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Purchasing Options for Energy Buyers

The Risk Management Way

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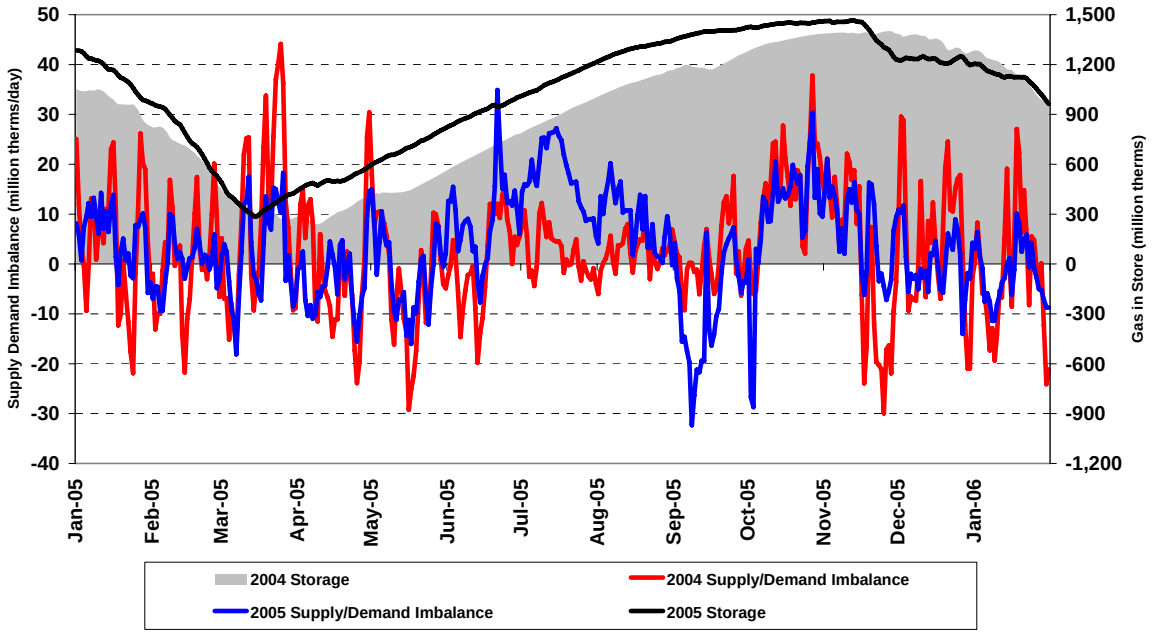
Overview

- Encore's view on 4 of the imperfections in the UK energy markets and why you need new ways of procurement and portfolio optimisation
- Show how energy buyers that risk manage differ from the many who don't!
- Explain how you can buy your energy flexibly and safely and optimise your portfolio from the day you set your budget to the day you consume the energy

Market Imperfection No. 1

- The supply demand imbalance in 2005 was not materially different to the supply and demand imbalance in 2004
- We actually had more gas in store going into the period than we had in the previous year
- We don't believe the high price were caused by the a shortage of gas supplies



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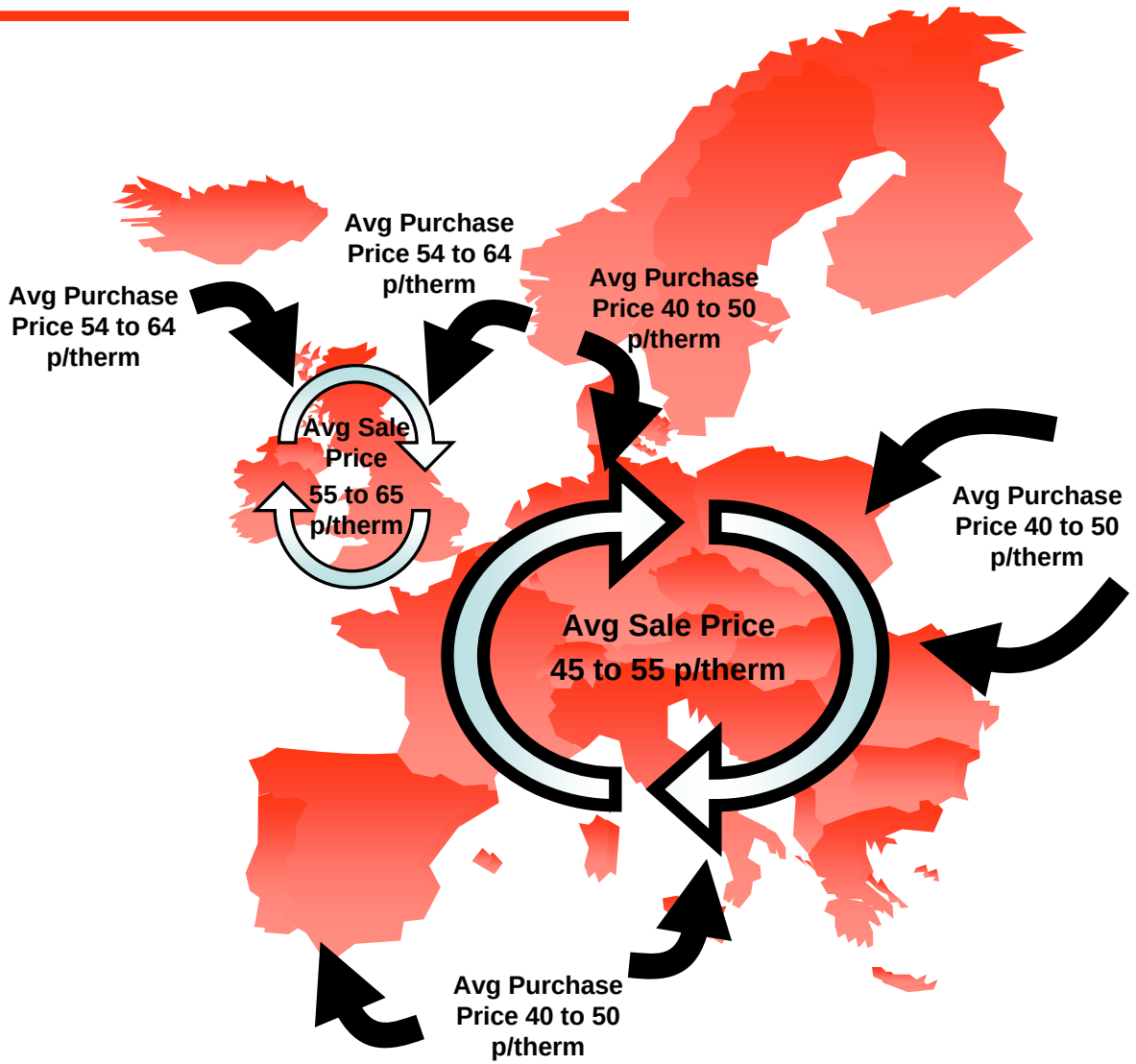
Market Imperfection No. 2

- Generally the UK energy market is not physically constrained, it is financially constrained
- Typically, the people who could deliver additional capacity to the UK wholesale market collect revenue from the UK consumer
- So why would they want to supply marginal energy to the UK which would lower the market price in the UK and consequently the sale price



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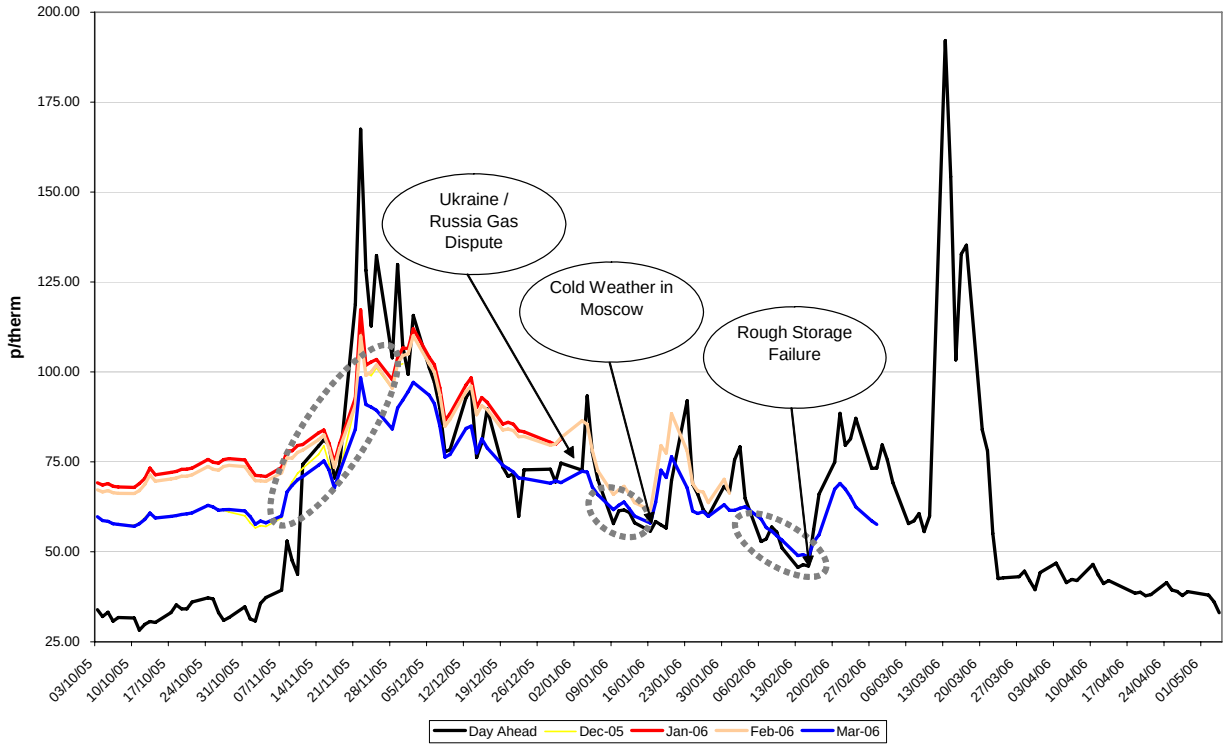
Market Imperfection No. 3

- Large Consumers on flexible contracts have bought very little energy for Winter-06, 2007,2008,2009
- The Suppliers, Traders and Banks have bought lots of energy, and they have bought all of the storage
- There are 182 days in the winter and the UK has 90 days of storage. Every time there are more days of the winter left than there is gas in store the market has the potential to be cornered
- The market was cornered in Q4 2005 and will be in Q4 2006 and each year until enough large consumers buy energy forward
- In previous years this was not a problem as enough large consumers had fixed prices and as such the suppliers, traders and banks had to balance the system amongst themselves. Now they can balance against all of the large consumers



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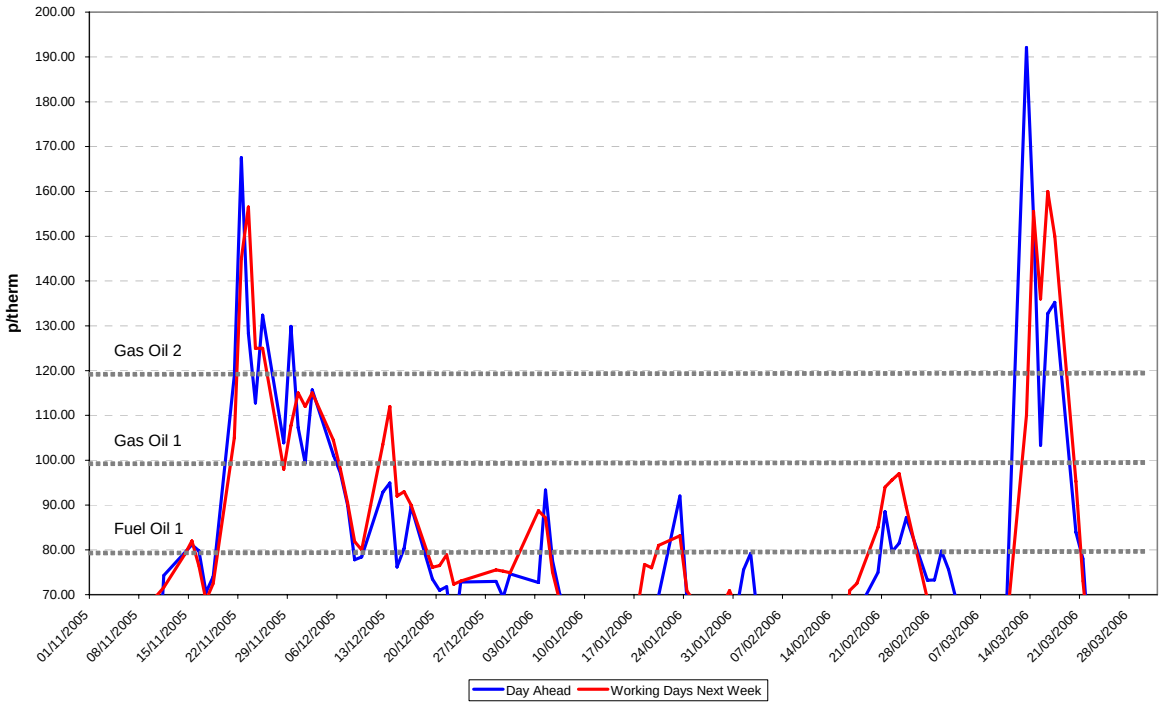
Market Imperfection No. 4

- The current Interruptible transportation contracts in the market allow for demand side respond in times of extremely high demand – this is an enforced response from people with alternative fuels
- We have not had a sustained period of enforced mass demand side response since 1995
- However just because there is not an enforced demand side response does not mean that there should not be a commercial demand side response
- However at the moment Large Consumers do not necessarily see the value of it



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What can we do about the Imperfections?

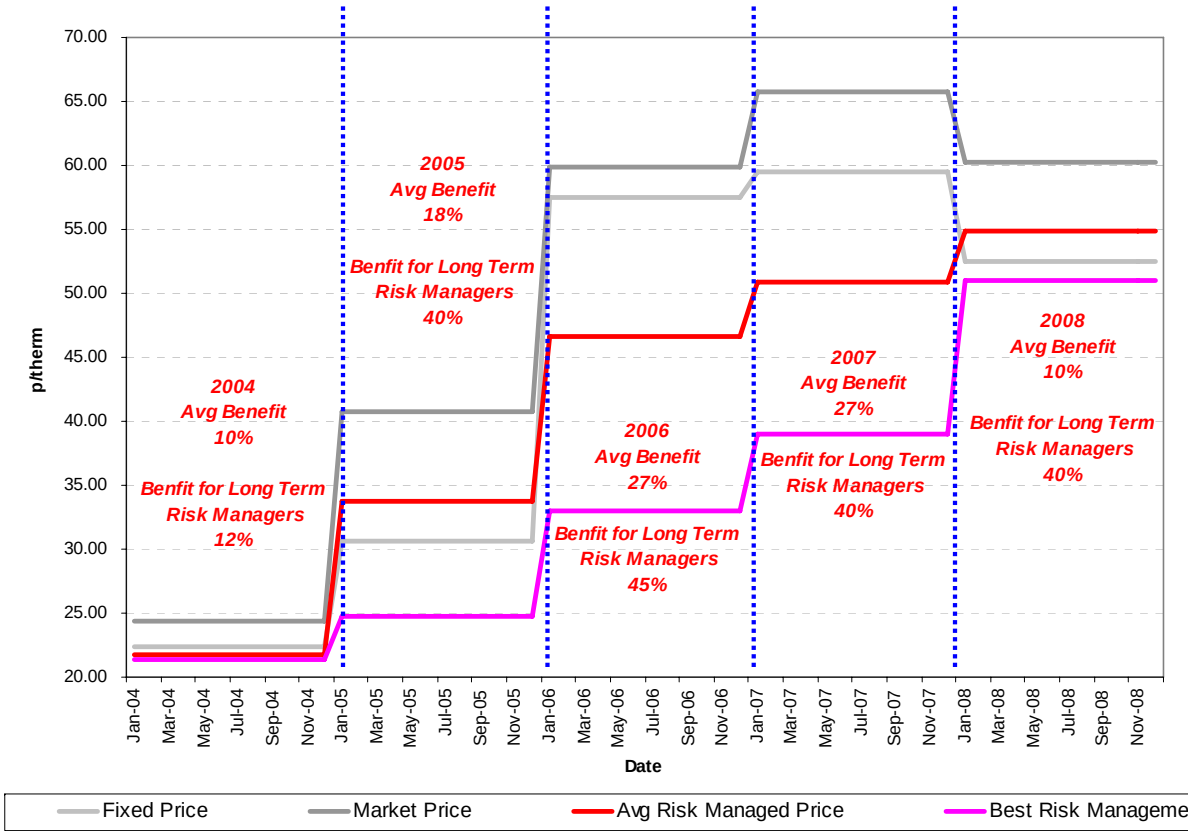
- Restructure the European Energy Markets - it's in hand but might take some time – 2008?
- You could make sure you have the correct supply contract, without the limitations, and a considered process for using it
- You could create a process where you're able to purchase future energy requirements now, without risking being stuck with high price energy when market prices fall.
- You can make sure you are ready to do things such as load management when the time is correct

Energy Procurement vs. Energy Risk Management

Features of Energy Procurement	Features of Energy Risk Management
Buying fixed price contracts or Flexible contracts with a price fixing only option Some companies have entered into contracts with price unfixing but often it is restricted	Recognises that a flexible contract is always better than a fixed contract because you can create exactly the same effect as a fixed price contract but you retain choices Recognises that because prices go up and down a flexible contract needs the ability not only the ability to fix prices but also to unfix prices in order to avoid speculation Recognises that prices move up and down without restriction and that the tools that you need to manage your energy risk are also need to unfettered by restrictions
Budgets are set and the performance against the budget is only looked at periodically If measurement is done only the value of the portfolio is measured and not the risk of it	Recognises that the value and the risk of your energy portfolio need to be measured every day as energy price don't double in one day - a risk manager can see it coming
The senior management of the company don't set clear objectives for the procurement team The senior management want you to have fixed your price and perform well against budget if prices have risen by the end of the year The senior management want you to have a market based price if prices have fallen by the end of the year They want to judge this using 20/20 hindsight with little reference to what happens in between	Recognises that large consumers of energy have conflicting objectives in terms of performance against budget and performance against market Creates a Corporate Risk Policy that is signed of by senior management and sets out the broad boundaries that the procurement team shall work to in terms of fixing and unfixing energy that are consistent with the large consumer achieving their corporate objectives Creates a process for quickly changing the Corporate Risk Policy as the business objectives change
Possibly outsources the procurement of energy to a consortium group or to a traditional procurement advisor The conversation focuses around a fixed proportion of the portfolio that should be on a fixed price and a proportion that should be on a floating price	Recognises that you should not give your portfolio to a third party to be gambled Recognises that no-one can predict the markets, if they could they would be out there doing it and keeping it a secret, rather than being paid by large consumers to try and do it with your money Recognises that you do need a risk measurement and control process to allow the proportion of the portfolio for which the price is fixed to be adjusted to match changes in the market conditions and in your business strategy Recognises that over an above this control structure you might over weight or under weight some decisions based on market information and commercial opinion
Consider implementing a demand side response at times of high price spikes but generally either has not bought the energy to be able to sell it back Even if energy has been bought the organisation internally has not set a strategy for price levels at which the energy can be sold and the alternative fuel bought or production ramped down to allow supply from stocks	Recognises that simply by having a predetermined capability to load manage you can optimise your commercial position Sells energy forward when spikes occur using the fact that they can load manage to make it a risk free transaction. Buys back the energy when the panic is over and in many cases never ends up actually interrupting anyway

Results of Energy Risk Management

- Reduced Risk
- Reduced Cost
- Controlled
- Simplified
- Adaptable
- Optimised to the needs of your business



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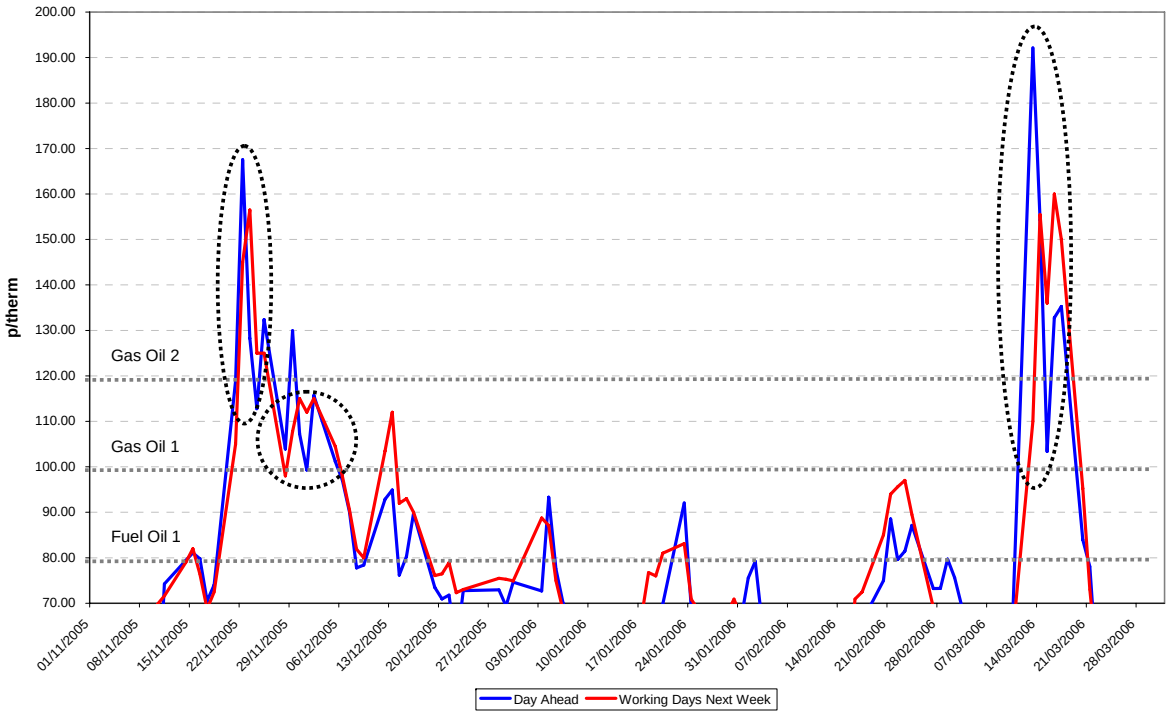
Optimsing until the day of delivery

- Once you have a risk management environment you can continue the optimisation process until the day of delivery
- You can monetise the options the options in your portfolio even without actually using them
- For example:
- 21st November sell Day Ahead switch to Oil
- 22nd November sell Day Ahead switch to Oil
- 23rd November sell Day Ahead switch to Oil
- 23rd November Sell Working Days Next Week
- 28th November buy back the balance of the week



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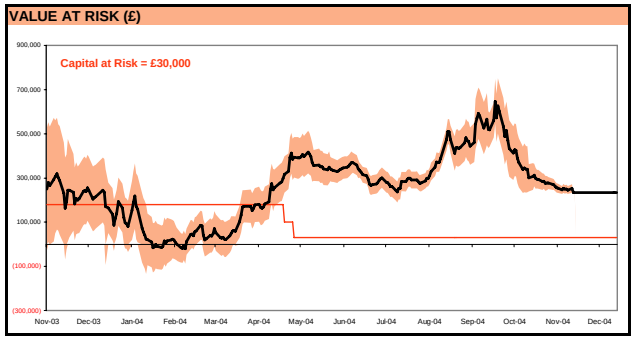
How do you do it?

- First set up a clear risk policy which allows you to match your company's objectives to your energy procurement position
- Second ensure you have a contractual relationship that allows decisions to be taken flexibly – without limitations
- Third set a budget and a limit to the amount of risk your business is prepared to take. Review and change this as the needs of your business change
- Fourth measure the changing value of your portfolio and its risk every day
- Five use this information with your procurement strategy and market expertise to optimise decisions
- Don't gamble or let other people gamble on your behalf

What Happens when you do it?

- You transform a horrible discussion with your FD



- Into amazing performance