



Customer lifetime value in retail energy markets

The essential metric to drive future success in transitioning energy markets

Redefining customer series

Energy retailers' traditional value models are under threat. As price competition intensifies in many markets, churn rates rise and margins fall. The energy transition brings in a range of exciting opportunities, but also new competitors from technology, finance, automotive and telecoms - all keen for a share of the customer base. To avoid a race to the bottom, companies should rethink their acquisition and retention strategies, target setting and operational processes. This means focusing on customers who bring high lifetime value, through greater loyalty and a willingness to purchase additional products and services. However, embracing the customer lifetime value concept is a major shift, calling for cultural acceptance along with new data intelligence capabilities.

Global Strategy Group

KPMG International

Bud van der Schrier

KPMG in the Netherlands

Jonathan White

KPMG in the US

Shuji Miyasaka

KPMG in Japan

Ben Twartz

KPMG in the UK

An energy market in flux

Across the globe, technological, political and regulatory developments are changing the way energy retailers create value.

Liberalization has significantly increased competition in many markets as new players – largely commodity-based – have stolen share from incumbents. In the US, for example, there are now more than 1,000 suppliers. Most of these new entrants use aggressive marketing tactics largely based upon price, pushing down margins and raising churn rates.

As electricity and gas margins fall, energy retailers¹ are also broadening their product offerings into new services designed to capture evolving value pools, like smart home solutions, energy efficiency services, solar products and electric vehicle (EV) charging stations. Many larger new entrants – from the technology, finance, automotive and telecommunications sectors – are seeking a slice of this wider, energy-related market. These companies are dangerous competitors; not only are they competent at pushing technology-related solutions, but they also have a very different risk appetite, enabling them to outbid incumbents.

As a consequence of these developments, traditional sources of value have become less reliable.

By simply playing a volume game, energy companies risk having large numbers of low-value customers, who sign up to the lowest prices and switch to better offers at short notice, all of which can erode margins.

We believe applying customer lifetime value (CLTV) is the key to success in the new energy landscape. Adopting a CLTV approach means carefully targeting consumer segments or pushing solutions that result in a higher lifetime value, avoiding a price war for fickle, disloyal customers who frequently switch suppliers. CLTV is a quantitative and holistic approach incorporating all products and solutions that customers purchase over the course of their relationship with an energy company, forming the basis for strategic decision-making as well as day-to-day management. It is not just a finance and commercial metric; but one that should also be used across the organization for target setting and operational activities.



About this paper

This study is based on in-depth interviews with 22 executives from Marketing and Finance functions of energy retailers in competitive markets spanning three continents. Complementing the research with insights from KPMG's Energy network and our Power & Utilities operating model knowledge, we present examples of where energy retailers are effectively using CLTV, and highlight how this vital approach can increase their long-term value by making tough decisions in the transitioning energy landscape.

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The concept of CLTV

CLTV measures the (expected) value of a customer

CLTV is the financial value of a customer based on the present value of her/his projected future cash flows, not just the current year's contribution margin. Although there are many, increasingly sophisticated ways to calculate CLTV, its base formula (where variables remain constant over time) is:

$$\text{CLTV} = \frac{(\text{Revenue} - \text{Costs}) \times \text{Retention}}{1 + \text{Discount rate} - \text{Retention}}$$



Revenue:

For energy retailers, includes forecast future revenue from electricity, gas and other new services.



Retention:

Calculated as 1 minus the (expected future) yearly churn rate. Estimated churn rates factor in the number of products consumed, the acquisition channel, churn rates of customers with similar characteristics and current length of contract.



Costs:

Mainly include forecast cost of goods sold, cost-to-serve and cost-to-retain. Cost-to-acquire is usually included for acquisition strategies (e.g. in a channel strategy) but is often excluded for existing customers, as these are historic, sunk costs. Ideally, costs are calculated at an individual customer level, although it can be a challenge for energy retailers to make such data available.



Discount rate (weighted average cost of capital):

Takes into account the time value of money and typically varies between 7-10 percent² for incumbents in competitive energy markets, depending on the specific market and the company size.



CLTV Maturity

Based on our research and experience working with energy retailers across the globe, we have identified different levels of CLTV maturity. These depend on two factors:

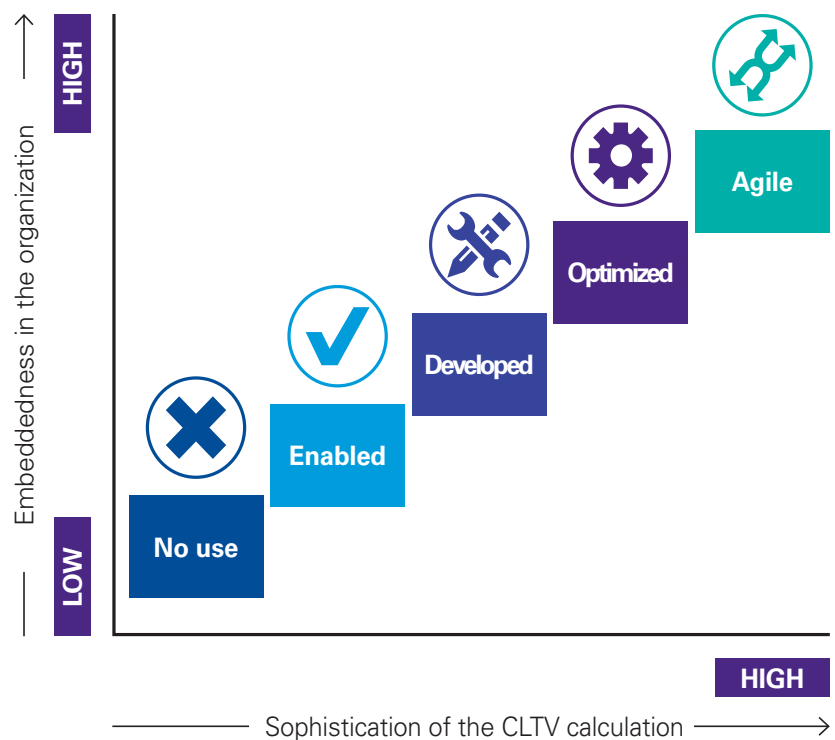
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The sophistication of the CLTV calculation;

2

The degree to which the CLTV approach is embedded within the organization's behavior.

CLTV maturity levels



CLTV maturity	Sophistication of the CLTV calculation	How embedded is CLTV within the organization
 No use	<ul style="list-style-type: none"> CLTV is not calculated at all. Company relies on other metrics, such as number of contracts and total margins. 	<ul style="list-style-type: none"> CLTV is not used at all. The company does use several components of CLTV, but mostly in isolation.
 Enabled	<ul style="list-style-type: none"> CLTV is calculated ad hoc using a limited number of inputs and on a customer segment level. Calculations are usually on a spreadsheet. 	<ul style="list-style-type: none"> CLTV is used for a limited number of purposes, mostly commercial strategy. It is not a standard KPI, but used on an ad hoc basis.
 Developed	<ul style="list-style-type: none"> CLTV is calculated using an increased number of parameters and updated regularly. Calculations are usually performed using analytics tooling. 	<ul style="list-style-type: none"> CLTV is used for key strategies such as product development, acquisition and retention. CLTV is used as one of the main metrics for steering the company.
 Optimized	<ul style="list-style-type: none"> Real-time calculation of CLTV at an individual customer level. Both internal and external data is used to calculate CLTV. 	<ul style="list-style-type: none"> CLTV is widely known and understood across the organization and used for strategy and target setting, but also for operational purposes.
 Agile	<ul style="list-style-type: none"> Artificial intelligence (AI) is used to increase the accuracy of CLTV calculations. A tailored model continuously updates CLTV calculations and evaluates which inputs produce the best CLTV estimates. 	<ul style="list-style-type: none"> AI-based systems make decisions based on optimizing CLTV. Commercial strategies and operational actions are based on CLTV insights. CLTV is linked to executive metrics and incentives.

CLTV usage globally

CLTV use is limited amongst energy retailers, especially in the less competitive markets.

The limited adoption of CLTV around the world suggests there are ample opportunities to create value through improved customer targeting. As competition grows, the need for CLTV becomes more urgent to acquire and retain loyal customers. In those markets that are already competitive, players should seek greater maturity in their use of CLTV to gain an edge.

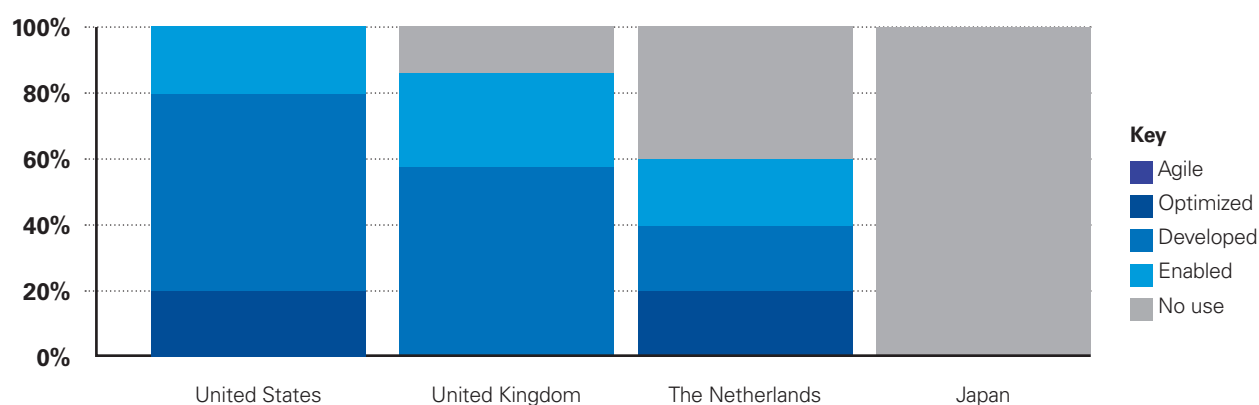
In fiercely competitive markets like the US and the UK, which both have a high number of players and high churn rates³, energy contracts are often loss-making in Year 1, due to low prices and/or 'welcome' offers to attract customers. Profitability is dependent upon customer longevity and subsequent cross-selling of additional services. In such a climate, a relatively high share of companies have adopted CLTV in a bid to target prospects with a higher propensity to be loyal and buy multiple services; however, there is still room for far greater usage.

The Dutch energy market is not as competitive as the US and the UK, with fewer players and lower churn rates. A significant proportion of Dutch customers are still on old contracts with relatively high margins and low churn rates.

Arguably, the need to adopt CLTV is slightly less urgent in the Netherlands, although this will change as competition heats up.

In the least competitive market studied, Japan, we did not find any companies that use CLTV. Prior to energy liberalization in 2017, Japanese energy retailers were able to create value without a lifetime view of the customer, thanks to modest churn rates and favorable margins. However, churn increased drastically to approximately 13 percent in 2018, while margins have started to fall. All of which suggests the time is ripe for Japanese energy retailers to embrace CLTV.

CLTV usage by country



How CLTV can improve competitiveness

CLTV should be embedded firmly in the energy retailer's organization.

Amongst the energy retail executives we spoke with, the most common use of CLTV was for acquisition and retention strategies. In order to make the most of this important resource, it should be used both on a strategic/tactical level, as well as an operational level. The five key uses for CLTV identified are:



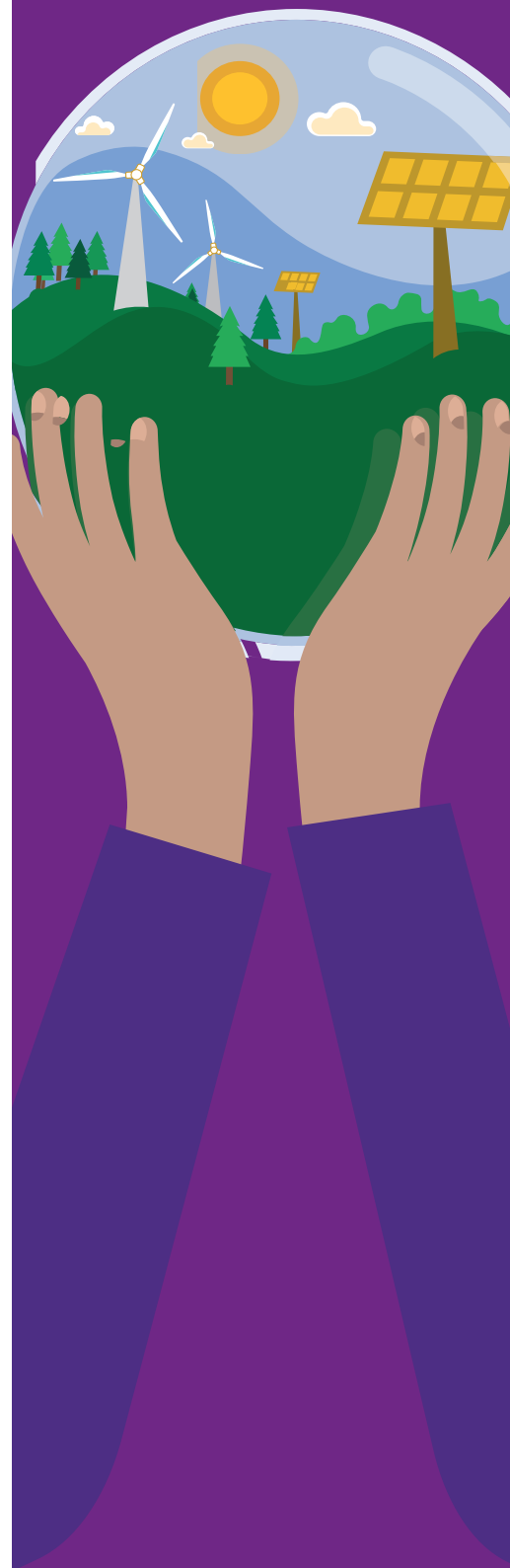
1. Product development:

Although CLTV is still mainly used for acquisition and retention strategies, it should also play a key role in answering product proposition related questions, such as: "Should we invest in home battery storage?"; "Should we offer EV-charging solutions to our customers?" and "How do we price our new energy products?"



2. Customer acquisition strategy:

CLTV can help determine which segments to target and which acquisition channels to use. As a result of CLTV insights, some energy retailers have decided not to participate in price comparison websites, due to low margins, high churn and limited cross-selling potential. Companies can also use CLTV to calculate the maximum acceptable acquisition cost per customer, in order to remain profitable.





3. Customer retention strategy:

Churn is largely driven by incidents like price rises, house moves or contracts ending. With knowledge of such events, in combination with other predictive analyses, it's possible to identify those customers most likely to attrite. CLTV can then be used to target at-risk high value customers with tailored retention offers. According to Harvard Business Review, retaining an existing customer is up to 25 times less expensive than acquiring a new one.⁴



4. Target setting:

The more progressive energy retailers have integrated CLTV into their organizations and set acquisition and retention targets based on the aggregated value of customers (as opposed to electricity and gas volumes or number of customers).



5. Operational set-up:

When CLTV is calculated on an individual customer basis, it can also be used for operational purposes – such as credit management and customer service choices. Credit management can, for example, give high-value customers better payment terms. The Customer Service department, meanwhile, could provide a higher level of service to the most valuable customers, to reward them for their loyalty and aid retention.



Case study: Spreading the word

Faced with ever fiercer competition from an increasing number of challengers, an energy retailer had managed to stabilize churn, but at the expense of revenue, with margins in particular sliding downwards. In response, the company's analytics team started to embrace CLTV and, crucially educated other teams within the organization including Marketing, Product Development and Customer Operations. By spreading the word and explaining in detail the potentially stellar benefits of CLTV, they began a shift in thinking throughout the company. Consequently, the Marketing team started focusing less on pure volume, and more on acquiring high-value customers; while the Customer Operations team could concentrate on retaining customers that they knew could make a positive contribution to value. The transformation across the organization has been rapid and impressive, with business units now basing their targets on (aggregate) CLTV, and CLTV always considered when making key strategic decisions. Leaders are now firmly convinced that effective use of CLTV helps them outperform the competition in terms of shareholder value.

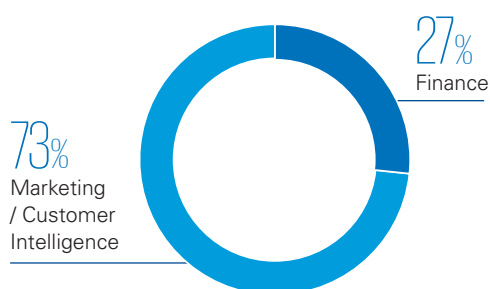
Building confidence in lifetime value

The way in which CLTV is calculated differs widely across energy retailers.

A number of factors can impact the reliability of the predictions, namely the team responsible for calculation, the variety of data sources, and the use of specific software and AI.

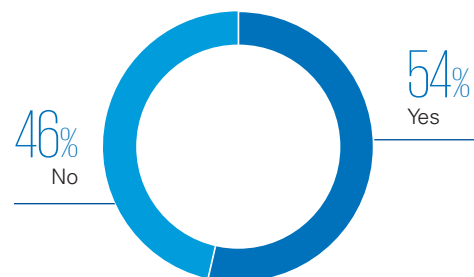
The executives we surveyed say their Customer/Marketing Intelligence teams are most frequently involved in CLTV, primarily for preparing and evaluating acquisition and retention strategies. In many instances, these functions possess superior analytics capabilities and deeper customer insights than their Finance counterparts. However, with this approach, organizations may miss out on valuable insights, by failing to integrate the CLTV calculation into underlying management accounts and finance systems. As a result, some retailers are moving towards cross-functional responsibility across the Marketing/Customer Intelligence and Finance teams.

Which team is responsible for calculating CLTV?



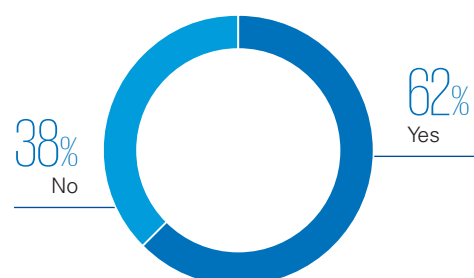
Over half of the respondents use specific data and analytics software tools to calculate CLTV. These applications can generate sophisticated CLTV calculations for individual customers/prospects that are updated in real time. Companies that invest in tools are likely to gain an edge, as they can refine their targeting to direct scarce marketing resources at the most valuable prospects and customers. As energy markets become more competitive, such capabilities can mean the difference between winning and losing.

Do you use specific tools to calculate CLTV?



When calculating lifetime value, the most common forms of data used are margin, churn and discount rate, as well as operational data like customer service costs and payment details, which can be used to calculate the cost-to-serve of customers. Accuracy can be further improved by increasing the variety of data used, including external sources, such as credit risk, demographics and customer feedback (e.g. through social media). A majority of respondents (62 percent) also use external data to enhance their analytics.

Do you use external data sources?



AI can further enhance CLTV capabilities. Firstly, it enables continuous learning based on past insights, to increase the reliability of the calculations. AI can also help recommend strategic and tactical decisions, based on patterns in large customer datasets allied with results of previous actions. One US energy retailer taking part in our research uses AI to automatically suggest next steps for call center agents, using insights based on CLTV and other customer data.

The most important metric in energy markets

In our discussions with energy retailers around the world, we found that those companies embracing CLTV have quickly acknowledged this metric as essential to their decision-making.

CLTV helps organizations to focus on developing high-value customers to increase the value of their customer base. Furthermore, CLTV is relatively easy for employees at all levels to understand, which means they can embed it faster. And, because lifetime value takes into account the main value drivers, it ensures that companies take a longer-term perspective.

“We have had great results with CLTV. We used to focus too much on customers with little value, who had very high cost-to-serve or high churn rates. Now we’re far more concerned with lifetime value.”

Strategy Manager
Large Dutch energy retailer

Energy markets are set to become more competitive, with an increasing focus on selling services like smart home solutions, solar products and EV charging. To address such challenges, energy retailers will have to carefully consider the CLTV implications of the solutions – and the impact they have on shareholder value. As they seek to increase customers’ lifetime value, we believe CLTV will be the key metric in this battle, ahead of financial, operations and traditional customer metrics.

“We don’t make product decisions without understanding the CLTV impact of those potential products.”

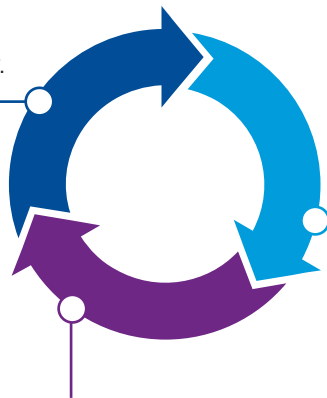
Head of Strategy
US energy retailer

How to effectively use CLTV

With fairly rich datasets, energy retailers are in a good position to implement CLTV.

KPMG has extensive experience helping retail energy companies implement or enhance their CLTV capabilities. We have found it to be a powerful metric for addressing challenging and changing competitive environments, and our work includes:

Defining the relevant parameters of CLTV and making high-quality data available to inform strategy.



Increasing the reliability of the lifetime value calculation, by using an increased number of data sources, analytics capabilities and AI.

Embedding CLTV across the organization, raising awareness and understanding of the concept, raising its profile in commercial and operational decision-making, and increasing its usage in reporting and target-setting.



Sourcing & notes

1. Suppliers of electricity and gas to B2C and B2B customers
2. KPMG analysis based on energy companies in Western Europe
3. Market regulators, KPMG Analysis
4. The value of keeping the right customers, Harvard Business Review, 29 October 2014. <https://hbr.org/2014/10/the-value-of-keeping-the-right-customers>

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Authors

Bud van der Schrier

Partner

Global Strategy Group

KPMG in the Netherlands

T: +31 206 564 671

E: vanderschrier.bud@kpmg.nl

Jonathan White

Managing Director

Global Strategy Group

KPMG in the US

T: +1 415 635 5149

E: jdwhite@kpmg.com

Shuji Miyasaka

Partner

ENR Practice

KPMG in Japan

T: +81 3 3548 5111

E: shuji.miyasaka@jp.kpmg.com

Daan Hofman

Manager

Global Strategy Group

KPMG in the Netherlands

T: +31 206 567 173

E: hofman.daan@kpmg.nl

Ben Twartz

Associate Director

Global Strategy Group

KPMG in the UK

T: +44 207 694 4576

E: ben.twartz@kpmg.co.uk



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