

Headline: Shocking prices

Intro: Deregulating the power game has increased its complexity but opened up opportunities for bright sparks

By Mark Searle

It wasn't all that long ago that an accountant's only interest in energy was to estimate next year's energy costs. Usually it was good enough to assume that the bill would be the previous 12 month's inflated by any upwards movement in the consumer price index (CPI). But all that changed a few years ago when the energy markets were deregulated. Energy (gas and electricity), is no longer supplied by monopoly utilities under the terms and conditions of regulated tariffs. Buyers now negotiate energy supply contracts with one of many competing retailers. Accountants are now becoming increasingly involved with the negotiation of these energy supply contracts. Whether acting for a client or negotiating on behalf of an employer the issues are always the same.

What is a good contract and how do you negotiate one? More importantly, how do you make sure that the advice you give is considered good? Energy markets are complex and they often require specialist expertise. In some cases, that expertise will have to be provided by a specialist with an appropriate Australian financial services license.

It is worth noting that a good contract may not always be the cheapest contract. Energy, and in particular electricity, is the ultimate commodity. But energy contracts are definitely not the ultimate commodity.

The wholesale electricity market that acts as a clearinghouse for all financial transactions is alleged to be the most volatile commodity market in the world. The pool price (or clearing price) can vary from a typical value of \$35/MWh to \$10,000/MWh within half an hour. Even more strangely, the price can drop to -\$1000MWh. This price is applied to all electricity traded on the market. The Australian electricity market is designed around 'gross pools', with the pool price setting the wholesale price for all electricity.

Electricity retailers typically manage this risk by entering into hedge contracts that are settled outside the pool. This creates an enormous commercial risk. One or two hours of high prices can cost a whole month's energy budget. Buyers must understand the commercial terms of an energy contract, especially the commercial risks, which also include usage penalties, restrictions on moving a load from one site to another, exposure to unpalatable default tariffs and incorrect or inappropriate billing.

Coupled with commercial terms are value adding services (VAS). Total energy costs are a lot more than retail rates. Total energy costs include a plethora of regulated costs and environmental costs that often account for 40 per cent of total energy spend. If an organization is responsible for many sites and many energy accounts then the total cost probably includes a significant 'internal management cost'.

Energy retailers are ideally placed to offer VAS to help manage these costs. Typically these services include a regular review of all charges, offering energy use information,

assisting with the connection of new sites or removal of sites that are no longer required, consolidated billing and diarised payments. The energy retailers may also be able to help identify energy saving projects.

Before looking at effective strategies for negotiating energy contracts it's probably worthwhile having a closer look at the environmental costs. These are a patchwork of state and federal programs that have been progressively introduced over the last few years. In fact, some of these imposts have only been introduced in the last 12 months. The federal government has mandated that all electricity retailers in Australia must source a minimum amount of renewable energy. Known as the mandatory renewable electricity target, this program currently adds about \$0.70/MWh to the cost of electricity and this is expected to double within the next few years as the target becomes more stringent.

The NSW and ACT governments both require all electricity retailers within their area to supply electricity below a benchmark greenhouse emission coefficient. As a general rule, the electricity retailers are passing their compliance costs back to their customers. Typically this adds about \$1.50/MWh to a bill. Again, this is expected to double in the medium term as this benchmark also becomes more stringent.

The good news for electricity consumers in NSW and the ACT is that they can sell the carbon benefit associated with any energy efficiency work they put in. While the concept may be a little fuzzy, the dollars are very real and it is a shame that more consumers in the ACT and NSW are not availing themselves of this opportunity. The Queensland state government requires all retailers in the state to source a minimum amount of their electricity from gas-fired generators. As a general rule, gas-fired units are more expensive than coal-fired ones so the cost of electricity is somewhat higher. Again, the retailers are usually passing their compliance cost back to customers and this scheme is probably bumping up costs by about \$1.65/MWh

It is unlikely we have seen the end of these environmental imposts. In the absence of a national carbon trading scheme, which is a medium term possibility, several other states including Victoria are considering the introduction of state based-environmental imposts such as those introduced by NSW and the ACT.

The political climate will dictate just how and when these are introduced. Many large users are already preparing for the possible introduction of national carbon trading schemes and carbon taxes. They are undertaking carbon inventories and estimating their potential liabilities. They are also making sure that all the energy efficiency work they undertake is rigorously documented so they are well placed to be retrospectively credited with these benefits should a cap and trade scheme be introduced.

Many electricity consumers are also electing to voluntarily increase their take up of 'green electricity'. This is power produced by environmentally friendly sources such as wind generators. 'Black electricity' is produced by traditional sources such as coal-fired generators. There are many varieties of green electricity from 'light' green to 'dark' green. The most popular green product is 'SEDA approved green electricity'. This meets the guidelines laid out by the Sustainable Energy Development Authority of NSW. The SEDA standard has been largely adopted as the de facto standard across Australia.

It can be expected that SEDA electricity will attract a premium of about \$40/MWh. This

makes it about twice as expensive as normal electricity. Hence most consumers only elect to use it for about 5 per cent of their total consumption.

Negotiating a contract

In addition to a basic understanding of the energy market and associated costs, there are a few pointers that can always be used to help ensure you get the best outcome.

- **Understand how much energy is required**
Energy retailing is all about risk management. On one hand, the energy retailer must manage the wholesale price risk. On the other hand, they must manage the 'volume risk' imposed by consumers who can't realistically estimate their energy requirements. Reducing the volume risk should result in a better price.
- **Understand how firm the price is**
We always recommend absolutely firm prices, including firm prices for the environmental imposts. Exposure to non-firm prices should only be undertaken after very careful analysis.
- **Get a feel for the retailers who are interested in your business**
Depending on the location and load there could be 10 or more retailers interested in your business. There can be very interesting differences in the prices they offer and the way they service your account.
- **Understand the commercial terms**
Undertake a critical analysis of the proposed contracts, identify risks (especially commercial risks) and ensure the contract meets your requirements.
- **Identify relevant value adding services**
Typically the retailer should be fully responsible for metering, transfer of your site and management of the relationship with the local network provider. You may also want the retailer to provide energy use data; help select the best tariffs; and if you have multiple sites, provide a consolidated account.
- **Negotiate when the wholesale market is low**
This might sound like commonsense, but many consumers leave the negotiation of their energy contract to the last minute. If this happens to coincide with high wholesale prices then energy costs could jump by up to 10 per cent.
- **Involve all eligible retailers**
Limiting negotiations to three or four retailers may make life easier, but it might also mean you miss out on the best deal.

Prices negotiated by any customer will always depend on their energy use pattern, commercial terms, negotiating strategy and the time at which they enter the market. This makes it near impossible to make specific predictions. A more relevant index is the 'year ahead' future prices.

The graph (top left) shows the 'year ahead' future prices for a perfectly flat load as they were at February 2004 and February 2005. As can be seen, prices in all markets have moved up. It will be interesting to see how prices move in the coming year and if we move any closer to a national greenhouse scheme.

Mark Searle is the principal consultant with Key Energy & Resources who hold AFSL 281356. Key Energy & Resources provide a wide range of advice on energy contract negotiation, greenhouse planning and energy management across Australia

