GB Energy Supply ceases trading—a commentary by Cornwall

On Saturday 26 November the retail energy market suffered its first forced exit in over eight years. Ofgem issued a statement confirming it was acting to "secure energy supplies for GB Energy Supply customers". At the same time the company's website announced "with regret … that GB Energy Supply is no longer trading and therefore you will be unable to access our website at this time".

The company's failure presents the most significant commercial challenge to the retail energy market since the exit of TXU Energi in 2002, and is the first exit since the failure of both Bizzenergy and E4B in the non-domestic market in 2008.

There had been a lot of speculation since wholesale prices started rising in the spring that many smaller suppliers were about to find out the risks in their businesses dominated by access to affordable wholesale energy. Several commentators have speculated that at least some of the recent entrants might be either be pushed out of the market or forced to consolidate.

GB Energy Supply's approach

With its low cost outsourced business model, GB Energy Supply was the forerunner of the second wave of new entry into the domestic energy markets. Entering the market in early 2015 with a cheap, variable tariff that—assuming it did not change its rates—would have a similar cost to the most competitive fixed price annual deals. Its cheap variable tariff was an industry first.

Unlike the large suppliers, as a new entrant it did not have legacy customers to cede margin to, so could price its offering sharply enough to attract customers through the main price comparison websites (PCWs). It also retained the flexibility to reprice these contracts on 30 days' notice if market conditions changed.

GB Energy Supply's other industry first was sustained use of the whole of market obligation on PCWs to drive customer acquisition. If they want Ofgem accreditation, the PCWs must now display all tariffs regardless of whether they are earning commission on the deals. GB Energy Supply was amongst the most vocal of a group of recent entrants objecting to the CMA's recommendation that the obligation be removed, meaning payment would need to be made for PCW listing.

Rapid growth

GB Energy Supply's most sustained growth occurred in summer 2015 and early in the following winter (see Figure 1). The company launched its first one-year fixed tariff in mid-November 2015. In the six months to January 2016, our market share survey recorded the company moving rapidly from 35,000 to 225,000 domestic energy accounts. Its first year growth is the second-fastest on our records; only Extra Energy beats it.

As winter turned to spring 2016, the company continued to cut the prices of both its fixed and variable tariffs. By June, the GB Energy Supply variable tariff was 20% below the level it had been when the company entered the market at just under £800 (based on Ofgem's medium dual fuel user), and its fixed tariff discounted this level by a further 4%.

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Change of strategy

The summer's disconnection between the competitive retail market—where consumer prices were falling—and the traded market—where wholesale prices were rising—set alarm bells ringing for many.

Come August the company announced a 7% increase in its standard variable tariff. It followed this up with a 30% increase announced in mid-October to a level within 5% of large supplier rates. By the time the 30 days' notice had passed, the latest rates will have been in force for a couple of weeks.

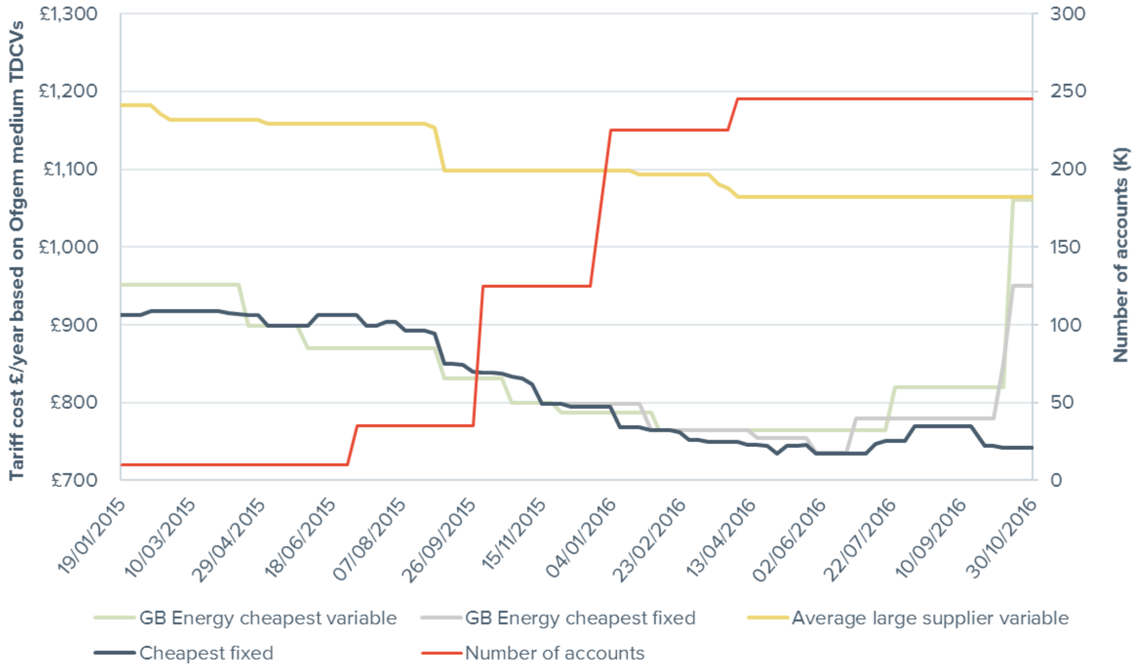
If the company was looking for cash to get a good start to the winter, it was having to compete with plenty of other suppliers to do so. For example, when it launched that last sub £800/year fixed deal in late June, it struggled to make the top 10 with one new supplier, Iresa Energy, undercutting it by nearly £50/year. Ahead of it were other recent entrants Affect Energy, So Energy and Places for People Energy but also more established competitors such as Sainsbury's Energy (the British Gas white label), Flow Energy, Extra Energy and Co-operative Energy. Perhaps because they were not hedging, many suppliers were able to follow the market down.

The fact that all these suppliers were pitching prices lower than GB Energy Supply underlines how highly competitive the PCW-driven switching market is. It also underlines the variety of business models that are being employed by new suppliers, but also suggests that the model of switching for switching's sake is high risk.

The events of the weekend

The first that the world knew of GB Energy Supply's demise was in Ofgem's statement. Perhaps surprisingly there had been no prior alert on the industry BMreports.com portal of a credit default notice under the BSC.

Figure 1: GB Energy Supply domestic energy customer growth and cost of cheapest dual fuel tariffs



Source: Cornwall domestic energy market share surveys and calculations of tariffs

As Rachel Fletcher, Ofgem's Senior Partner for Consumers and Competition, commented, "in any competitive market companies will fail". But Ofgem stated it "has existing procedures in place to ensure that their customers can have confidence that their energy supply will continue, and that domestic customer's outstanding credit balances are protected". It would see that the customers were transferred to a new supplier, adding that customers should "take a meter reading today and wait until their new supplier contacts them and tells them what to do about any credit balances they might have". Ofgem added that "customers should ask to be put on the cheapest deal [with the new supplier] or shop around for a cheaper supplier".

Ofgem's points emphasise the main commercial parameters of the supplier of last resort regime (SoLR). Energy flow to customers continues, the question is at what price and by whom.

The most significant supplier failure of the liberalised era was not a new entrant but an incumbent, when TXU Energi left the market in October 2002. Its 5.5mn customer contracts were acquired by E.ON UK. The remaining business went into administration. In that instance, and the subsequent failures of several small suppliers in winter 2005-06, the domestic customer prices were honoured by the new supplier. Other creditors were left to secure what they could from the administrator.

This time there is a new variable in the equation. GB Energy Supply sought direct debit payments in advance of delivery of the energy rather than the industry convention of collection in arrears. This shift in timing is very important as it brings the cash into the business in advance of delivery and reduces the credit requirements of the company. It is a model adopted by several recent new entrants.

The references to credit by Ofgem presumably recognise this factor as well as the historic tendency for consumers on fixed direct debits to build up credit balances during the summer that erode during the higher consumption winter months. Indeed over the summer Ofgem modified its SoLR regime to address the issue of credit balances. The process will now specifically account for any measures offered by a potential SoLR to address the loss of consumer credit balances. Ofgem also acted to ensure any costs from applying the supplier of last resort mechanism could be socialised across the remaining consumers.

Liquidity issues

A statement on the company's website from managing director Luke Watson attributed GB Energy Supply's exit to "swift and significant increases in energy prices over recent months and, as a small supplier our inability to forward buy energy to allow us to access the best possible wholesale prices, means that the position of the business has become untenable".

The data (see Figure 2) suggests that it is not that GB Energy Supply was not trading or trading badly, but that it could not access the products to manage their risk effectively in a world of more volatile imbalance prices following significant changes introduced in November 2015 (the so-called P305 changes). Their average absolute imbalance percentage was relatively low, at below 5% for the last two months. There do seem to have been a few days where no power was bought, but its overall charges work out at about an additional 15p-30p per customer per day on a typical annual tariff.

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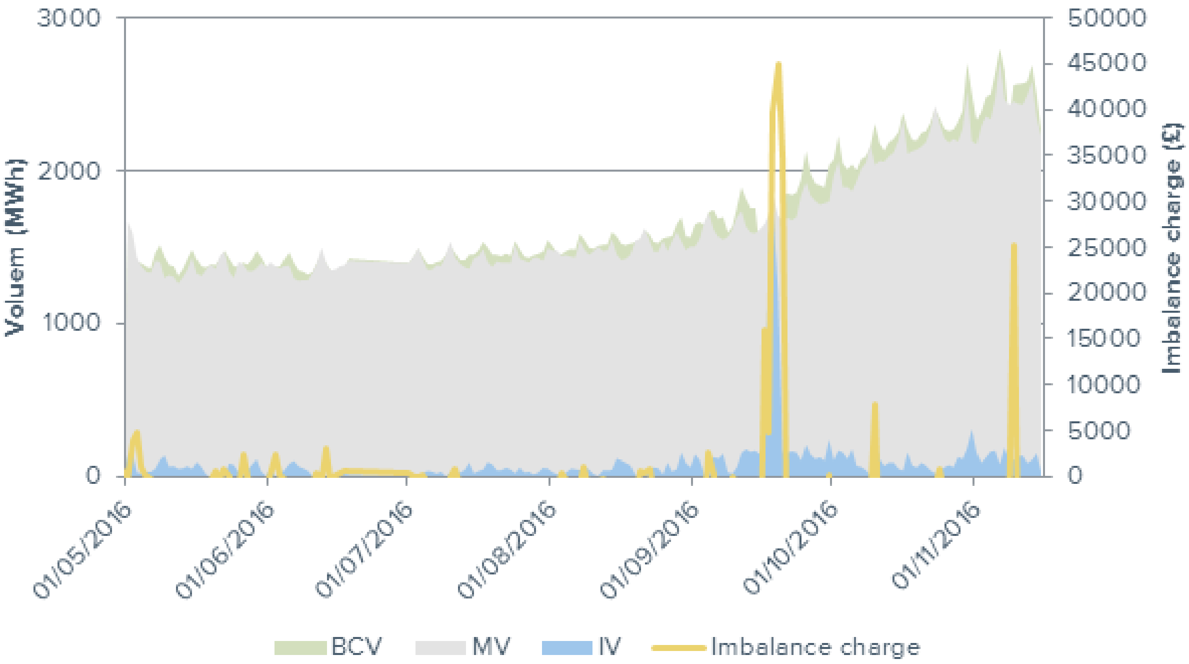
Figure 2: GB Energy Supply daily electricity volume and imbalances



Key: BCV = contracted volume, MV = metered volume, IV = imbalance volume. Cornwall analysis of settlement data sourced via Market Vuepoint

The best proxy hedge against volume risk on a domestic profile a supplier can manage is with "secure and promote" (S&P) products (baseload and peak), which were specifically introduced by Ofgem in 2014 to provide liquidity to new entrant suppliers often buying in small quantities. But it cannot protect against price risk over block five and six as there is very little liquidity in these products. These periods are also when within day and imbalance prices have been increasing significantly.

Structurally we should ask whether the S&P is working as it was designed to. Ofgem needs to ask if small suppliers can access short-term hedging products (a structural problem) or can they not afford to pay the prices that these products are quoted at (a commercial problem)? In addition we should be asking if the changes under P305, which has sharpened energy imbalance prices, have been exacerbating these effects on smaller suppliers. These events also raise important questions about the move to PAR 1, which will further sharpen imbalance process, in November 2018.

With hindsight the company's late summer change of strategy, with its two variable price increases can be seen as too little, too late. The weekend's news will naturally turn attention to similar suppliers with low prices and "pay as you play" business models, where suppliers buy ready-to-go companies that effectively rent industry and CRM systems from service providers.

This area of genuine innovation has lowered the barriers to entry in energy supply considerably and most recent entrants have used it in one way or another. But it now faces its first major challenge in circumstances where robust risk management processes are not layered on top. The most critical of these remains a prudent trading strategy and access to product.

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Our opinion

From the outside it looks like GB Energy Supply has been undone by rising and increasingly volatile electricity prices, combined with inadequacies in its hedging strategy. Such prices are a new and increasing feature of the energy market since the P305 price changes, but they are not unexpected: they were an intended, if not universally popular consequence of the change.

Our assessment suggests that the company was able to hedge to at least some extent but even then days of significant cash outflow occurred in each of the last three months. The steep rises in the Elexon credit assessment price (CAP) to north of £90/MWh probably also did not help the company's working capital.

The company will also have been on the hook for significant cash payments to its service providers. Its business model was to keep the core as lean as possible, with only around 20 direct employees, and outsource.

GB Energy Supply continued to play in the competitive switching market for fixed products almost until the end, maintaining a price below £800/year until early last month. However, such was the competitiveness of the PCW switching market at that time, that even with a price at this level, its customer acquisition was slowing.

Now wholesale conditions have changed, and recent entrants adopting an "off-the-shelf" model have to respond. Nearly a decade since the last wholesale price spike, it may be some of them do not understand the nature of the commercial risks they are taking as well as they might.

Whatever one's reading, it is clear that in the market there are good suppliers and less good suppliers, with different commercial models, and it is no longer just a case of large legacy suppliers versus the rest. But well-resourced players with strong balance sheets will always enjoy advantages in a rising market. Now with their wholesale deals, several larger small and medium suppliers are able to utilise the major companies such as Shell, BP and Macquarie, but several new entrants still do not have such deals.

Lessons need to be learned

The widespread fears that a supplier failure would happen have been realised and will no doubt boost speculation that more are on the way. From a regulatory and policy perspective, it will be important to learn from each individual exit or consolidation. The market infrastructure is still immature—the S&P regime is still bedding in but requires scrutiny. Significant credit barriers, which we have been flagging for several years, remain.

The CMA and Ofgem programmes are not addressing these underlying problems and both S&P and credit arrangements require urgent review. We need to be much more sensitive about distortions to competition in the traditional "dumb" market before we get carried away about smart transformation.

We would further question assumptions made by some stakeholders about supply business risks. In an interview with *The Telegraph* in July, the chair of the CMA's energy market investigation Roger Witcomb pressed his view that profit margins in energy supply should be much lower by arguing: "All [suppliers] are actually doing––and I shall get into trouble for this––is metering and billing. They are not actually making the stuff." No they are not, but the cashflow requirements that result in delivery can be exceptional, and a robust trading and hedging strategy is at the heart of a sustainable supply business.

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We also need to avoid making sweeping judgements about the robustness of independent supplier models. Going into a cold winter against a background of rising wholesale prices means there is still much more to learn.

If you would like to discuss this analysis further, please contact Robert Buckley on 01603 604404 or r.buckley@cornwall-insight.com.

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