KPMG

2018 – A turning point for UK retail energy?

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Current developments in energy retail

The UK retail energy market is going through a period of major change. We now have a record number of suppliers. SSE and nPower have announced a merger, Shell has announced its acquisition of First Utility and the Government has published legislation to introduce a market wide price cap. We summarise below the key developments in 2017 and the key trends affecting the sector in 2018.

The UK now has a record number of domestic retail suppliers, however there are early signs the market is beginning to consolidate, leading suppliers to evolve their strategy

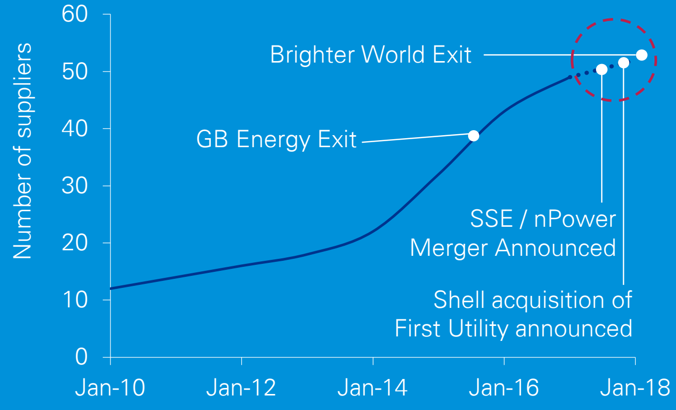
The number of new entrants to the UK retail energy market remained near historic highs in 2017 with 12 new entrants in the year ending June 2017.[1]

A wide range of businesses entered the market including European utilities, international oil companies and grass roots organisations. This diversity has and will continue to drive the conception of new and differentiated business models.

The market has also observed the beginning of what may be wider consolidation as signalled by recent mergers, acquisitions and exits.

Suppliers need to consider how to evolve their strategy in this changing environment and we consider some of the possible strategies on page 5.

Chart 1: Number of dual fuel providers [2 3 6]



Approximately 1 in 5 customers now use an independent supplier and switching data indicates that independents will continue to grow market share

Independents now have approximately a 18% market share compared to only 5% in 2013.[3]

Switching increased by 15% in 2017 with a total of 5.5 million customers changing electricity provider.[4]

Of those who switched, approximately half switched to an independent supplier and overall, independents gained over 1 million customers during the year.[3]

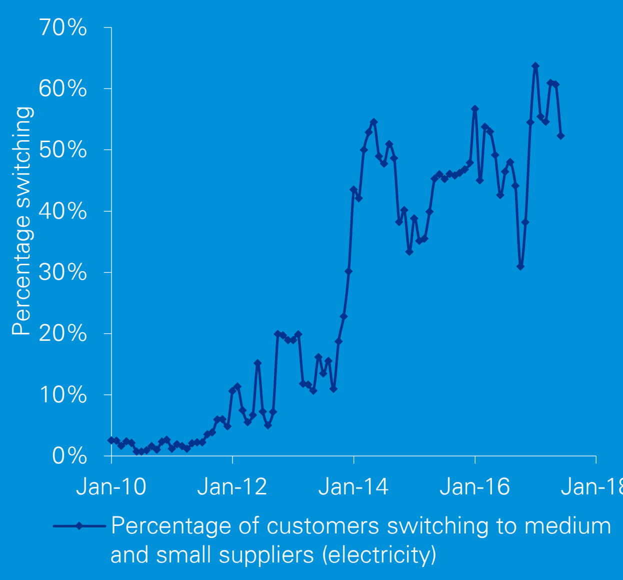
Despite the increase in switching, almost 60% of consumers remain disengaged from the retail energy market[5] and approximately one in four individuals do not know they are on a Standard Variable Tariff (SVT).[7]

There are three primary drivers of customer switching:

1. Lower price
2. Better customer service
3. Differentiated products.

Each driver is considered on the following page.

Chart 2: Percentage of switchers who switch to independent suppliers[3]



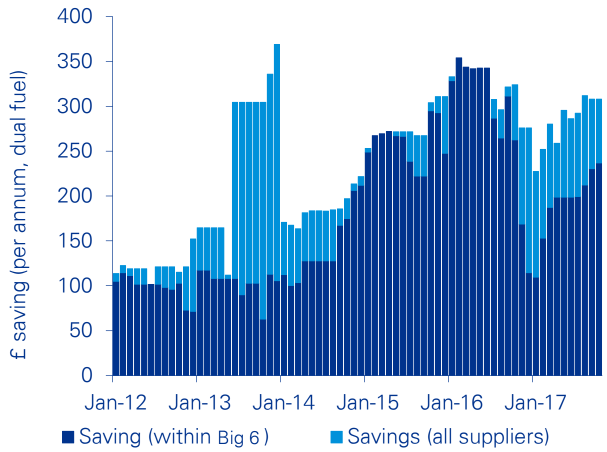
Sources: (1) Ofgem State of the Market 2017; (2) Company Websites; (3) Ofgem Retail market indicators; (4) Energy UK; (5) Ofgem Consumer Engagement in the Energy Market 2017; (6) KPMG Analysis; (7) Bulb Energy Survey;

There are still significant savings from switching

Significant savings are still available from switching between suppliers and to fixed price deals. However the price differential between SVT and fixed tariffs for the Big 6 declined from a peak of ~£350 to ~£200[4] following the Government threat of a market wide price cap.

Some of the cheapest deals on the market may be unsustainable in the long-term, as suppliers look to gain market share with minimal or even negative profit margins. Insufficiently hedged companies may face challenges in a rising wholesale price environment.

Chart 3: Savings available: switching from Big 6 SVT to a fixed price deal[4]

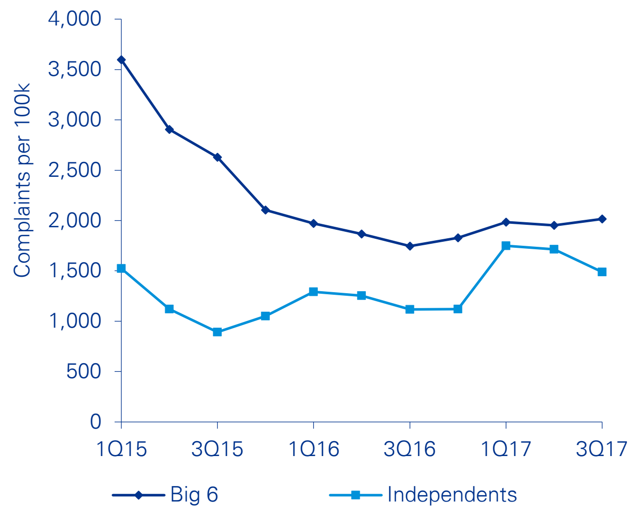


The gap between the customer service performance of the Big 6 and independents has narrowed

The number of complaints received by the Big 6 per customer has declined over the past three years. Conversely, independents have received more complaints per customer as they have grown.

KPMG Nunwood research[2] indicates that utilities remain one of the lowest performing sectors for customer experience excellence (CEE) and that utilities' CEE performance actually declined during 2017. CEE performance can be partially attributed to the impacts of legacy infrastructure that makes it difficult to adapt to modern customer needs. While, new suppliers who are unencumbered by legacy systems have differentiated themselves by offering customers a more digitally enabled service.

Chart 4: Complaints: Big 6 vs Independents[3]

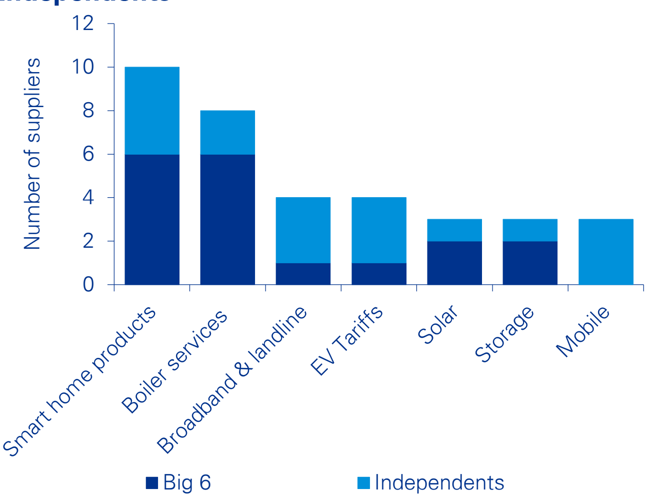


The range of products offered by retailers proliferated

Suppliers are now offering more products than ever before. New technologies allow diversification into products such as smart thermostats, for example Engie who offer a 'control plan' tariff with fixed prices for 3 years and a smart thermostat to assist with managing energy usage.[1]

Further, electric vehicles (EV) provide new opportunities for retailers. Suppliers such as Ovo have partnered with Nissan[1] and brought an EV tariff and vehicle to grid offering to market. Certain suppliers are also combining their retail energy offering with an EV charging network, like Ecotricity.[1]

Chart 5: Range of products offered: Big 6 vs Independents[1(a)]



Source: (1) Company websites; (2) KPMG Nunwood 2017 Customer Experience Excellence Analysis; (3) Ofgem Complaints Data; (4) Ofgem Retail Market Indicators
Note: (a) based on the Big 6 and a sample of 26 independent energy suppliers

Key trends for energy retail in 2018

Energy retailers need to continue to evolve their business models in response to significant political, technological and consumer trends

The Government intends to introduce a market wide price cap to protect consumers rather than relying simply on promoting competition

2017 was the year that both major political parties committed to intervene directly in the energy market to protect consumers.

Various reforms and exemptions have supported the growth of independent suppliers in recent years and the promotion of switching. However, the Government has now committed to introduce an absolute price cap for a wider pool of customers, with the intention to lower bills.

Draft legislation for the cap covering 17 million homes has been through pre-legislative scrutiny in Parliament. This is in addition to the price cap for vulnerable customers which is expected to initially impact approximately 1 million customers who are receiving the Warm Home Discount and is expected to be introduced by Ofgem in February 2018.[3]

As we discussed, in our June 2017 publication, on the energy price cap, one effect of the proposed legislation has been to reduce the price differential between SVTs and fixed rate deals. This is likely to reduce the incentive for switching and may make it more difficult to attract customers through cheap energy prices alone. Many suppliers are already pre-emptively reducing their reliance on Standard Variable Tariffs.[5]

The Labour opposition has outlined its policy for the introduction of a not-for-profit supplier in every region of the UK. Some councils have already established their own energy suppliers such as Bristol Energy and Robin Hood Energy with the objective to make energy more affordable for customers.

Rapid growth in the smart home market is driving sector convergence

Technological change is creating a huge scope for disruption in the energy market. The smart home market is estimated to be worth approximately $10bn[1] per year globally and is expected to grow rapidly, driving sector convergence as businesses compete to stake their territory in this rapidly evolving market. Technology providers with existing routes into the home and with trusted brands may be able to take advantage more effectively than incumbent energy suppliers.

As at Q3 2017, 4.72 million electricity and 3.52 million gas smart meters have been installed by large suppliers.[2] Some retailers now offer smart meter tariffs which offer energy consumption savings to customers in exchange for installing a smart meter in their home. Smart meters have been shown to reduce customer churn and as a result there is an incentive for suppliers to transition their customer base to smart.

The increase in data available to suppliers is enabling improved customer acquisition, service, retention and supply balancing. Forward thinking companies are hiring data scientists and machine learning experts to gain a competitive advantage.

Increasing take up of EV will also change the retail energy market over the coming years as suppliers look to integrate EV charging, storage and demand side response opportunities into their offerings for domestic and business customers.

Source: (1) IOT Analytics –State of the Smart Home Market 2017; (2) BEIS Smart Meters Statistics, Great Britain, quarter 3 2017; (3) Ofgem; (4) KPMG Winning in the Race for the Customer; (5) Company websites; (6) Ofgem Consumer Engagement in the Energy Market 2017

New consumer needs are emerging. However, the real prize is to unlock the UK's disengaged energy consumers

While consumer engagement in the UK energy market remains low, it is slowly increasing. KPMG has defined four consumer personas for the engaged segment of the market in 2018:

— In control: data-driven and is interested in optimising their energy usage (e.g. home energy management adopter).

— Price sensitive: cost-driven and fears an unexpected or high bill.

— Always on: need to be connected at all times without having to think about their power.

— Green conscious: will make purchasing and usage decisions based on a socially conscious set of values.[4]

Suppliers are pursuing different strategies to attract each customer segment with some focusing on price, some on green and some on specialist areas of the market (e.g. prepayment, digital offering).

However, the real prize in retail energy is accessing disengaged customers who currently make up almost 60% of the market.[6] Should a challenger or new entrant unlock these customers, it will fundamentally disrupt large suppliers dominant position.

This challenger may not come from the energy market and players need to be mindful of the wider sector convergence and "power of the customer".

Three example strategies for growth

Suppliers are working to address the challenges of increased competition, regulatory change, technological advances and consumer preferences. Below we summarise three complementary strategies suppliers are using to grow.

Strategy one: Engaging the disengaged

More than half of all customers have never switched, or have only switched once[1]. Expanding the pool of consumers willing to switch enables long-term sustained growth. Attracting these customers requires new approaches from energy retailers, and may help independents increase profit levels, which remain much lower than the Big 6.

Some methods we are seeing include:

— More targeted customer acquisition, focused on identifying and reaching higher value customers using push channels

— Tailored approach to the customer journey using data analytics to segment the customer base and determine the appropriate engagement and retention strategy for each customer segment

— Development of new tariffs that link closely with customer needs such as fully fixed tariffs, 100% renewable, wholesale price tracker tariffs, time of use and demand side response.

Strategy two: Diversify and partner

Meeting the needs of the customer will increasingly require more than simply energy solutions. Energy retailers need to compete with a broader range of companies as sector boundaries blur and the range of consumer choice grows – leading to rising customer power.[4]

The smart home market presents a significant opportunity for energy retailers. However it will require significant diversification from the core and, in some instances, it may be beneficial to deliver diversified products and services through strategic alliances with other providers (e.g. technology companies).

Suppliers are diversifying by:

— Going deeper into the energy market by offering storage, solar, EV tariffs and smart products

— Widening their offer to other services including telecommunications and home services

— Transitioning to 'energy as a service' including the provision of energy advice

Case studies

Doorstep sales

Doorstep selling was effectively banned in 2012 however it is now making a comeback with an added focus on compliance with doorstep sales requirements. At least 10 suppliers[3] are using this acquisition channel

Big 6 ending SVT

A number of the Big 6 energy firms have announced they are ending the use of SVT and will increase efforts to engage with customers. For example British Gas will move all customers on to a fixed rate deal from 31 March 2018[2]

Pure Planet – 100% green tracker tariff

Pure Planet introduced the first tracker tariff to the market which aligns the tariff rate to the wholesale energy price with no added margin. Instead, the supplier charges a £10 monthly fee.[2]

Engie – transitioning to energy services

Engie entered the market organically in 2017. It told media it intends that 50% of its business will be services revenue by 2020. It is also promising to move customers to its cheapest deal when their fixed price deal comes to an end[2]

Utility Warehouse – product bundles

Utility warehouse offers product bundles comprising a range of products including home phone, broadband, mobile phone, home insurance and energy[2]

E.ON solar and storage partnership

E.ON provides home solar and storage solutions to customers in partnership with approved and qualified installers.[2]

Source: (1) Ofgem; (2) Company websites; (3) Moneysavingexpert.com

Strategy three: Acquisition

Acquiring an energy supplier to enter the market or to grow an existing business is attracting interest due to:

1. Gaining a customer book - Unlike organic growth, some of this book will already be loyal customers and may offer a different customer segment or the opportunity to cross sell.
2. Operations - Gaining an accomplished customer services and regulatory programme delivery, with accompanying data analytics.
3. IT platform - IT capable of scaling and expanding into different products and services and interfacing directly with customer application. Strong process automation is also a key desire for acquirers to maintain a lower cost to serve.

We expect to see further M&A activity in 2018.

If you would like to discuss the issues highlighted in this report further, please get in touch.

Key contact details are listed on the following page.

Shell acquisition of First Utility

Shell announced its acquisition of First Utility, one of the largest independent suppliers with around 825,000 customers

Proposed merger of SSE and nPower

SSE and nPower have announced their intention to merge subject to regulatory approvals. The merger would create the second largest retailer by customer base in the UK

Vattenfall acquisition of iSupply

Vattenfall acquired iSupply, a Bournemouth based domestic supplier with under 250,000 customers. This builds on their existing European energy supply businesses.

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