Energy transition put at risk – The case of Belgium

To address the current deadlock, all market actors must build a shared vision

In trying to achieve the ambitious renewable energy target of carbon neutrality by 2050, many European markets are entering critical phases in the energy transition. Belgium is one such case, where the decisions in the next one to two years will have long-lasting societal and economic consequences. Energy retailers currently face unfavorable market trends that may prevent them from playing the important innovation and investment role we expect of them. Therefore, it is increasingly urgent that we forge a shared and common energy vision that builds a business case that addresses both the energy retail challenges as well as our much-needed energy transition. In this Viewpoint, we highlight the case of Belgium, which is an archetype for multiple other markets in Europe and beyond.

Worrying market symptoms

In February 2020, Arthur D. Little published a report titled "Energy Retailers: Facing the Toughest Transition in the Energy Sector,"[1] which highlighted five key challenges energy retailers throughout Europe face:

- Low profitability
- Sky-high switching rates
- A whole lot of new competition
- Changing and evolving regulation
- Low agility of the incumbents

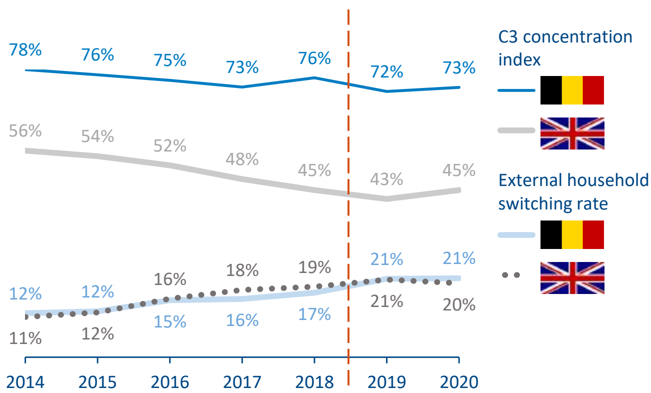
The report provided a series of recommendations for energy retailers, considering these five challenges as opportunities to leverage in order to unlock new pools of value.

In this Viewpoint, we zoom in on Belgium today, which demonstrates very mixed results from its management of the energy transition. Since early 2020, the Belgian energy retail market situation has deteriorated: new entrants struggle to expand their market shares, and the regulatory landscape makes it increasingly difficult for healthy competition and innovation to persist.

The C3 concentration index (the combined marketshare of the three largest electricity suppliers) provides an illustration of the situation (see figure below). At the end of 2020, the index was back at its 2017 level. The recent decision of Essent to leave the Belgian retail market could propel the market back to its 2014 level, when the three largest suppliers were serving nearly 80% of the market.

In response to this difficult market context, energy retailers take divestment and exit decisions that may structurally affect energy customers and can jeopardize the success of climate commitments Belgian authorities have made.

UK and Belgian electricity retail market concentration (2014-2020)



Source: Ofgem, CREG, VREG, BRUGEL, CWaPE, Arthur D. Little analysis

1 https://www.adlittle.com/en/insights/report/energy-retailers-facing-toughest-transition-energy-sector

Market concentration: consolidation and divestment

Low market concentration and high switching rates are good indicators of reasonable market health and its ability to attract new entrants and new investments.

Observing mature EU markets such as the UK (see figure page 1), can provide interesting insights, enabling us to put the Belgian situation into perspective:

- Between 2016 and 2017, the combined market share of the three largest suppliers dropped quickly and the external household switching rate[2] grew inversely proportionally. Many new suppliers entered the market and the suppliers' net entry ratio[3] amounted to +28.
- Since 2018, the concentration index and the external household switching rate are stabilizing. Many suppliers are exiting a market that saw few new entrants, and the suppliers' net entry ratio amounts to -13.

Applying the same analysis to the Belgian market raises two main concerns:

- We observe a similar stabilization phase since 2019. Essent's market exit decision could be a warning sign of what may result in a second exit wave after the one in 2018. At that time, many suppliers exited, including Eni, Belpower, Enovos, Comfort Energy, and Energy People.
- The stabilization of the market concentration happened at a much higher level than in the UK. The Belgian concentration index is stabilizing around 73% versus 45% in the UK (see figure page 1).

The decision taken by some suppliers to abandon less profitable segments also confirms the lack of perspective in the regional market at large. Engie recently announced its intention to divest its energy services subsidiaries (including Fabricom and Axima). Meanwhile, Luminus is following the opposite strategy by heavily investing in energy services companies. This could result in the two largest market players not facing sizable competition in their specific segments. In any case, these indicators do not suggest that the Belgian energy supplier market is attractive and therefore stimulating for new actors to enter the game; rather, it seems a market where it is complex to keep some retail activities profitable.

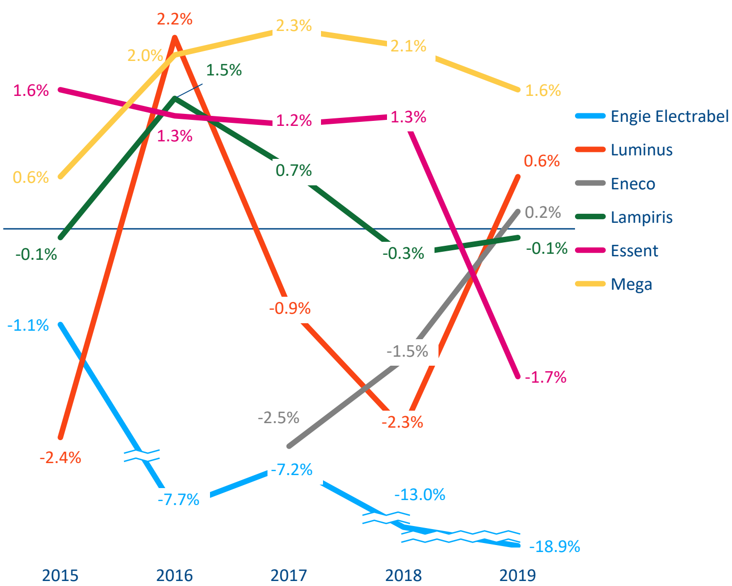
The energy transition bill: a pass-through to energy customers

In support of the energy transition and the nuclear phaseout, Belgian authorities are designing the capacity remuneration mechanism (CRM). The CRM will subsidize energy capacity through an auction system where the cost, estimated between €238[4] and €400[5] million per year the next 15 years, will be mostly borne by the customers through direct and indirect taxes.

In 2020, Belgium was among the top three EU countries in terms of high household electricity prices, with an energy price 31% higher than the EU27 average.[6] Taxes constitute one-third of this price (with the commodity component and grid tariffs each accounting for another one-third). The CRM mechanism will further increase the average electricity spending per household by 5% to 8%.[7]

Other alternatives beyond the CRM exist, such as requiring each supplier to make a certain capacity available, but that is possible only if those suppliers have a strong enough financial position. The figure below reveals that most of the Belgian energy players' operating margins are negative or close to zero.

Net operating margin[8] of the six largest retailers (including non-retail activities, 2015-2019)



Source: Company financial statements, Arthur D. Little analysis

2 The act of voluntarily changing supplier; in contrast to internal switching, in which the customer changes their contract but remains with the same supplier.
3 The number of suppliers entering the market minus the number of suppliers exiting it.
4 Source: Haulogy CRM cost assessment report (Feb 2021).
5 Estimation done by Professor Damien Ernst, University of Liege, LN24 (11/03/2021).
6 Source: Eurostat.
7 Assumptions: 5 million households consuming on average 3500kWh/year at a price of 0,28€/kWh in 2020.
8 Since 2016, the revision of the nuclear provisions has negatively impacted Engie Electrabel operating margin through non-recurring operating charges. Excluding the non-recurring operating charges, Engie's operational margin fluctuated between 1,3% and -6.4%.

The few retailers still generating a positive operational result have margins far below the Belgian cross-sectorial average (3.48% in 2018). This gives little breathing room to the suppliers, which means that additional market costs like new taxes or investments in alternative energy sources are automatically cascaded to the customers.

Regulatory pressure and new market models

The Belgian regulatory landscape consists of five different actors: one federal regulator, three regional regulators, and the European Parliament. The ever-changing regulation has various impacts on retailers who must constantly adapt their IT systems, billing/pricing processes, and reporting and accounting. In addition to affecting the retailers' operations, these changes typically negatively impact the end customer's bill since the retailers are not able to fully absorb the induced costs.

In parallel to new regulations, a new market model has been in the project pipeline of market actors since 2016. Atrias, a platform that should simplify the data exchange on the market, has been repeatedly postponed since 2018, mostly due to moving regulatory specifications and heavy test phases requiring market-wide synchronization. This challenging regulatory context adds an additional barrier that discourages new market entrants.

Conclusion and recommendations

The energy retail business clearly is under pressure. The worrying symptoms are not new; more concerning is the fact that these symptoms are getting worse at a defining moment where all active market forces should be enabled and allowed to focus on the energy transition challenges we face.

It is the role of local authorities and regulators to ensure that the competitive environment is healthy across regions as well as to prevent additional pressure on retailers that have been in a survival mode for a couple of years. The recent acquisitions and the absence of new entrants demonstrate the challenge to survive in this market, where the capacity to invest and diversify to gain access to new sources of revenue is extremely difficult even for best-in-class players. Unattractive markets tend to chase investors away.

So, what's next? Several tracks can be explored, among which we recommend:

- The establishment of a national regulatory platform rationalizing and simplifying the regulatory framework and funneling market communications. The platform may offer impact assessment, communication, and data consolidation services to the different regulators while allowing them to further develop their own regulatory agendas.
- The reinforcement of market consultation mechanisms with a stronger representation of market players, customer associations, and energy-intensive industries. Facilitation of the ecosystem must enable an appropriate degree of freedom to enable the market to do its job, which is to enable and stimulate the energy transition by creating a sufficiently attractive context for doing business.
- The definition of a strategy for procuring additional and alternative sources of flexibility (e.g., distributed energy flexibility from large assets but also from residential and industrial clients). Again, all energy players, and mainly network operators, would need to explore together what actions and incentives can be made available to all market participants.

Of course, additional efforts from energy retailers are necessary as well to improve their operational excellence through digitalization and lean processes with the objective to reach better annual results. But overall, there is a clear need for everybody (the regulator(s), the government(s), and the public and private stakeholders) to sit around the table together and to ensure the Belgian market remains attractive for their own sakes as well as for the sake of the energy transition.

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Viewpoint

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