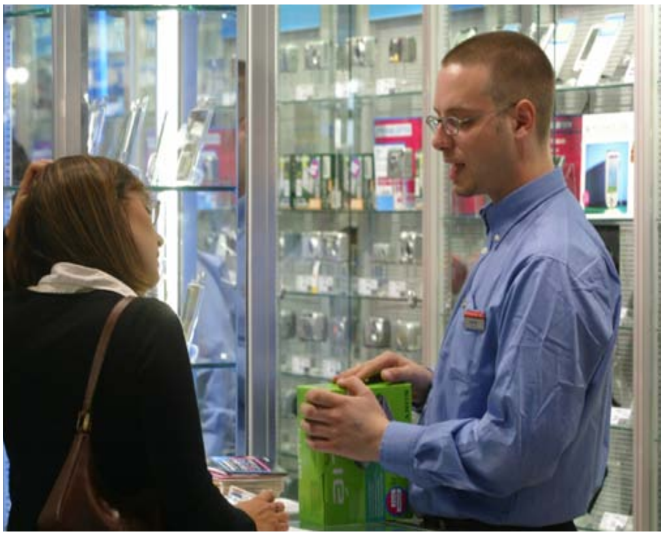
Rising Energy Prices Place Pressure on Business Costs and Profits

The rising cost of oil places pressure on business costs. However, the end consumer may not always pay the price, due to significant price competition in the retail sector.



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Fuel for Thought

Energy prices are on the move - upwards. Global oil prices have increased by over 45% in the last year. Wholesale gas prices have doubled in the last two years, whilst electricity prices have risen by 60%.

The rise in global oil prices might be good news for shareholders of oil giants like BP and Shell. But for many businesses, higher oil prices are putting pressure on **costs** and **profit margins**.

Some businesses are looking to pass oil-related cost increases onto customers. For example, British Airways and other airlines have already added "**fuel surcharges**" to ticket prices in order to claw-back some of their increased fuel costs. However, for businesses in other sectors, increasing selling prices to customers simply is not an option.

Higher energy prices affect businesses in different ways. Usually, the main effect is to increase the cost of energy used in manufacturing and/or distribution. Accountants PwC recently estimated that energy accounts for 10-20% of the **variable costs** of consumer-goods companies. This means that recent energy price increases translate into a rise of about 10% in overall company costs - a big change that could potentially wipe out profit margins unless a way can be found of passing the increase onto customers.

Price increases for customers? Now - that's the tough part. The reason? **Retail price deflation.** Put another way, the prices of many goods being sold in British shops are actually falling on average.

In 2004, prices in the grocery sector fell by 0.7% prompted by a **supermarket price-war** following Morrison's acquisition of Safeway. Retailers are reluctant to allow their suppliers to pass on price increases whilst they are locked into a price-led, discounting battle for **market share.**

Manufacturers of electrical goods are suffering the greatest pressure on their profit margins. According to market research agency Verdict, retail prices of electrical goods fell by 8.3% in 2004 and are expected to fall by another 7% in 2005. The electrical good sector has been hit hard by energy cost increases - and also by rising steel prices.

Profits Under Threat at Big Business

"Profit warnings" by UK companies have leapt by a fifth and business confidence has tumbled amid warnings that British firms could be facing a "rough ride" in 2005.

The number of profit warnings by businesses whose shares are listed on the Stcok Exchange rose to 85 in the first quarter of 2005, according to a survey by accountants Ernst & Young, This marks a rise of 14 when compared with the same period last year. The survey highlighted particularly growing gloom among distribution companies, which are the most pessimistic of any sector, in what may be another symptom of faltering consumer spending in Britain.

Trevor Williams, chief economist of Lloyds TSB, blamed the slide in sentiment on worries over higher interest rates, soaring oil prices and uncertainty over the election.

But Mr Williams said the drop in business confidence could be short-lived.

"British businesses are most likely underselling themselves. This view is based on a combination of economic fundamentals remaining strong, and the fact that the financial position of companies remains secure," he said.

"The economy's good health looks set to continue."

Sources: PricewaterhouseCoopers; Verdict; Financial Times