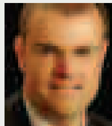
Ask the experts:

Time to focus on energy risk

How should treasurers be dealing with the impact of high energy prices?



Orrin Middleton, Director of Commodities, Barclays Capital

Compared with previous years, energy prices are indeed high, although they may go higher still. Many of the commodity markets are displaying tight supply-demand characteristics, with very little room left for unexpected demand surges or supply outages. A few weeks ago crude oil prices hit fresh highs after Hurricanes Katrina and Rita slammed into the US Gulf Coast region. It is also worth bearing in mind that commodities are global markets. In the immediate aftermath of Katrina US gasoline prices rallied 30% in two days. The impact was immediately seen at the UK pumps.

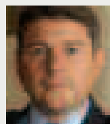
Just because corporates are now faced with high prices, there is no reason why they should not continue to monitor their risk exposure and manage it accordingly. Indeed, one could argue that the need for a disciplined budgeting process and risk management policy towards commodity prices has never been greater. This may mean that in some cases the responsibility for commodities, historically the domain of procurement departments, is brought within the control of the treasury department.

This summer, the Energy Partnership was commissioned by Barclays Capital and energy consultancy Utilyx to conduct a survey to assess the current energy-buying process of end-users and their receptiveness to new buying processes and risk management. One of the interesting conclusions that the Energy Partnership drew was: "The involvement of the treasury department is marginalised."

This is perhaps surprising given that lack of understanding of risk management was cited by 55% of those not adopting financial risk management tools as the reason they hadn't taken the plunge. Needless to say, there are many procurement departments that do actively use hedging instruments, but it is odd to think that treasuries, supposedly risk management centres, are often cut out of the commodity loop.

There is no reason why this should be the case. Crude and oil products, natural gas, carbon dioxide – they are all commodities whose price risk management now sits comfortably within treasury. UK power too is following suit. End-users can now adopt the same hedge guidelines that they use for the management of their foreign exchange and interest rate exposures, and can access forward financial commodities markets that display good liquidity going out several years.

Is it too late to enter these markets? Certainly not. After the cold snap in March that saw UK gas prices explode to over £1 per therm, much of the current attention focuses on this winter. But beyond that, there is no reason why corporates should not now begin the budgeting/ risk management process for the following summer and winter down the forward curve.



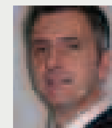
Chris Bowden, Chief Executive Officer of Utilyx, a provider of energy price and consumption risk management services

Energy prices hit record highs this September, following a year-long bull-run. But while producers and suppliers are turning in record profits, users are feeling the pain. Treasurers need to take a more proactive approach to the energy-buying process and look at adopting better risk management programmes.

Treasurers need to understand the profits at risk from high-energy costs. Take a company with £2bn of debt at a cost of 6% facing annual interest charges of £120m. The same company might have energy costs of £30m, yet because gas and electricity volatilities are four or five times that of interest rates both exposures represent similar risks to profits over the same period. Do shareholders really want to invest in a company where profit is geared to the highly volatile energy price in this way?

Some businesses are moving to flexible contracting arrangements so they can hedge price risk against an index or directly in the wholesale market. A number of contracts even allow the buyer to unlock, or sell back, the energy they have already bought. However, this creates a whole new set of risks – corporate governance, accounting, regulatory and procedural – all of which need to be assessed and managed.

This is why treasury departments need to own the process. Treasurers need to draw on both their training in risk management and on existing corporate risk management policy and procedures to help their organisation quantify, evaluate and manage energy price risk.



David Gray, Financial Director of international energy consultancy McKinnon & Clarke

Energy prices rises put a lot of companies at risk. By reducing their exposure to these escalating costs, businesses can ensure they are minimising their negative impact.

In some cases our clients have seen price rises as high as 60% over the last 12 months and there is no indication that this trend will stop any time soon.

Control of pricing and timing are key issues. There are opportunities for businesses to reduce costs through effective contract negotiation and placement. However, this is only one element of utilities' cost control; to reduce costs most effectively it is also important to address the issue of utilities' consumption and look for ways of optimising efficiency.

McKinnon & Clarke employs a two-pronged approach to utilities. By auditing, recommending, implementing and monitoring cost-reduction measures in both pricing and efficiency we are able to make regular savings for our clients.

Analysis of bills is another crucial element of ensuring that suppliers are charging correctly for the services they are providing. The task of analysing billing on a historic basis may be arduous but it can uncover many hidden errors, from small calculative mistakes to interpretative discrepancies; often adding up to sizeable refunds.

More than ever, it is vital that every business considers the options available when it comes to purchasing and management of their utilities.