COST MANAGEMENT

ENERGY MARKETING OFFERED AS NEW COST-CONTROL OPTION

JOHN S. MAYNARD

HEDGING ONE OF MANY RISK MANAGEMENT TOOLS

THE PULP AND PAPER INDUSTRY, LONG accustomed to hedging risks from fluctuating foreign currencies and interest rates, has struggled to tame the price swings in pulp and paper. Relying on often ill-timed mill expansions and unwieldy inventories, the industry's efforts to match production with demand have failed to instill a measure of control over price volatility. Slowly but surely, the industry's profits and returns have suffered while capital costs rise. Meanwhile, competition gains steam from new domestic and foreign producers, all of whom are courting customers with a growing choice of alternative media, including the Internet.

The trading floor at Southern Company in Atlanta, GA

But help is on the way from an unlikely source—energy marketers. Besides the promise of lower energy costs, these aggressive marketing firms are offering pulp and papermakers (and their customers) a fringe benefit: financial risk management tools new to the industry, but proven in other commodity-based businesses such as agriculture and energy. And some papermakers have turned to the larger energy firms for help structuring massive transactions, ranging from taking over a mill's energy assets to the outright purchase of a mill's production for 10 to 20 years.

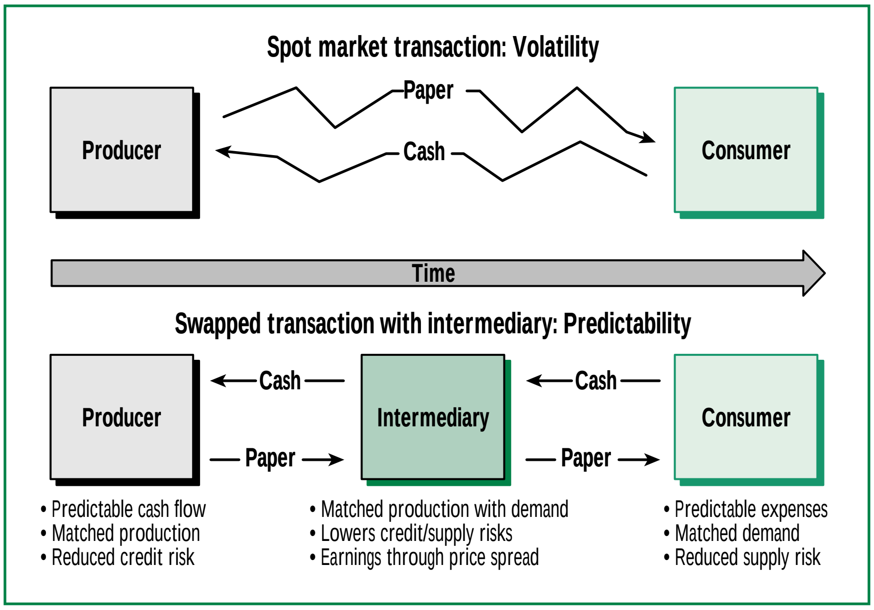
Proponents of these hybrid financial risk tools argue that swaps, futures and options contracts can return predictability, and thus stability, to the industry by stabilizing cash flow and earnings, which in turn should reduce lending costs and lead to a better allocation of capital assets.

Two of the more aggressive energy marketers to have targeted the pulp and paper industry are Atlanta-based Southern Company Energy Marketing and Houston-based Enron Capital & Trade Resources Corp. Southern Company Energy Marketing has close ties to pulp and paper through its parent company, Southern Company, the nation's largest producer of electricity with more than US$ 1 billion of its US$ 35 billion in total assets committed to serving the pulp, paper and publishing industries. Enron's interest in the industry reflects pulp and paper's high energy usage, equaling about one-third of its total production costs.

Both companies have published books on financial risk management for the pulp and paper industry that include detailed scenarios of how the industry can take advantage of financial risk management tools.

The significant marketing investments made by these energy companies and others targeting the pulp and paper industry seem prescient. Two markets for trading pulp futures have been established in the last year in London and Helsinki.

John Maine, vice president of Resource Information Services Inc., the Boston-based publisher of monthly pulp and paper price statistics, said prices in general have settled significantly since the roller-coaster period



Two market approaches

experienced from 1994 through 1996. "Producers and consumers are trying harder to work together in hopes of sustaining this current (price) recovery cycle," Maine said. "As a result, we're seeing more moderate price increases. Domestic producers are also concerned about losing marketshare to other grades of paper or to imports."

Whether it's the intense sales efforts of energy marketers, or perhaps the belief that the current reign of price stability is the calm before the storm, pulp and paper industry executives are beginning to seriously investigate the merits of financial hedging.

But hedging, which is the use of financial instruments to lock in current prices for goods sold or bought at a future date, carries its own risks and costs. It is not an industry cure- all. And price risk management techniques will entail learning a new lingo (i.e, the money, fixed-for-floating, calls/puts, collars) and new strategies that rely less on forecasting and more on price risk measures and their controls.

With the possible exception of crude oil, the volatility of pulp prices makes other commodities look tame. The price of northern bleached softwood kraft (NBSK) pulp soared from US$ 400 per ton in 1994 to US$ 950 per ton by 1995. Six months into 1996, the price fell back to US$ 500 per ton. Harried industry executives and customers are beginning to seriously consider hedging strategies, if for no other reason than nothing else seems to work.

"You're managing risk versus predicting it," is how Pasi Miettinen, marketing manager for Southern Company Energy Marketing, sums up the vision pulp and paper managers and their customers should adopt within a hedged market.

Southern Company Energy Marketing and Enron are two of, what at last count were more than 400, new energy marketers, all of whom are jockeying for position in a newly deregulated wholesale electricity market (where electric utilities mostly trade electricity among themselves). State legislatures and public service commissions are tackling the issue of opening retail electricity sales, including sales to large industrial and commercial accounts. The fact that full-scale deregulation of the retail electricity market is several years off in most states has not slowed the proliferation of energy marketing firms, which run the gamut from multi-million dollar capitalized giants with hundreds of employees to one-man shops. The industry formed its own association four years ago. Today, the Power Marketing Association's membership totals nearly 500.

To date, 10 states have passed legislation requiring utilities to offer customers a choice. Fifteen other states have major studies or experiments in retail electricity choice underway. The remaining states, including most of the southeastern states, have withheld action.

Mills located in states that have no electricity deregulation efforts underway can still take advantage of hedging services and consulting efforts now offered by energy marketers. For example, marketers have designed financial instruments that allow mills to fix their energy costs (natural gas, electricity and coal). These instruments can also be designed to peg a mill's energy cost to the price it receives for its production, helping to establish more predictable rates of return.

Electric utilities saw their wholesale markets begin to deregulate with the passage of the Energy Policy Act of 1992, which among other changes opened up access to electricity transmission lines. In an effort to position themselves for deregulation, many major electric utilities have merged with natural gas companies. (Southern Company Energy Marketing is a joint-venture between Southern Company and Vastar Resources, a Houston-based natural gas and oil production company.) The mergers permit utilities to offer one-stop shopping for energy. Also, the natural gas industry began its deregulation process almost a decade ago. Electric utilities have tapped its management expertise to help them confront deregulation.

Electricity traders have adopted the hedging strategies of their natural gas cousins to manage the price risks of their wholesale electricity trades. Enron and Southern Company Energy Marketing have made financial risk management the lynch pin of their pulp and paper marketing efforts. They have found their hedging expertise highly marketable and have used it to help sell other energy services, such as utility bill consolidation, or on a more ambitious scale, the takeover of a mill's energy assets or its production tonnage for extended terms—as much as 20 years.

The pulp and paper industry's huge energy appetite, second only to steel and oil refining in North America, has made it a plump target for these new arbitrage-savvy energy traders, many of whom have been hired outside the electric utility arena.

In fact, other than the occasional "y'all" heard among the traders at Southern Company Energy Marketing's operation in Atlanta, you could swear you were in the middle of a bustling Wall Street trading room. More than 100 traders, all young ("There's no such thing as an old trader," according to Miettinen), sit hunched before large brightly colored computer monitors scrolling the latest trades, breaking news or e-mail from colleagues. A sophisticated phone system, which records all conversations, dominates each trader's desk, flashing incessantly as trading volume mounts during the day. Traders are grouped together by the geographic areas for which they trade their electricity, natural gas, oil and other energy products. The walls in the trading room and in the offices that surround it are adorned with slick white marker boards used for impromptu scribbling of charts or notations of recent trades. Visitors are asked not to photograph these walls. Huge muted television screens broadcast CNN, the Weather Channel and other news networks.

The energy marketers' pitch to the pulp and paper industry is that their hedging strategies directly address the troublesome relationship papermakers share with their customer: that t one typically benefits at the other's expense. The financial instruments that enable papermakers to predict their future price levels and cash flows provide the same benefits to paper customers trying to manage their expenses, and without interfering with day-to-day manufacturing and sales practices.

Assuming it can demonstrate improved cash flows, profits and capital-savings with its hedging instruments, Southern Company Energy Marketing hopes to convince papermakers that it can take over or build from scratch the power systems necessary for large, integrated papermills. Southern Company Energy Marketing has done just that with the purchase and operation of the energy and recovery complex at the Mobile, AL integrated kraft mill owned by Kimberly-Clark and S.D. Warren Inc (see accompanying story).

"Southern Company wants to invest in energy assets," Miettinen said. "We bring economies of scale to manage a papermill's powerhouse. That allows a papermill to focus on its core business."

Free from funding power operations allows papermills to cut their capital requirements 20% to 30%, bolstering their balance sheets or making additional funds available for other improvements, such as faster paper machines.

That is exactly the strategy one major energy-intensive manufacturer has taken corporate-wide. E.I. du Pont de Nemours and Company announced last October the

TOP 10 POWER MARKETERS BY SALES

1. Enron Power Marketing, Houston, TX; http://www.enron.com/corppro/ees.fset.html
2. Electric Clearinghouse, Houston, TX; http://www.ngccorp.com/AnnualReport/eci.htm
3. Duke Energy and Trading Houston, TX (merged with PanEnergy to form Duke Energy Corp.); http://www.panenergy.com/trading/
4. Vitol Gas and Electric, Boston, MA; http://207.221.194.240/power.htm
5. Southern Company Energy Marketing, Atlanta, GA (recently merged with Vastar Resources of Houston, TX); http://www.southernco.com
6. Aquila Energy Corp., Omaha, NE; http://www.aquilaenergy.com/index.html
7. PacifiCorp Power Marketing, Portland, OR; http://www.upl.com
8. LG& E Power Marketing, Louisville, KY; http://www.lgeenergy.com/pmnr.html
9. Illinova Energy Partners, Oak Brook, IL; http://www.illinova.com
10. Engage Energy Houston, TX ; +1 713 877-1400

--*Source: Power Markets Week, a McGraw Hill Companies Inc. publication*

Other contacts:

O.M. Group's Pulpex Futures market: http://www.Pulpex.com
Finnish Options Exchange: http:// www.Foex.fi
Power Marketing Association: http://www.intr.net/ pma/
Resource Information Services Inc., Boston, MA: http://www.resourceinfo.com

formation with American Electric Power of two jointly-held ventures that will purchase, lease back and manage the energy assets of 16 U.S. Dupont plants, with 17 more plants scheduled to sign on later. Dupont said that energy purchasing services will be provided for the majority of its 80 domestic plants.

Dupont and AEP will each invest US$ 125 million in the new ventures, which will be called AEP Conoco Energy Capital and AEP Conoco Energy Management Services. Conoco is the energy subsidiary of Dupont.

"Any industrial or large commercial location with on-site energy assets is a potential customer," said the company at the announcement of its new ventures, adding that it believes the potential market for such energy services totals US$ 100 billion.

Not all manufacturers, however, are ready to give up control of their power houses.

Brad Karp, executive vice president of commercial operations for Duke Energy Trading and Marketing, said a manufacturer's energy-production strategy forces it to choose between the cost efficiency of outsourcing versus the comfort of centralization and control.

"We see industrial customers all over the lot on the outsourcing issue," said Karp, whose company also provides power-asset management services. "For some where energy costs are a big part of their overall operating budget, they feel it is too important to outsource to somebody else."

Duke Energy is the third largest electricity trader according to third quarter 1997 filings made to the Federal Energy Regulatory Commission. Karp said Duke Energy has targeted large energy users on a regional basis according to the terms and conditions that energy can be delivered, and has not stressed hedging or financial tools, at least on the customer side.

"We're more focused towards the physical delivery of energy," said Karp. Duke Energy has signed a 10-year agreement to supply natural gas to Willamette Industries' West Coast mills. "We're proceeding down the same path with them for electricity," he said.

Illinova Energy Partners, the energy marketing firm formed by Illinois Power, is concentrating its efforts on large industries located in states taking the lead in retail electricity deregulation. Illinois happens to be one of those states and Illinova has been a vocal supporter of retail electricity deregulation.

"If industries are in a state that is deregulating, they have a better chance to use our services. If not, they will have to wait," said James A. Buck, director of corporate communications for Illinova Energy Partners.

Miettinen of Southern Company Energy Marketing said the degree of electricity deregulation taking place on the state level plays no role in their marketing efforts.

"We're not limited to any specific state. In fact, we're not limited to the United States," he said. Southern Company Energy Marketing claims it can lower a mill's energy costs (including electricity) through the use of financial instruments that, for example, could peg a mill's energy costs to the price it receives for its products. These financial transactions, known as swaps, are separate from the normal energy bills mills pay, but have the effect of lowering their overall cost.

Enron, the biggest energy marketer by a large margin and an acknowledged industry innovator, parlays its strong balance sheet into liquidity for the paper industry.

"Customers rely on us for long-term contracts they can take to the bank," said David Cox, vice president of Enron Capital & Trade Resources Corp. "We are now looking at 10- and 20-year deals." Cox added that typical transactions involve 100,000 tons annually of a mill's product.

Energy marketers claim they are being well received at both corporate and mill levels.

"So many times the pulp and paper industry has seen new instruments come and fail. We've had a lot of education that's had to take place. But it's starting to pay off," Cox said. TJ

Maynard is president of Southeastern Coal Services Inc., an energy supplier to papermills located in the southeastern United States, P.O. Box 968, Watkinsville, GA 30677. He can be reached at +1 706 543-1189; email: jsmaynar@bellsouth.net.