

Ian Peters, MD Residential Energy, British Gas - Cornwall Energy Conference, 3 June 2014

Good afternoon. Thank you very much for coming.

I'm Ian Peters - and I'm the Managing Director of Residential Energy at British Gas.

Thank you to Nigel for inviting me to speak at this event.

Our subject today is competition and innovation in the energy industry.

With Ofgem considering whether to refer the energy sector to the CMA, it is difficult to think of a time when the subject of this speech has more relevance.

Today I want to explore two key questions:

Is the energy industry competitive?

And does competition in the industry benefit customers?

On this latter point, Nigel has asked me to set out my thoughts on the impact of innovation in particular – and as it's a subject close to my heart, I'm very happy to do so.

But before I get there, you may be aware that at the end of May we wrote to Ofgem saying that we welcomed a reference of the sector to the CMA. This wasn't because we have any concerns about the level of effective competition in the sector. On the contrary, I believe that if we look at the facts, it's very hard to argue that this is not a competitive industry.

In my part of the business - residential energy - that's supplying gas and electricity to homes of course - I have 24 competitors.

I have the other 5 who make up the rest of the so called 'big 6'.

There are 4 intermediate players who are now established as real competitive forces in the market – so much so they are starting to lose their exemptions from government environmental and social schemes.

And then there are 15 other suppliers who measure their customer numbers in the tens of thousands.

These 24 all compete vigorously for my customers' business.

Of course one of the measures of healthy competition - though not the only measure - is the ability to switch supplier.

In addition to the efforts of the 24 to woo my customers, the 11 accredited switching sites provide a simple 'one stop shop' for consumers - driving people to the company and a tariff that they feel is right for them.

Before the market was opened up, British Gas, by definition, was a monopoly - and had 100% of all gas supply customers in Britain.

Today, that figure stands at 38%. In itself, an indication that competition has worked in Britain.

And, of course, the 38% includes many customers who have financially benefited from competition by either switching away and returning or by switching tariff or payment method with us.

Conversely, at the time of its privatisation British Gas didn't sell any electricity - the electricity firms had regional monopolies on that.

Today, 80% of our customers receive electricity as well as gas from us - and every single one of those electricity accounts were won in this competitive market. This is hardly surprising given most customers engage with the market on a dual fuel basis.

So we've won business from the former electricity suppliers, just as they've won gas business from us.

Overall, more than 90% of Britain's energy consumers have had some kind of engagement with the privatised energy market - whether it's through a different tariff, a new supplier or particular discounts.

It is true that switching numbers have fallen steadily till last year due to the withdrawal of doorstep sales, improved service and an end to deep discounting. However, since October last year, 2.37 million homes have switched supplier - that's 10% of the market in seven months.

A very significant number in such a short period of time. Smaller suppliers took much of the benefit of this, in no small part due to the £70 advantage they enjoy through environmental and social levy exemptions. They now represent around 5% of the market, and continue to grow.

And how have we won each other's business? By being competitive, on price of course, but also service.

This competitive pressure has resulted in the UK having some of the lowest energy prices in Europe - we're the 2nd cheapest for gas and the 5th cheapest for electricity.

But it's important to remember that switching from company to company is not the only measure of a healthy, competitive and engaged market.

To get a rounded view of engagement, all customer interventions with the market that benefit customers should be included.

So switching within companies is also an indication of a competitive market - because we have to respond to attempts by competitors to 'eat our lunch'. Competition means that prices get driven down for everybody and we have to work harder.

At British Gas, through our tariff check service, we offer exactly the same deal to existing customers as we do to new ones - no particular group of customers gets a better deal. So even those who are less engaged with the market still benefit from competition - this is an important point.

And staying with the same company is a perfectly valid - and logical - customer choice.

We've seen so called 'intra' company switching grow significantly at British Gas - customers engaging with the market, making choices about the tariff they want - but electing to stay with us.

As recently as 2007, the amount of switching within the company was minimal. It's now around 25% each year. In 2014 alone we've seen 2.1m accounts change their product or payment choice as awareness of this service increases

It is wrong and - I would dare to say - rather patronising to assume, as some people seem to, that those who stay with one energy company are doing so out of inertia, or because of some imbalance or lack of competition in the industry. My mother is 80 and has had her gas with British Gas since 1956 (but never her electricity). She would take offence at being called inert – she has a fixed term, fixed price contract and manages her account off a smart phone.

In fact, many customers are proactively staying with us - they trust us, they like our service, and they know that we write to them if we have a cheaper deal for them.

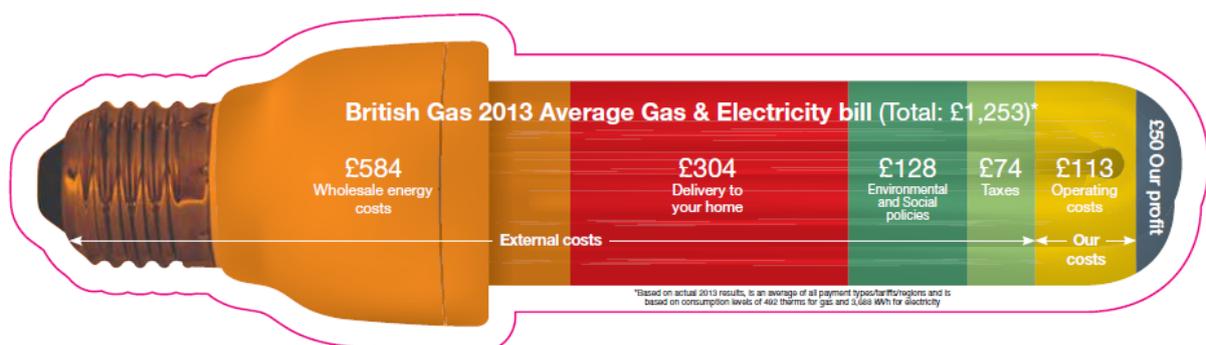
So we know that price is one of the main drivers of competition.

But can we see the benefits of competition in the price itself?

Let's look at the make-up of an energy bill. What defines the price?

Many of you will be familiar with our lightbulb graphic (see Fig.1 below) - you'll see some around the room. It shows exactly what drives the price we charge for a typical dual fuel household in 2013.

Fig.1



Starting from the left - **section 1** is the energy itself, the wholesale cost.

And you'll see how this is now less than half the bill.

And that simple fact partly explains why the wholesale price can fall, but overall prices don't - because other parts of the bill can rise. The other is that most suppliers buy their energy in advance, up to 3 years in some cases – to ensure security of supply and smooth out price volatility. It's one of the great misunderstandings of how this industry works.

This element is the one most controllable through improved energy efficiency. My average customer uses around 25% less gas than five years ago due to insulation and more efficient boilers – and I accept some changes in behaviour. It is also very weather sensitive – This year's bills are likely to be down on last year's.

Some of the other parts of the bill certainly have risen. Let's work through them (Fig.1):

- section 2, the cost of transport and delivery;
- section 3, government environmental charges (such as energy efficiency obligations and support for renewable energy), plus some costs for supporting our most vulnerable customers. Small suppliers enjoying exemptions from paying most of these;
- section 4, the tax we pay;
- section 5, our operating costs;
- and section 6 - by some margin the smallest part - our profit.

You will notice that the vast majority of the lightbulb - around 85%, is made up of factors that are external to our business.

I would, however, say that section 2 of the bill - transport and delivery charges - is one part of the energy bill that has not yet been fully scrutinised - and there are some opportunities for cost savings here. If Ofgem were to reverse two recent one off decisions that could see customers £13 better off. By making its proposed electricity price control more efficient we could save customers a further £10 a year.

We certainly welcome the Energy and Climate Change Select Committee's interest in this part of the bill, and we've written to the National Audit Office asking them to review whether customers are being as well served as they might be. British Gas does not own any part of the distribution networks - unlike some of our competitors. So as things stand, we just have to pay the regulated charges.

One part of the bill over which we do have direct control is our operating costs. We work incredibly hard to run the business as efficiently as we possibly can. And across our entire group, £600 million of costs have been removed from the business in the last few years, £300 from my part of the company, without impairing service.

But when our costs fall, our prices do too. In December, the government proposed to restructure the energy efficiency scheme ECO. British Gas was the first supplier to announce and introduce a £42 price cut as a result for all our customers, including those on fixed deals, the only supplier to do so.

Our profits at under 5% post tax are low in margin terms compared to other industries and have been steadily falling.

So overall, contrary to an increasingly popular view, lack of competition is not the reason prices have risen - in fact, high levels of competition have delivered, and kept prices lower than they otherwise would have been.

And in a market where external factors are the primary driver of price - 85% of the 'lightbulb' remember - it should be no surprise if pricing trends are similar across suppliers - it's because, aside from the small suppliers, we have broadly the same external costs.

It's why we utterly reject the suggestion that we coordinate or collude - tacitly or otherwise - with other suppliers on price. To think that we do is a fundamental misunderstanding of how this market works. It simply doesn't happen.

But for some of our critics, downstream - residential energy supply, is not where they think there is an issue.

They believe that industry makes excess profit in the upstream part of our businesses - where we extract, generate and purchase energy - and that our size and scale allows us to 'self-supply' - selling energy to ourselves.

British Gas is certainly part of a vertically integrated British energy company - Centrica.

Centrica has a global upstream operation, as well as my part of the business, plus a trading division known as midstream.

This vertically integrated structure actually brings a benefit to customers: it costs us less to borrow money to invest - our cost of capital is lower - and we need less upfront capital when we buy gas and power to supply. This all makes us a more efficient organisation.

Our vertically integrated structure, our size and our healthy balance sheet enables us to have long term contracts with international gas sellers - our recent deals with Norway and Qatar for example would have been much more difficult if we were a smaller business. Indeed, we have £60bn worth of long term gas contracts that secure supplies for UK.

As for selling energy to ourselves, in 2013, British Gas only bought 7% of its gas, and 14% of its electricity from Centrica Energy - and every single therm and kilowatt hour of that was at prevailing market rates in transactions that were independently audited by PWC. Even if we wanted to we could not supply all of our own customer base with our own supplies. So in our case, self-supply is something of a myth.

There are no 'hidden millions' in this part of our business - or any part of the business - that could be used to bring down prices for our customers.

We run each part of the Centrica business strictly independently - publishing more information than any other energy company on the profits we make in each part of the business.

Interestingly, SSE recently announced an intention to move its upstream business into a separate legal entity. This is something that we did in 2013.

I do accept that the industry overall has a case to answer on transparency of its upstream and trading businesses. Opaque reporting feeds suspicion. That is why we have taken the lead on our disclosures and urge others to follow.

To my second question - does competition in the industry benefit customers?

There's a simple answer to this question - yes.

We have a very competitive market in Britain - and you can see that in the number of suppliers competing for business and the low prices compared to much of the rest of Europe.

But if the answer is so simple - why am I asking it?

It's because it's important to remember that a healthy competitive market is not necessarily what everyone may think it is.

In fact, a competitive market which keeps prices lower - as ours has - should also drive service levels up - as suppliers must offer a better service to encourage its customers to stay with them.

And competition of course, exists in tandem with the current demands of simplicity of pricing and tariff structure. The two co-exist, but it is a sometimes uneasy relationship.

Ofgem's RMR has sought to bring greater simplicity to the market. We support this principle - although some of the measures have perhaps gone too far. For example we, alongside Consumer Futures, are currently lobbying Ofgem to allow us to offer a product with a low standing charge to help those who consume less energy than average, something I can't do with only four tariffs.

So in this debate about competition, we have to be clear about what a competitive market looks like, and be careful to ensure that we don't misunderstand some of the inherent dynamics that come with the complex business of supplying energy.

But there is something else that is also a sign of a competitive market - and that's innovation.

The recent State of the Market review expressed disappointment with the lack of innovation across the industry. However, I am pleased that it recognised that British Gas has taken a strong lead in this area.

Competition has driven us to be clearer in our billing (which has won awards and where I intend to go further), more transparent with our prices and profits, leading the industry on speeding up switching between suppliers and likewise on personalised tariff comparisons. We've made a lot of progress on this front and will continue to do so.

British Gas have introduced smart meters earlier than all our competitors with 1.3m installed (85% of smart meters are British Gas), putting customers in control of their energy and helping them to reduce their bills.

This innovation is benefiting all our customers. British Gas prepayment meter customers for example, will shortly be able to top their meter via their smart phone instead of going to the Post Office. We'll also provide them with configurable text alerts to let them know when their credit is running out.

Research shows that customers who have smart meters are far more engaged in their energy supply. We provide all of them with a monthly report (on line or paper) showing their usage by time of day or day in the week, compared with last month, last year, and with similar homes. It also gives an approximation of which appliances have used what. Ultimately, we're on a path to itemised billing – and that will create real understanding and control, the lack of which is a major cause of the mistrust which beleaguers the industry. A bill right now is a demand for payment expressed in kilowatt hours – a currency inexplicable to most.

When customers can see their usage leap when they turn on the kettle or their favourite gadget, they are more likely to think about how they contract for their energy, and whether their tariff is right for them. So we're also pressing ahead with a suite of innovative time of use tariffs that will capitalize on this engagement such as those for electric vehicle charging and Free Saturday's (despite what you may read in some of the papers!).

We're putting energy efficiency - cutting bills by cutting consumption - at the heart of everything we do.

And we've developed innovative propositions - like HIVE that allows you to control your heating and hot water from your mobile or smartphone. Did you know that the most common place from which to turn your heating on and off is – your bed! But beware, when both partners have a Hive enabled smart phone it's a recipe for domestic strife! Even within the constraints of RMR, we've already launched different ways to pay for Hive through you energy bill as both a 'mandatory' and 'optional' bundle.

Our website and suite of other apps is leading the industry with one million customers regularly using them. It's staggering even for me to realize that two thirds of all of our customer interactions are now digital, and more remarkably, nearly half of those now start from a smart phone. One unique development to recognize that demand is Mobile Energy (ME), as far as I know the first entirely smart phone energy service through which you can join, pay your bills and do everything you need.

Finally, and you might expect me to say this, customers benefit from further innovation and choice through affinity partners such as Sainsbury's Energy as they unlock additional tariff options. We've recently had in market a 2018 contract and a low standing charge offer through them. The future of these is currently being reviewed by Ofgem.

So a competitive market will see switching, and it will see more competitors. It will see downward pressure on prices, operating costs and profits, and it will see innovation that brings benefits and savings to customers.

I believe you see this in the industry, and I believe that you see this particularly at British Gas. This is a competitive market.

I'd like to wrap-up now with one final thought:

I have over nine million customers. I value every single one. And I never take them for granted. I want every single one to stay with us and to keep buying energy and related services from us. And I want more people to join British Gas.

This is the focus of everything we do - every day. And I hope that a thorough and comprehensive review by the CMA will be a great opportunity for us to demonstrate this fact.

Thank you very much.

ENDS