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ELECTRICITY PURCHASING STRATEGIES IN A VOLATILE ENERGY MARKET

In previous years, the value of an electricity procurement program was easily measured; 1) the Texas market was in its infancy, 2) prices were low, and 3) the only available option for most buyers was either Fixed Price or simply staying on the regulated Price-to-Beat product. Essentially, all participants started from the exact same place, and they measured the value of participation by comparing their regulated tariff rate to the competitive market rate, i.e., savings.

Times Have Changed

The unprecedented escalation in energy prices coupled with the extreme volatility of even daily pricing has driven buyers to look for alternative ways to meet budget requirements while managing extreme price risk.

Fixed Price Or Floating Index Rate?

Fixed Price is a premium product made possible by the deregulated market. Many buyers opt for Fixed Price because it is simple to describe and understand, and because it offers budget certainty for the period in question. However, for many buyers Fixed Price represents a higher level of insurance investment than they purchase in their normal course of business. Most entities operate in an insured manner, but they do so with a number of exclusions, limitations, and deductibles. (Fixed Price is the equivalent of zero deductible insurance with no exclusions.) Because Fixed Price maximizes the risk transfer from the buyer to the retail electric supplier, it also commands the greatest premium available in the market.

In Texas MCPE and Heat Rate are the most common index products. MCPE stands for Market Clearing Price for Energy, and is essentially a spot price. MCPE is the exact opposite of Fixed Price, as the buyer essentially takes a unhedged position for its electricity purchases. In relation to insurance, MCPE is the equivalent of being self-insured.

On the other hand, Heat Rate Products offer many advantages over MCPE. Particulars of Heat Rates:

1. Less risky than MCPE – on the risk continuum, Heat Rate Products lie midway between Fixed Price and MCPE.
2. Facilitate the mitigation of price risk by diversifying energy purchases over a period of time, i.e., the ability to “shop the market.”
3. Ensure flexibility to take advantage of favorable market movements in a timely manner.
4. Require discipline in order to minimize risk. This is done through the implementation of a well planned, defined purchasing strategy. Attempting to “time the market” at its bottom is not an acceptable strategy, as knowing when the bottom has been hit is only obtained after the fact.
5. Monitoring of performance provides meaningful feedback for future strategies.

(Note: In Texas the price of natural gas and electricity are closely linked most of the time. A Heat Rate contract fixes a formula for conversion of the price of natural gas to electricity.)

It is essential to remember that nothing is “free.” It is equally important to bear in mind that proper evaluation of risk can be a very complex undertaking, and absent a thoughtful strategy and a disciplined implementation, a heat rate strategy could likely lead to much higher prices than a Fixed Price.

At CETX we do not believe that we can predict the future behavior of the energy market, but we do believe in capitalizing on inevitable fluctuations of the market. In addition, we believe that the most responsible approach to a market characterized by extreme volatility is for consumers to mix the set of resources available to them to the maximum extent possible.

Phyllis Anzalone is the Texas-based managing partner of CETX Energy Agency. Having spent the early part of her career in commercial real estate in the Houston market, Ms. Anzalone began her energy career in 1996 when she joined Enron and relocated to the first state to deregulate, California. When Texas deregulated in 2002, Ms. Anzalone carried her supplier experience forward to build an energy agency firm that represents the client side of transactions in the procurement of electricity supply. Phyllis can be reached via email at panzalone@cetxenergy.com.