

Customers who convert to flexible contracts must be prepared to manage energy price risk in the wholesale market, says Richard Cockburn

Power plays

In October 1994, Proctor & Gamble (P&G) sued Bankers Trust for \$195 million (£110 million) in the US, alleging that the bank had misled it over the value and risks of its existing derivatives positions. It was the bank's contention that in order to enter into derivatives positions, P&G must have had some information about risk management, and that the bank should be absolved of its fiduciary responsibilities. In short, it argued that this was a clear case of *caveat emptor* (buyer beware).

Over the next two years, three other companies similarly alleged that the bank had misled them. All of the cases were settled out of court, at significant cost to the bank, but the most damaging aspect was the loss to the bank of its reputation as the leading risk management bank in interest rate derivatives.

There is a lesson for utilities whose customers are switching to flexible contracts, and assuming some price risk: it pays to try to make sure the customer can manage the risk they have taken on.

In the past two years, prices in the UK electricity market have risen dramatically, and these rises have been one of the causes of customers turning to flexible contracts. Flexible contracts tend to be a more risky contract than a fixed price contract, but they enable the customer to manage energy price risk. In order to be allowed to "go to market" more than once, customers pushed their suppliers to offer what have been generically termed "flexible deals". Flexible deals vary between suppliers, but the overall effect is to pass price risk to the customer. The customer has the opportunity to take advantage of a price fall, but will lose out if the price rises.

Some might argue that the utilities would benefit from high prices. However, most of the price rises have been as a direct result of higher raw material costs (gas, oil and emissions). Profit margins have not increased significantly, but the cost of credit and the risk of default have.

As gas and power prices have increased (sometimes dramatically), many customers have found themselves in a "short" position in a rising power market. The resultant potential increase in costs often brings out the "ostrich approach", where power purchasers or traders stick their heads in the sand, denying that the

market is going against them. If risk limits have not been set the customer could lose more money – not an ideal situation for either party.

Most utilities are aware that customers may not set proper risk limits and could therefore potentially be in danger of defaulting. As a result, utilities tend to offer customers help in the form of reports, which analyse market movement and market fundamentals, and some value contracts. However, both the utility and the customer are aware of the conflict of interest that exists, as the utility cannot act as auditor and analyst for a trading counter-party. A utility will have a credit risk limit with a counterparty, but it is impossible for it to act as a risk manager and add further price risk limits. To gain the best advice and price, the customer must be responsible for setting its own risk limits. To help do this impartially, consultants like Powerisk use specific risk management tools to assist customers in defining their risk limits, and give reassurance to their suppliers.

Most large customers have exposure to currency fluctuations that are defined, measured and normally valued by their finance department. Within the finance department, a risk manager will look at the potential losses and gains from all market movements. For example, if a company has a "long" US dollars position and the value of dollars against sterling looks as though it could fall, then it is the responsibility of the treasury department to switch this currency out of US dollars and into sterling.

Exactly the same procedure should occur with electricity and gas exposure, but energy managers tend to have to get board approval in order to trade. There is a good reason for this: most electricity trades are significantly larger than the equivalent foreign exchange trade. However, unlike the exchange markets, volatility in the power and gas market is much greater and liquidity is much lower. Experience suggests that if a decision has to go through a committee there is a danger of delay. If that delay is two or three days, it can result in serious cost. In 2005, if a customer had wanted to buy 20MW (the average market lot size) of Q1 2006 on 18 November and then waited for board approval, in three working days the cost of the delayed decision would have been £800,000.

It is not surprising that some customers




have found the gas and power markets treacherous, but this only strengthens the reasons for having risk management systems and proper risk limits in place.

Every company has a different view of risk. Therefore the role of the risk manager is to develop policies and limits appropriate for their organisation.

Risk management tries to answer the question "what happens if the market goes to X?", and tends to protect against a worst case scenario. Limits are created to cover the possibility of the market doing something unexpected. When markets move in a direction that makes money, risk limits will not stop someone trading. Risk managers are more concerned with the opposite. So by setting risk limits, a customer can state at what point they no longer wish to be exposed to the risk of increasing power prices.

Risk limits take into account the volatility of a market and the time it takes to hedge an unhedged position (known as unwind time). If a



The stakes are high:
speculating on future
energy prices is a high
risk business

customer wants to limit a loss to, for example, £2 million over budget, then this would be set as the risk limit. By measuring volatility and the unwind time, the customer can start to calculate how risky their position is. The moment the customer's position is higher than the limit, the risk manager would instigate a hedge in order to be within the limit. This hedge may be just enough to get the customer inside their limit, but it means that if the market does continue to rise the customer has covered some of its position. Tools are available to offer active market data, which show how potential price rises can influence a customer's position in the market. By valuing what is at risk, the company can start to apply limits relative to potential losses, rather than having to hedge later.

Can risk limits make trading decisions for you? Risk limits are designed to stop a company losing its shirt. They are the equivalent of going to the races with £100, knowing that is the maximum amount available to spend. They do not tell you which horse to back. Companies must first learn to accept that their

power purchasers are taking on greater risk by opting for a flexible contract, although the potential rewards to the company can be great.

An outline risk policy first defines the risks. The biggest risk is price exposure, but there are others: the energy trader going on holiday, supplier's credit or internal risk systems. Measuring risk is complex but allows a company to start to see benefits by putting a value to the potential trading decisions being made.

Company managers and energy purchasers must seek the right type of flexible deal in order to mitigate their risks. This may include some form of insurance against a price spike, but by having a risk management strategy the customer can start to quantify the cost of managing risk.

Communicating the results of the risk management process internally is essential. It starts to enable others in the company to develop an understanding of the power purchasing process, and gives confidence at board level so that the speed of the decision-making process can increase. Packages are available that sup-

ply pictorial and tangible evidence, offering explanation and reassurance to the board. Familiarity with such systems enables them to speed up the decision-making process.

When markets are as volatile as they have been recently, there is even more reason for risk management systems. What is more, suppliers benefit because their customers are less likely to get themselves into trading "holes".

Customers must access sophisticated systems, which are able to price half-hourly shapes, and build up confidence in their risk models before they actively trade. With the right risk models and the right limits, companies can develop trading strategies that take full advantage of the flexible contract they have negotiated. At the same time, it offers the utilities a more sophisticated and reliable customer, better able to forge positive customer relationships. ■

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