

# Power Play

Increasing energy prices and a complex market make it vital for purchasers in this area to adopt a risk management approach. Gary Worby looks at the factors to take into account

**Organisations of all types, from large manufacturers to small firms, are feeling the impact of rapidly rising energy prices. These hikes increase overall costs and can leave buyers faced with several different priorities - to procure energy at the optimum price, to reduce operational costs, to increase efficiency and to adhere to government policy such as cutting greenhouse gas emissions.**

It isn't simple. The number of variables makes buying energy a highly complex and risky spend area. There are multiple rates and pricing structure tariffs, and varying numbers of suppliers. Other forces include generation mix (nuclear, coal, oil and renewable), capacity constraints, political and economical drivers and market sentiment.

But when it comes to purchasing energy, companies often take shortcuts and their strategies do not fully evaluate the risks and rewards. Annual energy budgets are significantly understated, and they set unrealistic objectives that can increase the impact of risk.

Companies need to understand the embedded risks within the market they serve, and put in place robust modelling procedures and processes to deal with them wisely.

Most importantly, an executable strategy should be continually updated and based on changing market feedback and the company's objectives.

There are steps that can be taken to reduce risk. First, you need to set realistic expectations and budgets. Senior decision makers such as the finance and/or managing director, energy director, or contract negotiator must fully understand the market and plan a strategy accordingly.

The next step is to understand how utilities are being used. Consumption data should be readily available across all sites. However, the larger the organisation, the more complicated managing this data becomes. The information will not only be useful to suppliers, but will also identify areas where performance can be improved and establish whether you are on the best tariff. Bill checking and energy audits are crucial to energy management.

The opening of a "spot and futures" market - with spot purchases usually made within-day or day-ahead and futures purchases delivered in a later month or season - is now making a multitude of products available.

Depending on your risk exposure and internal capabilities, these can either be based on physical ownership or use a financial instrument. Retail customers, for example, buy actual quantities of power at a given price. A financial approach gives customers the opportunity to "play" other markets against the power market in order to "hedge" against volatility and therefore risk.

Strategies are best formulated through familiarisation, using expertise in the energy markets. Typically, familiarisation requires several key stakeholders to spend between four and eight hours with the energy expert, evaluating the energy options and risk components.

The energy expert should ask:

- What are your aims and objectives?
- Have these changed?
- Are these different within each level of the company?
- Can these aims be achieved?

Then an understanding of risk and analysis must be established. This would be based on the questions: what risks are you prepared to take? How technical do you want to be? How able are you to make quick decisions?

## Market conditions

A further aspect to consider is market conditions. These include global, regional and domestic issues, when to trade, contract length, and which are the preferred suppliers. The creation of a concise strategy can make product evaluation quick and seamless, and facilitate pre-tender supplier selection. The decision to take a fixed or variable contract will depend upon a firm's strategy and risk profile, and its correspondence to market conditions and trends.

Many small to medium-sized companies are comfortable making "one-off" purchasing decisions on a fixed-price supply style contract. The contract term generally varies according to the forward market price as rising prices is likely to cause customers to purchase far ahead.

With these styles of products, the principal risk remains with the supplier. Fixed contracts are therefore attractive to companies that need a measure of cost predictability for budgetary purposes. Companies considering a fixed contract need to use tools that can quickly analyse quotations and provide feedback to suppliers. Typically, this would be provided through e-sourcing functionality, such as a reverse auction process.

However, in today's volatile climate, some customers may wish to opt for variable-priced contracts, rather than obtaining a fixed price for the entire year.

One of the advantages of this is that a variable-price contract management offers greater flexibility, but it carries a corresponding level of risk. As a consequence, variable contracts are suitable only really for larger companies that have more experience, as well as the necessary time and support to deal with the extra work involved.

## **Wholesale buying**

Trading on the wholesale market is one option, but for this to be workable, companies need to consume a sufficient volume of energy annually - generally more than 120GWh. Alternatively, customers can be bundled together to create the required volume size and shape. Small customers willing to "aggregate" their volumes could have them purchased at the same time by an energy broker and all get the same price.

Usually these customers will show similar criteria in, for example, volume, load factors, risk aversion and credit rating. The bundled group will execute purchasing decisions as a single entity under a "memorandum of understanding".

Where customers choose flexible products, various factors play a significant part in the end result. These include their dependency on a strategy, access to daily market prices, an energy price model, and knowledge of the energy markets.

If their strategy requires many buying decisions throughout the year, much of their time will be absorbed in evaluating the price, with or without support from a consultancy.

The current energy market presents buyers with opportunity and choice. In their evaluation, they need to assess risk and their ability to manage this risk.

All stakeholders need to work together. And a strategic review that defines the current situation, aims and objectives, together with any internal limitations, is indispensable in easing the decision-making process, and getting the best deal.

## **Energy explanations**

Variable-price contract management products

- Trackers - market tracking products following feed market fluctuations.
- Caps and collars - these financial instruments are usually referred to in a different context as maximum and minimum levels - set by the client - at which a client chooses to buy energy. Within the financial context, these levels are priced with a premium that ensures that a client will pay no more (cap), or less (collar) than the agreed levels.

- Block purchases - separation of base (constant demand) and peak (peak demand) within supply profile, thereby spreading risk.
- Financial products - hedges and index-linked arrangements.