Industry in Focus

Rising energy costs - 10 point plan for business

29 September 2022

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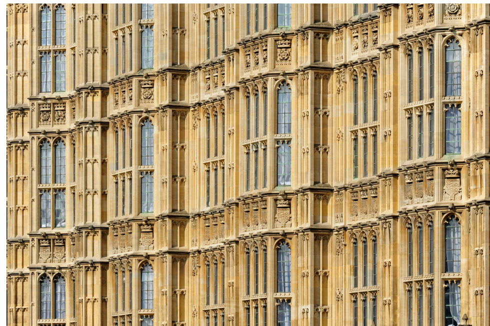
What next for business? Actions in response to high energy costs

Government policy announcement

Publication of the details of the Energy Bills Relief Scheme (EBRS) by the government on 21 September 2022 will be welcomed by non-domestic energy customers. Businesses and other non-domestic energy users such as charities and public sector organisations will benefit from the six month price support, which will be backdated to run from October 2022 to March 2023.



However, given the complexity of the business energy market compared to that for households, further details have not yet been released. The devil will be in the detail of the scheme and in particular, how the Government will support the most vulnerable sectors such as hospitality and health and social care beyond the initial six month period. The Government has committed to concluding its review of where support will be targeted at the end of the six month period, within three months.

Equally, we note that many industries are coming under severe financial pressure, impacting operations and at worst threatening shutdowns. SME's have been particularly hard hit. Before this announcement, renewal notices for energy contracts due in October have in some cases reflected increases in excess of two to three times, made worse for some by a move from the traditional 1,2,3 year fixed contracts to monthly rolling contracts, which will challenge forecasting and cash flows.

This document reflects on the details of the EBRS announced by the government and then focuses on the steps that businesses can take to address challenges around costs and financial sustainability. In addition, we reflect on measures announced across Europe.

Key recommendations:

- **Understand the implications of rising costs and revisit strategic options.** Understanding how rising costs affect the business (especially its cash flows), market, customers and suppliers is central to identifying strategic actions to mitigate the business's exposure and risks and identify new opportunities. Being in a position to engage key financial stakeholders early if needed is critical to maximise options.
- **Take action now on energy costs.** Consider options to improve energy efficiency, reduce demand, and review energy procurement strategy, including the use of corporate Power Purchase Agreements (CPPAs) to minimise exposure to higher commodity prices.
- **Look beyond energy to revisit options for reducing costs and delivering growth** including review of portfolio margin, third-party spend, working capital and the impact on investment decisions.
- **Leverage technology, shift to cloud and accelerate productivity.** Look at how functions and processes can be provided by others and how digitisation can deliver cost reduction and accelerate productivity.
- **Keep an eye on Europe and different country level measures as not everyone is following the same approach.** Plans to introduce a common approach in the EU but some country differences remain. Those with cross border operations will need to take account of different policies in place.

Even at the capped level of wholesale costs of £211/MWh for electricity and £75/MWh for gas, businesses signing contracts on or after 1 April 2022 could face a 2-3x increase in energy bills

The Energy Bills Relief Scheme aims to provide equivalent support for rising wholesale prices as the domestic support scheme. However, there are some notable differences to reflect the different characteristics of both markets, the key differences being:

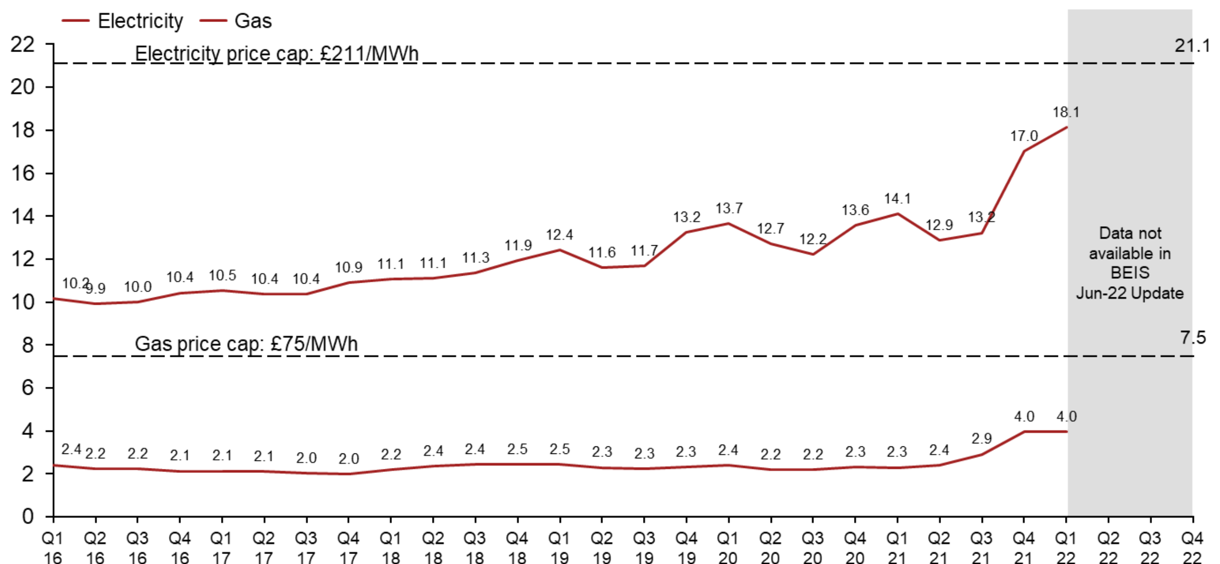
- **The scheme is initially scheduled to last for 6 months from 1 October.**
- **It only applies to customers on variable contracts or fixed contracts agreed on or after 1 April 2022, which we estimate could be approximately a quarter of the market.**
- **It provides a discount only on the wholesale element of the energy price unlike the domestic scheme which caps the overall unit rate.**

From November, the EBRS is designed to cap the wholesale price of electricity and gas at **£211/MWh** and **£75/MWh** respectively[1]. Customers on fixed price contracts will have the adjustments automatically applied by their supplier. The scheme has a maximum discount, with the effect that customers on default or variable price contracts could face higher wholesale prices than those above. The Government is working with suppliers to ensure customers will have access to new contracts to help give better certainty on their energy costs.

Supporting the electricity price is particularly important for business customers, because it forms a larger part of their overall energy costs (with some exceptions such as process industries such as glass, paper and food processing). Households in comparison are much more exposed to gas.

This is a significant intervention, which the Government estimates is approximately a **50% reduction** on prevailing wholesale prices. However, for businesses rolling off previous multi-year fixed price contracts (which is common for much of this market), the supported price is still likely to mean a **doubling or tripling** of the price they pay for their wholesale electricity and gas.

Evolution of non-domestic electricity and gas prices (p/kWh)[2]



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[1] Those non-domestic customers on default, deemed or variable tariffs will receive a per-unit discount on energy costs, up to a maximum of the difference between the Supported Price and the average expected wholesale price over the period of the Scheme. BEIS estimates the amount of this Maximum Discount to be around £405/MWh for electricity and £115/MWh for gas.

[2] Source: BEIS, Energy Prices, Non-Domestic Prices, Table 3.4.1/3.4.2 (30/06/2022) (Link). Based on BEIS average across Small/Medium, Medium, Large and Extra-large price segments. Prices exclude CCL.

There are several actions businesses can take to mitigate high energy prices and costs, from addressing energy usage and procurement to business plan stress testing and cost out exercises

The EBRS has created a six month window of opportunity for non domestic customers to look at building resilience against future high energy prices and the knock on impacts for the whole cost base. The pressure businesses are under is exacerbated by the broader macroeconomic environment including a further 0.5% rise in base rates announced on 22nd September, combined with wage and input inflation (primarily driven by energy prices) and consumers with falling disposable incomes.

This pressure for some businesses has increased further following the market's reaction to the Chancellor's Growth Plan statement. Tax cuts may be welcomed by some businesses but markets have not reacted well to these given the question of how they will be funded. The weakening of pound sterling, particularly against the US Dollar, has led to an increase in the cost of borrowing, dollar denominated products and services, including oil, and in turn may add to inflationary pressures that may require further intervention by the Bank of England through higher interest rates. While there will be some beneficiaries, these macroeconomic factors will likely put further pressure on many businesses already having to deal with rising costs.

> "We have increasingly been looking at hedging and more sophisticated use of derivatives. We need a more granular view on the direct and indirect links of our procurement contracts to specific cost indices"
> (Retail business)

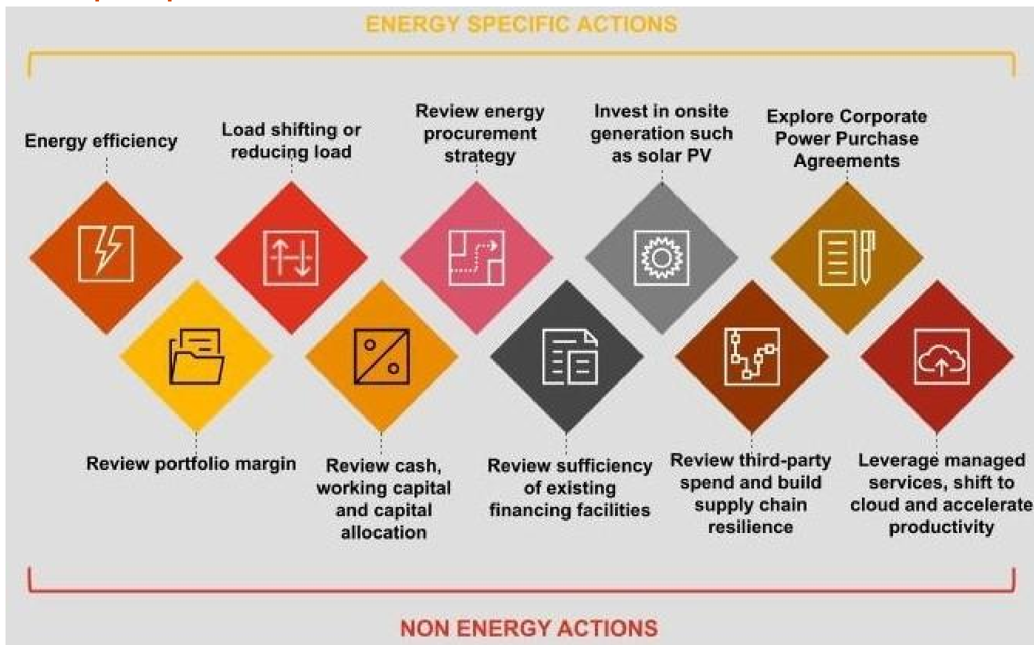
In our opinion, **EVERY** business should be looking closely at the EBRS to understand if they are protected and if so, the extent of this protection. With this information in hand, they should **stress test the impact of higher energy prices on their business and impact on business plans and cash flows** (even those who are contracted through this winter on favourable rates, particularly if their contract expires next April, where forward energy prices are likely to remain high).

This analysis will help quantify the impact on margins and cash flows in the absence of mitigating actions. It will also provide improved visibility across all main cost categories to enable a baseline for a targeted response and to understand how the line items of a cost base are affected differently by inflation.

There are a range of actions businesses could take to mitigate the impact of sustained high energy costs helping them to manage in the short term and understand and plan for the longer term strategic implications.

Businesses will need to strike the right balance in their approach to the situation to identify the most appropriate combination of actions, including passing through costs and targeting cost reductions in a way that maximises their value to the business. Some will be easier to implement and can be delivered in the short term, whereas others may either take longer to implement or may be harder to deliver. The actions will vary according to the sector the business operates in and the flexibility it has with respect to customers, supply chain or how it uses energy.

Our 10 point plan for business



Potential energy specific measures

1. **Energy efficiency**. The quickest win is to reduce demand or shift demand to lower price periods. While many businesses will already have accessed the low hanging fruit such as LED lighting, reducing out of hours lighting or Heating, Ventilation, and Air Conditioning (HVAC) running times, there may be value in investing in improving data accuracy on energy consumption, through use of sub-metering to identify additional efficiencies. This may also highlight where older energy inefficient assets could be upgraded or replaced. Equally, optimising the use of office space could minimise the need for heating and cooling and other office services costs.

2. **Load shifting or reducing load.** While load shifting may not be possible in many sectors, where there is some flexibility to shift operations this should be considered. Load reduction is a more extreme response which is now happening in energy intensive sectors across Europe such as aluminium smelting, but could be adapted through reviewing shut down processes at the end of shifts, staggering of work shifts or reduction of work hours. This analysis could be included as part of the stress testing of a business.

3. **Reviewing energy procurement strategy**. Government intervention will likely affect whether it is worth switching suppliers if an existing contract ends in the next six months. Customers who historically fixed prices should look at a variable offer or vice versa. In the immediate term there may be limited opportunities to reduce energy costs, but review of their procurement strategy could help businesses to understand their options and be more resilient in the medium term.

4. **Invest in onsite generation such as solar PV.** This may be an attractive option given current wholesale price levels significantly reducing the payback period for such investments. However, in practice this is an option that will take time to evaluate, pass through

planning and contract, so may be a more likely part of a longer term strategy to create resilience against the risk of continued high prices in the future. It is also subject to having suitable sites to install renewable assets. There may however be delays in supply chains given accelerating global demand, e.g. for solar PV panels.

5. **Explore Corporate Power Purchase Agreements (PPA's)** – we expect that the current market conditions will create a drive for more energy independence and greater price security from grid electricity costs. Entering into corporate PPA's linked to renewable projects can facilitate this with the added benefit of making a contribution towards organisations' ESG strategies. While the current PPA market is challenging both in terms of availability and pricing, nonetheless businesses could explore this as a viable option over the medium term.

Potential non-energy specific measures

6. **Review portfolio margin.** Higher energy prices are increasing operating costs at a time when corporations are facing wider rising inflation. The impacts on margin vary by industry/sector and customer profile. In the short-term, Business to Business (B2B) firms may have greater options for passing costs on to customers, whilst Business to Consumers (B2C) firms are increasingly having to absorb costs to retain consumer demand. Whilst short-term cost pass throughs can provide temporary protection to margins, the continuous passing through of costs risks damaging longer term demand (especially in retail and consumer sectors) and customers finding alternatives. Businesses should review existing contracts with customers to understand their existing contractual ability to pass on costs. Whilst businesses, as part of stress testing, should evaluate the potential for ceasing production of lower margin products, their options may be limited.

7. **Review cash, working capital and capital allocation.** Whilst some B2B corporates are passing on costs, increased sales levels are inflating debtor positions and inventory. Corporates who have pre-agreed capped asset based lending facilities face the decision of needing to increase their limits (where possible) or continuing to operate with existing facilities in a higher cost environment, leading to increased pressure on cash. The pressure on cash is being further exacerbated for some firms by the need to provide upfront cash deposits for fixed energy contracts. With such pressure on cash resources, consideration will also need to be given to how cash is used and investment strategy, given the impact on returns of a higher inflation and higher interest rate environment.

8. **Review sufficiency of existing financing facilities.** Businesses need to understand the overall cash flow impact of higher energy prices pre and post mitigations. Some of the mitigations may also have upfront costs or investment which would require funding. Businesses will need to engage with financing providers early to the extent additional funding is needed or if financial covenants look like they are coming under pressure. There are also refinancing risks for those who are more heavily impacted by higher energy costs as investors are more wary of their exposure to such sectors and may require a higher return for the increased risk.

9. **Review third-party spend and build supply chain resilience.** Given the likely variability in contracting discipline, a short term action to review existing contractual protections / controls in place to limit inflation could provide additional benefit. Reviewing the cost base and

procurement processes could also enable businesses to manage costs and discretionary spend to offset margin impact they are having to absorb. This could act as a catalyst to review strategic relationships and value in the longer term. Supply chain resilience is now a minimum requirement for businesses, but many still have more to do. For example, investing in automated supply chains, end-to-end AI enabled workflows and distributed operations. It will also be important to understand the financial health of critical suppliers and whether there is a risk to their ability to continue trading with higher energy prices and the overall macroeconomic backdrop. Having alternatives in place will be key to avoid any disruptions to the business.

10. **Leverage managed services, shift to cloud and accelerate productivity**. Look at new functions / processes that can be provided by others to provide more flexibility, e.g. change as a service. The current market environment is expected to accelerate a shift to cloud as the mid to long term costs of owning and running infrastructure should now act as an impetus to consider a more accelerated shift to cloud, e.g. for those businesses with retained data centres. Digitisation can also help decouple volume from human activity, at times of rising wage pressure. As with any disruptive period in the past, businesses have adopted a number of new behaviours coming out of COVID-19. Leaders must continue to harness these behaviours – the few that have allowed teams to solve problems quickly – to promote, sustain and build them into the new way of operating, including, for example: giving teams autonomy to solve problems quickly and taking accountability for decisions.

While there are measures that businesses can take to reduce their exposure to rising energy bills, some businesses such as SMEs may be disproportionately impacted and unable to absorb higher prices

Measures announced by the Government will be welcomed by many business owners and there are measures that they can take to further reduce their exposure to the higher cost environment, as outlined above. Despite this, we recognise that some businesses, particularly small and medium enterprises (SMEs) are arguably more exposed than other larger industrial and commercial (I&C) businesses.

While SMEs typically have lower average energy consumption than I&C businesses, they are more limited in the options they have to address high prices. SMEs are typically price takers and exposed to higher rates than is the case for larger businesses. Equally, their ability to shed load or invest in other energy savings measures is likely to be lower e.g. the ability of businesses in the hospitality sector to shed load is likely to be lower owing to their base load of energy demand for lighting, refrigeration or cooking, which is necessary to keep the business running.

> **"Small and medium businesses in the hospitality industry are seeing a drop in profitability as a result of both increased energy prices and customers starting to cut back on eating out."**
> **(Hospitality business)**

The alternatives to reducing demand is to then either pass through costs to customers, or look to absorb the higher costs themselves. Neither of these is likely to be a favourable option. Given the increase in the cost of living and expected slowdown in the economy, there is a risk that demand for products and services will fall, if SMEs start to pass these costs through. Equally SME's typically have smaller balance sheets and therefore have less capacity to absorb higher costs, provide certainty to suppliers and raise additional financing. This was evident through the closure of small businesses following the COVID pandemic.

The government has indicated that support beyond 31 March 2023 will be targeted at the most vulnerable sectors, hospitality being one of those sectors. We wait to hear what those announcements will look like but given the challenges faced by these businesses, note that measures may have to go beyond the current Energy Bill Relief Scheme.

Update on European actions in response to rising energy prices

The EU has set out proposed interventions to address the challenge of rising energy bills. In the annual State of the Union speech on 14th September, EU President Ursula Von der Leyen set out the interventions that the EU will take to address the current situation of high energy prices and gas security.

There is a focus on direct intervention through EU-level marketwide measures. This means EU member states agreeing on collaborative interventions to change the status quo and limit the impact of prices on households and businesses. Key interventions proposed include:

1. Measures for demand reduction (in general and during peak price hours) including: (1) an obligation to **reduce electricity consumption by at least 5% during selected peak price hours**, and (2) Introduction of EU-level **measures to reduce electricity demand by 10% by 31 March 2023**.
2. Introduction of two types of **measures to redistribute energy sector's surplus revenues to final customers**: (1) A temporary **revenue cap on 'inframarginal' electricity producers**, such as wind and solar farms, and (2) a **temporary 'solidarity contribution' on excess profits generated from activities in the oil, gas, coal and refinery sector**, which would not be impacted by the revenue cap.
3. **Expanding the Energy Prices Toolbox** available to allow below cost regulated electricity prices, and expand regulated prices to also cover small and medium-sized enterprises.
4. A comprehensive **reform of the electricity market to reduce the influence of gas prices**. The aim is to decouple the influence of gas on electricity prices. In the EU system, gas plants often set the price of electricity.

There are notable differences in the measures proposed by the EU from those announced by the UK Government on 8 September. Where UK intervention has focussed on price and supply side measures, the EU has placed greater emphasis on demand-side measures.

The other deviation in approach surrounds taxation of those energy companies benefiting most from the situation. Like the EU, the UK has signalled its intention to address supernormal profits being made by low marginal cost generation, including nuclear and legacy renewables, but it has ruled out, unlike the EU, further windfall taxes on energy companies, beyond the exis ting Energy Profits Levy announced May 2022 by the former Chancellor. The EU announced revenue cap and windfall tax on fossil fuel companies is expected to generate €140 billion (~€117 billion and ~€25 billion respectively) to be disseminated across the 27 EU member states to ease the cost of living crisis for households and businesses.

Visit the *PwC Energy, Utilities & Resources homepage* for further information.

For additional guidance on rising energy bills and how PwC can support your business on the imminent threat of inflation and the opportunities it presents. Please visit pwc.com, where you will be able to view our most recent insights, including those listed below.

PwC briefing on Government energy proposals (link), which sets out the measures announced by the government to address rising energy bills and our thoughts on these.

UK Economic Outlook September 2022 (link), which explores our latest analysis of the UK economy and focuses on how we expect geopolitical changes and the rising cost of living to impact the outlook for GDP growth and inflation, as well as policy recommendations to promote growth.

Strategy& Striking the Right Balance (link), part of our Recession Resilience series of reports that looks at strategic considerations for businesses in the high inflation environment.

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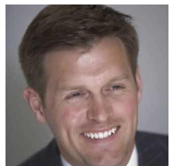

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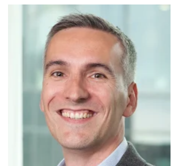

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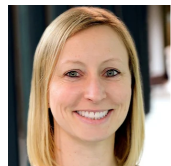

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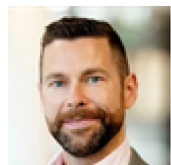

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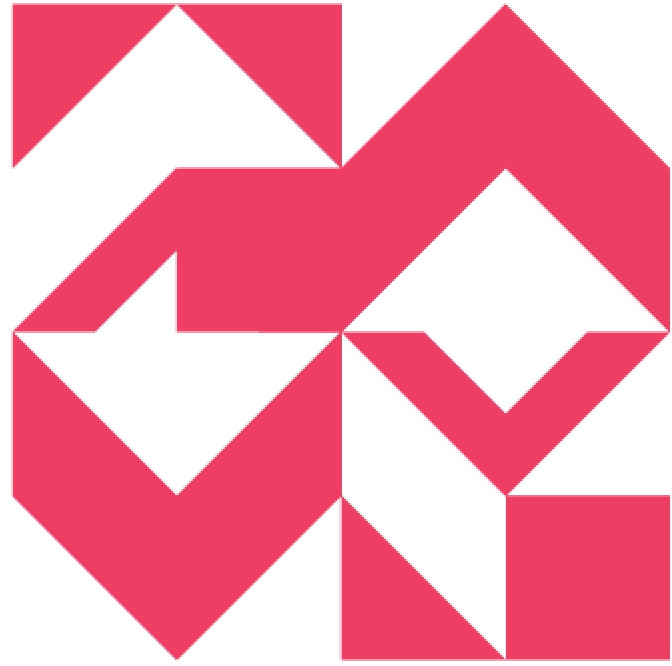

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