

# Supply *is at* stake

Everyone knows what's happening to energy prices. So what does the smart energy negotiator do? Can the risk be reduced in the price gamble? John Dwyer reports

**F**or some UK energy users, three decades of shelter as part of the world's fourth largest gas economy ended with a jolt as Russia and Ukraine traded blows before the season of goodwill. But in truth our troubles began as gas production peaked in 2001. By day one of 2005, a year before the latest cold snap, the gas flow in the undersea pipeline from Bacton to Zeebrugge, Belgium, had changed direction for good.

Now, says John Kenton, Nottingham-based energy procurement co-ordinator for the five UK manufacturing sites and Bristol head office of Imperial Tobacco Group (ITG), "we are currently paying something in the order of 5p to 6p a kWh for electricity. Two years ago it was less than 3p." ITG used to get gas at 0.7p/kWh; today it can peak at 1.2p.

David Hunter of consultancy McKinnon & Clarke (M&C) says companies are unprepared:

"Energy has become a huge budgetary item, and under-resourced managers are having to get authority from managing directors and financial directors who don't know anything about it."

Gary Worby, operations director for Energyquote, says users' main options are to continue buying a year's energy at a single fixed price or go for a flexible contract. On top of that they should reduce their energy usage, and they may want to invest in their own generation.

As you'd expect, most of the options apply to flexible contracts. But there are ways to save money on a fixed contract. Worby notes, for example, that a multi-rated structure is an alternative to buying blocks of energy at a single price. If your business doesn't need to use all its energy at peak times, it can buy some off-peak energy at lower prices.

Fixed contracts offer a known energy cost, but

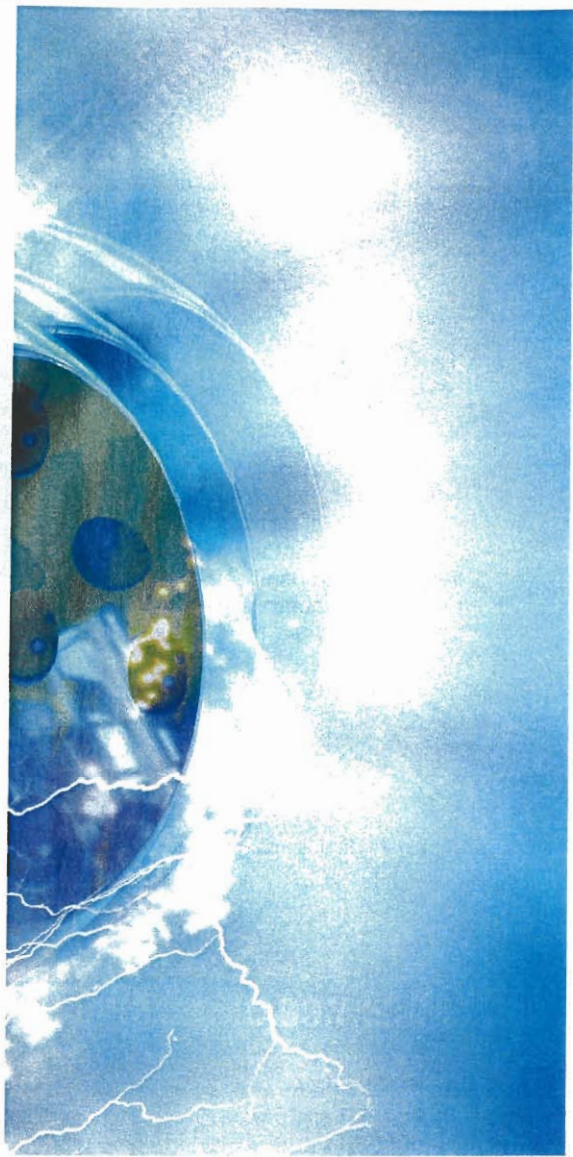


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companies are paying more than they need to. The bills contain a large number of mostly non-negotiable items, and it's very difficult to compare one offering with another.

Leaving the fixed and regulated costs on one side, the only room the user has for negotiation is the market cost of each unit of energy and the supplier's margin, though Hunter adds that M&C finds a lot of small, hidden calculation or interpretation errors that may add up to "sizeable refunds."

One pitfall or opportunity, depending on how you handle it, is the take or pay clause, which protects the supplier from shortfalls in the user's predicted energy consumption. Usually contract terms and conditions specify limits around which consumption may vary, but some suppliers are more flexible than others.

AstraZeneca's energy purchasing specialist, Mark Donigan, has no complaints: "[npower] haven't been as robust as they well could have been in terms of volume assumptions. They've given us a lot of flexibility," says Donigan.

Multinational companies appear to have an option to go for pan-European deals but it's more of an apparent than a real opportunity, says Hunter. It sounds fine in theory but falls down in practice.

ITG's overall energy demand is approximately 50 gigaWatt hours (GWh) of electricity and 100 GWh of gas, high enough to warrant membership of the Major Energy Users' Council (MEUC). Together, the £1.7m or so gas and £2m electricity bills make up 3-5% of ITG's materials costs.

ITG's sites in Nottingham, Bristol, Liverpool and Treforest, South Wales, used to buy their own energy: "Over the years we have aggregated the UK-based sites into a group deal," says Kenton.

Now ITG buys its energy on a month by month

that certainty comes at a premium for anticipated price changes over that period. Flexible contracts allow customers to make multiple purchase decisions throughout the term of the contract. Worby's analogy is with a dice – throw it once – as you have to for an annual contract – and you bet your whole energy budget on that one throw. Throw it a dozen times and the result will be at least no worse than the market average. "If you make multiple purchases, that reduces the risk," says Worby.

Worby also says that trading on the wholesale market isn't viable unless your total consumption is over 120 gigaWatt hours (GWh) a year. That threshold is coming down, and companies do have the option of joining consortia of like-minded companies to buy energy jointly. Normally, however, flexible contracts are only really suitable for larger companies who have more experience, and the necessary time and support to deal with the extra work involved.

They are "very different" from the annual reverse auction: "With the flexible contract, they are exposing themselves to the rigour of the market. They are leaving themselves open. You can see extreme price movements, and you have to accept things on a flexible price contract that you wouldn't accept on fixed pricing." These risks, says Worby, are why: "you need to get buy-in from the top."

Any energy contract can be immensely complex, agrees David Hunter, and eight out of 10

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David Hunter, McKinnon & Clarke

basis in the forward market, instead of year by year. This involves crucial judgement of when to buy it, but ITG's external energy consultant keeps an hourly eye on the markets and does the buying for them. The consultant is independent and has no financial connection with any of the suppliers.

Apart from regular meetings round a table to see if the market has changed significantly, Kenton admits that buying monthly involves "more work" than the annual fixed deal used to. He makes a phone call about every other day to the energy consultant, who deals direct with npower. ITG buys it from npower, and npower buys from the market.

Monthly purchasing allows ITG to deal with market volatility by buying energy ahead for any month. So if August's gas seems to be at a good price, ITG has the option of buying it straight away instead of waiting until July.

The company may also buy part of a month's supply. When *Works Management* spoke to Kenton in mid-January, ITG had bought 50% of its gas for February, as the assessment of the market was indicating that the price "might drop a little bit further" and the company could then buy the rest.

This strategy reduces exposure to short-term price increases, but still keeps open the opportunity for savings should the price drop.

"It can be very difficult to predict," admits Kenton, and it's often considered more of a 'black art' than a science. ITG has an energy budget for the year and so far this financial year it had slightly exceeded it, though Kenton is confident that buying forward is the way to trim energy spending in a volatile market.

Both ITG and AstraZeneca have a 'green' deal with npower. Under this arrangement, their power comes from renewable energy sources which are exempt from the Climate Change Levy (CCL).

Being green helps ITG to meet its own carbon-emission reduction targets and shows that the company is helping the environment: "We're one of the few UK-based companies who can say that all of our manufacturing sites are supplied with 100% green energy. We've managed to maintain this arrangement for the last five years."

This used to be a 'cost-neutral' arrangement, but being green now costs ITG several thousand pounds more per annum, although as Kenton points out: "With other suppliers, the 'green' premium might be considerably more."

As in ITG's case, the green element hasn't done AstraZeneca any harm. Donigan says employees, neighbours and the City like to see this kind of effort: "From a corporate responsibility point of view it means we can show our stakeholders that we are being green in our energy demands, and that we're not just going for the cheapest price."

Donigan says that until a year ago AstraZeneca bought energy for its 18 UK sites under annual fixed price contracts costing something around £18m to £19m.

By early 2004, however, the company noticed increasing volatility in the electricity price. AstraZeneca's energy budget had taken no account of this: "We needed to change our approach," says Donigan, so that year, "We moved towards a flexible contract to buy ahead on the forward curve."

With help from energy adviser Utilyx, the company went out to tender to look for the best deal. It now takes gas from Shell and, under a three-year, £30m deal signed in April last year, and electricity from npower.

The deals were "a major step change" for AstraZeneca, says Donigan. The company had always believed in long-term contracts because they offered budgeting certainty.

Utilyx trades under both contracts on AstraZeneca's behalf. "We don't want to hold the expertise," says Donigan, "We aren't energy traders and we don't want to be."

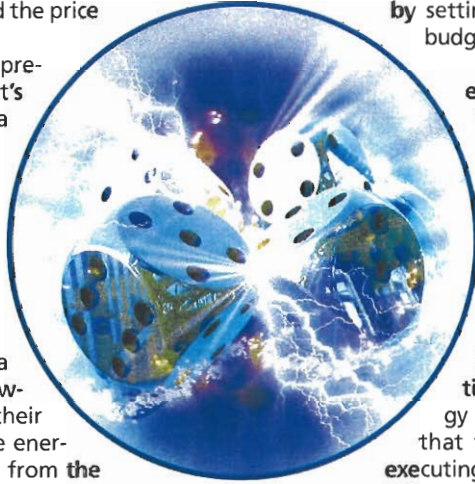
Worby says the purchasing function has to be carried out logically, not emotionally, rather than being a monthly panic buy. The way to make sure of that is to develop a strategy, a "strong framework" which has the commitment of the principle stakeholders in the business. That means the finance and or managing director, energy director, or contract negotiator. They can reduce risk by setting realistic expectations and budgets.

But to do that, Worby emphasises, the company has to watch the gas, oil and other commodity markets as well as its own. And it has to take account of weather, geopolitical and other risks. "You also need access to the trading community," says Worby, "because they know what's happening and they know where the opportunities." That's easier if the strategy sets out a number of rules so that the individual charged with

executing purchases on the company's behalf feels free to use his or her skill and judgement.

If you're going to buy at frequent intervals, for example, how frequent should those intervals be? Make sure you understand where the business is going, so that you know your future energy requirements match that direction. If you're going to expand, is there room for your energy options to expand too?

The stakeholders need to ask what their critical budget energy price is as a company, and what triggers they would look for each month to make them buy ahead or delay.



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Finally, you put all this in a simple document everyone can understand and sign up to. And you take those stakeholders through and work that into very clear procurement objectives.

After all that, the savvy industrial manager has to be as unforgiving of energy waste as he or she is of pointless inventory. At Pepsi-Cola, for example, ever-lower energy consumption is a continuous improvement issue. "That's been pretty much on the agenda since Kyoto," says Paul Campbell, a director of PepsiCo offshoot Walkers Crisps. Campbell, responsible for all Pepsi-Cola's UK snack manufacturing sites, says that Pepsi is "signed on" to continual energy reductions.

Hunter also advises companies to make sure they are running "ignored" cost centres like fresh water effectively and reducing waste water output. By doing that, he says, "Even if you find you have an uplift of 40% in energy charges," says Hunter, by good housekeeping, "you may find that you could get most of that 40% back." ■