Feeling the heat

CHRIS BOWDEN URGES TREASURERS TO TAKE CONTROL OF ENERGY COSTS.

Will this winter be the big freeze that everyone is predicting? Will the UK's gas supplies be enough? Can gas prices go any higher, or are they set to come back down? These are the questions occupying the UK's major energy consumers at the moment. Following on from the hurricane-induced spikes in oil prices, they are giving both energy buyers and treasurers a deeply concerning winter. For many, the full meaning of the Chinese curse "May you live in interesting times" has become distressingly apparent.

In fact, winter 2005/2006 is the culmination of a year which has seen a series of record price spikes as yet another factor comes into play and pushes them still higher. The result has been that energy, never a minor consideration, has become one of the biggest cost centres in the budget.

The current contract cycle perfectly illustrates the predicament in which many businesses find themselves. On 12 July, during the run-up to the October 2005 contract round, the price for October annual base-load electricity soared to £57 per megawatt, just when many buyers were renewing contracts. This represents an increase of more than 200% on prices for the same underlying contract period two years ago. For many organisations that are coming out of two-year or maybe three-year deals, these price rises are extremely damaging.

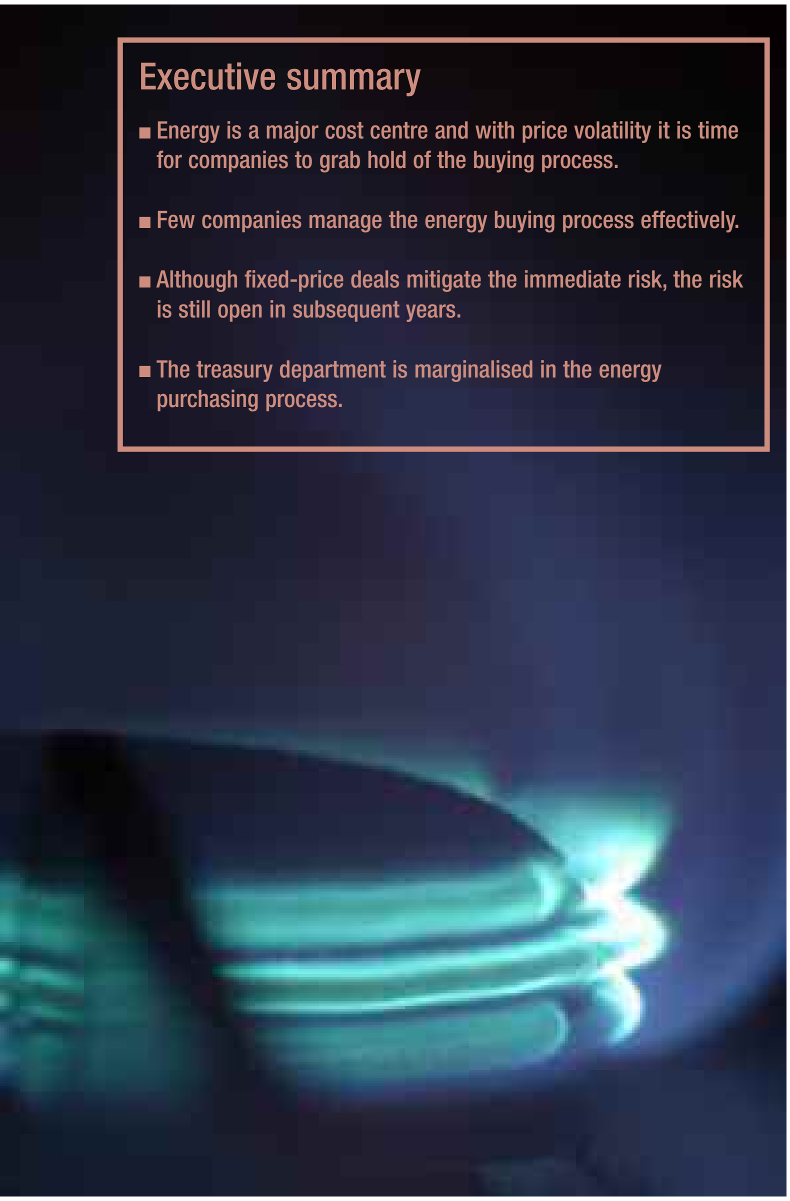
And then there's the meteoric rise in the cost of gas: spot prices are hitting highs of 170 pence-plus per therm. For companies used to paying a third of that price, this cost is potentially crippling. So much so that the Energy Intensive Users Group, which covers a large number of UK manufacturing plants, has evidence suggesting that some UK companies have shut their operations partly because of these spiralling prices. In fact, we have already seen some do so. It also seems likely that a higher than average number of profit warnings will be issued in the first quarter of 2006 as energy prices take their toll.

To make matters worse, energy has also become an increasingly unpredictable cost centre. Over the last 12 months, prices have not risen in a steady linear growth, but as a series of peaks and troughs, which has resulted in a cumulative price rise.

THE ENERGY BUYING CYCLE The fact is, whether it's a cold winter or not, the prices of oil, gas and electricity are subject to extreme price volatility. Energy-intensive consumers all over the world are affected by the fluctuating prices of an uncertain market.

And that makes it perhaps all the more surprising that most companies in the UK do not manage the energy buying process effectively. Had they hedged against the risk of price rises, they would not now be exposed to the extremely high spot prices for immediate supply, and the very hefty energy bills that come with them.

In the last three or four years the concept of reducing energy bills by reducing consumption and increasing efficiency has come into vogue. Perhaps not surprisingly, when prices are low – as they were during the mid to late 1990s – there is little incentive to reduce consumption. The current conditions, however, are an extremely effective spur to action.



Executive summary

- Energy is a major cost centre and with price volatility it is time for companies to grab hold of the buying process.
- Few companies manage the energy buying process effectively.
- Although fixed-price deals mitigate the immediate risk, the risk is still open in subsequent years.
- The treasury department is marginalised in the energy purchasing process.

Box 1. The reality of energy price risk

To understand the real impact of energy price risk, it is useful to compare interest rates on the money markets. For example, between 21 June and 28 June 2005 the 12-month Libor prices moved from 4.81% to 4.61%. This seven-day movement of 6% was the largest seen in two years.

Over a similar seven-day period the annual base-load electricity prices for October 2006 starts moved by as much as 11%, rising from £50.15/MW on 4 July 2005 to £55.71/MW on 11 July.

To put this in context, in terms of risk to the company's earnings before interest, tax, depreciation and amortisation (EBITDA), an energy spend of £10m is equivalent to more than £300m of debt being repaid at 6%.

But focusing solely on efficiency grossly undervalues the importance of a good energy purchasing strategy, which can save far more than the capital investment required for energy-efficient devices. In today's sophisticated, deregulated energy markets, major energy users must balance efficiency with effective procurement.

The typical approach to purchasing electricity or gas is to sign up to a fixed-price contract as the existing deal comes to an end. According to a survey of FTSE 250 companies, 74% of organisations finalise their contract negotiations within three months of the contract start-date, while 60% enter year-long contracts with their suppliers.

Although a fixed-price deal provides certainty over prices and makes budget forecasting simpler during the term of the contract, it does not allow consumers to react to changes in the market. As a result they are completely at the mercy of external forces and, as the survey also demonstrated, are suffering losses estimated to be as much as £1bn. As prices go up, that cost can only grow.

Furthermore, there are two clearly definable contract seasons each year, October and April, when energy buyers simply renew or replace their existing fixed-term contracts. As any trader knows, the best time to buy a commodity is not the point at which you are running out but when the price is low. With nearly everyone buying at the same time of year, the existing process is inherently risky and almost guaranteed to produce higher prices. The idea of buying at the same time each year, at a point when everyone else is also buying, is a concept that most traders find hard to understand.

The problem is that although fixed-price deals mitigate the immediate risk, they still leave the buyer open to price risk for subsequent years.

CHANGING DIRECTION Electricity and gas cannot be procured like other indirect spend items such as stationery. They are commodities with their own unique demand and supply characteristics which drive the price up as well as down. Yet the survey showed that this is exactly what is happening in the majority of British companies, where energy procurement is still viewed as a contract buying process rather than a risk management process.

To reduce exposure to energy price risk, companies need to adopt a strategy that involves active management of the underlying energy price risk. With appropriate risk measures in place it is possible to avoid much of the pain caused by the increasingly volatile markets, rather than relying on luck or hoping for an imminent and long-lasting price downturn – neither of which is recommended as a long-term buying strategy. That means that defined ownership of the problem is required. The survey also revealed that the involvement of the treasury department is marginalised, despite the fact that it is the department best placed within an organisation to take ownership of the buying process.

Because standard procurement procedures don't apply, organisations need to start engaging with professionals who have the skill and detailed market knowledge to manage energy price risk effectively. The market is no place for inexperienced buyers.

Energy is a major cost centre for most organisations. And while the recent price hikes are great news for generators and suppliers, they're less good for corporate consumers. With price volatility showing no signs of calming down any time soon, it's time for companies to grab hold of the buying process. A billion pounds is a lot of money for UK plc to lose.

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