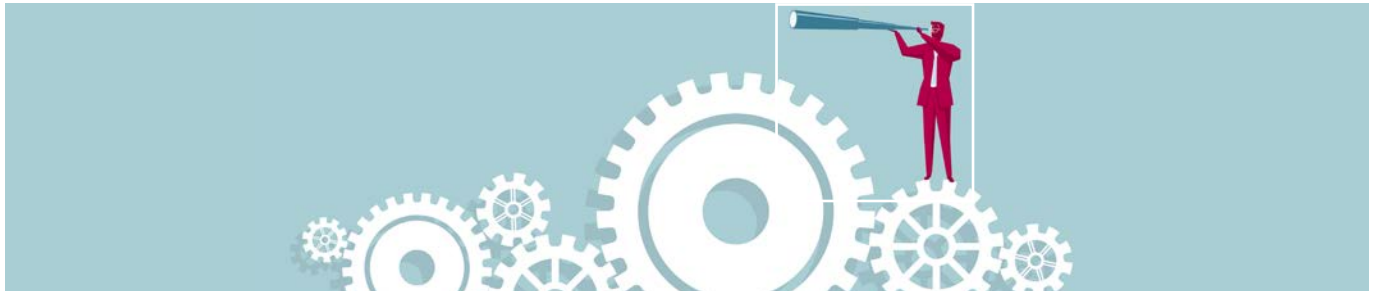


Energy & Utilities Benchmarking Study

Power & gas retail benchmark conclusions



As power and gas retail markets have been liberalizing in Europe in the past decades, the business of selling energy to retail consumers has been completely transformed. New products and services have been developed in most countries and utilities have launched new channels and ways to interact with their customers.

As with any retail-oriented business there is no doubt that understanding and segmenting customer needs, developing new products and launching new channels and promotions are essential to drive the business forward. But in the residential segment, having an efficient operation is a must-have, particularly in a context where the underlying demand growth is modest or non-existent.

The learnings and conclusions from our 2014 power & gas retailers' benchmark of European incumbents indicate that there

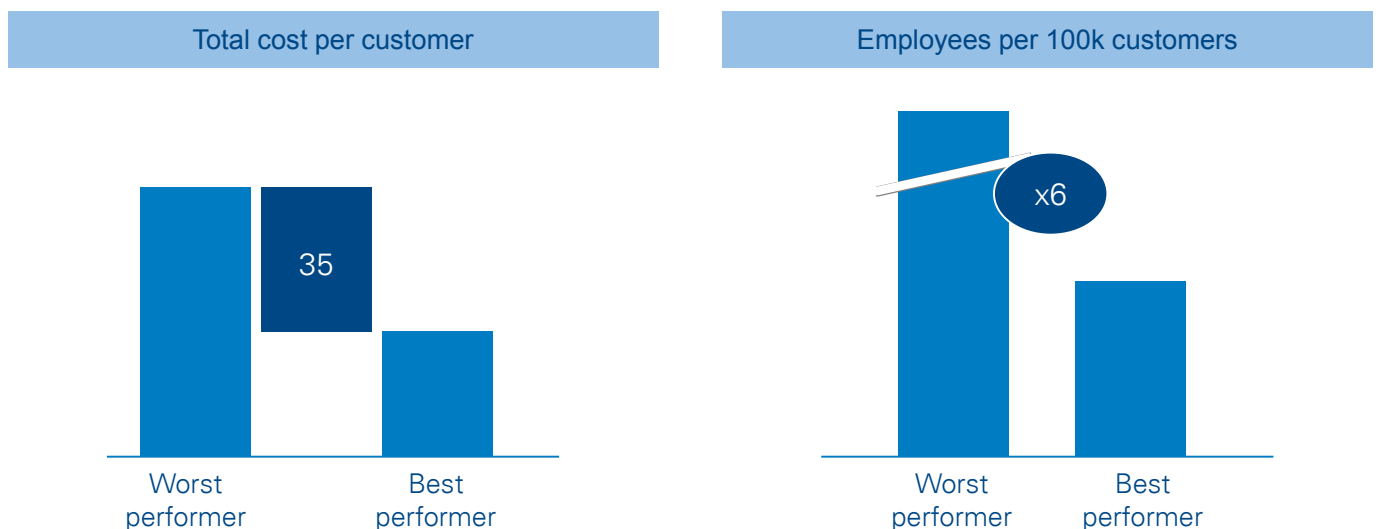
is a long way to go for many companies in improving their costs. The first section of this viewpoint reviews these findings and finds out that it is not uncommon to identify a difference in costs per customer of 35€ between best and worst performers. The second section summarizes the conclusions of the discussions and reviews we had with the different participants and the final remarks highlight some insights for power & gas retail executives.

Quantitative findings from the benchmark

Size matters ... up to a point

Economies of scale are relevant for retailers, particularly in the most massive segments. Most of the key activities in their

Figure 1: Differences among best and worst performing participants



processes gain from spreading their costs among a larger customer base – from building brands, putting in place new channels or IT systems- and certainly volume is extremely relevant from the energy risk-management side. We found that below 1 million contracts, companies do not seem to have enough scale to be able to invest in the key aspects of this business and run them efficiently.

However, our analyses show that there are limits to what these economies of scale can contribute. Among the best performing companies benchmarked we found some in the range of 2-3 million contracts and others with >8 million. Different elements play a role in these situations, but the most important is the focus of the company and its business-model so as to simplify the inherent complexities of such large customer bases and organizations.

Varying degrees of internet penetration in customer acquisition

Acquisition costs represent about 25-30% of the total. Here two main levers are found to have an impact: mix of channels used and unitary per channel costs. The mix of channels is very diverse and reflects different markets' preferences and degrees of development. Usage of internet channels, for instance, can vary from 3% of acquisitions to more than 20% in our sample. At the same time, our findings show that unitary, per channel costs can be 3x from one company to another. The efficiency on the channels' management and leaks on the acquisition process explain a big component of those differences.

The efficiency of the operations matters

Cost to serve represents for most companies half the cost base and illustrates the potential for improvement in most companies. These are components that receive most of the impact of regulation (in some countries, the minimal number of bills per year to be sent is regulated while, for instance, other companies are forced by Law to put in place toll-free phone numbers for complaints and basic operations of customer care).

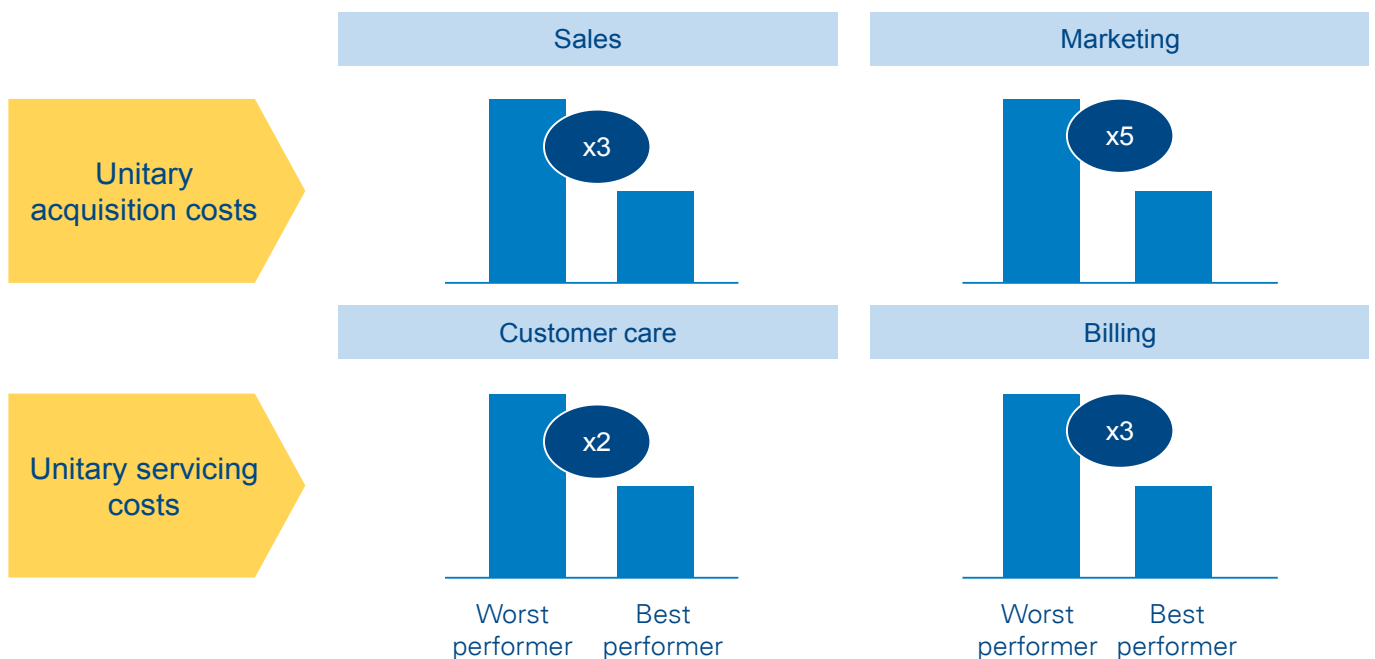
In the operations of billing and payments & collection, there are largely two groups of companies, those that on average bill and collect every month and those that do it every 3-4 months. Some companies manage the amount of bills to be sent by increasing e-bills – we found an e-bill penetration that varies from 4% to 55%. In the unitary cost comparison, we found that back-office processes unitary costs can vary by a factor of 3.

In the customer care operations, a factor of 2 can be observed between the best and worst performers. Here, part of the difference is explained by usage – an observed range between 1.1 and 2.1 operations by customer on average per year. Another relevant factor are the channel costs differences' -both in the usage mix and in their unitary costs- which follow a similar pattern to the one described for acquisition costs.

Great differences in overall productivity

In many companies overheads represent about a quarter of the total costs. Clearly, these are areas where the biggest differences can be found. From one company to another there are factors of x5.

Figure 2: Comparison of unitary per activity cost in different key processes



The productivity of total personnel differences we found are striking, as companies have an average of 14 employees per 100.000 customers but from best to worst performer there is a factor of 6. A good deal of the difference is explained by the degrees of outsourcing embedded in the business model.

On the other hand, IT spend reflects a stable percentage of the cost base, suggesting that more efficient companies are also more efficient at IT – in demand management, in project management as well as in the structuring of its architecture.

Conclusions from the discussions with participants

Cost management is a never-ending pursuit in power & gas retailers, although it is clearly only one side of the P&L equation. In some markets, good retail margins might be enough to pay their costs regardless of whether they are in the best performing group or not. But this situation might not last forever.

- Most of the companies involved in the benchmark are local incumbents. This means that they have followed a journey since the regulated days. In this journey each one of them has had to invest in new IT systems and tools, put in place marketing and sales departments, create new products and offering and -in the current era of digitalization- build up new channels and find new ways to compete. Not all companies are at the same stage in this journey – some have an advanced position, some others are in the process. In some instances this is reflected in the individual company components' cost – if they are building a new brand, or putting in place a new IT system, these are investments that will pay in the coming years.
- Acquisition costs tend to sky-rocket when churn rates begin to grow. We found a relevant relationship among companies whose churn rate is above their new customer acquisition rate, who tend to have very high acquisition costs. Managers in those situations are forced to use ever-more expensive channels to maintain their market share. The benchmark finds that companies that lose market share tend to have acquisition costs that are 2.3x higher than for companies that are growing. There could not be a more clear case for companies to invest in the loyalty of their customers.

- On the contrary, getting the most of the existing interactions of customers with channels also pays off. Maximization of the available cross-selling opportunities also makes a big difference to reduce unitary per channel sales' costs.
- Given the potential for automation of many of the operations' tasks involved in power & gas retailing and the big push towards digitalization, a high degree of outsourcing seems sensible. It facilitates a dynamic management of the cost base, it ensures labor costs are maintained at market rates and provides flexibility in a context of ever changing business models. Outsourced models require its own capabilities to be well managed, but are better suited to cope with shifts in volume (if particular sub-segments become unattractive, for instance). It is surprising to find out that for most of these commercially-driven organizations, the percentage of sales & marketing employees in the total headcount is quite low.

Final remarks

All in all, our findings show that incumbent power and gas retailers still have a long way to go to improve their efficiency. The prize is substantial. The greatly varying performance across many dimensions also indicates there are many areas that can be acted upon even for best-in-class, profitable companies. At the same time, these results also illustrate the difficulties of making it happen for companies who have been pursuing efficiency as a priority for many years.

In the current competitive context the number of new entrants is growing every day. Most of them develop new business models, without any legacies, and are born focused, with a segment and few products in mind. Most, if not all, are digital since the beginning or with organizations that the soon they reach a critical mass, they'll become hyper-productive.

Arthur D. Little's Energy & Utilities practice has been supporting leading power & gas retailers in Europe in their transformation into commercially effective as well as efficient organizations, across the different segments and processes. We have a deep understanding of the issues and trade-offs involved, as well as the market differences to help utilities win the battle for efficiency and customer value. Should you be interested, do not hesitate to contact us.

Technical note on the benchmark, 2014

- Costs of power & gas commercial companies, for the retail segment.
 - Costs include acquisition costs (marketing – above and below the line, sales' organization and channels and contracting), cost-to-serve (customer care costs, billing and collecting) as well as the related overheads or staff functions of the company or business unit (HR, Finance, Legal, CEO office,...). All related personnel, IT-systems and facilities' costs are included in the respective processes.
 - Costs excluded are: commodity costs, meter installing and reading and the costs related to selling services
 - A customer is considered to be a contract.
- Companies included in the benchmark are all incumbents in European markets (either in power or gas), with 2 million customers or more. Average sample size is 5 million customers per participant.
- Arthur D. Little Energy & Utilities Practice carried out the data management and quality and comparability control provided by participants as well as the comparative analyses

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Arthur D. Little

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