

Market Outlook Report

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Data management is not a business luxury in a recession

Markets thrive on uncertainty, as uncertainty brings risks and risks provide rewards. Well, this used to be the case, but for most of this decade trading and risk management has been arguably more conservative with the notable exception of the investment banks and funds. The catalyst for this conservatism was the implosion of Enron in 2001 and the subsequent demise of energy trading as a profit making business. This is unfortunate. The coming months will be the most uncertain period faced by the energy market since it was first opened to competition almost two decades ago and shoring up profits should be a priority if future infrastructure investments are not to be delayed.

Energy companies are facing a new market paradigm in 2009 – an energy recession. One of the major consequences of an economic downturn is the removal of energy demand as industry cuts back output, yet what is unknown is whether this demand is merely being deferred until the economy once again picks up or that this demand has been permanently removed from the market.

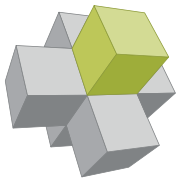
The debate over the consequences for future demand is not only interesting, it is vital for future business planning, as energy prices move on either supply/demand sentiment or actual physical fundamentals.

Demand uncertainty

Demand destruction is an economic term that describes the permanent downward shift in the demand curve, and is usually induced by either a period of high prices or constrained supply. It is interesting to note that in the first half of 2008 when oil, and other energy products, was relentlessly increasing toward its record high, there was a view that at some point the high oil price would prove unsustainable and force down demand. But the demand curve did not shift lower and prices came off on financial factors, such as a strengthening of the US dollar, not a shift in demand.

Similarly, in the past few months, the actions of OPEC to cut back the cartel's production targets has had a limited impact on oil prices, and demand. Although OPEC has significantly cut its targets since the fourth quarter last year the price of front month crude oil futures remains comfortably below \$50/bbl and this month the International Energy Agency cut its global oil demand forecast, with consumption set to decline for two successive years for the first time in over twenty-five years.

What makes the current removal of demand both more interesting and uncertain is that the demand curve has shifted downward on reduced demand and not on supply or price-related factors.



When the demand curve shifts downward on price-related issues, i.e. prices are too high and demand corrects accordingly, there is a tendency for consumers and industry to seek alternative energy sources or more efficient technologies that consume less fuel. Thus, when prices retract there is not a return to previous demand levels and the curve remains depressed relative to the previous level.

So can a similar demand curve analogy be drawn with a fall in demand due to the ongoing economic downturn? Arguably it can. The current economic downturn provides policy makers with an opportunity to re-structure the energy market, with the new US Obama administration joining the EU in calling for the development of a more robust green economy. But the demand curve will still remain depressed during the transition to a new green energy market as a consequence of higher energy prices and potential future supply constraints.

Two factors suggest energy prices will increase with a shift to a green energy economy. First, green energy is more expensive than “traditional” fossil fuel energy, and second, any significant long-term shift to a more renewable-centric energy policy would reduce OPEC’s demand certainty with the cartel almost certainly likely to respond by delaying, or even cancelling, new exploration and production and thus pushing up oil (and other energy product) prices through new supply constraints.

Given the extent of the economic downturn, and the corresponding political urgency to build a new green energy economy, it is unlikely that the demand curve will recover in the medium-term. How producers and suppliers respond to the new demand curve will influence future energy prices and these new demand curve risks will require efficient and effective management.

Political uncertainty

Aside from the recession-induced demand uncertainty, this year will also see the market potentially exposed to heightened political and regulatory uncertainty.

Although the prospects for a UK general election this year have receded with the poor opinion poll ratings of the government, there will be European Parliament elections in June and in September Germany, Europe’s largest energy economy, goes to the polls. Both could strongly influence the energy markets and thus induce more uncertainty, particularly from a regulatory perspective.

When the next European Commission takes office in November it will have to decide how to progress with EU energy policy. Will it, for example, retain the current legislation or, as previous new Commission’s have, seek to stamp its mark by amending or writing new legislation? And will it see the need for a more centrally run, and regulated, EU energy market.

And before the new Commission takes office the current Commission will likely seek to make progress on market transparency and competition. It will also have to take decisions on Emission Performance Standard legislation that will impact on new coal-fired plant, and as with last year the Commission’s energy policy will continue to be directed by climate issues as the EU seeks to forge a bipartisan relationship with the US on climate action and building a green economy.



Closer to home the government will finally make a decision on E.ON's application for a new coal-fired plant at Kingsnorth, Kent. Approval will provide the green light for a number of other planned carbon capture ready coal plants, and would lessen the risk of an energy gap. It would also send a signal that the new Department of Energy and Climate Change (DECC) still favours a market-led approach to energy investment.

But with DECC secretary Ed Miliband recently commenting that large renewable infrastructure projects will need to be centrally-funded, and with fresh questions over the economic viability of the London Array offshore wind project, there may be mixed signals on whether the government still trusts the market on investment decisions.

What is unknown is whether the government will be panicked into revising its renewable policy if investment economics worsen further. After all, since October the government has announced three major initiatives to arrest the impact and reduce the length of the recession, with each new initiative addressing the failures of its predecessor, and a similar revisionary approach to its renewable policy cannot be ruled out. Any government dithering or uncertainty will feed into the market and, as with the demand uncertainty, it has to be managed.

Managing uncertainty

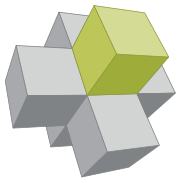
Companies can address market uncertainty either passively or actively, with both responses requiring risk management. A passive approach will likely entail a company fixing the price of all, or the majority, of its exposure, while an active approach would see a significantly smaller share of price fixing and providing more flexibility to manage the remainder of the exposure on a near real-time basis, thus reducing the risk of an opportunity loss.

Regardless of whether an active or passive risk management approach is adopted the viability of these approaches will be influenced by the data used.

During an economic downturn there is a tendency for businesses to cut back on costs, with the first cuts tending to be operational costs, such as staff, as businesses look to streamline their operations. Another popular cost target are those business functions that are perceived to be luxuries. But businesses must be careful they do not confuse business luxuries with business necessities.

Data management systems may be viewed by some as a business luxury, and during a benign market period this argument might have some validity, but at times of extreme market uncertainty, such as now, when risks are significantly higher, data is a company's most valuable business resource, whether it be metering, price or any other data source.

The market outlook over the coming months may appear highly uncertain, but this uncertainty is also highly manageable. Companies need to ensure they have the necessary business tools at their disposal to navigate through a recession and these tools must include an optimised data management system.



Conclusions

Eighteen years ago, when the UK economy was last in recession, the market was less able to adapt to the economic consequences. But there can be few, if any, excuses today. The main differential between 1991 and today is technology. For example, the development of smart metering programmes means that demand patterns can be better managed, thus increasing energy efficiencies and reducing costs.

Recessions tend to be a wake-up call; providing a notice that change is required. Governments have already accepted that changes are required to ensure the next economic cycle is more sustainable, and the need for sustainability has to include energy consumption. This recession is already changing energy behaviour with demand falling, but it is important that this new era of “energy responsibility” is not dismissed when the economy booms again. Smart metering technology can help provide this energy responsibility.

Economies will always move in cycles, but technology only moves in one direction – forward. Through advances in technology companies have become more efficient and profitable, and the business value of technology is never more evident than in a recession.