

*The U.K. faces "thousands" of job losses because of natural gas prices that have more than tripled this year, according to the Transport and General Workers' Union, the nation's third-largest labour group. "We're facing gun-to-the-head prices that are going to lead to thousands of job losses," said Peter Booth, head of the union's manufacturing group. "It doesn't get more serious."
(Bloomberg, 15.12.2005)*

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What Happens When the Christmas Lights Go Out?

Aily Armour Biggs and David Marshall take a seasonal look at some rather unsettling apparitions currently traversing the global energy markets.

It's always tempting as the end-of-year holiday season approaches, to let the festive good cheer get the better of us, and approach the oncoming year in an almost Dickensian party spirit. However, as Ebenezer Scrooge discovered all-too-readily, some varieties of Christmas spirit require more careful attention than others. In keeping with the time of year, and good energy analytical practice we have taken a "seasonally-adjusted" look at the energy markets, past, present and forward, to pose what ultimately might prove to be some rather unseasonal questions.

Looking at our first Yuletide visitation, the Spirit of Christmas Past suggests that the lessons of previous decades' experience are there to be learned, and with some obvious circumstantial differences, remain relevant to today's (superficially) more settled climate.

Instability is nothing new to the energy sector. When we look at the energy crisis of the 1970s, the question arises as to whether short-term symptoms merely pointed to the slow cycle of a much longer-term process. So long as China and India continue to develop we will have an ongoing imbalance between supply and demand in energy.

As the traders among us know, markets are about fundamentals and when demand outstrips supply prices rise. Now going forward as the IEA vocalised, we not only have security of supply but also demand to consider.

Markets have changed – risk management products are becoming more widespread and sophisticated, with individual position weaknesses open to exploitation. Some traders have already been caught out – one only needs to look back to the \$550 million losses suffered by China Aviation Oil on petroleum derivatives trading just over 12 months ago. Some US airlines have sought Chapter 11 bankruptcy protection in the aftermath of aviation fuel price hikes and basic shortages: only one major US carrier - Southwest Airlines - has a substantial energy hedge in place for 2006. Learning to live with uncertain energy resources and market prices means adapting organisational decision-making from a reactive to a proactive approach, encompassing buying, selling, budgeting and financing functions and risk methodologies.

More proactivity may also turn out to be a watchword, in retrospect at least, for the nuclear industry, where new build is being considered for the first time in over 10 years. This could

prove too little too late however. as now “replacing nuclear with nuclear” - the industry’s battle cry through the last energy review - falls a long way short of meeting the UK’s future energy needs. Perhaps more than a battle cry was needed from the industry: facts, concrete views and a discussion with the most influential people in the UK would have been more conducive to material progress in the current environment.

Where then, does all this leave us in December 2005? The Spirit of Christmas Present is already upon us, dispensing good cheer to some, and abject misery to others.



Scrooge's third Visitor.

London: Chapman & Hall, 1843.

The major energy users of the UK recently experienced some of that misery in the form of higher gas prices, so much so that they reacted swiftly to close production in the short term, with potentially alarming implications for us all in the longer-term.

The new winners in the current environment, and perhaps in the longer term, may therefore prove to be:

- Russia, Middle East, and other energy-rich economies (look at the rise of the Russian energy oligarchs, and the emerging Gulf State financial centres and markets).
- Oil & gas suppliers, particularly fledgling and state-controlled enterprises, which are proving increasingly prepared to take on the established major corporates in these sectors.
- Alternative energy projects, currently receiving in excess of £3 billion annual expenditure in the US alone.

Potential losers on the other hand are:

- Existing developed economies, where dependent on external energy sources.
- Major corporate energy users, particularly those with no coherent purchasing strategy (now exposed to commodity swings more pronounced under new IFRS accounting standards).
- Deregulated markets – by nature more volatile than their state-sponsored counterparts.
- Heavy carbon emitters – Kyoto restrictions, already beginning to bite, are likely to extend to new sectors such as the aviation industry.

The Christmas Spirit is all about generosity. But what happens when we start to experience commodity shortages? 95% of the goods in the shops get there through oil. So perhaps fewer Christmas presents and more food and drink? Sorry – no sale here either: 99% of our food is either transported or fertilised through oil-derived products.

Most informed commentaries suggest that the concept of future security of supply in the energy sector may be very similar to the final dark and spectral presence that filled Mr Scrooge with a 'vague uncertain horror'. The recent International Energy Agency Report (World Energy Outlook, November 2005) has led some sources to suggest that current growth in energy demand - and consumption - projected only a few decades forward, will lead to an unsustainable future for the world economy.



The Past of the Spirits

London: Chapman & Hall, 1846

Looking at the wider picture, such analysis inevitably comprises a truly overwhelming interaction of events, variables, trends and projections over years and decades. It is always tempting in such circumstances to assume that future generations will somehow adapt – or at least learn to live with – the concomitant social, economic and even physical upheaval that current trends appear to predict, and if history itself is a valid predictor, in all likelihood they will do so much more readily than we can currently envisage. For energy suppliers and users alike, this means becoming ever more inventive and resourceful within the parameters of supply, demand – and desirability of use – relating to scarce commodities and new sources of energy. To a certain extent at least, we can perhaps build in some expectations of human ingenuity as a mitigating factor in this context, as in others.

One major practical problem scuppers that approach however. The sheer size and timescale of investment required to get most energy sector projects off the drawing board, into construction, and, finally on-stream (some years or decades ahead) almost invariably dictates that we somehow attempt to address tomorrow's problems with today's expectations. As Scrooge finally realises, confronting the truly dire picture of his own demise some years hence, there are times when it is perhaps more and not less prudent to open up the coffers, and take action before it becomes too late to do so.

Today's energy markets, perhaps themselves haunted by the relatively recent failures of Enron, TXU Europe and others, still appear excessively

characterized by intrinsic uncertainty and short-termism. In such circumstances, it is difficult to foresee the emergence of conditions and prospects required to create a stable investment platform for the future.



Marley's Ghost.

London, Chapman & Hall, 1846.

Markets are driven by fundamentals – and in the energy markets, the weather is a key short-term driver. The accumulated expectation of a bitter winter in the northern hemisphere has led to predictions of a 60% probability of electricity shortages in the coming months. We therefore worry about the lights going out this winter. Ironically, as a consequence, we appear to be worrying a little less about the most likely scenarios of 10 years hence, where expectations and predictions point to more severe weather patterns and fewer energy commodities available to alleviate their effects.

From an investment perspective, planning for the future has been complicated by the advent – or perhaps more accurately, the realisation – of a carbon-constrained environment, and the consequent requirement to do more with less. The much-maligned Kyoto process has at least attempted to commoditise the ‘shortage’ of carbon, providing a market-comprehensible framework to address an environmental issue of global concern.

Whilst the weather and the protection of our global climate and environment add complex variability into the market-investment-financing decision cycle behind most major energy projects, they cannot – and ultimately should not – be allowed to become obstacles or inhibitors to that process. Nor for that matter should we allow ourselves the luxury of postponing or deferring the critical energy investment decisions we need to make for the ongoing prosperity of our enterprises, industries, nation states and ways of life, citing apparently insurmountable regulatory or political difficulties as valid reasons. There is far too much at stake to begin adopting a policy of disinvestment in our collective future.

Whilst the macroeconomic picture for security of energy supplies contains some dire predictions, it is worth making the point that for individual constituents of each economy – i.e. businesses and public services – the implications and effects will vary enormously. Energy-dependent firms need to consider:

- The validity of current buy/sell strategies;
- How exposure to commodity volatilities will affect their earnings, balance sheets and market announcements; and
- Risk management and business continuity, for example vis-à-vis interruptible gas and power contracts.

The Spirit of Christmas Yet to Come may prove a daunting prospect – particularly for those who steadfastly refuse to change their ways!

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Epilogue

In a fragmented and increasingly deregulated global energy market, successful investment decisions depend upon several key criteria, including the reliability of supporting data and the validity of assumptions behind financial modelling, together with a thoroughly comprehensive grasp of fundamental industry and sector business drivers.

At GEA, we are all too aware that our own contribution in these areas can make a pivotal difference to perceptions surrounding an investment, financing or trading decision. This is important to us. We do not run power stations, or trade in oil, coal or gas; nor can we claim to be large users of electricity in our own right. Nonetheless, we take our role in the industry every bit as seriously as those of you who are directly involved in power generation, trading, retail, purchasing and investment.

In wishing each and every one of you and your families the very best of health, prosperity - and fun - over the holiday season, we look forward to continuing to provide genuinely valuable advice and support over 2006 and the years ahead.

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