

Energy Contracting – The Contract is as Important as the Price !

Despite a few problems at Moomba, and some volatile activity towards the end of February, retail electricity prices across the National Electricity Market (NEM) have softened over the last year or so.

Any honest market commentator reviewing these prices would have to be 'baffled' at the least. There is still talk of supply shortages over the summer of 2006/7 and most market analysts would be inclined towards increasing prices. Even more perplexing is the wholesale price trend, as reflected in the OTC contract rates. For example, peak OTC energy rates for electricity 'two years out' have increased in most Australian Electricity Markets, in some cases by about 10%. So why a softening in retail prices ?

Nevertheless, many of our clients have been able to negotiate retail electricity supply contracts that have realised savings. Proof of the old adage "sometimes it is best not to ask why". If cost savings are available, take them. But be careful, there may be some strings attached.

The hard reality of life is that the Statement Of Opportunities (SOO) released by the National Electricity Market Management Company (NEMMCO) highlights a real possibility that demand for electricity will outstrip supply across most of the National Electricity Market (NEM) if there is a hot summer over 2006/7. Thus, savings are unlikely to last and it may be in your best interest to negotiate your next electricity supply contract as soon as possible.

As usual, price will be a key determinate when selecting your energy retailer. In parallel with price, careful consideration should be given to the commercial terms, especially those commercial terms that deal with risk, and value adding services. As the deregulated energy markets have matured the retailers have adopted a more objective view of risk. Many of the retailers appear to be quantifying risk and, wherever possible, passing this risk on to their customers.

Risk management and in particular, mechanisms to share the risk, are dealt with in the energy supply contracts put forward by the energy retailers. For the unsophisticated energy user these contracts are often difficult to read and even more difficult to understand. Without a firm understanding of how the energy markets operate it is not possible to identify all areas of risk, let alone appreciate your risk exposure.

In addition to the normal prudential and insurance risks associated with any commercial contract, the energy market probably presents at least two distinctive risks, namely the risk of price certainty and the risk of volume variation. Many retail energy users have been shocked to learn that the 'firm retail energy prices' they have negotiated are really not so firm. They are also shocked to learn of 'volume variation penalties'.

One method of dealing with this risk and trying to ensure that the energy supply contract has no unpleasant surprises is to present your own contract to the market. The benefit of this approach is that you have total control of the contract and, provided that the contract is worded correctly, there are no hidden traps. The down side of this approach is that it requires specialist knowledge of the energy industry along with legal assistance. Several of our clients have indicated that the cost of

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preparing a suitable energy contract is probably over \$10,000, possibly closer to \$15,000 or even more.

Another downside is the reluctance of the energy retailers to negotiate contracts. In the first instance many of the energy retailers will simply refuse to use anything but their standard contracts. Depending on your 'value' as a customer and perceived importance in the energy market, it will probably be possible to convince most of the retailers to reconsider their decision.

But, be warned, this will be followed by a long and protracted set of negotiations with many of the retailers about numerous contract conditions. In concert with this, the retailers are likely to start adding their 'cost of doing business' along with any additional risk premium to their price. Several of the energy retailers have indicated that the legal cost of reviewing a contract proposed by a potential client is in the order of \$10,000.

Thus the total cost of developing your own energy contract, allowing for your costs, the retailer's costs and the time spent negotiating the contract with prospective retailers could easily exceed \$50,000. This is before the retailers have added any risk premiums that they feel are appropriate.

For large energy users, this cost may be well worthwhile, especially if it results in a contract that provides all of the desired commercial terms. However, for many of us the cost and effort involved is often prohibitive.

In most cases, the development of a strong set of commercial terms that are appended to the energy retailer's contract provides the best outcome. At the very least, this is a good example of the '80/20' rule, where 80% of the benefit can be achieved for 20% of the effort. In fact, our experience is that this approach can probably result in the best overall outcome. Your efforts and 'cost of doing business' are minimised, the retailers are happy to negotiate and it should be possible to capture competitive prices along with suitable commercial terms.

Whatever you do, read the fine print of any contract offered by an energy retailer, seek guidance with terms and conditions that are poorly understood and make sure that low prices are not being off-set by commercial terms that transfer risk from the retailers to you.

Note: Advice contained herein is General in nature and not specific to any clients requirements. Personal advice from a qualified consultant should be sought before making a decision.