

## How much flexible purchasing should I do?

Many people ask Powerisk whether they should go completely flexible or completely fixed when reviewing their energy contracts. There is no simple answer because each company has a different appetite to risk. Flexibility is no panacea, and does need some careful management and input at the beginning. However, with a robust risk management system in place, it can reap rewards.

Signing up to a 3 year or 5 year deal at a fixed price will give your business some budget certainty. And when a market is backwardated – price for energy delivered today is more expensive than the price for energy delivered next year – locking in a long-term price will certainly be tempting. However in doing this you remove any opportunity to gain from potential falls in price in the future. This may impact your business competitiveness especially if other players have the ability to procure their energy flexibly. It is therefore important to understand what flexibility means and whether your business is missing out.

Firstly, let us be absolutely clear by what we mean by flexible and fixed. If you renew your contract for 1 year, 3 year or 5 year at an agreed price for the duration of the contract, then you have a fixed contract. It may be that your 'agreed price' is linked to an energy price index and is recalculated at regular intervals. Even in this case, though your price may be variable the contract is still fixed. If however you renew your contract, for a period of time but the terms of when and how much energy you purchase allow for flexibility – then you have a flexible contract. For example you may purchase a chunk or 'tranche' of energy at a fixed price for the duration of the contract but you then have the flexibility to build up to your full energy requirement by purchasing the energy on the forward market at different points in time.

There is value in flexibility but there is also risk with flexibility. An energy market that is in contango – the price for energy delivered today is cheaper than the price for energy delivered next year – presents real significant value to those consumers able to purchase their energy needs on a flexible basis<sup>1</sup>. However, prices move and can sometimes move dramatically in response to market information (fundamentals such as weather, fuel supplies and operational reliability).

This is why it is important to quantify risk and fully understand how a change in price will impact your energy purchasing costs. By measuring this and understanding this, you can put in place a contract that you are comfortable with and that satisfies your risk appetite. It may be that you lock in a portion of your energy needs at a fixed price – you hedge - giving some budget certainty. This leaves a portion of your energy volume 'unhedged' enabling you to respond to price movements.

Having some or all of your energy volume unhedged will give you exposure to energy price movements – and the aim is that this will hopefully be to your benefit. However 'hope' is not enough and you will need to have in place a risk management system and a trading strategy. The risk management system, or 'risk rulebook', will set out the risks to be measured and valued; it will state the 'risk limits' the business is comfortable operating within and it will state the trading rules.

So, if your energy procurement strategy allows for some energy purchasing flexibility, then your business has some energy price risk. It is important that you understand, quantify and manage this risk. Powerisk can help you to do this.

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<sup>1</sup> For example full flexibility may see a consumer purchasing their energy requirements on a day-ahead basis (i.e purchase today your energy requirement for tomorrow). With a market in contango, the 'day-ahead' price may be some £5-10/MWh less than the price quoted for energy delivered next year.