

From costs to prices – a puzzling road in the energy industry

By João on April 13, 2015 at 8:00 am

Posted In: Ch 14 - Pricing & Customer Profitability, Ch 19 - Cost Management, Value Creation And Sustainable Development

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We all know that while costs are relevant to determine selling prices, they are only part of the story, and other factors may lead to unexpected outcomes – or perhaps not really so unexpected, once we are aware of the whole picture. The current plunge of oil prices provides another example.

Crude oil price is currently around \$50 a barrel, the lowest since 2009. Since the cost of crude oil is a major component of the cost of petrol, petrol prices have also been decreasing, as expected.

However, as [National Geographic](#) puts it “airfares and some home energy bills still seem head-scratching high”. Why?

Looking at economic reasons, some consumers and companies have secured their fuel purchase prices for several months, either by buying in advance or by using hedging strategies, so they are not able to take advantage of the current lower prices. So, a lag effect may exist. [The “Management Accounting in Practice” example 9.3 “Action for beating variances” of our book considers fuel costs hedging strategies when discussing how to proactively avoid variances; you may want to have a look at it].

Others argue that “airlines are “doing good things” with the extra money, but they’re doing them “for everyone except the consumer.”. A justification by an industry group spokesman that “Until we can adequately reduce debt, return cash to shareholders, renew our fleets, and share profits with employees, there is work left to be done” basically means that competitive pressures are not enough to pass the fuel cost savings on to consumers, enabling airlines to, among other things, improve their bottom line.

Of course, regulators and politics are also part of the story. The energy sector is strongly regulated. Interestingly, some regulator-driven policies may partly promote this situation, as National Geographic reports: “in Massachusetts, low energy prices don’t matter, because regulations compel utilities to contract for power six months in advance, according to Jake Navarro, spokesperson for National Grid”. However, the general current picture is of regulators (e.g., Ofgem, the Office of Gas and Electricity Markets, a non-ministerial government department and an independent National Regulatory Authority, in the UK) and particularly politicians to press for cost savings to be passed on to consumers. When George Osborn, UK Chancellor of the Exchequer, tweets “Oil price was \$53 pbl last night – lowest in 5yrs. Vital this is passed on to families at petrol pumps, through utility bills and air fares” and launches a Treasury investigation on this, the pressure is clearly on.

So, what are the explanations? As our friend Prof. Hanno Roberts so uniquely put it in FB: “answers fluctuate between lame, hypocritical, and “go away!””. Intrigued? Check the next post for a follow-up on this comment.