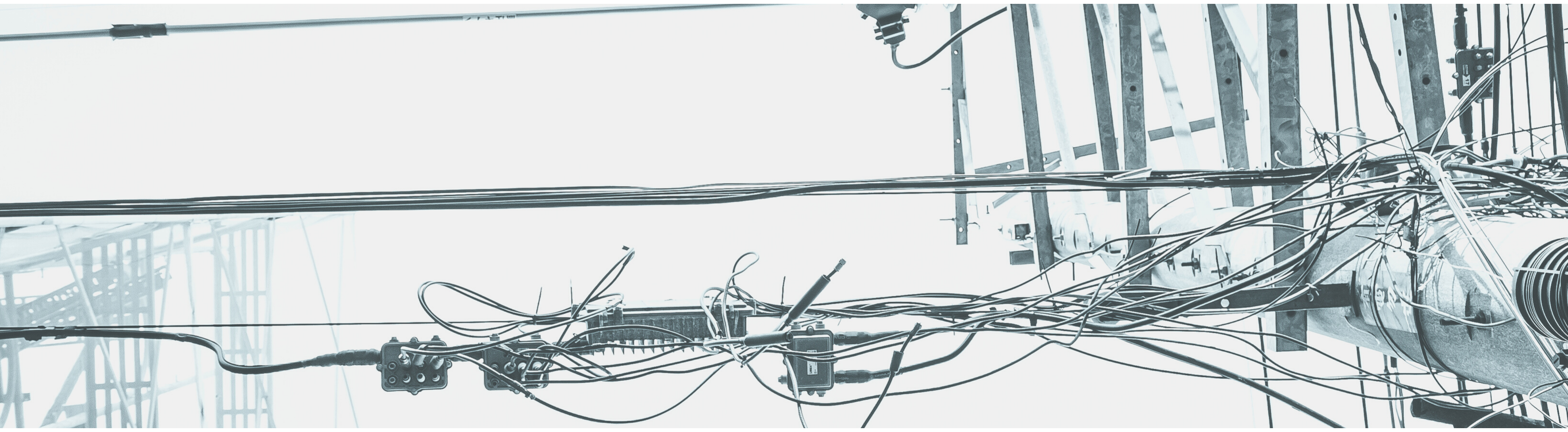

What NRG's Acquisition of Direct Energy Means for C&I Buyers in the U.S. and U.K.

In a surprise move on Friday, NRG Energy announced that it would purchase Direct Energy in what was described by Energy Choice Matters as a "highly compelling unsolicited offer" from NRG. The deal was a warm welcome for the ailing Centrica, which saw its shares pop by more than 20% when the deal was announced on Friday.

The transaction is subject to approval by the Federal Energy Regulatory Commission (FERC) as well as Centrica shareholders, and is expected to close by the end of 2020. Once the transaction is complete, it will likely take several years for NRG to fully integrate Direct's retail business into its own platform.

Centrica, the parent company of UK based British Gas, whose financial position has deteriorated in light of the pandemic due to collapsed gas prices paired with a precipitous drop in demand from customers, has seen a loss of over 200,000 British Gas customers in the first half of this year. The $3.6Bn cash infusion from the transaction could go a long way to shoring up the position of British Gas.

Impact on UK Consumers of British Gas

Prior to 2020, the UK had already seen a transition towards consolidation of energy suppliers with the acquisition of Npower by E.ON, which has meant fewer options for consumers. The latest move from Centrica to divest its Direct Energy business, however, may have the potential to improve the British Gas unit by allowing Centrica to focus resources and attention on this marquee business.

British Gas is already a top player in the industry, and without the distraction of North American Direct Energy, Centrica would have the ability to focus on its principal markets as expressed by Centrica's CEO. This belief was shared by the market, as Centrica shares reacted positively after the announcement on Friday with shareholders believing the move could lead to British Gas gaining market share in their core UK and Ireland markets while strengthening the struggling balance sheet.
"This disposal is aligned to our strategy to become a simpler, leaner business and in addition it will materially strengthen our balance sheet and remove a source of earnings volatility from the Group," said Chris O'Shea, Centrica's group CEO.

Although the UK and US markets are both deregulated and structured similarly, there are major differences in how each market operates. Supplying energy in North America is becoming increasingly more complex, with electric capacity costs harder to forecast and capacity exempt industrial gas consumers becoming more problematic to manage. Divesting of the North American Direct Energy business is likely a good move for Centrica and British Gas, and thus its consumers. Direct Energy has been rumoured to undercut the market in order to gain marquee clients, even if doing so resulted in losses to their business. This was believed to be happening in the wake of the Polar-Vortex in 2014.

British Gas now has an opportunity to improve its business to better serve its customer base. O'Shea has said Centrica's mission "is to turn around the company by putting customers at the heart of everything we do and creating a simpler, leaner, more modern and more sustainable company". British Gas lost 226,000 customers in the first half of 2020, on top of the 107,000 energy customers lost in 2019. The divestment of Direct Energy will allow Centrica to place British Gas in a better position to retain and grow their customer base going forward.

Impact to US consumers of losing Direct Energy

Direct Energy has consistently maintained a position as one of the US' largest electric retail suppliers despite a history of forming and acquiring peripheral initiatives that have at times seemed to distract from the main business. They've maintained the market leader position on the front lines of regulatory battles across the country as an advocate for the C&I client, and most recently led the regulatory charge to open the Virginia market to a wider category of retail consumers.

Direct has thus far been able to advocate for the position of the C&I consumer without capitulating to the conflicts inherent of retail suppliers owned by large generation behemoths, as interests of the generation owner oftentimes does not align with that of the retail consumer. Being owned by NRG may have an impact on the independence of the business' strong Regulatory Affairs' group.

Full integration of the Direct Energy retail business into NRG's platform will likely take several years, and NRG will have to decide if they want to preserve Direct's strong brand that is well known in each of its North American markets.

It isn't uncommon for acquirers of multiple retail businesses to keep each unit operating as its own business line with only a shared infrastructure. If NRG takes this approach, it won't appear to consumers that the market has consolidated at all, but the truth is that shared infrastructure is bound to lead to a levelization of prices, or in other words less competition.

The acquisition is expected to have an outsized impact on the Texas market especially, and would make NRG the effective controller of 75% of the deregulated market in the state. As reported by the Houston Chronicle, consumer advocate groups, such as the Texas Coalition for Affordable Power suggest that the "shrinking market for retail electricity is a sign that the 2-decade-old deregulation effort might not be working as the Legislature intended."

Having the backing of a large owner of generation assets in North America will make Direct's pricing more accurate, allowing the business to avoid repeating some of the mistakes that have led to significant losses in previous years. Being owned under an umbrella of other retail businesses will mean that prices of each of the units will in all likelihood converge, but the synergies with an owner of generation assets should allow Direct to offer even more competitive pricing and product structures to C&I customers. However, with reduced competition, it's hard to say whether these synergies will result in lower costs for the consumer, as competition acts as the primary mechanism for ensuring low prices.

The bottom line for C&I clients in the US is that the acquisition of one of the nation's top three retail suppliers will lead to less competition, which will make having an independent advocate to negotiate for contract terms and innovative product structures even more important.