply prefer to stay with the same supplier because it is costly or inconvenient to switch. In others, they may be indifferent, even in the face of apparent savings.

This customer stickiness changes the economics of competition. It means that suppliers can increase prices after customers have been acquired, without necessarily losing a significant proportion of them. This means higher margins on mature customers. In a market with such dynamics, it becomes worthwhile for suppliers to engage in loss-making customer acquisition strategies on the basis that they will retain the customers until they have consumed enough of the high-margin service to cross the supplier's break even point.

Our work with retailers in mature markets confirms the obvious – understanding this stickiness is clearly critical to planning both growth and retention strategies. But, sometimes, events can disturb the status quo. The emergence of a significant new entrant with a different business model may make it worthwhile for customers to switch provider when they previously did not bother. The same is true of adverse media coverage. This has happened in insurance, credit cards and several other customer relationship businesses. Alternatively, new technologies – such as CHP or smart metering – may open up opportunities for competitors to secure a step change in customer loyalty, and hence justify aggressive acquisition strategies.

If such events increase the level of customer switching or change retention characteristics, they potentially reduce the period over which a supplier can profit from a customer relationship before they leave. A new balance between pricing, customer acquisition and customer retention is called for.

THE PRICE OF LOYALTY

Increasingly, as the relative scale of inert "legacy" customer bases declines, energy retailers will need to focus increasingly on acquiring and retaining customers who are likely to be profitable over the course of their relationship.

This will mean two things.

First, understanding the way in which different strategies interact across each of acquisition, service and retention.

In deciding on the cost it is worth paying to acquire a customer, the supplier needs to understand the period over which that customer will be retained and the profit it will make on that customer in each time period

It is relatively straightforward to estimate the cost of acquisition of different sales channels and the acquisition offer being made. The largest part of the cost of sales channel tends to be a commission payment to the successful sales person (be it the person knocking on the door or the owner of the internet switching site). This is often, therefore, the focus of attention.

However, these costs are only half of the story. Retailers also need to estimate what profits the customer will contribute over its lifetime. If certain acquisition methods attract less loyal customers, then while they may be cheaper in terms of direct costs, they may turn out to be unattractive in customer lifetime terms. For example, an internet switching site may be a cheaper route to acquiring customers – however, it might also be expected to attract the most price sensitive customers. If this is the case then these customers are likely to have the lowest lifetime value – they will not be profitable to serve and will be expensive to retain.

Second, developing an increased focus on retention.

In the early stages of energy competition, a large proportion of the customer base was unaware that they could change energy supplier. It was consequently less important for energy suppliers to focus on schemes that provided incentives for existing customers to remain with them at that time. Such schemes cost money and would be expected to have little impact on customer retention (since most customers would stay anyway).

Now that such a large proportion of customers have already switched at least once, retailers need to consider the factors which will have an impact on retention, and the ways in which they can secure retention of profitable customers. An improvement in average retention rates can have a large impact on profitability. For example, an improvement in customer retention of one percentage point per year for ten years could have a net present value of around £18.50 per customer on an average customer bill of £1,000 per year. If the cost of retention is low, improvements in retention rates can be extremely profitable.

This will impact both on retailers' pricing, and operational, activities:

- Overall pricing is, perhaps, the bluntest retention tool in the box. Attractive retention tariffs applicable to all customers may reduce churn, but will also hit profit. More sophisticated retention tools are seen as standard in more mature markets – these include loyalty discounts, such as second or third year discounts, and contractual lock-ins. However, having such contracts available is not enough. The key is to understand which customer groups are most profitable and, therefore, where such retention efforts should be targeted.

- There should also be operational implications from an increased focus on retention. Poor customer service – a particular risk following changes in operational processes or systems – can be a key driver of churn. Hence, retailers will need to consider the level of certainty required in relation to the effectiveness of new processes before they "go live". If this is done, the financial impact of getting it wrong (and therefore how much it is worth spending to get it right) becomes much clearer.

They key questions for a retailer in a more mature market are summarised in Figure 2.

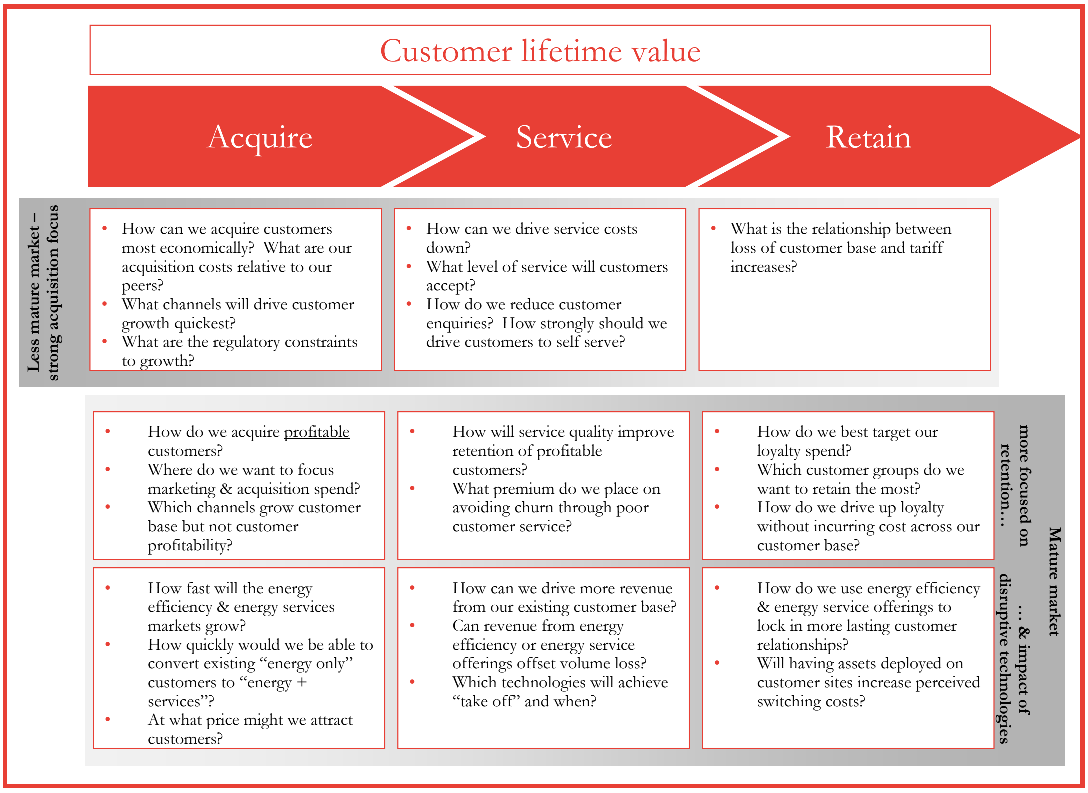

Figure 2: Strategies in a maturing market

Our experience of retailers in sectors with similar customer lifetime value characteristics, including banking, insurance and mobile telephony, amongst others, confirms that the companies that succeed are the ones that:

- best understand the ways that the actions they take impact each of acquisition, service profitability and retention; and
- shape the environment in which they operate and find new ways to exploit their competitive advantage in a shrinking market.

BEYOND ENERGY RETAIL…

Understanding the potential interactions between acquisition, service profitability and retention, although key to re-optimising energy retail businesses, will only be a part of the solution. Retailers will still be faced with the threat that the market itself is likely to shrink overall. Growth opportunities will be harder to come by and may even lie elsewhere. For forward looking retailers, this could present an opportunity to move into a new and growing market.

Retailers have historically been wary of embracing energy efficiency programmes and moving into the energy services and energy management markets. The first has traditionally been seen as a route to reduce volume rather than grow revenue.

Making money out of the second has always been difficult, even in the larger customer market, making retailers cautious of any further moves into the area. Looking forward, though, there may be reason for greater optimism. New technology is presenting a number of opportunities for retailers to broaden the services that they provide to a customer. In the future, this may include:

- provision of smart metering;
- multi-annual energy efficiency based tariffs; or
- rental and ongoing maintenance of distributed generation equipment (solar panels, micro-CHP etc.).

These technology developments are in many ways analogous to those seen in the telecoms sector, where fixed line voice volumes are falling, but new products such a broadband, IPTV and video on demand are being used by phone companies to maintain growth in revenue streams and deepen customer relationships.

As a standalone proposition, even with technology developments, branching out into domestic energy services may continue to look like a difficult option. However, as an integrated part of the energy retail offering, aiming to deepen customer relationships as well as generating revenue in its own right, it may look more attractive. Indeed, it could be seen as a critical source of competitive advantage if it resulted in:

- the addition of a new and growing revenue stream at a time when the core retailing market is in decline;
- increased perception amongst customers of strong green credentials; and
- a material increase in energy retail retention rates.

CONCLUSION

Energy retailers are set to face some of the most uncertain times since energy markets were fully opened up to competition. Retailers with the best understanding of time-dependent markets are most likely to be successful. This means considering the impact of all key decisions on the three drivers of value: acquisition, service profitability and retention. Strategy must be based on achieving a positive overall impact on these drivers, against the backdrop of a structural change in customers' acquisition and retention characteristics and increased regulatory scrutiny.

However, understanding the customer lifecycle is only part of the solution. In order to continue to maximise total customer lifetime value in future, forward looking retailers also need to understand the potential scale and nature of the revenue opportunities new technologies can provide in their own right.

CONTACT	**Sarah Deasley** sarah.deasley@frontier-economics.com
	Dan Roberts dan.roberts@frontier-economics.com
	Simon Trussler simon.trussler@frontier-economics.com
	FRONTIER ECONOMICS EUROPE BRUSSELS | COLOGNE | LONDON | MADRID
	www.frontier-economics.com