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Managing Energy Price Risk with Financial Instruments

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Agenda

- What are derivatives?
- Types of derivatives
- Why use derivatives?
- Examples
- Questions

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What is your business' perception of derivatives?

DOES IT CONJURE UP A SENSE OF HIGH RISK AND HIGH COST?

Current perception……

- Too complicated
- Don’t understand them
- Don’t like paying premiums
- Too expensive
- Waste of money
- Outside my comfort zone
- That’s the responsibility of Treasury or Finance
- “That’s trading isn’t it”?
- Too hard to upsell internally
- We’ve had our fingers burnt before

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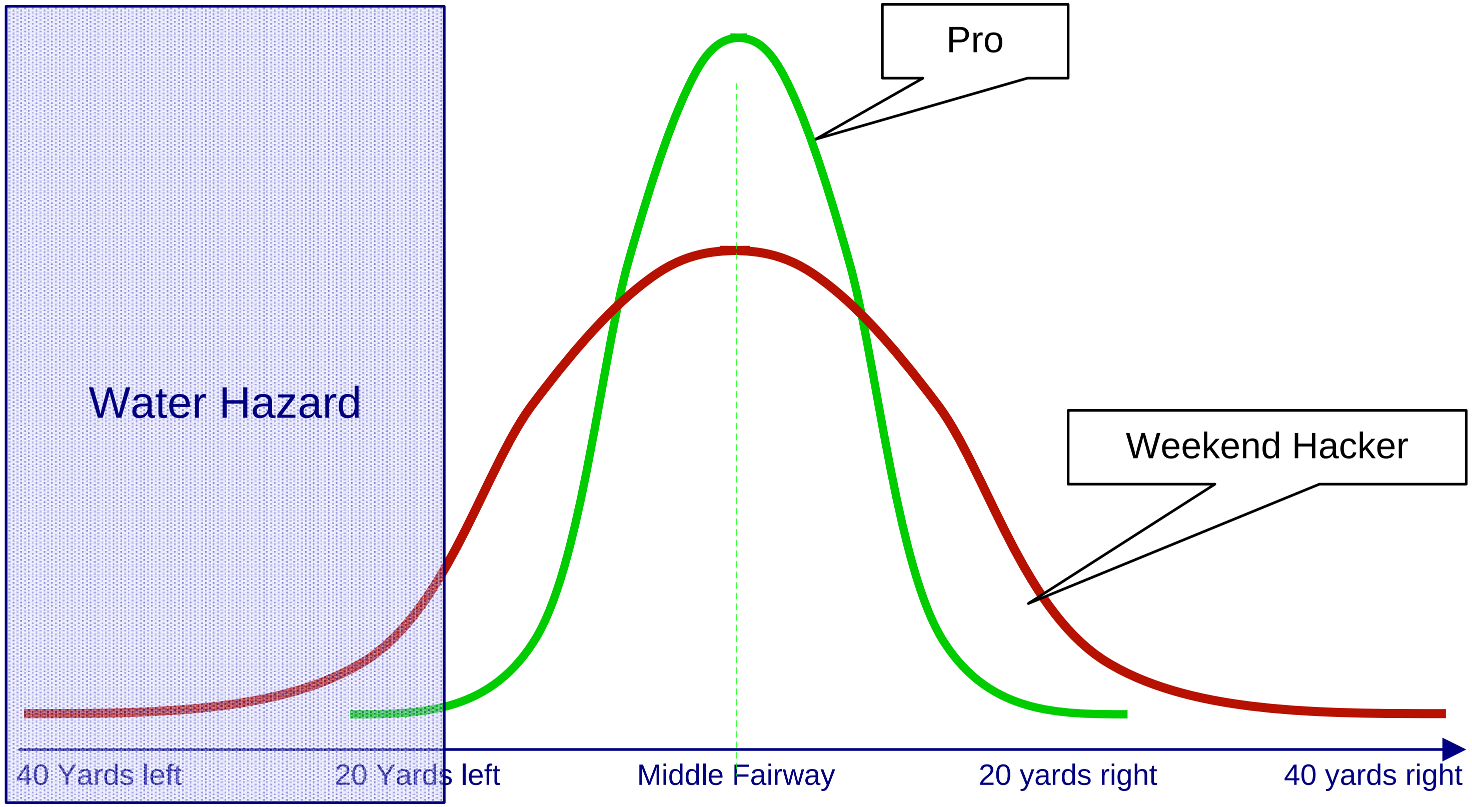
What they can be…….



What they can be…….

- How many can say that they have never delivered bad news regarding energy budgets in the last 4 years?

What they can be…….

- When does your current supply contract expire?
  - < 1 year
  - 1 – 2 years
  - 2 – 3 years
  - 3 – 5 years

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What they can be…….

- An insurance policy
  - Manage the shocks
- Certainty of budget
- Managing risk beyond the supply contract end date
- Can be used with both flexible AND fixed term deals
- Can be incorporated into day ahead strategy to provide protection
- Sometimes zero cost
- Lower physical supplier margin from day ahead
  - Construct your flexibility outside your physical supply contract

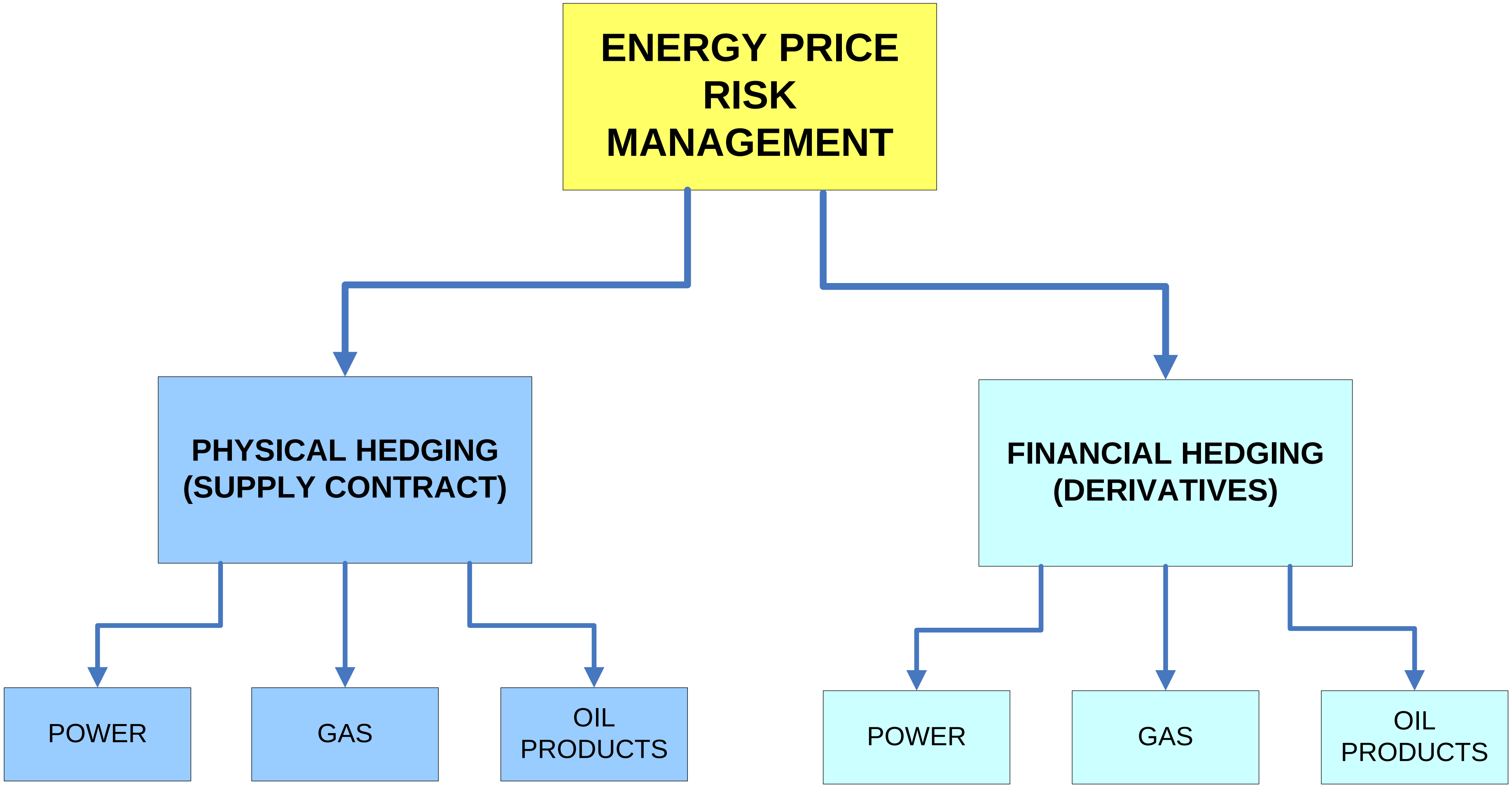
Types of financial instruments

- Futures
- Contracts for Difference (CFD)
- Swaps
  - Fixed for Floating
  - Participating
  - Extendable
- Options
  - Calls
  - Puts
  - Combinations

Why use financial instruments?

- Limited flexibility within supply contracts
  - Can only buy or sell forward physical power or gas
  - Cannot manage risk outside the timeframe of your supply contracts
- Limited to dealing with incumbent supplier
  - Banks
  - Financial Institutions
  - Traders
  - Other suppliers
- Other constraints within the supply contract
  - Suppliers restricting the volume you can buy
  - Suppliers restricting how far forward you can buy
  - Some suppliers now beginning to call margin

Why use financial instruments?



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What are the benefits?

- Can reduce risk and not increase it!
- Can provide greater earnings stability
- Can provide a GUARANTEE
  - Triggers cannot
- Absolute budget certainty
  - Current budget and future years
- Can benefit from downwards price movements whilst capping upside
- Sometimes zero cost
- Greater number of market counterparties
  - Currently limited to incumbent supplier
- Greater flexibility

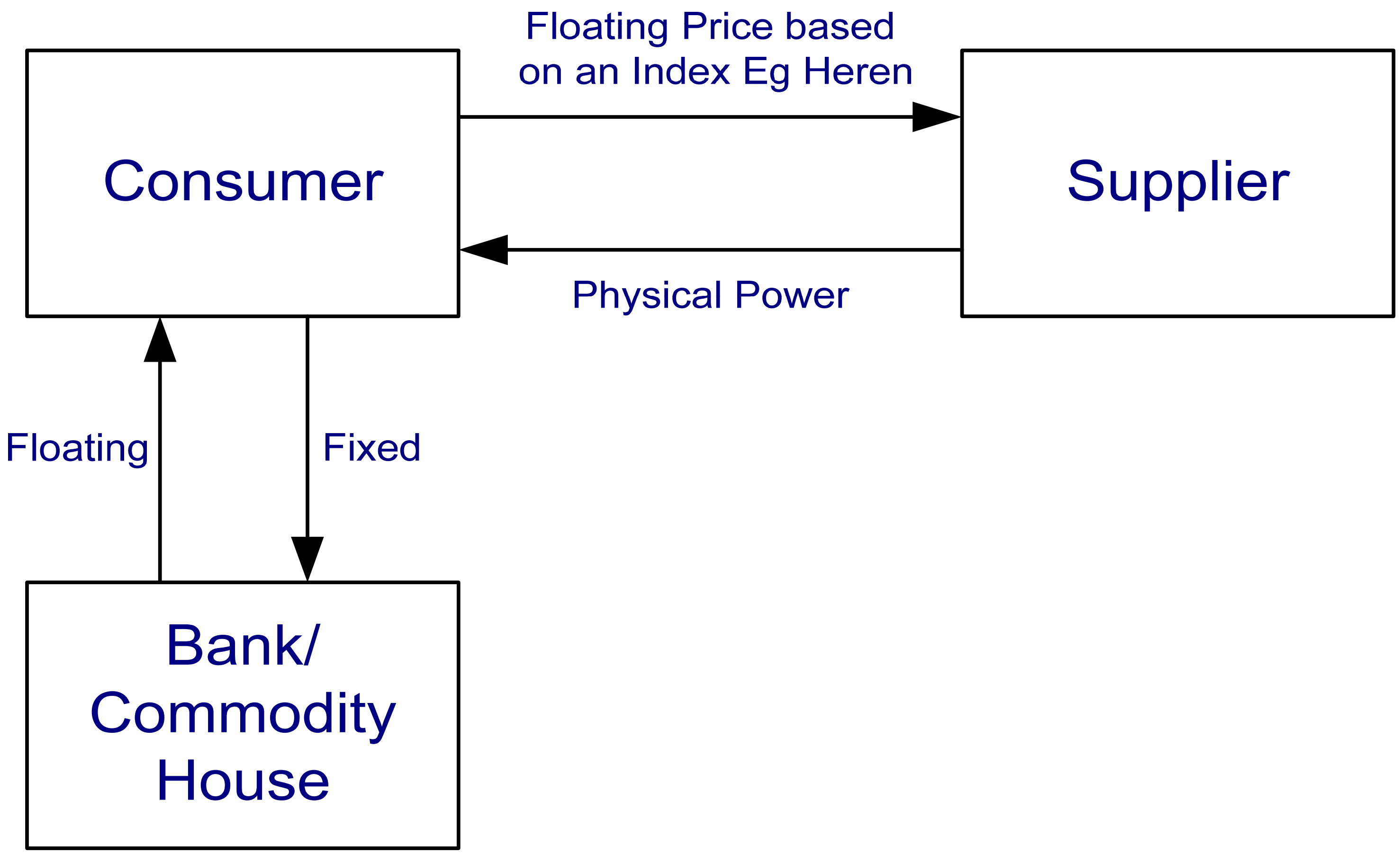
Example 1 – Managing budget risk

- Risk
  - End user has a physical power supply contract that expires in April 2008
  - End user has already set budget for April 2008 financial year
  - End user cannot buy power through physical supply contract
  - Budget risk

- Objective
  - Protect budget
  - Currently sit 10% below budget

- Strategy – “Fixed for Floating Swap”
  - Swap floating price power risk for fixed price power risk with swap provider for 100% of volume

Example 1 – Managing budget risk



Example 1 – Managing budget risk

- Transaction
  - Buy fixed power through a fixed for floating swap
    - 20MW Summer 08
    - 20MW Winter 08
  - Negotiate physical supply contract from April 2008 at your leisure

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Example 2 – Managing budget risk – Zero cost collar

➢ Risk

- End user has a HH renewal due for April 2008 start but can't get to tender until March 2008
- Financial year runs from April to March
- Budgets signed off today

➢ Objective

- Provide a guarantee for HH portfolio
- Budget currently sits at 16% higher than today's MTM
- Unwilling to pay upfront premium

➢ Strategy – "Zero Cost Collar"

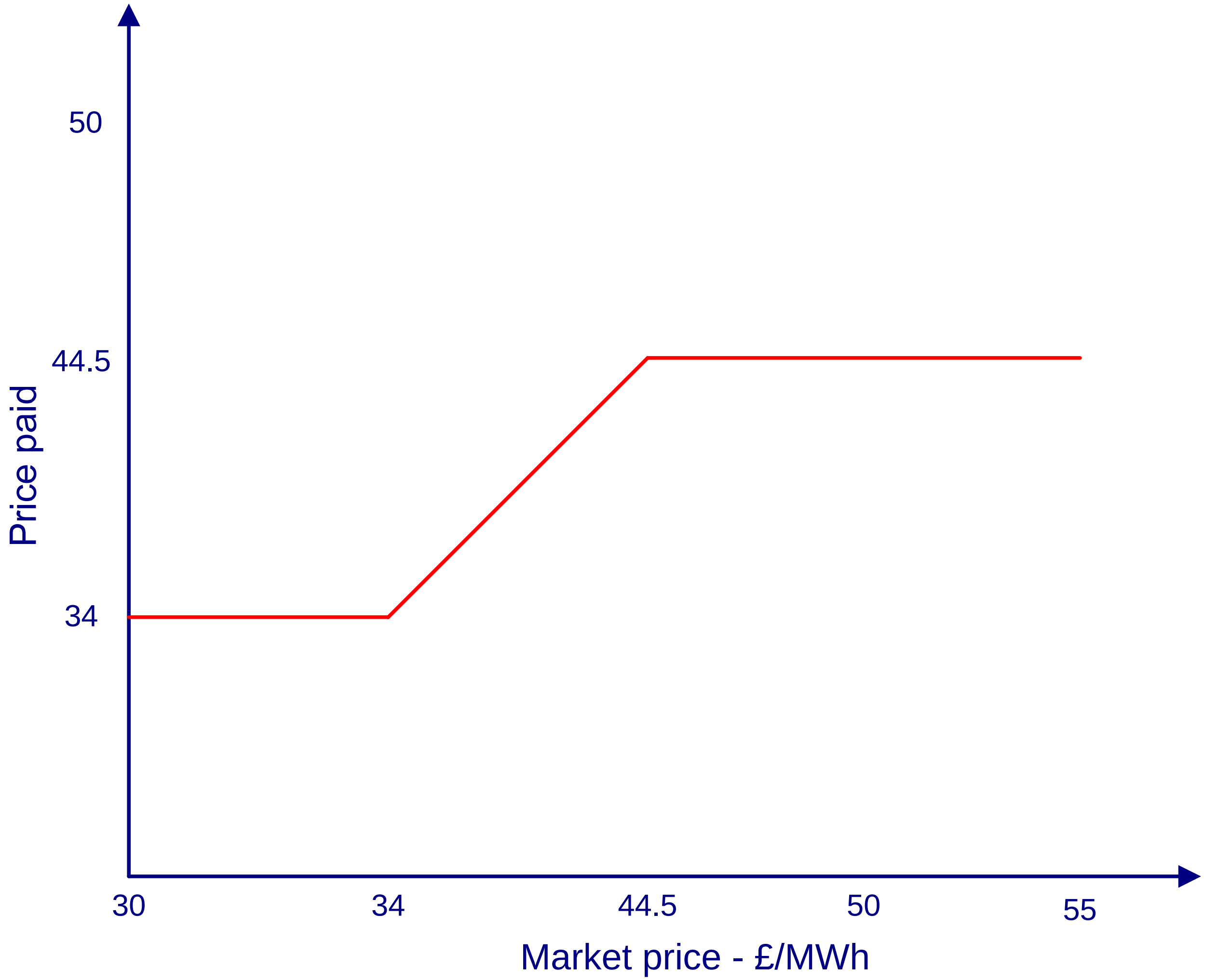
- Renew current HH portfolio on fixed price fixed term contract in March 2008
- Buy a zero cost collar immediately to protect the upside but limit the downside
- 1st March 2008 exercise date

Example 2 – Managing budget risk – Zero cost collar

➢ Transaction

- Tender HH contract in April 2008 – fixed or flex
- Buy a call option for 20MW for period April 2008 to March 2009
  - Current annual price £38.50
  - Strike £44.50/MWh
  - Exercise date 1st March 2008
  - Premium £2.50/MWh payable
- Sell a put option for 20MW for period April 2008 to March 2009
  - Current annual price £38.50
  - Strike £34.00/MWh
  - Exercise date 1st March 2008
  - Premium £2.50/MWh receivable
- **NET COST ZERO**

Example 2 – Managing budget risk – Zero cost collar



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