

Industrial Compass for General Counsel

Soaring energy costs and inflation - maintaining profitability

Why is this an important issue for Industrial companies?



Supply chain instability is at its worst in decades. There is a real concern that the recent trend in cost base increases, which are likely to continue in the short to medium term, could be business critical right across the supply chain. It is more important now than ever to consider the steps your business can take to mitigate against rises in its internal cost base and your contractual relationships with both your suppliers and your customers.

Initial considerations



Conduct a supply chain risk analysis to identify fundamental suppliers who may be at risk and ensure your future proof supply arrangements going forward



Identify applicable support packages available to your business across the various EU jurisdictions you operate across. For example, The UK Government has announced a broader package of relief aligned to expanding the energy intensive industries compensation scheme.



Consider procurement of contracts which can reduce or hedge energy costs, for example buying low carbon sources of electricity and heat directly from generation sources, either on an on-site basis or via the "grid", acquisition of renewable energy project pipelines and/or energy efficiency contracts

The aim of a supply chain risk analysis

Consider a red, amber, green coding to identify those relationships to focus on



Identify the potential ramifications of failing to deliver to your customers



Identify key suppliers and their sub-suppliers to ascertain supply chain weaknesses

Existing supplier relationships

- Assess risk in your supply chain - identify suppliers potentially in financial distress and take action early. Signs include failure to deliver on time, defective or poor quality goods, changes in management or behavior and market intelligence
- Identify key jurisdictions and consider if local law provides contractual relief a supplier can rely on, such

Future supplier relationships

- As market prices inevitably become volatile, consider incorporating pricing clauses into new supply contracts which not only reflect raw material increases but other factors such as energy costs and inflation. Consider which indices best reflect the services or goods being supplied

as hardship, which may impact any future price negotiations

- If a supplier is considering attempts at re-negotiating its contract pricing, consider the behavior adopted and if this could be deemed to be so aggressive that it is found to have exerted undue pressure on its customer
- If a supplier refuses to supply, as part of price negotiations consider if a customer could obtain an injunction to compel the supplier to continue to supply if it has no alternative
- Review unprofitable contracts for exit provisions and evaluate potential costs for terminating vs losses being suffered, taking into account current market pricing
- Identify high-risk key suppliers and consider steps to manage the relationship, such as introducing dual supply proactively from different geographical locations
- Consider clauses providing additional opportunities to exit contracts, such as wider force majeure provisions
- Ensure you have the necessary financial and design rights to important tooling to respond to distress situations
- Consider including rights to audit suppliers and sub-suppliers in respect of their financial position and status of goods in production
- Exercise caution in agreeing to long-term exclusive supply contracts and consider the benefits of break clauses

Energy Contracts – investing now to mitigate against inevitable future costs



Power Purchase Agreements (PPAs) can allow you to lock in a long term energy supply (either on a physically connected or a “virtual” basis) at a fixed price and/or for a fixed volume – thereby providing price certainty and security of supply. The acquisition of renewable energy projects under development may reduce power procurement costs



Consider optimizing your existing assets (e.g. land, network infrastructure, roof space) to procure on-site power and/or heat generation and/or storage facilities. This can help you avoid supply levies (due to these supplies being off-grid), provide security of supply and potentially sell any excess to the grid as a revenue source



Long term PPAs as well as renewable energy projects can provide “additionality” (i.e. support the development of new renewable generation projects) and will support your decarbonization/ESG goals as power can be sold together with renewable energy certificates



Invest in energy efficiency measures (including where possible utilizing alternative forms of heat generation) – the cost/benefit analysis of investing in these measures will only increase in the coming years and there are several sophisticated market participants who will assess and fund the CAPEX for the required measures

What actions should General Counsel consider?

Boards are questioning what they can do to manage the impact on a dramatically increasing cost base as well as the potential impact of this on their supply chain. Focus on the following:

1. Are there any government incentives/schemes which your organization can benefit from? Whilst support from the UK government is currently limited, other EU governments are offering much broader schemes.
2. Conduct a review of existing core contracts to assess break opportunities, pricing methodologies and contractual compliance. Carefully consider new long-term exclusive supply contracts and seek to negotiate wider price indexation provisions/ greater levels of flexibility.
3. Ensure commercial and operational teams are aware of early indicators of suppliers in distress, consider putting in place a red flag system to enable proactive steps to be taken to manage any implications on supply chain.
4. What renewable energy options can be integrated into your business? Consider how to optimize existing assets and whether to procure onsite generation of power and wider energy efficiency measures.