

ENERGY

Careful analysis of energy tariffs reveals that the market is far from perfect, and that means wily marketers can exploit the gaps • Peter Franklin explains

What's the difference?

Every energy retailer knows there are six drivers behind customer profitability: geography (transmission and distribution cost differences), size of household (energy off-take, volume and shape), cost to serve, non-energy product and service income, lifetime (how long the customer stays), and cost to acquire.

The marketer needs to take all of these into account when assessing the lifetime value of a customer. The marketer then sets investments (advertising, sales resource and so on) and tariffs to try and maximise the value of the customer over time. At least that is the theory.

When considering market opportunity, the marketer is always hunting for "imperfections". These imperfections are niches in the market where the marketer can focus his or her forces to generate above average returns. The more imperfect a market, the more chance there will be to grasp opportunities that the competition has failed to spot.

So where is energy retail in terms of offering exploitable imperfections to the wily marketer? It is more than ten years since competition started in the UK's energy markets. Over that period we have seen more than 75 per cent of those households connected to both electricity and gas (representing more than 80 per cent of all households) embrace competition and make a switch of either one or both fuels.

We have also seen the number of suppliers shrink from 23 active players to just 6 majors plus some small specialists. Churn rates have dropped from a high of about 25 per cent five years ago to around 20 per cent today.

Of course, each company's tariffs are an output of the internal marketing machine. But comparisons of competitors' tariffs are both the yardstick by which an individual company's tariff is gauged and also, in aggregate, a means to gain deep insight into the functioning of the marketplace itself.

If the structural cost differences between customer types have simply been arbitrated away by competition (in other words, prices have converged and fully reflect these cost differences), then the opportunity to grab market advantage is not there. On the other hand, if wide divergences exist in the margin available for different segments then the wily marketer has a target to aim at.

Tariffs cannot give us all the answers but we can gain significant insight into the first

three drivers of customer profitability, namely geography, size of household, and cost to serve as indicated by transaction type and payment behaviour.

We appear to have a market that has changed, developed and matured over time. But have we moved into an era where opportunities for creative marketing no longer exist?

If the market is indeed mature, and there-

Geographical targeting is still a major profit opportunity for suppliers

fore lacking in opportunity, we would expect to see cost differences reflected in price differences – and, all other things being equal between suppliers, prices converged between suppliers for given customer types or geographies. The reality could not be more different. In fact, the marketplace shows dramatic differences in profitability by geography and customer type. The energy market is fertile ground for the clever marketer who can identify and exploit opportunities to optimise the customer base through tariff positioning and re-targeting of marketing and sales investment.

Enstra's Retail Information Service analysis clearly shows that opportunities to optimise profitability abound since the market has not yet arbitrated away the structural cost differences associated with different customer groups. So, geographical targeting is still a major profit opportunity.

Chart 1 on the facing page shows annual gross margins (price minus commodity cost minus transmission and distribution costs) for incumbent electricity companies (for instance, London Energy in London or Powergen in East Midlands) plotted against those for the lowest of the big six competitors – British Gas, Npower, ScottishPower, Powergen, Scottish and Southern Energy, and EDF

Energy (UK). Each spot on the chart represents one of the 14 electricity regions.

So, for example, in the region depicted on the far right of the chart the gross margin achieved by the local electricity company is £68 a year, and the margin achieved by the lowest "big six" competitor is -£62 a year. These margins are for a medium-sized household as defined by Energywatch, and the price is that offered to new customers in that region.

The first point to note is that for the lowest competitor all regions deliver gross margins that are highly negative. These margins are based on estimated current wholesale gas (50 pence a therm) and electricity prices (50£/MWh), both of which have risen steeply over the past year and are now at historically record levels.

This has meant that upward movements in published tariffs have lagged increases in commodity prices, putting the industry into a highly negative margin position based on replacement costs of product. This is unsustainable. Either we shall see very large price rises over the next few months or wholesale prices need to drop, which looks unlikely in the short term.

Given that prices must change, now is the time to think about how to change them cleverly to address the anomalies that appear to exist in current tariffs.

In terms of geographical targeting, the regions on the right hand side of the chart should prove the most attractive because these have an incumbent who has hoisted a high price umbrella under which competitors can slide. This is evidenced by the fact that the lowest competitor in these regions earns better margins in these regions (the ones on the right hand side of the chart) than in others (those in the bottom left of the chart).

If we examine the bottom left of the chart further it is interesting to note that while the incumbent electricity supplier's return is roughly the same across all of the regions in this quadrant (-£40 per year), there is a great disparity between the pricing of the lowest competitor in each of the regions, ranging from -£59 to -£101 per year. This implies the intensity of competition is dramatically different across these regions, again offering a market selection opportunity.

The second chart on the facing page shows the scale of gross margin differences being experienced by one of the six majors for its

monthly standard credit dual fuel tariff. Each bar on the chart represents one of the 27 regions (combinations of electricity distribution areas and gas local distribution zones) tracked within the analysis. The length of each bar shows the (negative) gross margin earned at today's wholesale commodity price levels.

Again we can see a very unhealthy picture given the highly negative gross margins. The least bad regions (the shortest bars) are the home areas of the company concerned. However, the spread of margins across the other areas indicates a very immature market offering plenty of opportunity for competitors to play the differential tariffing and targeted marketing game. It also graphically demonstrates the scope for margin optimisation for the supplier in terms of steering the customer base towards the regions of higher returns and changing prices to make poor-performing regions more attractive.

We have analysed similar pictures for all of the suppliers in the marketplace. If you do this you observe that British Gas's gross margin return across the regions lies mainly in a narrow band spanning less than £10. However, if you look at the other majors, their span of margin is much greater – £30 to £40. This would suggest that British Gas is well ahead of the pack in managing the marketing mix to optimise profitability.

If we look at size of household in terms of quantity of energy off-take it is clear the market has not come to terms with the fact that a household is a household is a household. All other things being equal (which in practice they are not), a perfect market should generate the same net margin for supplying household A as household B even if the energy off-take of household B is much greater than that of household A. This is because in principle cost to serve is independent of size of off-take (again all other things such as meter type, payment type and payment behaviour being the same). If we assume that all the other drivers of profitability (lifetime, other product income, and cost to acquire) are the same for households A and B, then competition should lead to prices being set such that the net margin achieved at each household is identical.

This could not be farther from the truth in the marketplace over years that we have been tracking it in detail. While today we have the anomalous position that large households are much more unattractive than small ones since suppliers lose money on each additional unit of energy sold at today's prices, we can see that large differences exist in the relative profitability of different sizes of household. This is itself a market targeting and tariff design opportunity.

If we finally look at net margins (after cost to serve charge) for different payment types and payment behaviours we can again see that significant market targeting opportunities abound.

It may seem obvious, though rarely adopted in practice, that the costs of chasing revenues are fully attributable to late payers. This means that the true costs of late payers are often underestimated as they are averaged into the costs of servicing standard quarterly cheque payers. This has led to monthly direct debit tariff payers becoming over-rewarded by

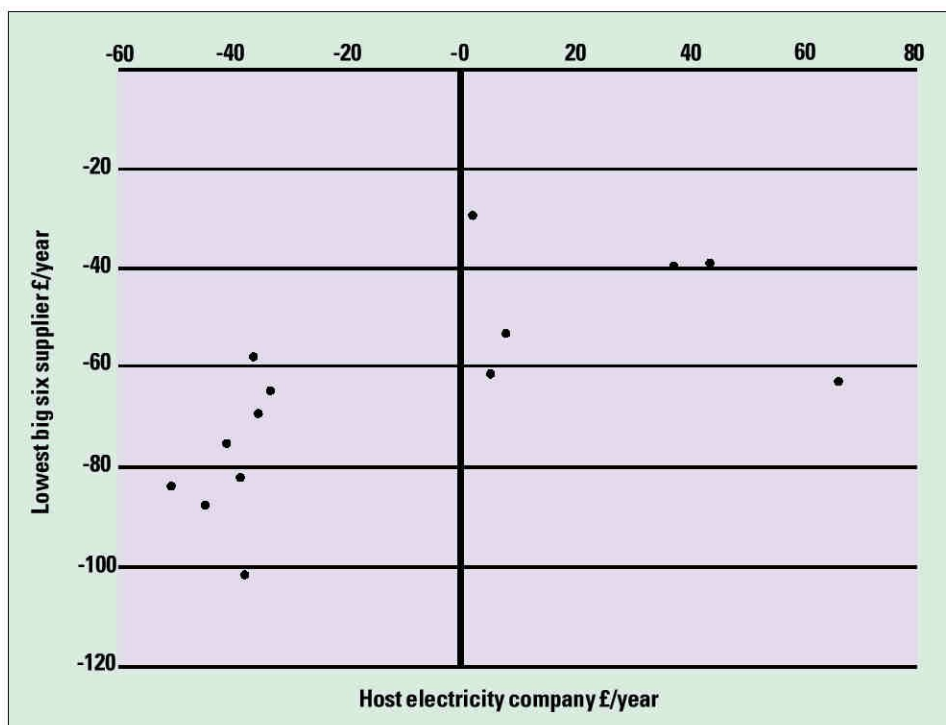


Chart 1: regional gross margins (medium-sized household, monthly direct debit, dual fuel)

the market, while prompt paying standard credit customers are under-rewarded. In a perfect market prices should adjust to make net margins the same for all types. This is clearly not the case today.

So the opportunity for substantial profit improvement is manifest. This review of the market indicates that opportunities for margin optimisation abound. They can come through adjusting tariffs to change relative attractiveness in particular geographical areas or among particular customer groups. They can also come from reallocating marketing and sales resources to higher profit potential targets.

It is a sobering thought that for a major player with five million customers a mere £1 per customer gain in net margin across the

customer base is worth £5 million a year to the retailer, and that in turn, when valued as an annuity, is worth over £75 million in shareholder value.

Given the scale of the market imperfections that characterise the UK energy market, a "profitability driver" focused review of competitive tariff positioning can yield real dividends. Such a review can deliver the insights needed to enable a supplier to meet and exceed that £1 per customer target. That is the challenge for the energy marketer of today.

● Peter Franklin is managing director of EnStra Energy Strategies, a business analysis and market development consultancy focused on the energy sector. Internet: www.enstra.com.

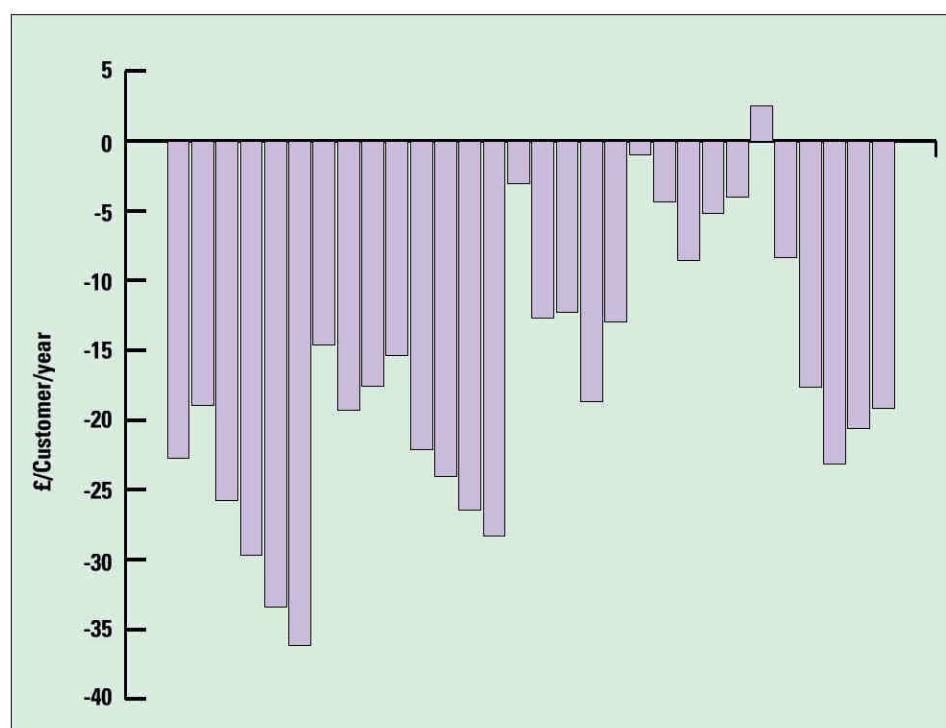


Chart 2: gross margin of a 'big six' supplier by region (med household, standard credit, dual fuel)