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All the ingredients for successful utility retailing can be foun

The European energy market is a true laboratory for learning for the retail industry. With competition progressing at different rates in different countries, and with regulatory regimes, market cultures, demand patterns and other conditions exhibiting significant diversity across the Continent, there are plenty of lessons for those immersed in the science of selling to learn from.

But as far as defining a winning retail strategy goes, there appears to be no single recipe for success. However, the reasons for success and failure are becoming clearer.

First, it is clear that the design of the competitive market structure is crucial to the development of competition. If obstacles such as complex switching processes, low price transparency, discriminatory third-party access and predatory pricing are not removed by the regulator they can heavily impede switching and curtail the efforts of new entrants.

In Germany, where these obstacles were not removed, there are only a few new entrants that have successfully acquired significant numbers of customers. However, if we look at the UK large Industrial and Commercial (I&C) gas market, the opposite is the case: the incumbent, British Gas, lost over 90 per cent of its share within a few years of market opening (but has since recovered to around 30 per cent of market share).

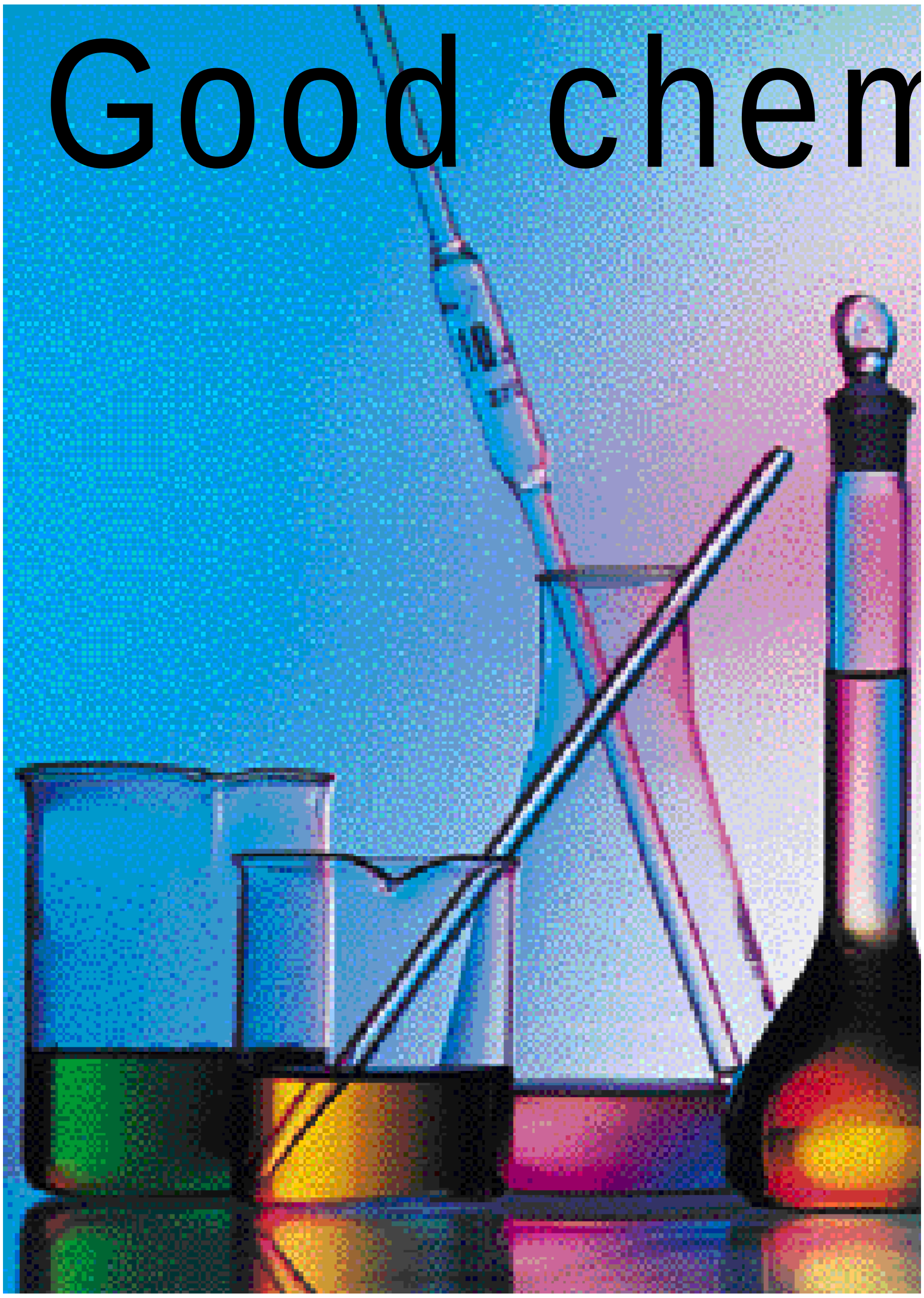
The role of the regulator is also pivotal in establishing effective market supply-side operations (for example, providing transparent transportation price information). Markets with transportation cost transparency such as Norway and the UK show a higher frequency of switching than markets like Germany and Sweden, where costs are not clear.

Second, market demand patterns influence the viability of the multi-utility concept. Single fuel competition is the norm in Sweden, while dual fuel is the norm in the UK. Why? In Sweden all houses have electricity but only a small minority have gas. By virtue of the infrastructure, dual fuel is a severely limited option. In the UK, over 80 per cent of households have access to both gas and electricity.

Since commissions paid for dual fuel contracts are about the same as those paid for single fuel, suppliers can effectively halve customer acquisition costs (per service account) by actively promoting the dual fuel offer. In addition, customer service costs for a dual fuel customer are typically 25 per cent lower per service account than the equivalent single fuel situation.

These cost savings enable dual fuel suppliers to more than double the annual savings they can offer consumers – and still leave them with more attractive margins. Clearly under these circumstances dual fuel becomes the only way to compete successfully.

Third, market cultures influence scope potential. While the UK residential market has switched to dual fuel, the I&C market has not. This behaviour stems from a belief that there would be no significant financial advantage – and indeed perhaps a penalty – from putting all one's eggs in one basket. The perception is that it is better to get the best price possible for gas and then separately get the best price possible for electricity.



Finding the winning formula: there are many reasons why some countries see higher switching levels than o

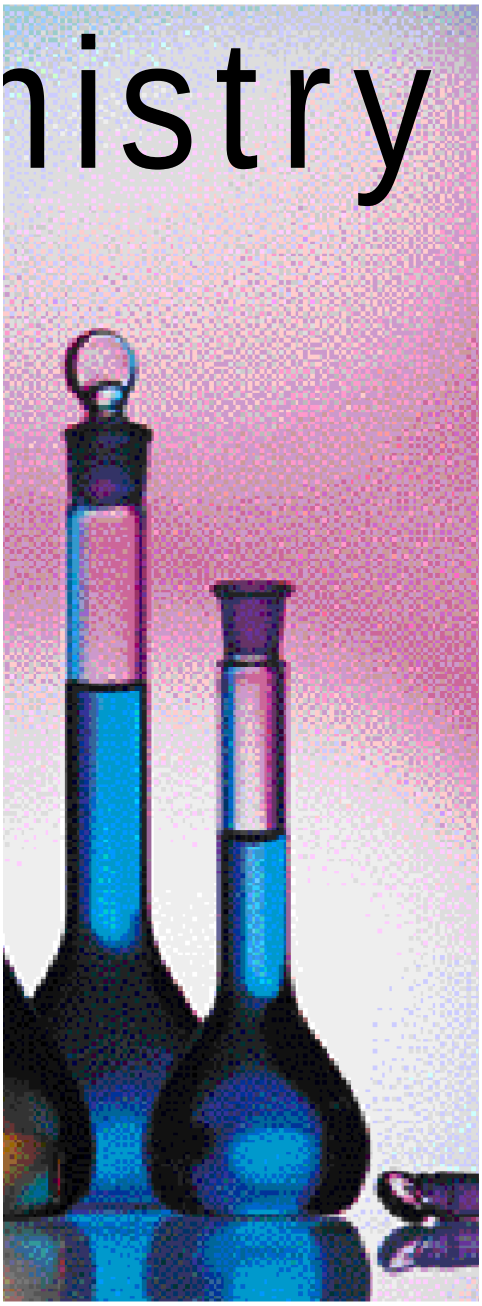
Looking to the future this may change in respect of large (100-plus) multi-site groups which present suppliers with an administrative burden. It is possible that significant dual fuel savings might be attainable which, if passed on to the market, would lead to a shift towards dual fuel contracting.

Scope, however, is broader than just gas and electricity. Home heating services, and boiler installation, maintenance and repair are natural adjuncts to a gas supply (and are seen as essential competencies of a gas supplier by the vast majority of consumers in the UK). However, the list can evolve to include plumbing services, insurance, security systems, financial services and so on.

The global leader in scope creation is Centrica with over 55 products in its global portfolio. Centrica's strategy is clear – maximise the value of the customer relationship. Indeed, the signs are that it is working, with a number of its additional products and services now proving profitable – but whether this will endure is not yet proven.

However, in Sweden the multi-product marketers have all found themselves on the path to ruin with low consumer acceptance, high systems costs and negative margins.

d by drawing from European experiences • By Peter Franklin.



thers, but the structure of the market is always key

Brand management is the key. In Sweden, energy brands will not stretch – and scope is not achievable. In the UK even Centrica (a brand used only for the City and shareholders) has used a multiplicity of brands (British Gas for customers in England, Scottish Gas for customers in Scotland, AA for motoring services through the Automobile Association, Goldfish for financial services and so on) to build its flow of products into its consumer base.

Inattention to supply-side fundamentals can destroy a business. Centrica's sound shareholder value performance has been underpinned financially through the profits made on its upstream gas assets. Centrica has been careful to manage its market exposure through purchase of additional upstream assets in both gas and electricity – aiming to cover around 25 per cent of demand from owned sources.

Lack of attention to customer-side fundamentals can also cause great pain. All customers are not equal. Some will ring the retailer every week, some once in a blue moon; some will pay electronically and on time, some will delay payment till the very last moment; some will consume twice as much energy as others due to the size of the residence they occupy or their life stage and family size. In regulated markets these differences are averaged out and cheap customers used to subsidise expensive ones.

Retailers have been slow to understand and capitalise on these differences. In fact, early new entrants in the UK suffered from a surfeit of high-cost customers as door-to-door sales agencies focused on high density housing to maximise sales per day. With cost to serve (including working capital charges) averaging £20 per service account, which is more than 50 per cent of the gross margin, and with customer service costs varying from £3-£110 per customer per year, a failure to adopt a focused segmented approach can destroy the value of the customer portfolio.

While scale is important, it can be achieved through depth (servicing more utility customers), breadth (providing non-utility products) or innovative business models.

Scale economies abound in both the marketing and infrastructure arenas. In marketing, those with existing customer bases can achieve relative cost competitiveness by using high fixed-cost channels of communication such as TV advertising. Clearly, the cost per customer of a £3 million campaign to a player with ten million customers is but a small fraction of that of a small new entrant with a few hundred thousand customers.

On the infrastructure side, the enormous costs of IT for billing and customer relationship management provide another source of scale economies.

The wisdom in the UK as domestic competition unfolded was that the survivors would have three to four million customers. Now the industry believes numbers in the range of five to seven million are more appropriate (although today we must talk of service accounts (for example, dual fuel counts as two) rather than customers). At the last count, Centrica had over 40 million service accounts, so the threshold looks ready for an upgrade.

Does this mean that the successful retailers of the future will necessarily have burgeoning IT departments, their own arrays of hardware and numerous call centres? Not necessarily, because of the emergence of 'managed service' operations which have come into being to meet the infrastructure needs of the utility retail community – for example, in the UK there are Vertex and Ventura.

Elsewhere, we have seen a Netherlands utility give birth to a managed service offshoot (AnyG, part of Remu) and recently Eon and Cap Gemini Ernst & Young have announced their intention to go down the same route in Germany.

Finally, many companies have reverted to mergers and acquisitions as the means of creating scale. This first happened on national stages and is now moving to the international arena. However, the prices paid in the UK for customers have varied from £38-£380 each, which raises two issues: managing the risk that overpaying for customers will outweigh the scale advantages gained from increasing the overall size of the business; and how to maximise the value of the customer base.

So, the answer to the question 'What is the recipe for success in utility retail?'is that there isn't one. As it turns out, a winning strategy in one place could well be a recipe for disaster in another. The best we can hope for is a recipe which is fit for climate. Comparing and contrasting the diversity of experience in the European Union will help.

Comparing and contrasting the regulatory regimes and their impact on market structures enables suppliers to gauge what the likely 'rules of the game'are going to be in the markets they wish to operate in.

This scrutiny needs to embrace both the regulatory conditions as they apply today and how they might develop in the future.

An interesting case in point is the Netherlands, where recent government policy decisions to prevent water becoming part of the privatisation/liberalisation process has led to industry players unbundling their hitherto multi-utilities into separate energy and water utilities, to avoid the water rules dictating strategic options for the energy parts of the business.

Companies not only need to understand the implications of regulatory choices, but also to take a pro-active stance in trying to influence the choices made.

Comparing and contrasting market demand patterns will help suppliers decide whether the multi-utility concept will work in their geography.

Scope economies will be determined to some extent by demand patterns. For instance, if most consumers buy both gas and electricity the potential for a dual fuel offering is increased, as illustrated previously in the contrast between the UK (residential dual fuel) and Swedish (residential single fuel) experiences.

Additionally, a necessary condition is that the scope broadening should generate a structural cost advantage on the bundler. Thus we saw dual fuel becoming a hallmark of the residential markets in the UK but not in the I&C sector.

Comparing and contrasting market cultures will help define the potential for profitably using product scope to carve out additional customer value. Brand stretch is the issue. To what extent will the local culture accept the stretch?

Comparing and contrasting supply-side fundamentals will highlight the trading and risk management competencies which need to be developed or accessed.

Companies that have entered into long-

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Finding the right mix: Centrica has made a roaring success of multi-product marketing in the UK, but in Sweden similar strategies have failed

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term supply agreements have seen their gross margins cut to ribbons. A well developed trading and risk management competency is an essential skill for ensuring a competitive gross margin is achieved.

Had the Californian utilities enforced stringent risk controls and not signed up to regulatory deals that led to unhedged contracts (where consumer prices were fixed and wholesale purchase prices were allowed to float) the debacle that ensued might have been avoided. The rising consumer prices that would have been the natural consequence of the rising trend in energy demand should have stimulated the necessary investment in new power stations, which could have averted the black-outs.

Whether this would in fact have been the case will never be known. What is clear is that any market that adopts the Californian hybrid between central planning and free market economics at opposite ends of the energy hedge will be courting disaster. With wholesale markets tending towards the fully liberalised model it is difficult to see how any retail price maintenance initiatives can endure over time.

In order to hedge the retailer's position, the key questions are, what markets need to be accessed (primary markets, derivatives and so on)? And what terms can safely be entered into without prejudicing the future profitability of the retailer?

Comparing and contrasting customer-side fundamentals will enable suppliers to identify opportunities for creating value through pro-active segmentation.

Cost to serve varies from £3 to £110 per service account; annual churn from 3 per cent to 40 per cent; acquisition costs from £20 to £190. These differences mean the profit potential of customer segmentation varies greatly from place to place. However, marketers have found it difficult to adjust from the 'averaging' norm of the pre-liberalised markets to the 'segmented' approaches which will characterise true success in free markets.

As more and more companies, and markets, start to fully recognise the value creation potential of segmentation strategies, the higher the imperative to learn and leapfrog historical experience.

Comparing and contrasting the potential options for value creation through scale will enable suppliers to identify success factors for creating sustainable competitive advantage.

Scale economies are a universal truth, but scale needs to be seen in the context of retail functionality. Having a large distribution business does not necessarily give a scale advantage to a retailer. Only if a retailer can get preferential treatment or cost sharing arrangements from the distributor will this be the case. In most cases such actions will be curbed through regulatory intervention or competition law.

Looking at growing the customer base, in many cases it is cheaper to acquire customers organically – but their 'quality'may mean that an acquisition may be more attractive, even at a higher price.

Some acquisitions have created value – others have destroyed it. Decisions to buy should be based on expected churn, expected cost to serve, expected propensity to buy other products and services and expected scale economies.

In summary, accessing the library of knowledge gained across Europe will not guarantee success for utility suppliers – but it will enable them to ask the right questions. ■

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What markets need to be accessed, and under what terms, without prejudicing profitability?