

Week of March 17-23, 2006

Buying power in a deregulated market has its ups and downs

In deregulated markets, the choice of electricity product can have a significant financial impact.

Power purchasing options vary according to a company's size, energy usage and appetite for risk. The five most common types of electricity pricing products in Texas are:

Index. Buying at the index price delivers power for a price that is the average of spot market settlements over the delivery period. Index is the most volatile yet simple of the five products. There is no variance between what the company uses and what the supplier intended to buy, so there are no risk premiums or hedges to manage.

The index product is most popular when historical index prices are relatively low compared to fixed prices. Index products almost immediately reflect any changes in gas and oil prices, so customers are engaged in a constant risk-reward dynamic.

Index is most suitable for industrial companies that can shed load, manage power consumption, pass on the cost of electricity to their customers, or use a majority of their energy during off-peak hours.

Index with fixed price trigger. Index with fixed price trigger allows companies to play the market with the option of locking in a price at a later time. Companies purchase energy at the index rate, but specify a price target — high or low — that will trigger a fixed rate.

This product is growing in popularity because it provides a type of safety net. If prices rise, a fixed-price trigger can lock in the rate before it rises even higher. On the other hand, if prices drop, the fixed-price trigger lets the customer lock in an abnormally low rate before it rises again.

This option is best for those willing to bear the risk of paying an index price but who also want to take advantage of any market dips to lock in a fixed contract price. Companies considering this option should be able to handle a moderate degree of risk.

Heat rate. Companies typically choose a heat rate product when they want to pay market-based

prices and power indexes in the market are not available, or they are not as transparent as gas prices.

Natural gas is a liquid commodity for which pricing information is widely available, and it's less volatile than electricity. Natural gas prices move once a month, versus on-peak index prices for power, which change every 15 minutes.

Heat rate products are most popular when gas prices are expected to decline. This includes when extreme temperatures are not expected during the winter or when conventional gas supplies look good going into the winter heating season.

Oil and gas companies, or companies having a strong commodities hedging function, sometimes choose heat rate-based electricity supply contracts. These companies are looking for ways to tie their expenses to expected revenue streams. For example, in a gas market where prices are increasing, a heat rate contract will result in higher electricity costs for the company. Conversely, in a declining gas price market, electricity costs will be less.

Fixed price-full requirements. Companies that require budget certainty and cannot bear price risk will select a fixed price-full requirements pricing strategy. "Full requirements" implies that a customer must take delivery of all of the operation's power needs at a certain price rate.

This product delivers budget certainty because in choosing a fixed price product, price risk is borne by the supplier (except for the price components that are passed through or quoted separately).

For risk-averse companies, a fixed price product is ideal in all market conditions. Bill auditing and verification are simplified. It's the easiest way to buy energy but it comes with a price premium.

In a low-price market, it makes a direct comparison of the supply contracts easier. In a high-price market, it's more challenging. End users must be wary of how line losses, capacity charges and other components are treated in the contract. A price that appears lower may include contract terms and conditions where these fees show up separately, or at a later date, like a balloon payment on a mortgage.

Fixed price-full requirements is the product of choice in most markets since it is easiest to understand. The company's primary risk in selecting a fixed price offer is in trying to



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Comparison shopping

A comparison of electricity costs from June 2004 to July 2005 for a typical Texas-based, 100-employee manufacturer, with an annual power bill of about \$2 million, indicates that the energy deals ranged from \$1.88 million to \$2.06 million, or a difference of \$188,000, for the same amount of energy with no changes in usage.

- Index — \$1.88 million.
- Index with fixed price trigger — \$1.96 million.
- Heat rate — \$2.04 million.
- Fixed price-full requirements — \$2.06 million
- Fixed price block with remainder at index — \$1.88 million.

accurately compare quotes from a variety of retail electricity providers.

Fixed price block with remainder at index. For companies willing to shoulder some risk but have concerns about letting 100 percent of their energy pricing ride on the index, a block-and-index combination is a good choice. This offers the option of reducing price, while mitigating the risk of variable pricing.

This product lends itself well to a growing business that can layer in additional electricity usage as the business expands. The company can lock in a fixed price up front for a portion of its load and pay the index price for the remaining volumes. This strategy also makes sense if the company wants to lock in portions of the contract price at various times, since the company can buy multiple blocks of power over time.

Block and index is attractive in all market conditions. Customers benefit financially when prices fall below the current market rate. In a rising market, the company is partially hedged with a portion of its usage locked in at a lower price.

When companies seek a power contract, they should consider their business environment and the energy market. Energy managers should become familiar with their options because energy choices can significantly impact the bottom line.

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