Economic Consulting Associates
Viewpoint

Price caps, merger talks: why bother?

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The recently announced merger between the supply businesses of npower and SSE is in stark contrast to the emergence of much smaller suppliers including municipal energy offerings. Is the move to greater scale a correct defensive response? And how has the threat of price caps affected the decision? What is the future of supply in GB?

What is an energy supply business?

The superficial answer is that it is a means of getting generation and gas to customers and then billing the customer. This is a GB definition but, with separation of supply from distribution, it is now the EU norm. In GB it has developed as a means of delivering a bundled product to customers with the supplier having the key commercial relationship with the customer. The bundled nature of supply has led to ever more obligations being placed on suppliers: support to vulnerable customers, green tariffs, energy efficiency initiatives; the supply business is becoming more than energy procurement, metering and billing.

In the reverse direction, the customer is no longer a passive receiver of services. Smart metering will supposedly herald an era of active consumption management; already electricity ancillary services are being offered by customers to National Grid.

Much of this is exaggerated. The essence of a supply business remains: making a supply contract with the customer, procuring wholesale energy, forecasting short-term demand and minimising imbalance, metering, billing and collecting. Another major element of the supply business is cashflow management: forward purchase, customer credit and collection of money.

Are there economies of scale?

Ignoring the mooted new services that smart metering is meant to deliver, the supply business is a bulk business for the most part. A large database of customers will link together customers, meters, meter readings, load profiles and sundry other information to provide a pool of demand that must be procured. There are economies of scale in procuring new customers but, in the technological age, not many real economies in database management. There do remain economies in credit management (for wholesale energy procurement) and there used to be big economies in demand forecasting (because the forecast error percentage is inversely proportional to size of portfolio); in the new world of a single electricity imbalance cashout price, this scale advantage diminishes – the advent of multiple new small suppliers is testimony to this.

New small suppliers offer a new perspective. Some are specialist (eg green suppliers) but most others rely on nimbleness (smartphone apps, etc). The real issue for these suppliers remains access to wholesale energy; the Secure and Promote licence condition (in electricity) has done much to provide such access, mitigating the previous advantage held by the Big 6 through vertical integration. There is also a small advantage from a few services that small suppliers do not need to provide. It remains to be seen how robust these new entrants will be in a situation where there is

an unexpected jump in wholesale energy prices.

So what would a price cap do?

Much of the increase in retail electricity cost has been due to an increase in obligations (such as green supply) placed on suppliers as well as higher network costs that suppliers must pass through. But suppliers have been blamed when wholesale prices have risen, and they are certainly exploiting the inertia of their core (but probably diminishing) customer base who failed to switch to competitive – ie lower margin – supply contracts. The drive towards price caps is therefore driven by misplaced anger at generally rising prices and 'justified' anger at exploitation of loyal customers to cross-subsidise new customer acquisition.

The form of price cap is not yet determined but it is most likely to cut margins on supply to loyal customers. This will mean that suppliers will be forced to charge more to new customers in order to maintain a positive margin. With less to offer in terms of price advantage, suppliers will need to rely on the elusive and nebulous 'better' service in order to win new customers; it is far from clear that the current large businesses will be adept at this strategy although imitation of services offered by rivals will generally not be expensive.

This leaves the market open to the nimbler small suppliers to offer service packages that entice customers; those reliant on cheaper energy to attract new customers are likely to be no more successful than their larger competitors.

So does merging supply businesses make sense?

In light of the above, what advantages do npower and SSE foresee in their proposed merger; two large weak businesses merging will not usually create one large strong business unless it enables exertion of market power, which price cap prevents.

There will be some economies of scale in administration but no respite from price cap and reduced advantage from vertical integration as the new business will need to be separated from the unintegrated generation portfolios of the parent companies. It is not clear that such a business would be able to offer a superior service to customers. With price cap preventing exertion of market power there is only really potential in monopsony advantage in wholesale energy procurement and even here, it is not likely that they will want to cannibalise upstream profits to their generation businesses by cutting wholesale prices.

The true advantage may well be in pure financial robustness. This would put it in good stead for offering Supplier of Last Resort services (to Ofgem); which gives it a cheap way of building market share as fringe suppliers fail under market pressures (price cap limits margins on all suppliers). Or it may simply be that this provides a means to start to exit an unattractive market where there are few obvious external buyers given the lack of any distinctive competitive strength among any of the Big 6 supply businesses.

But the logic of all of this is that the process will continue until a near-monopoly supplier exists operating under a regulated price cap, returning us to something like the pre-privatisation market.

Economic Consulting Associates was established in 1997 to provide economic and regulatory consulting services to industry and government. Our senior staff have many years' experience of carrying out economic, market and policy analyses in the electricity, natural gas and water sectors.

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