

Opening of the Gas and Electricity Markets to Retail Competition

What lessons can be learned from our European neighbours? What will be the impact in France?

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Introduction

The date is just beginning to be discussed, as a result of a long process launched by the European Commission in Brussels in the late 1990s: the complete opening up of the gas and electricity markets to competition in a small number of countries which had opted to postpone the event as long as possible – notably France and Italy¹, as well as Greece, the Baltic States and a number of countries in Eastern Europe (the other European countries have already taken this step over the course of recent years).

What can be expected as a result in France? Will consumers benefit from competition? If so, how long before the effects are felt? What consequences will the separation (unbundling) of sales and distribution activities have for the consumer?

It is useful to turn to (recent) history in an endeavour to find the answers to these questions, and to examine market behaviour in areas where consumers have now had a choice of suppliers for a number of years. To illustrate our study, we have selected the United Kingdom (1998-1999), Sweden (1999) and the Netherlands (2001-2004)².

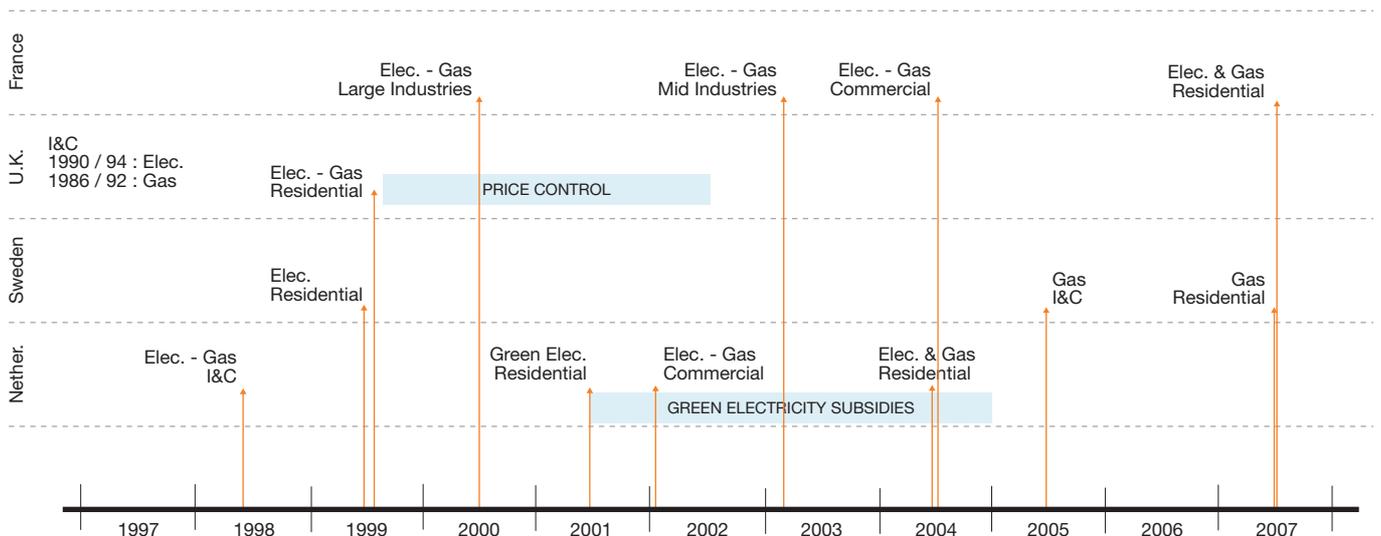
In each of these countries, we will first examine consumer behaviour over the first 2-3 years of market competition and then look at energy operator and supplier behaviour and the new offers they have developed.

Market Sizes (Millions of customers)

	Electricity	Gas
France	28	11
United Kingdom	26	20
Netherlands	7.1	6.9
Sweden	4.5	0.03

Source: Capgemini

European Energy market opening milestones (UK, Sweden, Netherlands, France)



Source: Capgemini

¹ For the electricity market only; the gas market has been open to retail competition since January 2003.

² Other markets such as Germany (opened in 1998) and Spain (opened in 2003) warrant being studied, as they are fairly similar to the French market in terms of size. Nevertheless, their specific characteristics (high regionalisation in Germany and 'dormant' retail competition in Spain) would make comparative analyses somewhat irrelevant.

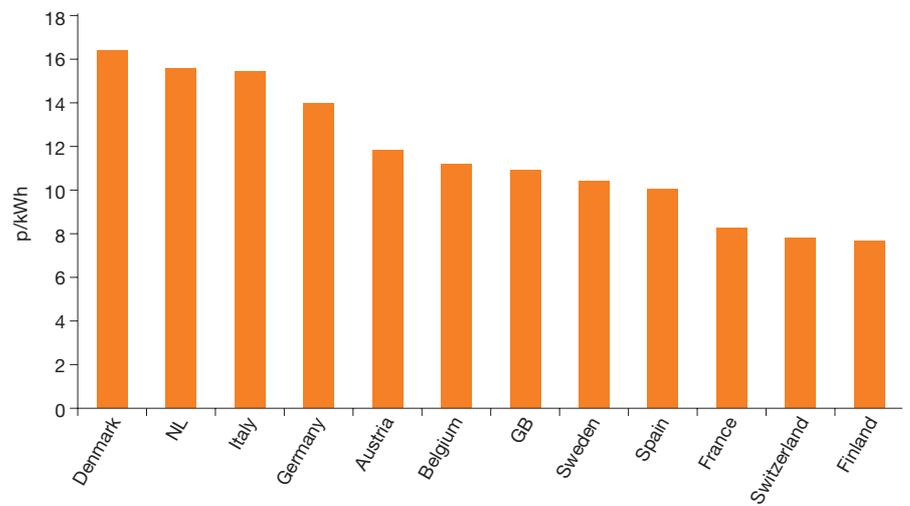
Sweden, the United Kingdom and Holland: three specific contexts

It is essential to mention the overall context as well as the specific circumstances (both economic and structural) of each of these countries at the time when their markets were opened up to competition.

- First, the size of the markets in question: 26 million electricity customers in the United Kingdom (comparable to the French market with its 28 million electricity customers), but only 7.1 million in the Netherlands and 4.5 million in Sweden;
- The importance of energy bills in household budgets: whereas British, Dutch and French households tend to have fairly comparable electricity consumption patterns, the electrical bill for a Swedish household can reach over twice the European average;
- The period of time when the markets were liberalised: nearly the same for the United Kingdom and Sweden (1999) and more recently (2001 and 2004) for the Netherlands, which is a key factor for consideration, since the late 1990s were characterised by low-cost energy and a downward trend in prices, which continued on until 2003-2004;
- The energy mix used for residential consumption in each country: fairly balanced between electricity and gas in the United Kingdom and Holland (also true in France and Italy) and mostly 'electrical' in Sweden, with marginal use of natural gas by households and quite developed district heating;
- The domestic policies that preceded or accompanied these market openings: price control mechanisms for the first 4 years of competition and an opening that coincided with the end of coal subsidies in the United Kingdom; substantial subsidies for green energy suppliers in the Netherlands beginning in 2001 and continuing until 2005, no transitional regulatory mechanisms in Sweden.

European household electricity price comparison

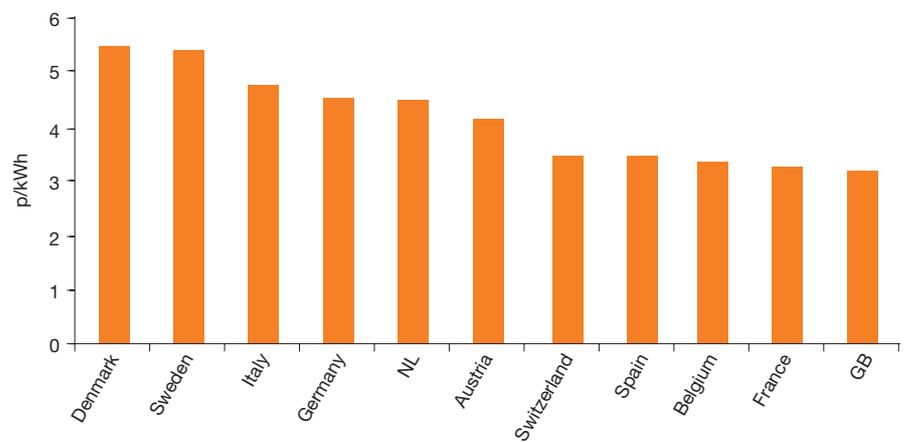
(October 2006, pence/kWh)



Source: OFGEM, May 2007

European household gas price comparison

(October 2006, pence/kWh)



Source: OFGEM, May 2007

Who are the alternative suppliers?

Of the three markets studied, the opening to retail competition resulted in competition between the incumbent local operators and a significant increase in new entrants, a number of them being “pure marketers” without generation assets.

In the Netherlands, five new entrants developed during the initial years of liberalisation. They initially built up portfolios of 100 to 250,000 customers and captured a combined total of approximately 12-15% of market share from the incumbent utilities. Several years later, the results are less encouraging. While the largest of these new entrants, Oxxio, was purchased by the British operator Centrica in 2005 and now boasts a portfolio of some 700,000 customers in the Netherlands (representing market share of roughly 10%), others such as EnergyXS have declared bankruptcy.

In addition, should the two largest incumbent utilities, Essent and Nuon, merge as announced in early 2007, they would then control nearly two thirds of the supply market (all segments combined) prior to intervention by the competition authorities.

An analysis of the other European markets shows that alternative suppliers without competitive generation capacity, sufficient financial backing or existing client base, have difficulty surviving after their first few years of operation. The only ones that seem to stay afloat are those which are backed by major operators (YelloStröm in Germany, a subsidiary of EnBW with over 1 million customers; Plusenergi in Sweden, jointly owned by Vattenfall and Gothenburg Energy with over 400,000 customers) or those which have since been purchased by foreign groups (for example, Oxxio purchased by Centrica).

Consumer information and satisfaction

Before examining the energy suppliers marketing strategies and consumer mobility within these markets, let us first take a look at the information provided to consumers and the degree of simplicity of the procedures required for a household to switch suppliers. The following are determining factors in consumer mobility:

- Several years after the market was opened in Sweden, only 11% of customers who had switched felt that the procedure was complicated. More recent studies show that in Sweden the process for changing suppliers is perceived by consumers as being rather complex and that the management of disputes and claims (which are fairly high in number due to the lack of clearly defined industry rules) has proven to be long and tedious;
- In the United Kingdom, despite the 28-day notice required before a consumer can switch operators, the first years of free retail competition generated numerous complaints to the consumer protection organisation EnergyWatch. Three years after the opening of the markets, nearly 100,000 complaints had been filed annually with EnergyWatch, many of which pertained to aggressive operator sales tactics (door-to-door sales, etc.), with others dealing with incorrect invoicing and problems encountered during the switching process;
- In the Netherlands, although the process for changing suppliers is simple for the consumer³, significant problems arose during the initial market opening phases, with the incumbent operators being poorly prepared to process the sizeable demand for the creation, modification and cancellation of customers contracts. In some cases during this period, nearly 15% of switches resulted in errors and subsequent claims.

To improve the free flow of information between suppliers and distributors, countries such as Sweden are now implementing a platform called EMIX (Energy Market Information Exchange), which is intended to automate the process for Swedish households changing suppliers, while at the same time making it more reliable⁴.

In terms of consumer information, it should be noted that both the United Kingdom and Sweden were fairly quick in equipping themselves with an independent body which could compare the various offers available in their region. This idea was taken up by the Commission de Régulation de l'Énergie (CRE) in France and was just recently implemented at the end of May 2007 with the launching of its website at www.energie-info.fr⁵. This was created to inform individuals of their rights and of the relevant



processes involved in the complete opening of the energy markets on 1st July. It should, however, be noted that when consumers were asked about their ability to compare energy suppliers' prices – and this several years after the effective opening of the market – 70% of Britons responded that they could do so easily, whereas only 40% of Swedes had the same level of confidence⁶ (at that time in Sweden, there were over 300 electricity offers available from nearly 70 suppliers).

³ 15-day notice and no penalties

⁴ In Sweden in 2006, over 180 local distributors were supplying electricity country-wide, and over 120 "marketers" had developed electricity offers.

⁵ Website designed and developed by CRE in association with the DGCCRF and the DGEMP of the Ministry for the Economy and Finance.

⁶ Source: TEMO – Sweden / S. Littlechild, November 2005

New Offerings

Overall, our study confirms that price is the major differentiating factor for commodities such as electricity and natural gas.

Our comparative analysis identified three main categories of offers destined for residential customers:

More targeted price offers

The first category of offers concerns specific price offers targeting particular consumer profiles, rounding out energy supply with financial offers suited to customers (smooth payment plans, personalised payment schedules, insurance, etc.). *For consumers concerned with risk, suppliers have proposed contracts based on a fixed price that is guaranteed for one, two or even three years* (this is the most popular offer in Sweden, particularly for those consumers who opted to stay with their original supplier, but who have renegotiated their agreements).

In the Swedish market, consumer savings on these guaranteed fixed price contracts, as compared with the operators' standard price offers, was approximately 5% for a three year commitment and 20% for a one year commitment⁷.

For consumers more inclined to risk-taking, suppliers proposed rates indexed against market prices. These offers were popular in Sweden during the first two years of liberalisation, when wholesale prices were dropping, but they have been decidedly less in demand since then.

In the United Kingdom, guaranteed fixed price contracts were not marketed as such until prices started to rise significantly in 2003-2004.

For a number of years now in France, EDF has been offering peak and off-peak period rates for residential customers and Interruptible contracts for Industrial & Commercial and, in some instances, for private individuals EJP⁸/Tempo. Time-Of-Use (TOU) type offers, which allow consumers to reduce their peak periods and thus their bills, have had some success in the United States. They can be developed by utilities if consumers are equipped with new "smart" meters capable of measuring household consumption for very precise intervals and, above all, if the communications infrastructure is such that the suppliers can interact with consumers in near real-time. In the United States, some suppliers have even created systems that allow them to act directly upon the load curve of their customers (who have subscribed to the programme), via remote control of certain household equipment. Consequently, in the event of a heat wave when demand for electricity increases, suppliers can switch off certain equipment (such as air conditioning, pool pumps, washing machines, etc.) during the most critical hours of the day, thus reducing their investment in peak production capacity. Consumers who opt for this type of offer are billed at lower rates.

⁷ Source: S. Littlechild: Competition and contracts in the Nordic electricity markets, November 2005

⁸ EJP: Effacement Jour de Pointe, an EDF contract which, for 343 days out of the year, provides rates close to the off-peak prices offered on the Peak / Off-Peak Periods price schedule; in exchange, pricing per kWh is higher during the remaining 22 days, which are spread out between 1st November and 31 March.

Dual fuels

The second category of offers concerns the supply of two types of energy (electricity and gas) by the same supplier (dual fuel offer). The advantage for the consumer is lower rates and a single invoice. This marketing strategy, made possible through back-office gains, was heavily developed by British operators. For example, the gas operator Centrica played the bi-energy card very early on and now holds a market share of 20% for electricity, while at the same time retaining a gas market share of nearly 50%. In the Netherlands, the two main players, Essent and Nuon, have each built up fairly well-balanced gas and electricity portfolios of nearly 2 million customers. In Germany, the two top electrical companies are also important gas suppliers (E.ON-Ruhrgas and RWE-Wingas).

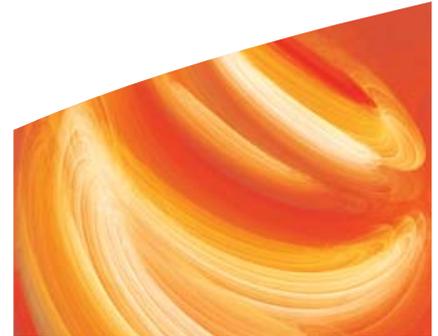
Incidentally, we would like to note that the dual energy strategy is different from the multi-utilities strategy. The latter was highly popular in the late 1990s/early 2000s but did not prove to be profitable. Some may recall the case of British Gas/Centrica – widely studied in the industry during the early 2000s – which incorporated the marketisation of multiple services into its economic model. These services (such as an automobile associate network, financial and insurance products, telephony, etc.) had virtually no relation to its core business product, gas and electricity. The model, which in the end did not appear to be a decisive factor

in customer loyalty, did not survive over time and it would seem unlikely for it to ever return to centre stage. Likewise, nearly all energy suppliers with telephony or cable television activities have sold off the latter in recent years, earning a substantial profit in so doing. At present, only local utilities (for example, the Stadwerke in Germany) have retained bundled services, ranging from waste collection to water distribution.

The environment & sustainable development

Finally, *the third category of offers concerns* – as demonstrated by the Dutch example – *the marketisation of green (environmental) offers likely to attract a significant share of consumers.* It should be noted, however, that the explosion of green offers in the Netherlands – those associated with the green certification mechanisms based on the amount of electricity produced from renewable energy sources – would not have been as extensive if the government at the time had not established a subsidy policy that was extremely favourable to operators, financed of course by Dutch taxpayers.

In Sweden, Green labelled energy offers have also developed, supported by governmental subsidies, triggering households to re-think their energy mix (e.g. replacing domestic fuel boilers by heat pumps or bio-fuels) thus generating consumer mobility.



The marketing of “green label” energy will certainly continue, given consumers’ growing awareness of the importance of the environmental factor. For that matter, “choosing a cleaner energy supplier” was the top argument put forward by French consumers in a recent survey – far ahead of others such as “benefiting from better prices” or from “better service”⁹.

⁹ March 2007 Eurobarometer Survey of French consumers on the advantages of the opening up of energy markets to competition

Consumer mobility: what is the bottom line?

Before addressing this topic, a full understanding of the meaning of mobility ratios (also referred to as “churn” or “switch rate”) is beneficial. The definition is simple: a consumer’s deliberate decision to change his/her supplier. In general, this indicator is published as a cumulative percentage corresponding to the total number of “movements” made by a particular segment of consumers (for the purposes of our analysis, this will deal with residential customers) and thus incorporates the actions of consumers who have changed suppliers more than once, and those who left and returned to their traditional suppliers. (For example, cumulative mobility of 10% across a population of 10 million inhabitants does not mean that 1 million consumers have changed suppliers, but that there were 1 million “movements” over the period in question.)

In some instances however, churn is measured based on consumers who have changed contracts, but not necessarily suppliers; in others, the indicator is not restricted to the residential segment but takes its

measurements across a broader segment of the population to include professionals (independents, artisans, SMEs and so forth), making attempts at comparative analysis rather difficult.

In the United Kingdom as in Sweden, the opening to retail competition took place within a context of low-cost energy, with wholesale prices generally on the decline. In the United Kingdom, this factor, coupled with the existence of players already well-versed in competition (the market had been opened to industrial and commercial customers in 1990 and 1994 for electricity), allowed suppliers to develop marketing policies based on lower prices. This strategy resulted in significant customer mobility over the first three years of free competition, with an average decrease in energy bills of 8-15% and a switch rate of 35% for electricity (cumulative)¹⁰.

In the Netherlands, the government’s subsidy policy in favour of green energy suppliers, running from 2001 to 2004, was at the root of the vast majority of consumer movements. In late 2004,

40% of Dutch households had opted for a green electricity offer. However, it is of interest that, amongst these 40% of households, 82% had chosen simply to switch to their traditional supplier’s green offer. The number of households that switched immediately after the full opening of the market in July 2004 (e.g. when both electricity and gas markets opened to competition for residential customers) may represent a more meaningful measurement. These households represented 4% (cumulative) of the market in the months following the event, and 11% and 5% during the first two years of free competition for electricity and gas, respectively (cumulative). In Sweden this same measure, six years after the complete opening of the market, is at 29% for electricity (cumulative); it is close to 50% in the United Kingdom for both electricity and gas¹¹.

Consumer mobility comparison (Electricity) United Kingdom / Sweden

	3 years after opening	6 years after opening
United Kingdom	34%	43%
Sweden	18%	29%

Source: S. Littlechild, March 2007

Evolution of consumer behaviour in Sweden

Annual consumer mobility (Electricity)

Consumer who...	2000	2001	2002	2003	2004
Switched suppliers	10%	13%	18%	23%	29%
Signed new contracts with their suppliers	18%	17%	17%	22%	25%
Total “active” consumers	28%	30%	35%	45%	54%

Source: TEMO / Sweden, 2005 estimates

¹⁰ Source: S. Littlechild: Retail competition in the UK electricity sector, March 2006

¹¹ Source: European Commission – progress report on the creation of an internal market for gas and electricity, 2005

What can we learn to prepare us for 1st July 2007 in France?

As mentioned at the beginning of this article, comparing the experiences of some of our European neighbours who have already established a competitive retail energy market is a challenging exercise.

Politicians and consumers have many questions regarding *the advantages of this final stage of liberalisation of the energy market*.

- **First observation:** in most European countries, eligible consumers' energy bills (for electricity and gas) have been constantly increasing in recent years. Some accuse market liberalisation of having caused this price spike. That is untrue. The rapid rise in prices has been the result of a number of factors: the increase in the prices of oil and gas have led to increased wholesale electricity prices in Continental Europe (which are aligned with German prices); the (unjustified) spike in the price of CO₂ emission rights certificates in 2005 and early 2006 also resulted in rising prices; finally, the lack of investment in electric and gas infrastructures has created situations of strong pressure between supply and demand, which resulted in a sharp increase in price volatility.
- **Second observation:** the political decision in France to maintain regulated tariffs set by the government at relatively low levels has not created the conditions necessary for true competition on the energy market. In France, consumer associations such

as "Que Choisir" have understood that it is in the general interest of customers to keep their existing rates and have called for the French "not to move" on 1st July 2007, particularly given that, once consumers have switched rates, there is no going back.

This is why it seems likely that few households in France will switch after 1st July 2007.

The incumbent operators have long been preparing for this important date, notably through changes to their customer relations and invoicing/billing systems. They have also been preparing technically for the separation of distribution from sales (unbundling), so that consumers will know who to address (the distributor or the energy supplier) for their various interactions with "their" operators.

This separation may however lead to a certain degree of confusion amongst customers during the first weeks or months following the 1st July.

What will be the longer-term impacts? Multiple factors seem to indicate that it will take some time to be able to assess the true effects of complete liberalisation of the energy market in France.

- The French market is one of the most concentrated in Europe, and nationwide winners EDF and Gaz de France possess key assets to help them retain their leadership in French

households. For example, for EDF, the cost of production and sales per kWh is one of the most competitive in Europe, thanks to its nuclear generation fleet. Not to mention the appreciation of EDF's service quality, shared by the vast majority of its customers, as well as the substantial marketing efforts developed by the two operators over the past two years vis-à-vis commercial consumers;

- Our neighbours' experiences show that switch rates increase with time and can accelerate when attractive offers are made available on the market;
- Finally, the average energy bill for a French household: electricity in particular is one of the lowest in Europe, despite significant recourse to electric heating (offset by low prices). The few dozen euros which French consumers could save each year by switching will probably not be sufficient to convince them to leave their traditional operators, with whom they are quite satisfied. Only offers that combine real innovation with competitive, transparent pricing will be able to foster French consumer mobility over time.

In conclusion, several months or even years will be necessary before it will be possible to evaluate the impact of the opening of the electricity and gas markets to competition, as concerns prices, customer relations, offers, and both incumbent and new operators.



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