



Risk Management versus Budgeting

Powerisk has recently been involved in helping CFO's understand the role of risk management and how this can deliver budget certainty. Many clients have a preconception that you can only opt for risk management or budgeting. It is perhaps a relief when Powerisk deliver risk management solutions which give budget certainty. This article looks to answer some of the issues that surface in these types of debate.

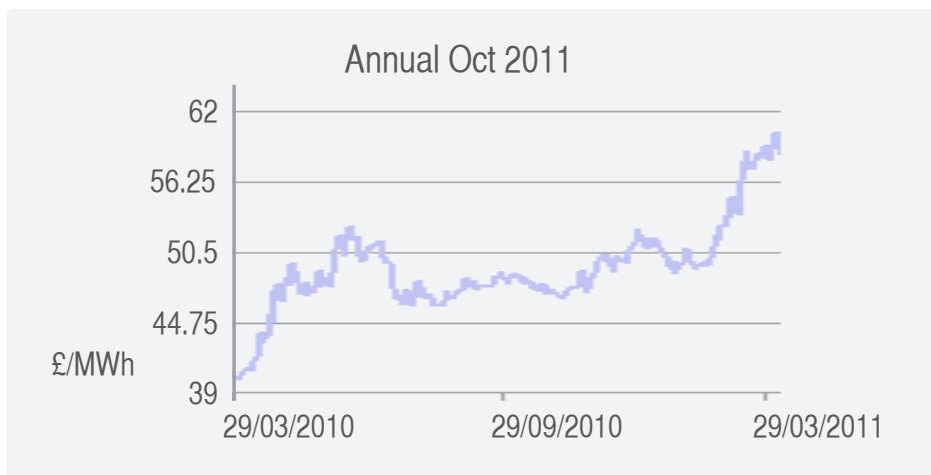
Why budget at all?

A budget is a best guess case of what you intend to spend as a business. As a CFO it is critical that you understand what your costs are and ensure that you have enough revenues to cover them. Most budgets are on products where the volatility of the cost is relatively small. Staff costs, for example, tend to be one of the bigger budget costs where the budget drivers are number of staff multiplied by estimated wage. The volatility on this cost is driven by growth or decline in staff numbers and the change of value in wages. Staff numbers tend to fluctuate with the growth and decline of the business, so this is correlated with revenue while staff wages normally move in line with inflation. So as business revenues grow it is likely that the correlation between staff costs will be high. In this example, the possible movement in budgetary cost is pretty small (i.e. staff cost volatility is low). Furthermore, as staff costs are a natural hedge with revenue, the need to manage these costs into the future is limited.

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If we take the same example but convert it to energy we get a very different story. The two drivers on your energy budget are volume (the amount you forecast you will consume) and the cost of energy. It is quite possible that at the beginning of the year you looked at your previous year's costs and stated that you expect business to be in line with last year. Therefore the costs will be, broadly speaking, the same though you may add inflation to create this year's budget. However, we can see that the price of electricity has risen by 48% between 1st April 2010 and 1st April 2011. This staggering rise in costs would surprise most CFO's, and perhaps proves that the cost management process for energy should be treated differently to the traditional budget process.

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Is Risk Management the solution?

It is interesting to note that the definition of risk is about trying to assess the probability of an unknown outcome. If an energy manager was looking at risk, they would have seen last year that there was a probability that the budget costs could rise or fall, by a certain amount (probably not as much as 48%). However, they have made the first step in understanding risk, which is to concede that the volatility on energy budget costs is large. In other words the size of the “risk” is much more sizeable than other budget costs.

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RISK

define ➔ measure ➔ manage ➔ communicate

So how do we manage these volatile costs?

Where risk management differs slightly from budgeting is that it looks to define the risk. In most cases this is price risk. Having defined the risk we put in a number of measurements which assess the risk. The most simplistic might be a mark to market, but as we start to look at price volatility we may well look at Value at Risk (VaR). There are many other measures of risk, but for most energy managers, the need to replicate the risk systems of Goldman Sachs isn't necessary! Having quantified the risk, it is perfectly reasonable for the CFO to draw up risk limits. Risk limits are a very clear line showing where the business is not prepared to operate. You therefore give an energy manager a clear instruction as to what should happen if the market moves to a risk limit. The final part of the equation is the constant feedback of risk positions to the business.

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There are three key risk management techniques that many companies use:-

- Flying Wedge – A timed purchase which ensures an average price move.
- CaR (Capital at Risk) Model – A set some of money agreed to be used in the management of risk. Generally as the market falls and profits are attained the Capital at Risk is returned to the business.
- Trading Model – This is a black box model which looks at the way a market trends. If the market looks set to rise, it will ensure that you are more hedged, if the market looks set to fall then it will look to unlock hedges.

All of the above methods suit different companies for different reasons, and there are more risk techniques that can be used to manage energy costs. What is critical is that the right technique is applied to suit your risk appetite. You may wish to run a range of strategies or choose to over lay risk techniques within an existing budget process. Your supplier will want to help you on many aspects providing a flexible energy deal (remember they are obligated to sell you a product that you understand). Some suppliers even offer risk management services although the potential conflict of interest should be considered. As always, getting some impartial and independent advice makes good business sense.

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So it is no longer “Risk Management versus Budgeting” but rather “Risk Management equals Budgeting”.





Powerisk provides tailor-made energy risk management solutions, independent trading advice and impartial market information to energy users.

Services

- Energy Risk Management Solutions
- Independent Trading Advice
- Impartial Market Information
- Tailored Training Courses
- Online Energy Data and Risk Management Tools

RISK MANAGEMENT

Risk presents itself in many forms. Those businesses that take steps to fully understand, quantify and manage their risks put themselves in a strong position going forward. The team at Powerisk will work with you to put in place the rules and procedures to ensure that you are effectively managing your risk position.

TRADING ADVICE

Flexible energy contracts as well as energy contract renewals require procurement teams to make energy purchasing decisions. Powerisk can help you interpret and analyse available market information ensuring you extract maximum value from your contracts.

POWERISK ONLINE

Accessing simple to use risk management systems can enhance business operating performance. Powerisk Online provides businesses with a suite of energy information and risk management tools. Access latest energy forward curves or upload your energy position to generate daily mark to market and risk position reports.

TRAINING COURSES

Your gas and electricity costs are significant and influence your profitability in a number of ways. Enhancing your knowledge of how the energy markets work, types of energy contracts available as well as price risk management tools will empower your business. Powerisk will work with you to understand your knowledge requirements and deliver a tailor-made training programme that will help you improve business performance.

Contact: POWERISK LTD

Tel: 0203 137 8838

Mbl: 07801 798962

Fax: 0871 989 2765

Web: www.powerisk.com

