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CORNWALL INSIGHT
CREATING CLARITY

Insight Paper

Consolidation in the domestic energy market

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Emma Bill, Kate Hill and Dan Atzori

About the authors

Emma Bill

Lead Research Analyst

+44 (0)1603 542127

e.bill@cornwall-insight.com

Kate Hill

Lead Research Analyst

+44 (0)1603 542136

k.hill@cornwall-insight.com

Dan Atzori

Research Partner

+44 (0)1603 604400

d.atzori@cornwall-insight.com

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About Shoosmiths

Shoosmiths LLP is a major UK law firm, well respected in the field of mid-market M&A, currently ranked 3rd in the UK Legal Adviser league tables by Experian MarketIQ based on deal volume (2021 H1). The corporate team advises UK and international organisations on achieving their strategic goals and prides itself on delivering highly complex, high-profile transactions for clients. Clients include entrepreneurs and high net worth individuals; fast-growth companies and SMEs through to FTSE 250 businesses as well as financial advisers and institutional sponsors. This range gives an unrivalled 360-degree view on the M&A market both from a buy-side and a sell-side perspective.

With more than 210 partners and 1355 lawyers and business support employees operating from a network of 13 locations in all UK jurisdictions, clients are offered strength and depth in all the core disciplines, together with key specialisms and deep sector expertise. Infrastructure & Energy is a focus sector for the firm with a strong team of dedicated advisers ideally placed to support clients on projects in these fields. In particular the team has extensive experience of advising developers, funders and other stakeholders on a wide range of renewable and clean energy projects, including solar PV, onshore wind, waste-to-energy, biomass, biofuel and hydro projects.

Clients say Shoosmiths get the “people bit” right, never take a client for granted, and invest in the relationships which are at the heart of great service. Shoosmiths was named National Firm of the Year at The Lawyer Awards 2019.

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- Stephen Littlechild, Associate at the Cambridge Judge Business School
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- Clementine Cowton, Director of External Affairs at Octopus Energy
- Richard Hughes, Director of Sales and Marketing at EDF
- Robert Buckley, Head of Relationship Development at Cornwall Insight
- Josh Montgomery, Director of Risk at Together Energy

Foreword

Not many companies have experienced such a large change to the way they operate as those that supply gas and electricity in the UK. From regional monopolies and state-owned infrastructure to a full blown 'open to all' market in a couple of decades. That pace of change has been most marked in the last five or six years with an explosion of new entrants, an erosion of the market share of the Big Six (and even a change as to who make up the Big Six!) and innovation around product offering and customer service.

Inevitably there have been winners and losers and the market is now in a period of consolidation - either willingly or via the Supplier of Last Resort mechanism as new entrants struggle to cope in a market where price is so important to consumers and margins are getting thinner and thinner. The pace of technological change and an increasingly electrified world will also have a bearing on who emerges as successful businesses in this market. When I buy an electric car will it come with so many miles worth of power from a supplier as part of the deal? Will the same bundling happen when I buy a washing machine or a TV? Who knows, but one thing is for sure, when we look back in five years' time this market will be unrecognisable from the one it is now.

Having been involved in several deals in the energy supply market (both solvent acquisitions/disposals and insolvent situations using the Supplier of Last Resort mechanism)) it is clear that the consolidation continues apace. As a result of this we were keen to work with Cornwall Insight to explore more closely the dynamics at play and better understand what is driving change and the M&A activity we have been seeing.

If you have any questions regarding the findings in this report or if you would like to speak to someone from Shoosmiths we would be delighted to hear from you.

Tim Jackson-Smith

Partner at Shoosmiths

03700 865 774

tim.jackson-smith@shoosmiths.co.uk

Throughout his career Tim has operated at the highest level in a number of organisations and has a wide range of corporate/ commercial legal experience acting on a number of high-profile transactions in both the public and private markets. He has nearly 30 years' experience as a corporate lawyer and held senior management (CEO and Chairman) and NED roles in several listed companies – Bglobal plc, MBL Group plc and Source BioScience plc - for over seven years. The experiences he has had outside of private practice have given him a distinctive skill set that sets him apart from his peer group and his advice and guidance is borne of first-hand experience of having to actually make and live with the consequences of commercial decisions. Since joining Shoosmiths Tim has been involved in several high-profile transactions including the sale of Xtrac Transmissions to Inflexion, the sale of Sandcastle Care to Waterland, the sale of No. 1 Spinningfields to a large investment fund and the acquisition of Avant Homes by Berkeley DeVeer. Tim has acted on a number of transactions in the energy supply, solar, wind and waste to power sectors.

Executive summary

The domestic energy supply market has gone through a period of intense competition over the last five years. Lower barriers to entry saw a rise in licensed competitors to a peak of 62 in 2018, diversifying propositions, service and added value options for consumers. Today, that number has fallen to under 50 fully licensed suppliers as the market has moved into a phase of consolidation. Challenging market conditions have seen exits through acquisition or using Ofgem's safety net, the Supplier of Last Resort (SoLR) mechanism, which has ultimately led to a supplier licensing review.

Key findings of this research include:

- Suppliers are required to diversify their revenue streams to gain sufficient margins to reinvest in their business. Those that fail to go beyond selling energy will not be sustainable in the long-term.
    - International growth and expansion into other markets is common among today's leading suppliers.
    - Those able to access and invest in the technologies to streamline their business will be the ones who remain.
    - As the retention of customers becomes critical to a business' survival, creating a reason for customers to engage beyond energy supply will be key.
- The role of prosumers in a future energy system is considered to become increasingly important as the heat and transport sectors are electrified.
    - Some interviewees consider self-generation at the household level as niche, with its growth subject to the development of larger scale renewable plant and community energy.
    - Regulation can limit a supplier's ability to provide a niche offering.
- Further market exits are expected, through both Ofgem's SoLR mechanism and mergers and acquisitions.
    - These could include suppliers exiting with larger numbers of customers than we have seen to date.
    - However, over the next few years as market entrants are few and far between, we may see less competition and a corresponding impact on energy prices and switching rates.

Expect consolidation to continue, but that's probably not nearly as big a story as the major shift in business models that is underpinning this trend.

Companies that serve energy consumers, that move beyond the commodity/price paradigm, genuinely engage consumers on a broader platform of service in areas that really integrate with their lives, genuinely commit to the net zero transition through innovation, and have scalable platforms that drive business efficiency at scale, will be well placed to succeed as we move into this world. This though requires upfront risk capital to be put to work, and patience from those that invest in it before returns follow.

By consequence there will be fewer players that win through, with earlier adopters/movers acting as magnets for the finite number of investors with the right risk reward appetite. This is a dramatic shift from relatively frictionless and cheap "price and volume" market entry models we saw from the middle of the last decade, with the correction in the market now seeing these companies most vulnerable to failure. There is a changing of the guard occurring.

1. Chapter 1: The evolution of the GB retail market

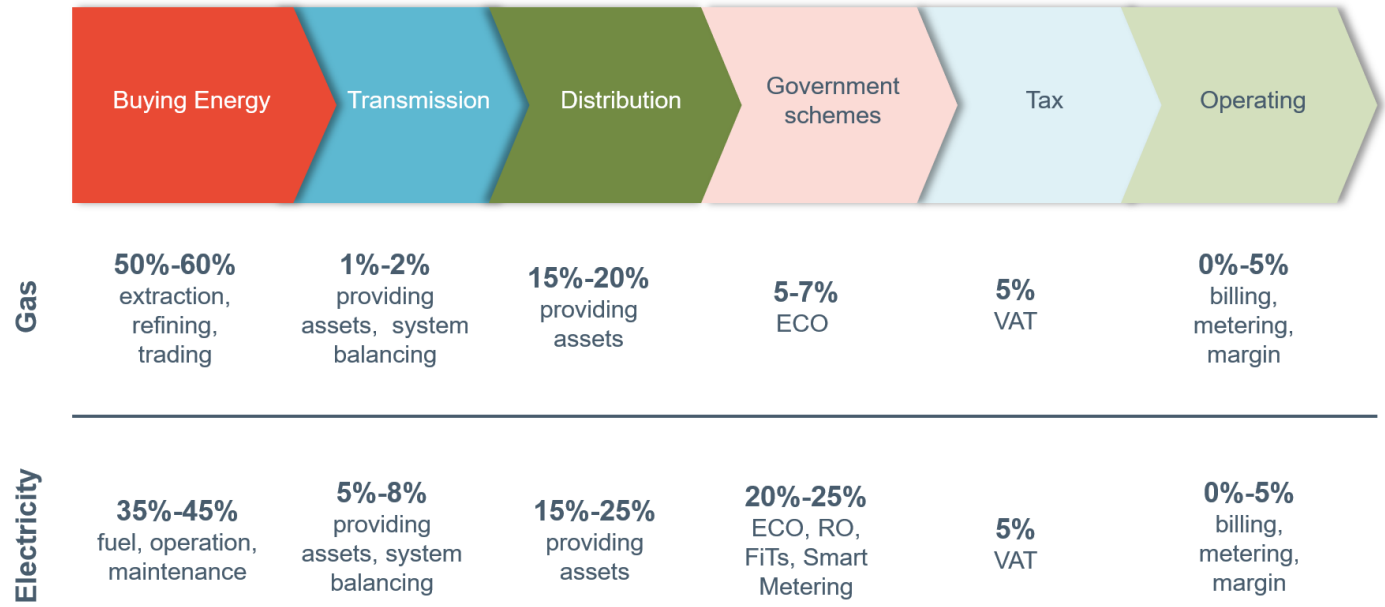
1.1. Market liberalisation and the 'Big Six'

Since privatisation of the gas and electricity markets in 1986 and 1989, respectively, the supply market was gradually opened up to competition. An eight-year programme concluded in the 1990's with households (and businesses) able to choose their supplier regardless of location. The result was the networks being put into private hands. Unbundling the ownership of network assets from supply resulted in 14 regional energy companies being allowed to sell energy in other regions. Supply and network activities became legally separated from a regulatory perspective and are governed by independent sets of rulebooks covering electricity and gas, respectively.

It was decided that it would be the supplier who would be the main interface between customers and their energy supply. As the sole party responsible for the transfer of costs and information up through the supply chain, suppliers are the only party required to sign up to every single industry code. Referred to as the supplier hub model, the approach means that suppliers are the ones who collect all of the money owed to the network companies, generators and Ofgem (i.e. policy costs owed to the regulator for environmental schemes such as the Renewables Obligation (RO) and Feed-in-Tariffs (FiT)).

The energy supply cost chain for gas and electricity (Figure 1) illustrates the low profitability in energy supply with supplier margins considered to be generally good if they reach ~3-5%. Of course, many suppliers are loss-making under the traditional operating model. In 2018, Ofgem issued a statement saying current supplier hub arrangements are not going to be fit for purpose over the longer term. It issued a call for evidence challenging the supplier hub principle[1].

Figure 1. Energy supply cost chain



Source: Cornwall Insight

[1] https://www.ofgem.gov.uk/publications/future-supply-market-arrangements-response-our-call-evidence

Market design principles

- Trading parties best placed to know what they want to buy/ sell
- Trading allows price discovery which means that consumers get best deal
- The System Operator should only need to undertake 'residual balancing' actions – assuming parties have traded well
- Incentivises parties to forecast output/ customer demand
- If a party is not good at forecasting and trading it is exposed to higher costs than its competitors

Then we saw a consolidation occurring in the early 2000's, which involved private overseas investment from utility companies. In 2001, the French utility EDF entered the market. German utilities RWE and E.ON followed in 2002. Ibedrola acquired Scottish Power in 2008. By 2010 there were six large energy companies, five of which had electricity heritage and represented the consolidated 14 regional companies. British Gas created the dual fuel market by offering their gas customers electricity, with the other supply businesses then entering the gas market. This was a significant attraction to consumers who, for the first time, would be able to have a single supplier for electricity and gas.

1.2. Rise of the insurgents and diversification

A further phase of the retail market in now well underway and the former six largest companies (British Gas, EDF, E.ON UK, npower, Scottish Power and SSE) no longer have the dominance that they once did. In Q410 these large suppliers held 99.5% market share of the household energy market; by Q221 the figure had fallen to 69.1%. From 2010 we saw a rise in new entrants, which was especially pronounced in 2015. Among these, it was (and still is) usual to offer a specialism. Community or locally branded energy suppliers including the likes of Bristol Energy and Robin Hood Energy (Nottingham) have since departed the market. Low-cost suppliers, suppliers positioning themselves as leaders in technology and energy management and green suppliers offering premium products (e.g. Ecotricity, Good Energy and Green Energy) are other examples of differentiation by market participants. Similarly, Utilita, focused on smart and prepayment meter customers. What is more, at July 2018, Cornwall Insight noted that there were 16 white label suppliers active in the domestic market, 12 of which entered two years prior[2].

While the surge in domestic suppliers can be attributed to new entrants distinguishing themselves from the former 'Big Six', the growth of some of those suppliers was spurred by attractive referral schemes and 'word of mouth'. It was also much easier to set up an energy supply company than it is today, especially through the purchase of pre-accredited solutions. Richard Hughes, Director of Marketing and Sales at EDF, considers that "a lot of the players who entered the market using software as a service solution were not really innovating either [as well as some of the former Big Six]", and describes those types of offering as "the same cookie cut approach" that may have worked for a limited segment of the market, for example standard Direct Debit customers.

It was not uncommon for new entrants to actively seek investment on the basis of remaining below the then 250,000 customer account thresholds for the Energy Company Obligation (ECO) and the Warm Home Discount (WHD) schemes. Laura Penny, former Innovation and Strategy Manager at Bristol Energy, observes that upon reaching policy thresholds for certain obligations "you almost want to push past it [threshold] so that you're getting economies of scale for increased costs to serve". Indeed, while some suppliers, including the former Bristol Energy, voluntarily offered WHD to its customers (in line with the company's social objectives), small and medium sized companies are less likely to have the team or resource to be able to facilitate that and deliver on those obligations.

Despite these various challenges, Richard Hughes considers that the proliferation of competition has created some new suppliers that are innovative which has "had positive effect on the remaining large suppliers who seem to have some form of plan [to innovate] and from an EDF perspective we are well are on track to improve our own offerings".

1.3. Rise in market exits

While competition in energy supply made consumer choice possible, from 2018 onwards the level of exits rose sharply across the household market (Figure 2). The rise in exits can be attributed to a combination of fundamentally unsustainable business models, strategic choices to exit and/ or a lack of a differentiated

[2] *Energy Market Analysis | Whiter than white supply? - Cornwall Insight - Newsroom (cornwall-insight.com)*

business model. Additionally, wholesale market prices that could not be passed onto customers quickly enough led to some unfortunate exits (Figure 3).

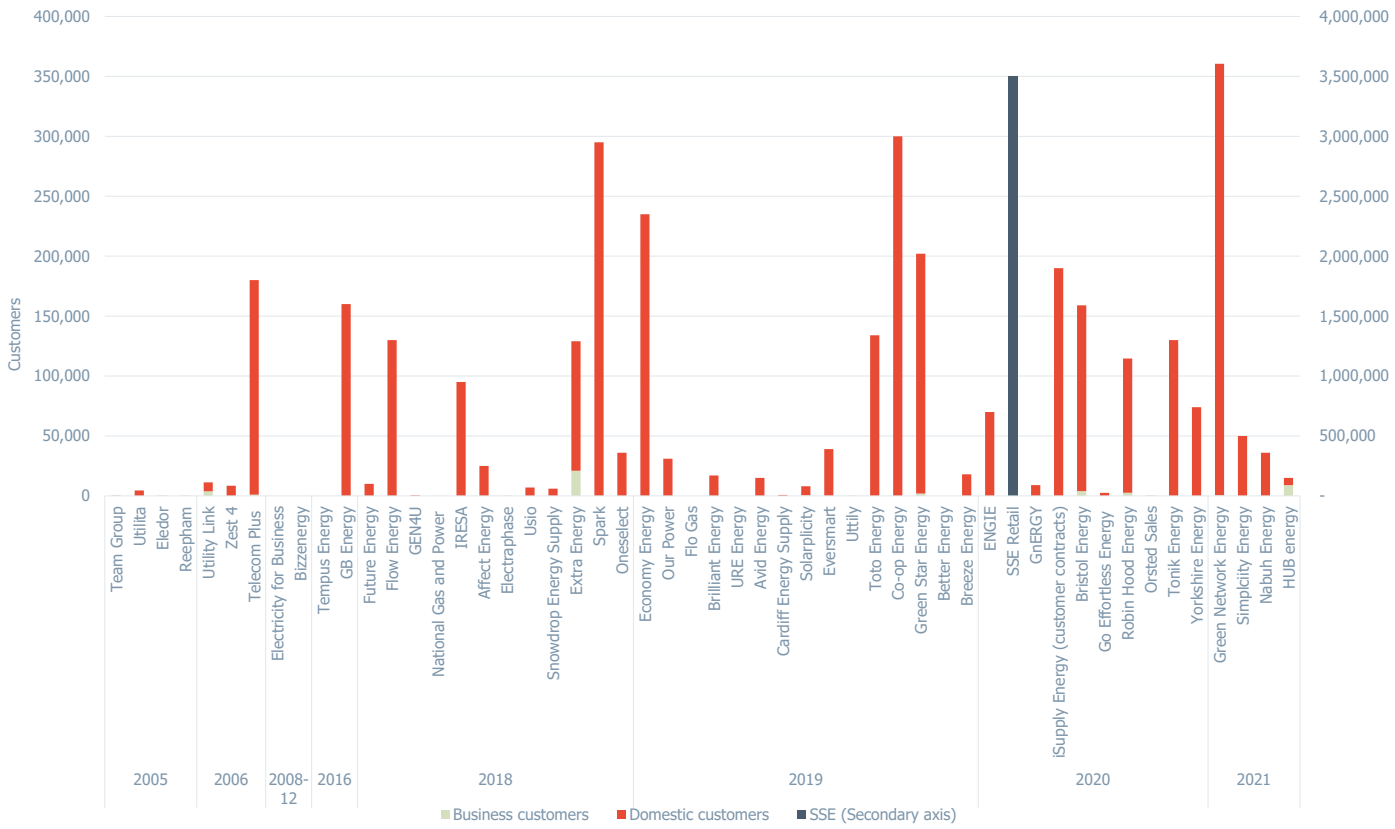
Of note is Green Network Energy's departure from the market in January 2021, which was a "surprise" to many. Its exit was attributed to high wholesale prices and increased volume demand from customers which led the supplier to default on its trading credit facility with Smartest Energy[3].

Another interviewee explains that "there's very few suppliers that seem to be making money from just supply, it's a low margin business and you need to reach that scale…and even then, you have to be incredibly efficient, how much of that is due to the competition and how much is due to the price cap is debatable, but it's having the same impact". Clementine Cowton, Director of External Affairs at Octopus Energy, agrees that the price cap has intensified competition. More generally, Richard Hughes (EDF) observes that "there are very few markets that can cope with the level of competition that we've had for this long, so there's always going to be casualties".

Market exits include customer book sales (trade sales) and companies in administration. Through its Supplier of Last Resort (SoLR) process the regulator, Ofgem, has the right to appoint a supplier to take on customers of a failed supplier. Suppliers may bid as part of a competitive process, with Ofgem to make its decision based on the offer it considers to be in the best interest of consumers. As shown in Figure 2, the largest supplier to exit the market via SoLR was the aforementioned Green Network Energy with 360,000 domestic customers, and a small number of business customers. HUB energy became the latest supplier to exit the market in August 2021 via SoLR with 6,000 domestic customers and 9,000 non-domestic customers. The largest customer acquisition was SSE by the former challenger brand Ovo Energy with a similar number of customers ~350,000. While none of the largest suppliers have failed to date, the Energy Company Administration scheme exists should a large supplier become insolvent[4]. Many small and medium sized suppliers have questioned the fairness around whether certain companies are theoretically 'too big to fail'.

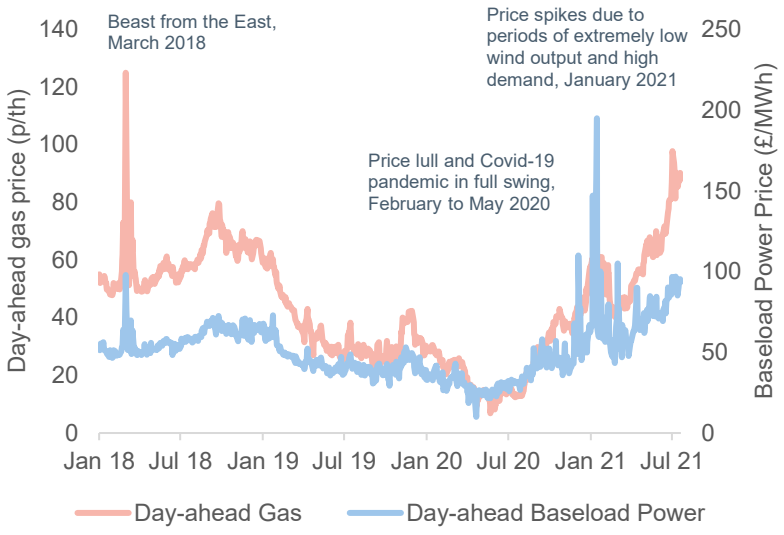
Source: Cornwall Insight

Figure 2. Customer numbers of domestic and non-domestic market exits, 2005 to date



[3] Statement of Administrator's Proposal, Companies House
[4] Memorandum of Understanding: Energy Supply Company Administration | Ofgem

Figure 3. Wholesale market price trends 2018-21



Source: Cornwall Insight

Richard Hughes (EDF) considers that "the SoLR has done a good job at protecting consumers" but notes that the process may encourage unhealthy risk taking [by new entrants and their investors]. Pietro Di Maria, former General Manager of Green Network Energy, observes that, in some cases, suppliers with different approaches to compliance would have a similar outcome. For instance, while some suppliers may proactively temporarily suspend onboarding customers until they meet a certain obligation, others may not do this. Where Ofgem engages with suppliers to ensure they are compliant, this may not result in formal enforcement action and a financial penalty. Moreover, it is true that a financial penalty given to a supplier could pose a risk to it defaulting.

Intense competition has ensued over the past decade or so, down to the fact that customers are primarily concerned with price. Even now, Ofgem's quarterly survey on Consumer Perceptions of the Energy Market for Q121 notes that even when prompted with non-cost reasons (service, reputation, incentives, and green tariffs), the main reasons for selecting a supplier are cost related[5]. Over time, this has resulted in a race to the bottom with some suppliers selling energy at low cost in the hope that they would quickly build up their customer base to such a size and attract better financing/ borrowing from investors and banks. One interviewee explains that "there certainly was a lot of loss-leading tariffs being offered at one point, because it is the main thing that those consumers seemed to be interested in".

As part of its Supplier Licensing Review (SLR), Ofgem referred to unsustainable pricing practices by some suppliers, notably consistently pricing at the bottom of the market. As a result, the regulator has introduced a swathe of reforms including a Financial Responsibility Principle which, among other things, requires suppliers to "*provide evidence that they have sustainable pricing approaches that allow them to cover their costs over time, or if they are pricing below cost that the risk sits with investors and not consumers*"[6]. Of course, price is not the only driver, with the role of genuinely green tariffs and products playing an increasing role (Chapter 4). Ofgem's SLR brought in new supplier licence requirements in July 2019 and in 2021. In March this year, for example, Ofgem introduced a requirement for suppliers to have in place a Customer Supply Continuity Plan (CSCP). The CSCP sets out the licensee's strategy for safeguarding the continuity of supply for its customers in the event of its failure and are intended to improve the experience of a SoLR event from a consumer perspective. Further reforms that seek to limit the amount of customer credit balances suppliers can hold are expected in Summer 2022[7] (Figure 4).

Robert Buckley, Head of Relationship Development at Cornwall Insight, explains that "intense competition has eroded investor and shareholder value in the market". Interviewees also acknowledged that growth is becoming increasingly difficult in view of multiple SoLRs with the costs of a failed supplier being spread across the industry.

[5] Consumer Perceptions of the Energy Market – Q1 2021 | Ofgem
[6] Decision on the Supplier Licensing Review: Ongoing requirements and exit arrangements | Ofgem
[7] Supplier Licensing Review: reducing credit balance mutualisation | Ofgem

Case study: Toto Energy SoLR

Administrators of Toto Energy *reported* that after completion of the final billing process, EDF estimated the failed supplier's 'gross debtor book as at SoLR date to be ~£15mn (of which ~£3.5mn was realisable, as per the directors' statement of affairs)' in their progress report for the period 30 October 2020 to 29 April 2021. Administrators have received £3.3mn from EDF in respect of debtor collections and said that 'collections have now slowed significantly and the level of further realisations in respect of the customer debtor book is uncertain'. The report notes that the administrators 'may need to extend the administration if we are unable to realise the residual debtor book or reconcile the funds received into the pre-appointment account before the administration is due to expire on 29 October 2021'.

The outcomes of intense competition are complex. While competition offered opportunities for the engaged part of the market to get a better deal for their energy, the approach has made it very difficult for suppliers to form long term relationships with customers, explains Chris Welby (former Bristol Energy). That is, it created "a situation where price is king". Now of course, and as Clementine Cowton (Octopus Energy) points out, we can see that the intense competition "has reduced the ability of business models that require exploitation of customers to thrive".

Customer service offerings, brought to the fore by intense competition, will only become more important as suppliers seek to develop lasting relationships based on energy as service offerings (Chapter 4). Clementine Cowton considers the leaders as being those [suppliers] who focus on understanding and responding to their customers "…as we move from a high churn, low trust model to a low churn, high trust model".

1.4. Drivers of exit and expectations of how they may change

Some suppliers that have now exited the market, had been issued Draft and Final orders by the regulator. Often, this enforcement activity was due to missed payments to Ofgem or poor customer service. One interviewee confirmed that while all of the regulatory obligations impose considerable costs on suppliers throughout the year, the RO payments have been a contributing factor to a number of suppliers going out of business. Indeed, BEIS and Ofgem have been considering the need for more frequent payments (e.g. monthly, quarterly, and six-monthly settlements) for the RO in particular. Several consider this would enable Ofgem to identify early warning signs of potential supplier failure, with the regulator able to intervene sooner[8].

Ofgem's complaints reporting was mentioned by interviewees as a good indicator of supplier customer service. However, several noted that the range of ways in which a supplier's customer service is assessed can cause confusion among customers and suppliers alike. Laura Penny (former Bristol Energy) explains that "there's not a universal way of assessing what's best for customers unfortunately". Clementine Cowton agrees that "some KPI based customer service rankings can do more harm than good" and noted Trustpilot as one example of how customers can assess quality of service. Also noted was the range of experience that customers have had. For example, the latest Citizens Advice rankings for Q121 highlighted a wide gap in the quality of customer service offered by suppliers in the top five compared to suppliers in the bottom five[9].

In view of the challenges brought about by Covid-19, interviewees acknowledged that suppliers have an obligation to support vulnerable customers. It was recognised that, overall, the industry responded well to the pandemic. However, one interviewee expressed concerns that failure to recognise the existing support offered by suppliers will result in further exits this winter. It is expected that this would further damage the market's reputation and increase mutualisation costs across the industry.

[8] *Changes to the Renewables Obligation scheme: Government response to the consultation on changes to RO mutualisation arrangements (publishing.service.gov.uk)*

[9] *Worst energy suppliers five times more likely to provide inaccurate bills than the best ones, Citizens Advice research reveals - Citizens Advice*

More generally, interviewees commented on the vast amount of regulatory changes in energy and the limited ability of the smaller suppliers to keep up with those changes, from a resourcing point of view. It was suggested that the regulator could perhaps do more to assess the changes that it has implemented before looking to bring in further changes.

Figure 4. Ofgem's Supplier Licensing Review—Overview

Supplier Licensing Review Reform	Date Implemented	
Supply licence applications assessed against three new criteria.	5 July 2019	Phase 1
Changes to the Application Regulations to consolidate Tiers 2 and 3 into a single tier.	5 July 2019	
Assessment of whether applicant is "fit and proper" to hold a licence.	5 July 2019	
Fee changes.	5 July 2019	
Financial Responsibility Principle requiring suppliers to take action to reduce the costs that will be mutualised in event of their failure.	22 January 2021	Phase 2
Operational Capacity Principle to require suppliers to have sufficient operational capability to be able to effectively serve their customers.	22 January 2021	
Milestone Assessment requests for information (RFIs) to be issued when a domestic supplier meets 50,000 and 200,000 domestic customers per fuel.	22 January 2021	
Dynamic Assessments which can be undertaken by the regulator in response to financial warning signs.	22 January 2021	
Requirements to increase the accountability of suppliers and incentivise responsible behaviour.	22 January 2021	
A requirement for people with significant influence in the business to be 'fit and proper' persons, and the introduction of a new principle for suppliers to be open and cooperative with the regulator.	22 January 2021	
A requirement for suppliers to undertake, at Ofgem's request, an independent audit of their financial position and/or customer service systems and processes.	22 January 2021	
A requirement for suppliers to inform Ofgem of trade sales and powers for the regulator to step in where it does not approve.	22 January 2021	
Customer Supply Continuity Plans which are to be maintained to protect customers and minimise wider market impacts should they exit the market, and the need to report changes in control of the business to Ofgem.	18 March 2021	
An auto refund policy which would require suppliers to refund any credit balances for domestic credit customers paying by fixed DD, each year on the anniversary of the contract start date.	*Summer 2022*	Phase 3
A threshold policy which would see credit balance thresholds set at key points during the year. Suppliers that exceed the threshold at an aggregate level would need to protect credit balances above the threshold.	*Summer 2022*	

Source: Cornwall Insight

2. Chapter 2: Market leaders and their strategies

2.1. The current market leaders

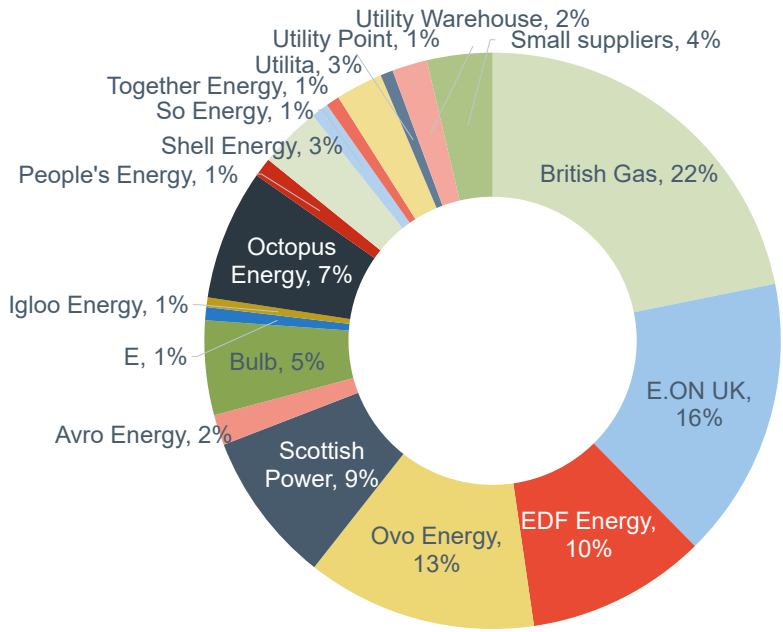
While we have seen a significant number of SoLR events, there has also been a growth in acquisitions and customer book sales. For example, at Q419 Shell Energy announced it would acquire medium supplier Green Star Energy (as well as non-domestic supplier Hudson Energy). During the same period, small supplier PFP announced it had acquired gas only supplier Better Energy's ~10k accounts. Octopus Energy also gained ~750k accounts through its acquisition of Co-op Energy and ENGIE.

More recently, we have seen mergers between the likes of npower and E.ON UK and SSE and Ovo Energy. Starting in 2008-09, Ovo Energy has grown to such a position that it purchased SSE's domestic supply business and is now one of the largest suppliers. This is in line with definitions used in Cornwall Insight's Domestic Market Share Survey for Q221 (Figure 5). At 30 April 2021 there were 47 fully licensed suppliers in the market consisting of five large suppliers, 13 medium suppliers and 29 small suppliers. The large suppliers include British Gas, E.ON UK, EDF Energy, Scottish Power and Ovo Energy. The small supplier group decreased by three in Q221 as Simplicity Energy exited and Igloo Energy and Green. became medium suppliers.

In view of the regulatory framework and economic outlook for suppliers, Josh Montgomery, Director of Risk at Together Energy, explains that having a large customer base is critical to a company's survival.

In spite of the developments in the retail market, one interviewee observes that there remains a single dominant market leader. Similarly, a large volume of customers remain on the typically more expensive standard variable tariffs (SVTs) of some of the incumbents. Ofgem has noted that the default tariff cap protects ~15mn domestic customers on SVTs and other default tariffs[10].

Figure 5. Domestic energy account share 30 April 2021



Source: Cornwall Insight

At 30 April 2021 Cornwall Insight defined medium suppliers as having >250,000 to 3mn energy accounts. Small suppliers have fewer than 250,000 household energy accounts.

However, at the end of 2020, Ofgem introduced the following bandings for supplier market share:

- Large legacy includes suppliers which have held a market share of at least 5% in either fuel since privatization of the electricity and gas sectors.
- 'Other large' includes suppliers with market share of at least 5% in either fuel, having increased market share from below 5% at the time of privatization.
- 'Medium' includes suppliers with market share exceeding 1% but remaining below 5% in both fuels.
- 'Small' includes suppliers with market share below 1% in both fuels.

[10] Reviewing the potential impact of COVID-19 on the default tariff (ofgem.gov.uk)

2.2. Facilitators and strategies of success

Interviewees highlighted the important role of systems in a supplier's growth and success. Stephen Littlechild, Associate at the Cambridge Judge Business School, observes "[Octopus] has grown immensely quickly, but has also innovated as well in the sense of having a platform [Kraken] which seems to be quite new and quite different, and significantly more efficient and effective than anyone else's platform. And of course Octopus has sold it to half a dozen suppliers in this country and a handful overseas as well, and I see Octopus plans to serve 100mn customers in 15 years….they may well achieve that". Another interviewee also recognised that, among the leading suppliers, there is evidence of diversification, innovation, and global expansion.

Some of the largest suppliers now include those types of companies that are growing and innovating simultaneously. As Laura Penny (former Bristol Energy), explains "they have the scale in terms of the buffer from a financial perspective, but also the ability to offer stuff that's quite innovative and new and attract those people that want to be retained by that company". Richard Hughes (EDF) agrees, noting "the ones [suppliers] that are seen to be enduring better are the ones who've taken control of their IT and innovation and are trying to do something different".

Commenting for Sky News on what has become of npower following its acquisition by E.ON, Michael Lewis, CEO at E.ON explains "what we've done with the npower business is completely transform it, we've moved 2.3mn customers onto a new platform with our technology partner Kraken to create a new business under the banner of E.ON Next"[11]. Expanding the customer base through such acquisitions and competitive tenders (SoLRs) has enabled some suppliers to cement their position in the market. The current phase of retail market consolidation has, in itself, become a strategy for growth. Some interviewees predict further activity in this area, with potentially greater numbers of consumers being affected per exit. One interviewee commented on the number of conversations on potential customer book sales this year, involving over 10 suppliers.

Also common among interviewees is the belief that suppliers must diversify their offering in order to maintain a competitive advantage. As Pietro Di Mara, former General Manager of Green Network Energy, notes "there's no way, in my personal opinion, to avoid the commodity pitfall, electricity and gas are commodities, that's all, therefore suppliers need to provide added value services on top of the mere commodity". As retaining customers is a significant challenge in today's market, the role of value-added services is key. Essentially, the supply of energy provides a means to acquire customers, while retaining them will depend on what a supplier can offer beyond energy (Chapter 4).

[11] *E.ON CEO, Michael Lewis on Ian King Live - YouTube*

2.3. New entrants

Historically, new entrants have competed on price, and while saving money continues to be the key driver for consumers to switch energy supplier, there are other important 'hygiene' requirements that customers have come to expect. Most obvious of these are customer service and a company's Environmental, Social and Governance (ESG) outlook. Richard Hughes (EDF) considers that while customer service is not a differentiator, "companies who cannot deliver excellent service at excellent cost will not survive". Similarly, Mark Neveu, Head of Sales and Partnerships at Rebel Energy explains that "competitive advantage can't be price because it's so short-term, it has to be impact and just engaging on the subjects that people want to engage on".

Case study: Rebel Energy

- The supplier used a pre-accredited supply solution from Utilisoft and launched its investment round to the public via Crowdcube on 4 March 2021.
- According to Rebel Energy's Crowdcube fundraising page, the supplier's pre-money valuation stands at £6mn. It was targeting £150,000 for 2.73% equity, and, as of June 2021, the supplier had raised almost half a million pounds (£459,045) from 624 investors.
- The supplier has partnered with BluePrism to ensure industry leading automation powers all their backend processes. Not only does this reduce their cost to service but it also allows them to improve the customer experience and have extra time to help the most vulnerable customers.

Rebel Energy recently cited the use of automation to free up customer staff will enable it to "give more meaningful and helpful support". Indeed, it is common for new entrants to be resource scarce and less likely to have the ability to influence in all areas of the industry. Chris Welby (former Bristol Energy), explains that it can be difficult for suppliers to "get anything done", particularly in a changing regulatory landscape where additional regulatory obligations are being brought in. Digital innovation including automation will enable suppliers focus their resources elsewhere and away from support back-office processes " which are traditionally a drain on both time and morale for call centre staff"[12].

Despite the challenging economics and evolving regulatory landscape, there are people entering the market. Rebel Energy and Logicor Energy entered in Q221. Still, Mark Neveu considers that the next couple of years are going to be "quite quiet in that new entry world". While it is true that there is a higher bar for those entering the market, milestone assessments introduced this year will force suppliers to plan ahead, with all suppliers subject to increased financial and operational scrutiny as they grow their business (Figure 4).

[12] *How Rebel Energy is using automation - Startacus*

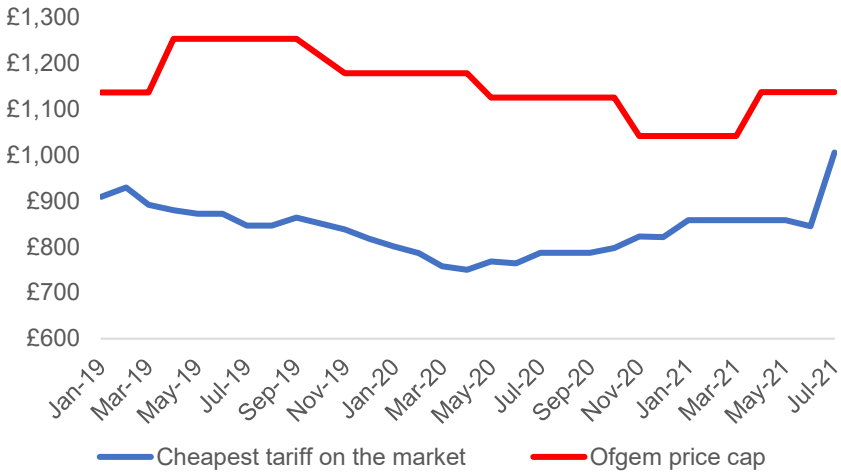
3. Chapter 3: Prosumer engagement

3.1. Levels of consumer churn and influencing factors

One of the metrics used to assess churn is how often customers choose to switch suppliers. Relatively speaking, energy has one of the highest rates of switching. On average, there are ~500,000 switches per month or ~20% of contracts in the household markets per annum (switching broadband provider, for example, is much lower at ~5%). However, as Clementine Cowton (Octopus Energy) points out "switching does not indicate customer happiness, rather unhappiness".

While around two-thirds of consumers are said to use a Price Comparison Website (PCW), customers only tend to switch when there is a greater saving to be made. With the price of fixed tariffs increasing due to high wholesale prices, the level of savings that can be made by a customer switching has reduced. According to Cornwall Insight's Domestic Tariff report, the savings between the cap and the cheapest fixed tariff on the market has fallen from £328 in July 2020 to £198 in July 2021. This has contributed to a reduction in the level of switching in the market and might prompt suppliers to look to alternative routes to market. Prior to this, the gap between the cap and Ofgem's cheapest tariff basket reduced from £188/year at the end of Q420, to £107/year at the end of Q121 (Figure 6). This was the lowest level seen since the introduction of the cap in January 2019.

Figure 6. Ofgem price cap versus cheapest tariff 2019-2021



Source: Cornwall Insight

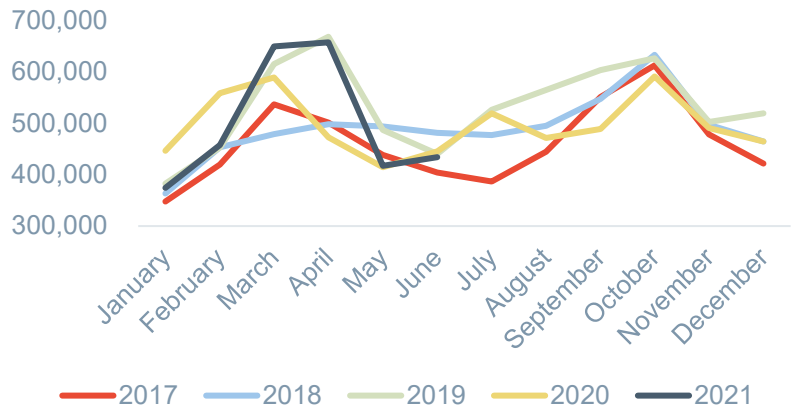
Throughout Q121, data from Energy UK and Ofgem has indicated that switching by customers among domestic energy suppliers was down on previous quarters. Some of the latest switching figures from Energy UK show that electricity switching in May was below the five-year average of 447,000 switches for the month at 427,346[13] (Figure 7).

Regulatory intervention to promote energy switching

- Under its Switching Significant Code Review launched in 2015 Ofgem set out to introduce faster, more reliable switching for both domestic and non-domestic customers. The new arrangements are expected to go-live in summer 2022. Ultimately, domestic customers will be able to switch by midnight on the next working day after initiating a switch, while non-domestic switches have an additional 24 hours built in.
    - Underpinning the new switching arrangements is a new code – the Retail Energy Code – for electricity and gas.
- In its 2016 energy market investigation one of the Adverse Effects on Competition (AECs) identified by the Competition and Markets Authority (CMA) was the Domestic Weak Customer Response AEC.
    - The ECOES/DES Order was subsequently issued by the CMA and was intended to remedy, in part, the identified AEC. The Order resulted in PCWs being able to access to the Electricity Central Online Enquiry Services (ECOES) and Data Enquiry Services (DES) databases containing information to help customer switching.

[13] publication.html (energy-uk.org.uk)

Figure 7: Energy UK electricity switches 2017-21



Source: Cornwall Insight. NB. Data from Energy UK.

3.2. Changing role of consumer engagement

For a number of years now, households have been able to generate, store and sell-back flexible demand to a system characterised by increasingly intermittent generation. A relatively new scheme to incentivise small-scale generation is the Smart Export Guarantee (SEG)[14]. Compared to its predecessor (Feed-in Tariffs) SEG is much more market-based, with mandated suppliers required to offer more than 0p/kWh at all times in order to be compliant[15]. Social Energy, for example, recently launched a new solar export tariff offering 20p/kWh for the first 1,000kWh exported per year. The tariff then drops to 6p/kWh. One interviewee suggested, however, that the return of the FiT scheme is necessary to align small-scale energy generation with net zero targets.

While some interviewees consider self-generation at the individual household level as “niche”, this is expected to change as the heat and transport sectors are electrified and electricity demand is expected to roughly double by 2050. For example, the new Smart Systems and Flexibility Plan notes that the electricity requirement for an electric vehicle is almost three quarters of today’s typical household consumption[16].

Others consider great potential in community energy renewables compared to solar panels on individual houses or electric vehicles. Josh Montgomery (Together Energy) observes there are efficiencies from small-scale community renewables. It was also noted by Laura Penny (former Bristol Energy), that “there’s no government strategy at the moment to engage the public in transitioning to net zero, so it’s going to be hard for us to increase that consumer interest”.

At the same time, Ofgem is concerned that the current arrangements may be holding back innovation and potentially disruptive business models by giving traditional suppliers privileged access to information and control over processes. Laura Penny explains that while the existence of grid-edge technologies (smart meters, vehicle to grid technology etc.) is continuing to innovate the way that consumers interact with energy, the current retail market is not designed to facilitate that decentralisation and the volatility of renewable generation.

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[14] *Defined as no more than 5MW of total installed capacity or no more than 50kW for Micro-CHP.*
[15] *Guidance for SEG Licensees | Ofgem*
[16] *Transitioning to a net zero energy system: smart systems and flexibility plan 2021 - GOV.UK (www.gov.uk)*

4. Chapter 4: The future drivers of change

4.1. Green credientials and ESG

In view of the supplier hub model, suppliers are considered to have a paramount role on ESG compliance. As one interviewee explains, “the key driver for any change in the UK is basically pushed by the supplier”.

Clementine Cowton (Octopus Energy) explains that “retailers have the power, opportunity and role to drive climate change through the mass consumerisation of technology”. In this way, the leading suppliers are likely to be those who act on social and environmental objectives. For example, they will have experts and dedicated teams responsible for overseeing, and delivering on, the company’s ESG impact.

Energy suppliers and ESG

Ovo Energy

- *Signed* a power purchase agreement (PPA) with Eneco to buy 100% of the power from the 62.5MW Crystal Rig windfarm in East Scotland. This is the second PPA Ovo Energy has signed this year.
- *Appointed* the Climate Change Committee’s Dr Heaton as Director of Sustainability at the supplier. Dr Heaton will shape Ovo Energy’s commercial initiatives in line with the UK’s climate change agenda, and lead on the delivery of Ovo Energy’s Plan Zero.
- *Published* its Belonging Report in which it renewed its commitment to building a “diverse community and an inclusive culture where everyone can thrive because they are valued, respected and supported in the right way”.

Bulb

- *Announced* it launched the Tech Zero taskforce, a group of UK tech companies committed to a climate action plan. The action plan involves setting a net zero emission target by the end of 2021, publishing scope 1, 2, and 3 carbon emissions annually, as well as appointing a member of the executive team to be responsible and accountable for their net zero target. The taskforce comprises of 16 founding members and is backed by the UK government, with Bulb aiming for 1,000 companies to join the climate action plan by COP26.

E.ON UK

- *Committed* to restoring ecological corridors by 2026.

Josh Montgomery (Together Energy) observes that while there is “growing interest [in green products and services], there’s little understanding of what green really means in the energy supplier world”. USwitch’s characterisation of green tariffs for instance is viewed by Stephen Littlechild, Associate at the Cambridge Judge Business School as “a very practical response to concerns among some customers around the ‘greenness’ of the energy they consume”. Others commented that other switching sites may follow suit and, in applying different criteria to ascertain ‘green’, may result in further confusion. Richard Hughes (EDF) believes “green is almost by definition now greenwashing” and proposes using carbon and science-based targets as opposed to green labelling.

In view of wider ESG compliance, Stephen Littlechild observes that additional conditions to protect vulnerable consumers imply a higher cost to serve. All interviewees recognised the importance of supporting vulnerable consumers with some suppliers, in this instance Together Energy, focusing on services and products tailored to low-income households. Josh Montgomery identifies a tension between social and environmental ESG goals in that many low-income households are “not going to have an electric vehicle” in the next few years, at least. The development and uptake of electric vehicle specific tariffs, for instance, are to an extent dependent on a supplier’s customer base.

4.2. Technology drivers

Clementine Cowton (Octopus) explains that "the price cap forced businesses to look at efficiency and technology". For example, Kraken Technologies has enabled businesses such as Good Energy and E.ON UK to offer innovative tariffs that otherwise they would have been unable to do. She considers the "leaders will also be the ones who are able to develop high-quality long-term relationships with customers".

Increasingly, we are seeing the need for suppliers to provide services beyond energy supply. As small-scale generation becomes more widespread – be that at the individual household, building or community level – the transition to low carbon heating provides an opportunity for suppliers to participate in retrofitting.

Chris Welby (former Bristol Energy) considers that the future leader in energy retail might be yet to enter the market. Market-wide half-hourly settlement and the rollout of smart meters offer opportunities for new suppliers once it has been introduced and embedded. Such future market entrants would not have to foot the costs of implementing these industry programmes. Neither would they be required to change their systems to adapt to new processes and technologies.

Octopus Energy has partnered with Ohme, National Grid Electricity System Operator (ESO) and Scottish and Southern Electricity Networks (SSEN) for the "UK's largest ever home energy flexibility study". The Crowdflex study started in June 2021 and will involve over 25,000 households. It will analyse customer energy use patterns to demonstrate how they might change their behaviour and charge electric vehicles, heat pumps and home batteries at different times to access cheaper, greener power. The analysis will look at how usage patterns change in response to price signals from Octopus Energy's smart tariffs and instructions from Ohme's smart electric vehicle chargers and app.

5. Concluding remarks

The UK energy retail market is undergoing a significant restructuring with some interviewees predicting further, and potentially larger, supplier exits later in 2021. This is not surprising in view of rising energy costs more generally, looming supplier payment deadlines for policy schemes such as the RO, and support to consumers struggling to pay for their energy throughout the Covid-19 pandemic. Additionally, the price caps on default and prepayment tariffs and the interlinked volatile wholesale market will continue to put pressure on suppliers over the coming months.

Having experienced over 20 suppliers exit the market through SoLR since 2016, the industry has improved its understanding as to what is expected of suppliers in order to take on the customers of failed suppliers. However, the requirement for suppliers to have a strategy in place for safeguarding the continuity of supply for their customers in the event of their failure was introduced only in spring 2021. All suppliers should now have a Customer Supply Continuity Plan (CSCP) which reflects the size and complexity of their business. The aim is to ensure that all suppliers have carefully considered the arrangements that would be needed to ensure an efficient exit well ahead of these arrangements ever being required in practice. While Ofgem would take early corrective action where plans are inadequate, it may only see a supplier's CSCP as part of new Milestone Assessments when its customer book reaches 50k and 200k customers. Earlier this year, we saw a supplier default with well over 200k domestic customers, which is the threshold at which suppliers must undertake such an assessment. If the number of SoLRs among the smallest suppliers has reached a "tipping point", the CSCPs will do little, if anything, to reduce the impacts of mutualisation. The socialisation of costs may in fact be greater if suppliers with greater customer numbers are at risk of failing. Still, Ofgem can use its powers to direct a Dynamic Assessment of suppliers exceeding the 200k threshold where it has concerns about a supplier's financial sustainability or ability to serve customers.

For suppliers who have acted as SoLR (some on more than one occasion) and taken on the customers of a failed supplier, the SoLR process has also brought to light the challenges associated with onboarding large numbers of customers in a relatively short period of time. Suppliers able to demonstrate to the regulator that they have the resources, IT systems and processes in place to do this are typically those that have fared well in this "hyper competitive" market.

Going forward, should the number of suppliers already present or entering the market continue to reduce, there is a risk that less competition will mean less competition on price, as Josh Montgomery (Together Energy) observes. As price becomes less of a differentiator between suppliers, it will be critical for those remaining suppliers to maintain and secure economies of scale. Suppliers who transition to service-led business models, for example through dynamic tariff offerings, can position themselves as technology companies, beyond just energy supply. While many consumers have come to expect good customer service, how suppliers engage with their customers to administer such new models will be critical for customer relationships and retention. For all of the above, suppliers will require sufficient financial backing. Companies without the resource to adapt and diversify – in order to support policy goals and consumer demand for net zero – are unlikely to remain in the market.

CORNWALL INSIGHT

CREATING CLARITY

Level 3, The Union Building
51-59 Rose Lane, Norwich, Norfolk NR1 1BY

T 01603 604400
E enquiries@cornwall-insight.com
W cornwall-insight.com