OAKLIN INSIGHTS

Riding the energy storm:

How to survive and thrive in a destabilised industry

Oaklin Partner, Barry Hahn, assesses how the wobbling energy industry will fare in 2019 and shares his recommendations for building dynamic, profitable businesses.

Introduction

"*I'm in the middle of a chain reaction*" – a famous line from Diana Ross' 1985 hit song – is an apt chorus for the energy industry right now.

£59 million shortage in Ofgem policy funds

In 2018, eight energy suppliers including Spark Energy and Extra Energy ceased trading. In early 2019, another two suppliers – Economy Energy and Our Power – have already gone bust, leaving 270,000 customers with an unexpected New Year's headache. Ofgem's environmental policy funds, including its Renewables Obligation buy-out fund, are estimated to be £59m short because smaller companies can't afford to pay their liabilities.

Company debt is growing. And Ofgem itself is under more scrutiny than ever due to its liberal distribution of licences in the early 2010s.

All of this means that the stage is set for an extremely volatile 12 months in the energy sector.

At Oaklin, we recognise that 2019 is a critical year for energy suppliers, both young and old. Faced with growing wholesale prices and diminishing margins, most service providers are either too small to be profitable or too big to be agile. The industry is arguably facing its greatest upset since the oil production crises of the 1970s – and there is no sign of immediate relief.

In this insight, we will examine Ofgem's role in the crisis; what this means for consumers; how their behaviours are likely to change; and what the energy industry can do to remedy current trends. We will also provide Oaklin's perspective on what strategies and tactics can be adopted by energy suppliers, not only to buck the trend and survive; but to thrive and be commercially successful during a period of unparalleled uncertainty.

We hope that this insight will help your business to grow, in 2019 and beyond.

8.4 million switched energy provider

Between January and October 2018

32% gains made by small and mid-tier suppliers from the Big Six

The tyranny of choice

At the start of the decade, *The Economist* published an article called "The tyranny of choice" which opened by celebrating the diversity of western supermarkets.

At the time, Tesco stocked 91 different brands of shampoo, 93 varieties of toothpaste and 115 types of household cleaner, presenting customers with an abundance of choices on every single aisle.[1]

The energy industry – like many others – also increased its choice offering, with the number of utility companies growing from 11 in 2008 to more than 70 by 2018. Customers started to move away from the Big Six in droves, with the promise of cheaper prices and better customer service proving unsurprisingly attractive. Switching continues on an upward trajectory with more than one million domestic customers switching in December 2018. In electricity, the number of domestic switchers in the 12 months to October 2018 was 5% higher than in the previous 12 months. In gas, the figure was 11% higher.[2]

Ofgem has always argued that customer choice is fundamentally a good thing. Its website states that the energy market needs "effective competition between suppliers if they are to work in consumers' interests". It claims that competition "is necessary to incentivise suppliers to improve their cost efficiency" and that it should also "push suppliers to improve their prices and services in the fear that if they do not, they will lose customers to their rivals and will struggle to attract new business".[3]

Of course, none of this is untrue – but the strength of the rhetoric, given consumers depend on the energy industry for powering their everyday lives, is striking. While the "credible threat of switching" may pressure "suppliers to innovate and offer better products and services" as Ofgem suggests, it has also promoted cost cutting; encouraged unprofitable customer acquisitions; decreased margins; and created colossal debts among smaller players. This has occurred at a time when wholesale prices are rising quickly as a result of China, the USA and Britain simultaneously flexing their foreign policy muscles; the Organisation of the Petroleum Exporting Countries (OPEC) cutting outputs; and growing political support in several countries for expensive shale gas production. Ofgem's domestic agenda has, in reality, failed to anticipate or account for global political instability, and this is reflected in analyst predictions that "up to ten more suppliers" will collapse in 2019.[4]

1. https://www.economist.com/christmas-specials/2010/12/16/you-choose
2. 3. https://www.ofgem.gov.uk/data-portal/retail-market-indicators
4. https://www.bbc.co.uk/news/business-46838689

The dichotomy of customer choice

Following a decade of choice and exoticism, it's bad news for consumers that so many energy companies are facing significant financial distress.

Why? Well, firstly, it's inconvenient. Although Ofgem will protect consumers in the eventuality of their supplier going bust, sharing personal details with *yet another supplier* isn't high on the public's agenda in a post-GDPR, post-Cambridge Analytica world.

Secondly, it's proving expensive. More than 800,000 customers have been rescued so far, at a cost of £171m to bill-payers. These costs will ultimately be passed onto consumers via a mechanism known as 'Supplier of Last Resort (SOLR)'. While £171m doesn't sound like a huge amount of money, SOLR costs are increasing at the same time as Ofgem's policy funds are decreasing. This means that the public's mandatory "insurance" costs are growing.

£171 million added to customer bills in SOLR costs

Thirdly, the promised 'nirvana of disruption' – better service levels and lower prices – hasn't fully materialised. Before their demise, Spark Energy and Extra Energy, two of the best-known disrupters from the past decade, were rated among the worst three energy companies

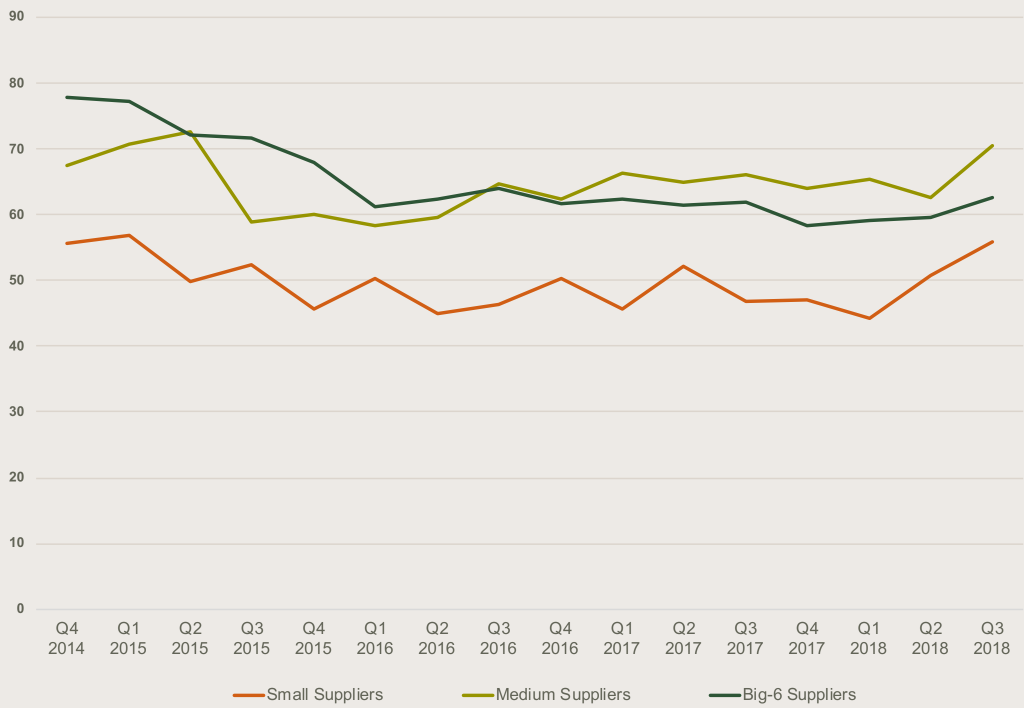

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Figure 1: Average % of complaints resolved by the end of the next working day

in the country by *Which?*. This is reflected in Ofgem complaints data which shows that the small suppliers are least effective at resolving complaints promptly.[5] This situation is only likely to worsen if, as expected, wholesale prices continue to rise and customer service purse strings are tightened.

Despite this turmoil at the more populated end of the marketplace, at the other end, customers continue to walk away from the Big Six in droves with more than 50% of switches to small or medium-sized suppliers.[6] In the past 12 months, SSE has reported annual customer losses of 570,000. Npower has reported annual losses of 500,000. And British Gas lost 370,000 customers in just four months between June and September 2018. Even if the government's price cap inadvertently discourages switching by equalising perceived differences between small and large players, its short-term impact on switching volumes is likely to be minimal – which means further disruption for the big players in 2019.

On this basis, it might be concluded that consumer choice has inadvertently become destabilising and that the energy industry – in its fight for customer volumes – has undermined its own raison d'être: profitability. 2019 is, consequently, a critical time for the industry to reset its dial and look beyond short-term disruptive behaviours. The industry should should "*stop in the name of love*" as Diana Ross so memorably put it, and explore three ideas to refocus its collective strategy.

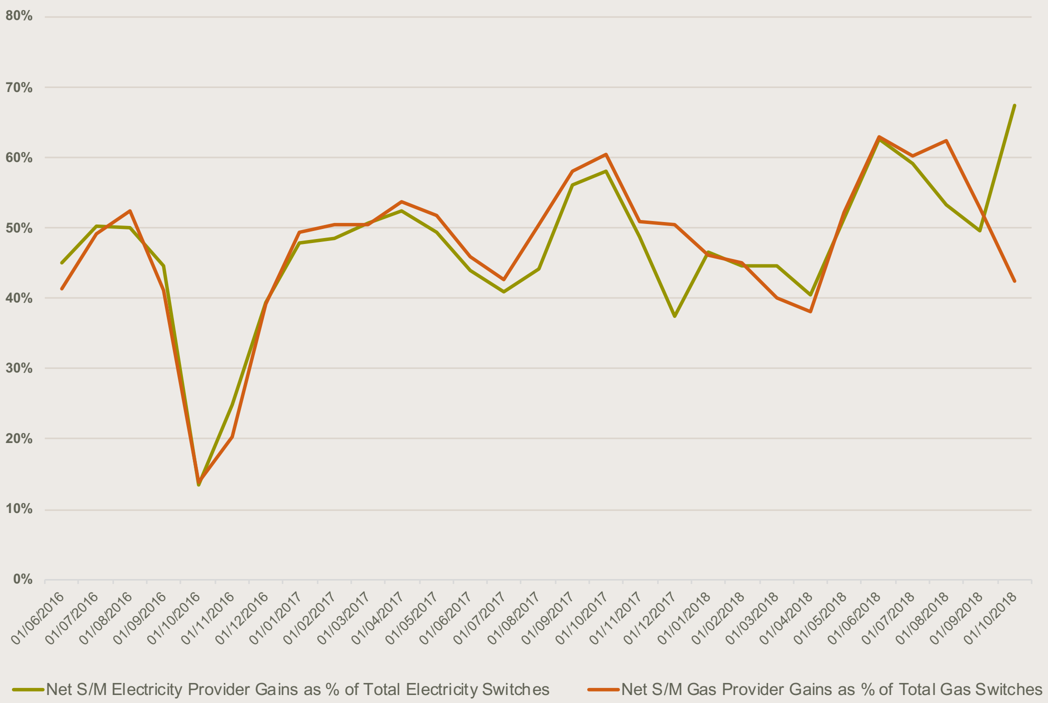

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Figure 2: Net switches to small and medium electricity / gas providers, as a % of total small / medium electricity / gas switches

Building for the future: How the industry should respond

1 The industry needs to focus on the protection of the majority of customers.

Historical focus on regulation naturally encourages suppliers to focus on customers at the fringes but this has created a culture that ignores customer value. It is an expensive, time-consuming strategy. While fundamental obligations cannot and should not be avoided, the industry needs to focus on building better customer experiences for all. This will require an intense and potentially uncomfortable focus on customer journey mapping and continuous improvement – but it will quickly cut the number of complaints, reduce customer churn and subsequently boost profitability. We recommend the appointment of a Head of Customer Experience and a Head of Continuous Improvement to lead this charge.

2 The industry needs to drive genuine efficiencies.

The cost of doing business is rising almost inexorably, partly driven by assertion-based policies such as smart metering. This means all players – large and small – must become leaner and promote self-service to drive efficiencies and materially improve customer experiences. This requires a shift in cultural mindset to focus on operational excellence, as well as a clearer understanding of commercial levers and associated key performance indicators. Parallels with the retail banking industry should not go unnoticed. Like in banking, bigger companies must re-platform onto more agile infrastructure which has already been purposefully built for the energy industry. While this brings its own data migration risks, sticking with mainframe legacy system from the 1990s simply isn't an option if energy suppliers want to drive internal efficiencies.

3 The industry needs to offer truly unique propositions to customers to earn their loyalty and differentiate on value rather than price.

In Germany, Shell PrivatEnergie has leveraged the Shell brand and its motorsport heritage to stake a claim on being better and faster than its competitors. It uses a unique distribution channel to promote its products (service stations) and has created bundled products and services which include gas, electricity and fuel products. New Zealand energy supplier Powershop has also differentiated on service rather than price, presenting itself as a bold, future-thinking company that empowers customers using the strapline "same power, different attitude". This has helped the company to establish itself as a trusted advisor "where [customers] make the rules" – including ending fixed-term contracts, offering guaranteed savings and providing free power in year one, even though the company is ultimately more expensive than some of its competitors.[7] There are a range of similar differentiating tactics that UK-based companies can consider as part of a value-led business strategy including bundled products, connected home products and energy as a service. Without creative thinking and investment along these lines, the industry will likely continue its destructive "race to the bottom" on price.

7. https://www.powershop.co.nz/

How to thrive in 2019

While these industry-wide recommendations are useful, they won't help everybody survive given the range of socio-economic and political pressures facing today's energy suppliers. There will be casualties. So what can energy companies do to ensure that they not only survive but thrive in 2019?

Firstly, they need to actively consider (or develop) a robust merger and acquisition (M&A) strategy in advance of making or receiving approaches. This should align with wider corporate objectives. The creation of a Mergers, Acquisitions and Divestments (MAD) Office or team is highly recommended so that energy suppliers are prepared and able to respond swiftly and effectively to unpredictable competitor behaviour. For sizeable players, there are two primary options: "go big" and hoover-up small- and medium-sized suppliers to become a monolith. This could lead to some hostile takeover propositions which will no doubt attract the regulator's attention; or "go home" and focus on more profitable pursuits

Figure 3: Big Six annual profits versus intra-year average gas / electricity price (day-ahead contracts)

such as electric vehicle infrastructure and digital grid technologies which ultimately offer higher margins. All suppliers are advised to develop coherent diversification and monetisation strategies so that they can effectively pivot in either direction. The Big Six's customer books are *still* valuable assets, offering unrivalled potential for competitors as well as protection from market volatility, as reflected by the consistent profits of British Gas and SSE between 2011 and 2017.[8] We can, therefore, expect one or two attempted divestments in 2019.

Secondly, energy suppliers need to review, rationalise and simplify their product and service offerings, especially in the retail sector where complex calculations and industry jargon alienate customers. This tactic must be adopted to build customer trust. Several industries including telecommunications, retail banking and FMCG have made good progress in this area. Product and service rationalisation will likely coincide with increased political pressure on the Big Six to explain and limit price increases. This will require regulation and compliance teams to work more closely with commercial and product development teams to enable acceptable consolidation.

Finally, given unprecedented market headwinds, we recommend investing in sophisticated modelling and data analytics, underpinned by artificial intelligence (AI) decision-making, to hedge and forward-price wholesale costs more effectively. Conventional wisdom dictated playing “the long game” – locking businesses into favourable fixed prices weeks or months in advance, to insulate consumers against short-term uncertainty and volatility. But in a world where volatility is the norm, this approach is no longer sufficient. This is clearly apparent in the capital markets industry where there has been a notable movement towards algorithmic and high-frequency trading. Energy suppliers also need to develop and execute hedging strategies that are near-time so that they can effectively make short-term profits from market movements across a diverse range of energy sources including wind, solar and tidal. This is essential for the margins of smaller players who would benefit from combining their purchasing power with similarly-sized competitors to achieve economies of scale. While this may sound easy in principle, it will require a range of complex commercial agreements, process changes and legal negotiations which will need be well-planned and seamlessly implemented to succeed.

Surviving the perfect storm

At the end of a decade characterised by growth in service providers, customer choice and ease of switching, the energy industry is facing a perfect storm. The vast majority of service providers are either too small to be profitable or too big to be agile; wholesale prices are rising; margins are dropping; and Ofgem is uncertain about how to stem the tide. That said, every cloud has a silver lining and, thankfully, this storm is no different.

In this insight, we have advocated three changes which we believe will transform the industry: focusing on building better customer experiences which benefit the majority; driving operational excellence by becoming leaner; and offering truly unique propositions to earn customer loyalty and differentiate on value rather than price. Individual businesses also need to review and/or develop robust M&A strategies; to rationalise and simplify their product and service offerings; and to invest in sophisticated modelling and data analytics expertise to hedge and forward-price wholesale costs more effectively. Cumulatively, this is a big ask – but the market opportunity for fast-moving, dynamic businesses is significant.

Get in touch

Please contact Barry, if you would like to discuss the issues raised in this insight, or how Oaklin could deliver lasting change in your business.

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Data accurate as of 11.02.2019.

Amid unparalleled uncertainty, some energy suppliers will flounder; others will excel. For those companies who have anticipated and adequately prepared for the storm, 2019 could be their most exciting and commercially significant yet. **We hope that your business will be one of them.**