Building an energy business in a changing market

By early 1995, the move towards UK energy market liberalisation had been under way in the commercial/industrial market sector for several years. As an era of intense competition dawned, UK energy consumers enjoyed unparalleled price reductions, leading to manufacturing industry obtaining the lowest gas costs in the Western industrialised world. By Peter Franklin, energy, resources and chemicals practice, PA Consulting Group

The new competitors, drawn, in the main, from the ranks of the oil companies and the electricity companies were often to be found in joint-venture arrangements: Shell and Esso in Quadrant Gas; PowerGen and Conoco in Kinetica; BP Statoil and Norsk Hydro in Alliance Gas; and Elf and Compagnie Générale des Eaux (now Vivendi) in AGAS.

In the domestic market, British Gas (then comprising the now demerged Centrica and BG plc businesses) held the franchise monopoly, but competition was due to be introduced the following year, with the whole market becoming competitive, by statute, at the end of 1998. As a consequence, the government had decided on an accelerated programme for the introduction of competition in the domestic market.

Window of opportunity

It was clear that a window of opportunity existed to enter this market. Gas prices at the beach had fallen to well below the levels at which long-term supplies had been contracted for by the incumbent. While there was uncertainty as to the political complexion of the next government, both the ruling and opposition parties supported the liberalisation process – one espousing the virtues of competition – the other the virtues of consumer choice; the likely outcome of either vision – a fully-competitive liberalised market.

An attractive market opportunity was in prospect, but for many companies there were a number of market entry challenges, which had to be faced.

A key question was how to compete with British Gas if it controlled the monopoly transportation system that accounted for 40% of the cost structure.

"Chinese walls"

The regulator had put in place "Chinese walls" to separate the natural transportation monopoly and the marketing organisation, but could these be expected to function effectively under a chairman who controlled both entities?

This was one of the many questions facing potential new entrants to the retail gas market. One new company was Calor Mains Gas, the fledgling mains operation of the leading liquefied petroleum gas (LPG) marketer and distributor, which, since 1994, had built up a modest client base in the small- to medium-size business market. Given the level of complexity, any new entrant would need to identify the determining factors for a successful market entry into the liberalising gas market and to assess how flexibility could be built into an operation to accommodate the extremely broad bandwidth of uncertainty.

Incremental approach

From Calor's perspective, extensive analysis of the potential demand and evolving industry supply structure demonstrated that both short- and long-term success in market entry would depend on an incremental approach to manage the uncertainty of the market take up. This would be based on a combination of three factors. Firstly, a market proposition based on a strong commitment to understand customer perceptions and requirements, and a rigorous testing of the best channel to market.

Secondly, strategic sourcing and the establishment of a virtual company would provide the scale flexibility and access to a range of additional functionalities and skills necessary to manage this extremely uncertain environment.

And, thirdly, the chosen company vehicle of a joint-venture partnership ensured the synergy of complementary competencies and brand identity, together with a reduction in market entry risk.

From the beginning, Calor based its business and market proposition first and foremost on the customer.

The first point was to commission market research to determine how domestic consumers would react to the option of choice, how they would make their energy purchasing decisions, what criteria would be used and who in the family would be involved.

Shortlist

The information suggested that it was likely that consumers would put together a shortlist of three or four suppliers who met their criteria concerning safety, and could guarantee long-term supply of an essential product. Thereafter, the decision would be made on price.

Customer service would not immediately impact on the purchase decision. Since the market had been serviced by a monopoly provider, by definition there was no competitive track record, and given the incumbent's service delivery at the time, there was certainly room for improvement. However, customer service was identified as a potential reason to switch away again – so a focus on customer satisfaction would be paramount to protect the investment in customer acquisition.

Calor's research revealed that

consumers saw it as synonymous with technical capability in managing gas safely, but as an operator on the periphery – supplementary heating as opposed to having the status of an "essential service" provider. If the company was to portray gas supply and transportation competency, it was necessary to add stature to the branding proposition. This could be done through a partner who could provide the other "half" of the equation – the scale and security of supply elements. Calor entered into negotiations with an organisation with a complementary image – Texaco – who could provide the other pieces of the brand jigsaw and, just as importantly, a meeting of minds.

Market research was again used to test out a number of ways of combining the brands to create the optimum consumer proposition.

The joint-venture company, Calortex, was born, underpinned by the parent logos, which the consumer identified as Calor and Texaco coming together to create a new entity in the mains gas market.

The actual logo design also proved interesting. The initial composite looked a little staid, yet when more upbeat versions were tried out, consumers considered the traditional treatment to represent a safe and reliable company – an important criteria in switching choice.

As the market was to be opened in stages, initially by geographical region, marketing investments would be limited, different approaches could be trialled and information gathered for subsequent phases of market opening. Investing in a specific software package that tracked various test-market cells, Calortex used targeted promotions, including direct mail, leaflet distribution, Calor retail outlet promotion, direct TV response and door-to-door sales.

Door-to-door

On 29 April 1996, the first competitive gas flowed and, within a few months, the results of the channel test marketing had become strikingly clear. More than 95% of all contracts were being delivered through door-to-door sales; the route to market had revealed itself.

However, one of Calortex's major competitors failed to control this activity and consumer concern and media interest mounted. For Calortex, the priority was self-evident: it needed to enforce and apply exemplary standards of performance on the field force. After each sale, the company checked the representative had behaved correctly, through a follow-up phone call or letter. This ensured a higher quality service, albeit at higher cost, but the channel had to be protected. In addition, the company lobbied the regulator for improved industry standards comparable with those being championed by the company.

The experience of Calortex is clear: in liberalised markets, perception and branding are central to success. But companies should beware – customer perceived need is dynamic and, as consumer experience develops, decision criteria will change and, in response, so must a company's proposition.

Sales forecasts for the first year by Calortex indicated that between 2,000-15,000 households would switch to the company and come on stream in the southwest of England, the first region to open up to competition, comprising 500,000 households. Within five years, this figure had been predicted to rise to anything from 250,000 to 3 million customers, depending on how many customers switched from the incumbent – and how many of those who switched Calortex could gain.

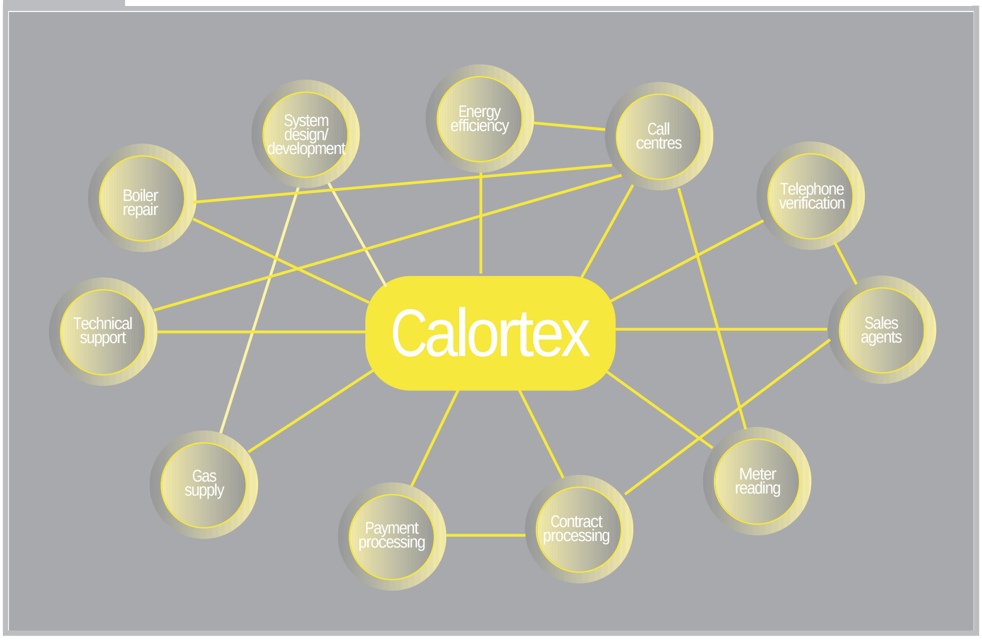
Management's challenge

Given such broad uncertainty, senior management's challenge was to build an infrastructure that could be flexible and cope, and also to ensure that the business was not wrong-sized. Too restricted an infrastructure and the company would not be able to manage the growth, leading to poor customer service, loss of customers and waste of the investment in customer acquisition. Too large an infrastructure, and there was a risk of a fixed cost base which could not justify the business scale, leading to a lack of cost competitiveness and a vicious spiral of decline.

The answer was strategic sourcing – tapping into the scale and infrastructure of organisations whose business it is to provide the type of functionality required for the business. In practical terms, this meant constructing a web of partnerships containing meter reading, call centre, contract administration, field force, energy efficiency advice, technical support and gas acquisition and transportation. By increasing the share of each partner's activity, it would be possible to scale up reasonably smoothly and quickly. For example, going from 10% of the call centre provider's activity to 20% would be much easier than expanding an in-house facility from 100% to 200%.

It was decided to retain in-house

Figure 1 **The networked organisation**



specialist administrative interfaces with the national transportation system, sales and marketing management, corporate affairs (media, regulation and government), an escalation team for dealing with serious complaints, IT, billing and the business partner managers.

By the end of year one, 23% of the 500,000 households had switched from British Gas and, of this total, one in two had switched to Calortex. The company had effectively managed growth four times that envisaged at the top end of the business plan range. This structure, coupled with the focus on channels to market and customer proposition, enabled Calortex to continue to grow. Even as the geographic rollout started across the UK and more competitors entered the fray, Calortex continued to attract 25% of all customers leaving British Gas.

Dual-fuel package

In 1998, the market moved to dual fuel – combined gas and electricity contracts. The company initially found the pressure of building an electricity business, in addition to managing the existing gas business, challenging. Arrangements were put in place to "partner", with a third-party provider, the necessary administration to allow Calortex to offer its own "dual fuel" package. The dual fuel experience demonstrated that strategic sourcing can also bring with it significant economies – the cost of managing dual fuel customers was 60% of the cost of managing separate gas and electricity accounts.

Strategic sourcing for Calortex certainly provided a means of gaining scale flexibility and accessing new competencies as circumstances changed. Experience indicates that virtual organisations will probably grow in popularity as the business model of choice in turbulent environments.

However, in early 1997, stability was definitely not the order of the day. With the demerger of British Gas into Transco and Centrica, Ofgas had ruled that "competition had been established" and that the sleeping lion could awake. Price cuts, highly successful heavyweight advertising campaigns highlighting the 15% price reductions available from the incumbent (for switching payment methods), and leaps forward in improving customer service standards, transformed the attractiveness of the incumbent to the UK public. Consequently, switch rates started to decline and business growth for the new entrants started to slow down. Industry analysts predicted that the BG supply company Centrica looked like holding onto 80% of the market.

Joint ventures unravel

The margin pressure in the commercial sector and the restricted share of the market being wrestled away from the incumbent in the domestic sector, combined with a number of international strategy reviews, triggered a never-ending sequence of corporate restructurings, mergers and acquisitions. In the commercial industrial sector, a number of joint ventures began to unravel. The first casualties appeared on the domestic stage as the London-Total joint venture unwound and Sweb Gas and Midlands Gas were sold to Amerada Hess. By the end of the year the focus had started to shift to the opening of the electricity market and its implications.

Calortex itself had been born as a joint venture of Calor Gas and Texaco. This had worked well as it pulled together complementary competencies to enable competitive advantage to be gained, reduce market risk and limit investment risk, as well as a meeting of minds. However, changes in shareholder aspirations outside the activity of the company can lead to an unravelling of such arrangements.

Twist of fortune

By 1997, following a strategic review, Calor Gas's parent company wanted to reduce its exposure to the mains gas market. By a strange twist of fortune, this was matched by a Netherlands' utility's interest in the liberalisation process in the UK. Negotiations with Nuon, the largest Dutch multi-utility to join as a major shareholder, were concluded, bringing to the venture valuable electricity and large-scale billing and administration competencies.

The utility landscape continues to change as companies merge, demerge and are acquired. The strength of Calortex was inevitably recognised in the market and, in early 1999, National Power acquired Calortex to add a strategically-placed and successful gas supply business to its energy portfolio.

In assessing the rise of the company to its leadership position in the independent sector, there are a number of pointers to success. The joint-venture vehicle certainly provided a pragmatic base for market entry, accessing complementary competencies and brand identities. Creating a customer-focused entity was essential and providing flexibility to manage regulatory, competitive and demand uncertainty through strategic sourcing was critical to cost-effective expansion.

Issues looming

Looking ahead, as more countries start to experience the tide of energy market liberalisation and restructure accordingly, a number of issues are looming. European-scale structuring, monetary union, the growth of the internet, digital television and the convergence of energy and telecommunications utilities are all themes to be woven into the fabric of the industry. The regulatory environment will shape the outcome to a significant extent – incumbents and new entrants alike will need to know how to interact with the framework development process.

Whatever the structural rules appear to be today – they are most likely to be different in 12 months' time. Has Centrica defined the new model, having moved towards its ultimate goal of becoming a home services provider, with mains gas, electricity, and financial services with its Goldfish credit card? Will the traditional utility concept wane, or will a number of alternative industry models co-exist? The jury is out, but one thing is certain, we can look forward to interesting times. □

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