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Opportunities and Challenges of Procurement

A Primer for Energy Managers

C O N T E N T S

**Corporate Energy
Managers' Consortium**

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A Primer for Energy Managers

Nathan Adams and Arthur Venables

EXECUTIVE SUMMARY

Electric and natural gas markets in North America are a labyrinth of regulations, market forces, and extreme volatility. For any large company with high energy costs, there is great opportunity to save money, but there is also the risk of paying much higher prices during certain periods. Understanding both the potential risks and the possible rewards is the beginning of developing a better energy procurement program.

The success of an energy procurement group is driven heavily by the knowledge and expertise of the staff and its outsourced assistance. Participants must know the involved markets intimately while also being well-versed in the construction of legal contracts. And it is of equal importance that the energy procurement effort is properly aligned with the corporation's goals and level of risk tolerance.

E SOURCE spoke to eight savvy corporate energy procurement experts to gain an understanding about what makes a successful procurement program. This report summarizes their advice and experiential knowledge into a set of operational guidelines that can be observed by any corporate energy team.

Given the variability of business needs, there is no one correct method of procurement and there are no silver bullets. Energy markets in the U.S. are fragmented and complicated, so just getting a handle on them is a big challenge.

Introduction

For corporations that spend millions of dollars a year on electricity and natural gas, effective energy procurement operations are a desirable asset. With volatile energy markets as the norm, the possibility exists to pay substantially higher prices for short periods, which is unacceptable to many companies. In January 2004, temperatures in the Northeast dropped to record lows, briefly driving natural gas spot prices to over \$70 per million Btu (MMBtu).¹ Energy managers who did not hedge properly could have lost a tremendous amount of money in a very short time.

Given the variability of business needs, there is no one correct method of procurement and there are no silver bullets. Energy markets in the U.S. are fragmented and complicated, so just getting a handle on them is a big challenge. Each company will need to shape its efforts to best fit its specific corporate attributes and goals.

E SOURCE interviewed eight high-level corporate energy managers about their procurement programs to get advice on avoiding some common pitfalls and tips for how to run a successful energy procurement effort. (Some of the energy managers we interviewed requested that they not be identified.) From these interviews we were able to gather an effective set of operational guidelines for any energy procurement effort. Although this report concentrates primarily on electricity procurement, many of these guidelines apply to natural gas procurement as well.

Our interview results showed five things that energy managers should do to optimize procurement operations in this hazardous marketplace:

- Be well educated about your own energy needs,
- Conduct due diligence to evaluate your energy suppliers,
- Carefully structure the right supply contracts,
- Negotiate favorable rates in regulated states, and
- Evaluate your company's procurement performance.

Know Thyself

The first order of business in developing a well-oiled energy procurement strategy is to understand your company's goals, physical characteristics, and intellectual assets. Until you understand these things, your procurement strategy will lack guidance and continuity.

Gather Facility Data

It may sound rudimentary, but producing an inventory of all of the company's facilities, complete with demand and consumption data by fuel, is a necessary starting point. Consider the facilities' capabilities for load profile manipulation, through such means as load shifting, load curtailment, or possibly using or adding dual-fuel boilers. When you have smooth load profiles and more flexibility to curtail during peak periods, many energy providers will offer a much lower rate, and—in regulated states—will often also reduce demand charges.

This data serves two additional purposes. First, it allows you to rank your facilities in terms of energy consumption. Starting an energy procurement operation from scratch is a daunting task, and this data will help you determine how to prioritize your efforts. You will want to target either facilities with the largest consumption or states with the largest number of facilities first. "Use the 80/20 rule," says one energy manager from a large computer manufacturer, "Know where you spend your money and concentrate on that." You will also want to separate facilities in regulated states from those in deregulated states.

Second, you will need to have this facility data when conducting a request for proposal (RFP). Suppliers will have to see your consumption levels and patterns to help determine pricing. They are also likely to need a list of all facility addresses and meters as well as permission to access utility billing data.

Characterize Your Facilities' Planning Strategies

As necessary as historical energy usage data is, future planning for your facilities portfolio may be equally important. Is the company in a pronounced growth phase where square footage will be steadily increasing? Conversely, is the company divesting itself of buildings? Which buildings may be phased out in the next two years? Knowing the plans for each facility will help prevent over- or underestimating energy needs for a procurement contract. One large defense contractor, for example, is characterized by a lack of long-term stability in its facility needs. The nature of its business means that expired government contracts may require facility shutdowns from time to time. The energy manager for this company says, "The longest we ever sign a contract for is a year because, quite frankly, we don't know if the facilities will be around after that, or how big they will be."

It is also important to know about any plans or potential for self-generation, energy-efficiency, or equipment additions. Installation of generators, major efficiency retrofits, or additional energy-consuming equipment will change energy needs and should be considered when you are contracting for a certain amount of load over the term of a contract. "When a plant adds or modifies equipment, it can affect the plant's energy profile. If I don't know about it ahead of time, I can't build the

"When a plant adds or modifies equipment, it can affect the plant's energy profile. If I don't know about it ahead of time, I can't build the flexibility into the energy contracts to avoid penalties."

***—Tad Nordstrom
Ball Corp.***

flexibility into the energy contracts to avoid penalties,” says Ball Corp.’s energy risk manager, Tad Nordstrom.²

Determine the Company’s Risk Tolerance

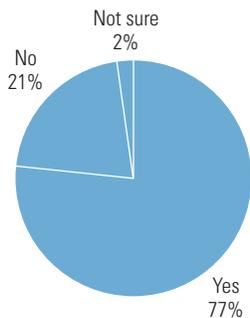
Understanding your company’s risk tolerance is an absolute necessity before any procurement decisions should be made. “Can you afford a \$100,000 hit one month if the contract could possibly save you \$200,000 over a longer term, or do you need more price stability?” asks Don King, director of maintenance operations and consulting services at Kaiser Permanente.³ You should consider such questions as:

- Which is the higher priority for the company: to achieve price stability or to minimize overall procurement costs?
- How much do energy prices affect the price of our products?
- How far in advance do we need to determine budgets?
- Is our budget flexible enough and our cash level high enough to withstand some market fluctuations?
- Does the company have any accounting policies regarding hedging? (Some companies have policies that do not allow the use of financial derivatives. Some of these policies are driven by the Financial Accounting Standards Board’s standard #133, which dictates how derivatives are reported in financial statements. For more information, see www.fasb.org.)
- Do the answers to any of these questions differ by operating company or individual facility?

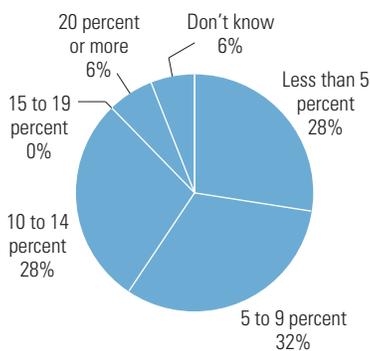
Figure 1: Expectations for energy expense reductions

Our survey results showed that nearly 77 percent of energy managers surveyed have a goal to reduce their facilities’ energy costs. Almost 60 percent of the same energy managers expect to save 9 percent or less on electricity.

A. Does your company have a goal for reducing total energy costs?



B. What savings are you achieving as a result of switching electric power suppliers?



Source: E SOURCE [4]

Many companies have a goal to reduce overall energy costs, both through procurement efforts and through improved energy management. (See **Figure 1**.)⁴ However, it is important to understand that there may be trade-offs between achieving the lowest price and hedging against sudden price spikes.

And not every company is out to nab the lowest price above all else these days. For example, the lower of two price offers may have less usage flexibility, which may result in the payment of more penalties if consumption varies. Many energy managers report that although they are looking for a low price, it has to be within their risk-limiting specifications.

For some companies, stability of price is paramount and only fixed-price contracts will suffice. One energy manager from a large telecommunications firm says, “We seek to mitigate risk wherever possible. We like predictability and we like to understand what our cost structure is going to look like over the course of a year.” Conversely, other companies may be willing to play the markets, hoping to create

lower total costs over time. An energy manager from a large computer manufacturer we talked to says, “Risk decisions can depend on the company’s budget situation as well as the market situation. If the budget is looking good and the market is appropriate, management may ask me to take a little more risk to take advantage of some potential downside.”

Getting all of the key corporate stakeholders together to establish risk thresholds will ensure that the company’s risk profile is fully defined. It will also ensure that all involved parties will have a say in what the risk requirements are. Some people you may want at the table include:

- *CFO, COO.* Corporate officers can convey the corporation’s taste for risk and how much saving energy matters on a companywide basis.
- *Operational managers.* If the company is split into multiple individual operations, representatives from each one can define risk-tolerance differences among the operating companies.
- *Corporate facilities vice presidents.* Those in charge of managing corporate facilities’ needs will have a better idea of how energy fits into the corporate facilities budget and what room there is for risk-taking.
- *Individual plant managers.* Even though corporate-level risk policies may frame energy decisions from a companywide perspective, it is also important to know how energy procurement risk decisions will affect each plant or facility. “If we pay \$10 for gas, it may not be a big deal from a corporate perspective, but it could blow an individual facility’s budget right out the window,” warns an energy manager from a large computer manufacturer.

Once you have a well-defined risk policy, you can use that to drive price structure decisions. There are many different options that exist, and suppliers will offer different pricing products. (See the *E SOURCE Corporate Energy Managers’ Consortium* report, “Gas Procurement Strategies for Volatile Times,”⁵ for a description of complex hedging strategies for natural gas.) Some common pricing options for electricity purchases are shown in **Table 1** (page 6).⁶ Additionally, you may want to familiarize yourself with some key components of electricity prices, as shown in **Table 2** (page 6).⁷

Design a Strategy and Get Buy-in from All Stakeholders

Once you have assessed your company’s goals, you will need to develop a cohesive procurement strategy that is in appropriate alignment with those goals. In the strategy, you may want to address issues such as:

- Which facilities will be targeted for pursuing contracts with alternative suppliers, and in what order?

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Table 1: Pricing options

This table shows some of the more common energy-pricing options.

Pricing option	Description
Full requirements	The supplier agrees to provide all energy, regardless of usage. This is a very low-risk contract because the consumer never has to be concerned about the risk of over- or underconsuming.
Fixed price	The supplier agrees to a fixed price for a given amount of energy. The buyer has price certainty but still has consumption risk.
Floating price	The price will vary with market fluctuation. This may be combined with a fixed price such that the contract entails a fixed price for some time period and a floating price for some time period. Many floating price contracts also have a trigger—a ceiling price point that the buyer does not want to go above. If the price rises to the trigger point, the price is locked at that point for the duration of the contract term.
Collared price	The price floats with the market, but has both a floor and a cap. This mitigates the amount of variability that the market price can impose on the customer.
Indexed price	The price varies with an index, such as the spot market or futures price.
Contract for differences	A fixed price is agreed upon but the supplier does not conduct any hedging to guarantee the price. Instead, the buyer pays the market price. If the market price is higher than the fixed price, the supplier reimburses the buyer for the difference. If the market price is lower than the fixed price, the buyer reimburses the supplier.

Source: E SOURCE; data from Lindsay Audin [5]

Table 2: Some components of energy pricing

Understanding pricing terminology such as the terms listed here can help when making pricing decisions.

Pricing term	Definition
Installed capacity (ICAP) charges	Charges that energy providers must pay to some independent system operators to secure generating capacity if the provider does not hold enough of its own generation or bilateral contracts to cover its obligations.
Locational marginal pricing (LMP)	An electricity pricing scheme in which different prices are charged in different defined areas or zones. The price is equal to the cost to supply the next increment of load at that location.
Transmission congestion charges (TCC)	A financial instrument signifying a right to transmit electricity across a line at the agreed price regardless of the current transmission charges.
Transmission and distribution (T&D) charges	Charges for energy that cover the cost of delivering the product.
Competitive transition charge (CTC)	Charge from the distribution utility meant to cover stranded costs in an unregulated state.
Fuel adjustment charges	Electricity contracts that allow for adjustments in price based on changes in the price of fuel used to generate the electricity.

Source: E SOURCE; data from www.energybuyer.org [7]

- What are the energy needs of those facilities, both at the present and in the future?
- For which facilities do you want to aggregate loads?
- What pricing structures meet your risk tolerance?
- How often will this strategy be reevaluated?

Once these questions are answered, energy managers should establish the overarching goals of their efforts with management. “I can’t think of anything that would shorten the career of an energy manager more quickly than executing an energy price risk plan without getting high-level buy-in first,” notes Jon Ervin, manager of national energy programs for Hospital Corp. of America.⁸ “Take the time to develop an effective strategy, do a good job of communicating it, and obtain executive endorsement.”

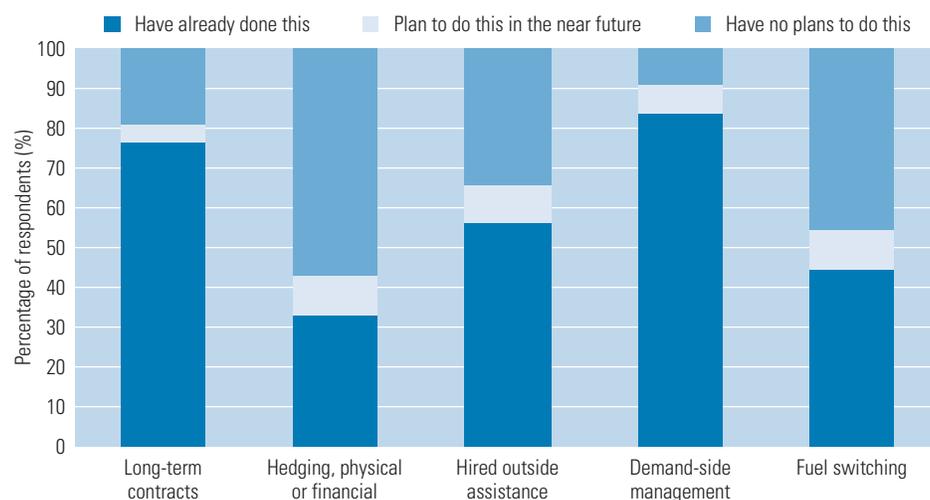
Additionally, expectations for internal customers, such as plant managers, need to be managed. “You have to set expectations with your internal customers and let them know your job is not to get the lowest price, your job is to reduce risk for the corporation,” says one energy manager for a large computer manufacturer. You may also need to help them understand how their responsibilities will change if you are resorting to a more centralized procurement approach. The same energy manager talks about communicating the company’s new centralized approach to procurement: “We told the plant managers who had previously been responsible for procurement that we still wanted them to participate; we still wanted them involved. But we explained to them that we had to roll the effort up to the corporate level in order to manage it from a strategic standpoint and a risk-management standpoint.”

Assemble a Team

The raging river of energy procurement is not one to wade into unless you are a strong swimmer. Growing market complexities are driving a need for more energy procurement resources in companies. A 2004 E SOURCE survey found that more than 64 percent of energy managers surveyed claimed that they had increased the level of resources they had dedicated to energy management and procurement, relative to five years ago. The same survey found that nearly 56 percent of those surveyed had hired outside assistance for their procurement efforts (**Figure 2**).⁹

Figure 2: Managing energy price volatility

An E SOURCE survey conducted in 2004 asked corporate energy managers to indicate how involved their companies were with several ways to manage energy price volatility. The results showed that nearly 56 percent of the energy managers surveyed had used consultants (outside assistance), and another 9 percent planned to.



Note: Respondents were asked the question:
“Please indicate your company’s level of involvement on the following actions that your company could take to manage energy price volatility.”

Source: E SOURCE [9]

The size and expertise of an energy management team varies by the size of the company's portfolio and needs. **Table 3** shows the makeup of the energy procurement teams interviewed for this study. The energy managers we interviewed recommended the following kinds of team members.

Energy experts. Subject matter experts are an obvious necessity and one that most organizations need to supplement with external consultants. Given the complexity and extreme volatility of the U.S. energy markets, it is rare to have an internal

Table 3: Description of the energy management teams interviewed

Judging by our interviewees, energy procurement teams often include both energy expertise and legal expertise.

Company	Size and footprint	Energy procurement resources
Ball Corp.	34 facilities in 18 states, 3 provinces, and Puerto Rico Over \$50 million annual energy expenditure	1 energy manager 1 consultant
Hospital Corp. of America (HCA)	200 facilities in 25 states 50 million square feet \$200 million annual energy expenditure	1 energy manager 1 energy analyst Contracting support from HealthTrust Purchasing Group, an HCA affiliate
Kaiser Permanente	900 facilities in 9 states \$100 million annual energy expenditure 80 percent electricity	1 energy manager 1 internal lawyer 1 external utility lawyer 1 consultant
Large computer manufacturer	30 million square feet in 25 states \$220 million annual energy expenditure	1 energy manager 8 engineers 1 internal lawyer 2 procurement specialists
Large defense contractor	California only 5 million square feet 200 million kilowatt-hours annually 300,000 decatherms annually	1 energy manager 1 internal lawyer 1 corporate procurement manager 1 consultant
Large telecommunications firm	2,000 facilities in 50 states Over \$100 million annual energy expenditure	1 energy manager 1 outsourced consulting firm
The Limited	4,000 facilities in 50 states 26 million square feet \$80 million annual energy expenditure 100 percent electricity	1 energy manager 1 senior analyst 1 demand-side manager 1 administrative assistant
Texas Instruments	19 million square feet \$160 million annual energy expenditure (12 million square feet, \$80 million annual energy expenditure in ERCOT region)	1 energy manager 1 internal lawyer 1–2 procurement experts 1 risk management expert Several operational managers
United Technologies	4,500 facilities worldwide 100 million square feet Over \$100 million annual energy expenditure	1 corporate energy manager 8 representatives from operating companies (1 from each) 1 internal lawyer

Source: E SOURCE; data from interviewees

energy team with enough experience and expertise that consultants aren't needed to advise on procurement issues. The importance of market knowledge was stressed over and over by the procurement specialists we interviewed. "It's absolutely critical to have either someone on the staff or a consultant who absolutely understands your marketplace. The one thing I've learned about energy procurement is that you shouldn't get into it unless you've got a 20-year background," advises the defense contractor energy manager.

Lawyers. Although they are characterized as sharks or ambulance chasers in the comedy world, lawyers are a must-have in the commodity procurement world. Getting the corporate in-house counsel to help craft and review contracts is an obvious requirement, but an external utility lawyer may be of equal value. Kaiser Permanente uses an outside lawyer to help track all of the pertinent regulatory issues. "He understands all of the current and pending legislation and is invaluable in helping us shape contract terms in light of what is happening in the regulatory world," notes King.¹⁰

Accounting. Accounting and financial-modeling expertise is necessary to ensure proper profit-and-loss accounting to each affected business unit. In most sizable corporations, energy expenditures need to be allocated to the profit-and-loss statements of the proper business units or facilities. This can be difficult with large contracts that cover a number of facilities. You may not require a dedicated resource, but having access to the proper authorities in corporate accounting can help see that this is done properly.

Set Up Signature Authority

You need to be well aware of all of the people in your organization who will be affected by energy decisions and whose signature or approval is needed on each contract. Oftentimes, pricing offers in energy deals are only good for a matter of minutes or hours because the markets change so rapidly. Being able to get the appropriate signatures in a very short amount of time is paramount in order to lock in desirable pricing. The defense contractor energy manager describes his company's typical pricing situation:

We get the pricing from an [energy service provider] as we are sitting in a conference room with the consultant; we usually have about an hour to commit. As soon as we get the pricing, the consultant dumps it into the spreadsheet model they have developed for us. Just looking at the pricing is not enough to make a decision, because you are given different on- and off-peak prices as well as different monthly prices. It's too hard to see what it all means, so plugging them into the model shows you the true total cost. We make a decision based on the model's output. We may take all of it or just a limited period of time of it,

or we may decide to hold off and see if there are any fundamental market changes. If we do go with it, we basically have about 20 minutes to find a vice president with signature authority in the \$1 million per month range. The procurement guy and I sprint for the VP's office. We have already warned him about the urgency of pricing signatures, so he understands that we may barge in on him in any meeting, no matter what he is doing, to get the signature.

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***—Emerson Drakes
United Technologies Corp.***

The ability to execute a pricing decision rapidly is contingent on having contracts prepared—and even signed—before pricing offers need to be made. Some energy managers will prepare and sign master contracts with multiple vendors so that they can solicit different price options from each one. Emerson Drakes, supply chain manager for United Technologies Corp. (UTC), notes how important this is: “One of our protocols is to have all of the contracts agreed to and signed by UTC Supply Management ahead of time, before the final pricing comes in. You don’t want to be at a point where you have a price but then have to haggle over terms and conditions.”¹¹

Know Thy Suppliers

With the advent of deregulation producing a stampede of questionable energy suppliers and Enron’s subsequent collapse, many a corporate energy manager has learned a thing or two about taking a close look at who they get into bed with. Although deregulation in the United States has settled a bit, there are still plenty of suppliers in existence that may not be in an adequate financial or physical position to reliably supply your company.

Many procurement experts will initially whittle down a long list of potential suppliers to a short list of candidates. Texas Instruments (TI) provides an excellent case study for the supplier evaluation process.

TI begins by sending out a detailed request for information (RFI) to a large number of providers. The most recent RFI included 24 questions grouped into six categories. The first category focused on minimum requirements and asked for information such as credit rating and the size of the provider relative to the size of TI’s account. Any suppliers that did not make the minimum threshold on any of these questions were eliminated from further consideration. The remaining suppliers were evaluated according to the other five categories: Retail Experience, Product Pricing and Flexibility, Company Financials, Customer Service, and Other. The Other category asks whether the supplier currently supplies TI. Mark Leypoldt, TI’s energy manager, notes that this is important because it is easier from an administrative standpoint to stay with the current supplier than to switch.¹² If the switch is botched in some way, the company could be left on the incumbent utility’s

default rate until the issue is resolved. The default electricity rate can sometimes be as much as double the competitive retail market price.

TI weights each question based on its importance. Once the RFIs are filled out and returned, each member of the energy management team, the outside consultants, and the attorneys separately score each RFI and then all reconvene to discuss them. From this, a medium list is developed and contract negotiations are attempted with each supplier on it. The suppliers that TI is successful in negotiating with move to a short list and receive an RFP. Final selection, according to Leypoldt, “is based primarily on bid price, but we will adjust it if necessary by the perceived value of the negotiated contract terms.”

A good starting point to developing a list of potential suppliers is the state public utilities commission (PUC) Web site. (Visit www.naruc.org for a listing of all state PUC Web sites.) The PUC should list contact information for all licensed providers in its state. You may want to use this list of utilities as a reference when sending RFIs.

An RFI might ask questions about the following information:

- *Credit rating.* As a buyer of energy, you need to be assured that the seller will not only exist throughout the term of the contract, but that it will also be able to back up any claims you may need to make against it.
- *Size.* Make sure the company is large enough to handle your load. Some companies may want to only use suppliers that are very large players.
- *10Ks.* Have an experienced financial statement analyst assess three to five years of balance sheets to get a better sense of the supplier’s financial health.
- *Litigation history (at least three years).* Knowing a supplier’s history of legal interactions may shed some light on its propensity for contract disputes.
- *Markets entered/customers abandoned.* Some providers may have a dubious history of dumping customers if they haven’t hedged and prices get too high.
- *Energy sales history.* Get data on how much they have sold, where, and when to gain better knowledge about their experience.
- *Bankruptcy/loan defaults.* Discover if they have a history of defaulting on loans or bankruptcy.
- *Pricing products offered.* Find out if the pricing products they offer match what you are looking for.
- *Costs of other services.* You will want to know what the extra fees are for components such as billing and metering.

Although deregulation in the United States has settled a bit, there are still plenty of suppliers in existence that may not be in an adequate financial or physical position to reliably supply your company.

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—Jonathan Swann
The Limited

Structuring the Best Deal

The small print, or terms and conditions, in your contract is a key issue in deal structure. According to Jonathan Swann, senior manager of energy savings at The Limited, “The number-one strategy is to mitigate risk, and there are two types of risk: price risk and contract risk. We typically go after the best price and, more importantly, the right terms and conditions on contracts.”¹³ The right set of terms and conditions will vary by company, but the following ones are key.

Force majeure. Knowing what is included in the force majeure clause is important. Make sure that it only entails events outside of any party’s control, such as terrorist attacks or natural disasters. Be wary of contracts that include market situations that cause price spikes in force majeure.¹⁴

Nonperformance provisions. Carefully examine all of the instances where the contract allows for the provider’s nonperformance. For example, some contracts may allow for nonperformance if prices rise to a certain amount. Logically, it is in the buyer’s best interest to limit the amount of nonperformance provisions for the seller.¹⁵

Dispute resolution mechanisms. Negotiating appropriate dispute resolution mechanisms up front can prevent legal difficulties down the road. The more minor contract breaches you can address and provide solutions for, the fewer disputes you will encounter.

Billing/payment policy. The contract should spell out exactly what the payment terms are. Energy supply contracts typically have short terms, around 10 days, and some may require electronic funds transfer. The contract should also clearly state from what point the 10 days starts counting: Invoice date? Receipt date? In addition, be sure to cover any currency issues if you are dealing with cross-border transactions.¹⁶

Delivery point. Where the energy is contracted to be delivered is an important detail. For natural gas, you will likely want to have it delivered to the city gate as opposed to some other spot, such as the Henry Hub. Otherwise, additional transportation charges may apply. Electricity delivery points can be important as well, because you may have to pay congestion charges if the delivery point is in a different zone than your facility.

Usage flexibility. Typical fixed-price contracts will offer a flexible band of plus or minus 5 or 10 percent of usage around the quantity specified in the contract. Deviations in usage outside this band are subject to penalties, because the provider has to procure energy to cover them. If you are aware of planned large fluctuations in usage, be sure to have the contract include them. Another tack you might take is to allow for large increases or decreases in usage as long as you provide the supplier with 30 to 60 days’ notice.

Procurement Tactics in Regulated Environments

Just because your facilities sit in regulated states doesn't mean there aren't things you can do to help lower prices. Nearly every energy manager we interviewed expends effort to either favorably shape regulation or to negotiate prices in regulated markets.

Join an Energy User Group

The first strategy recommended by many energy managers is to join a state energy user advocacy group. Most states have one or more; some are targeted primarily at industrial customers, but many exist for specific commercial segments as well. (For a list of energy advocacy groups, check out www.energybuyer.org/directory.htm.) These groups typically intervene in utility rate cases and other pertinent utility regulatory actions on behalf of the energy consumers. Joining an advocacy group provides two advantages: First, membership gives your company a voice in regulatory interventions, allowing you to help shape what the organization lobbies for. "We've been very active in the past two years, intervening in state rate cases, and have found it to be one of the best strategies we've employed in terms of cost/benefit. The interests of large commercial [companies] are always underrepresented in utility rate proceedings," says Hospital Corp. of America's Ervin.¹⁷

Second, many of the organizations provide a great deal of regulatory and market information. "Getting involved helps you learn and understand what is going on in your regulatory and legislative arena. With that information, you will have a better understanding of what your procurement strategies should be, going forward," says one energy manager.

Use Your Size to Negotiate Better Rates

If your company has a significant footprint in any single utility's territory, it may be possible to negotiate a better price with them than their otherwise applicable rate. The energy manager from a large computer manufacturer notes that his company tries to get to know the utility first to see if there is some give-and-take that can be

Getting the Most Out of Your Supplier

Information is king in the energy procurement business. The fragmented and complicated nature of the markets combined with the volatility of the commodities makes knowledge attainment a priority, and few realize how helpful suppliers can be.

Many experienced energy managers tout the guidance and information that suppliers can provide. "Talk to your providers—they can give you good insights and a lot of them are willing to

A Note on Comparing Pricing Offers

Comparing offers based on energy price is nearly impossible to do, because every supplier has contractual nuances that make pricing offers different. "When comparing prices from vendors, make sure you are comparing apples to apples," says one energy manager. "For example, one vendor may use the utility as the metering agent, whereas another might use an outsourced data collection company, which will require reinstallation of telephone lines for the meters and permission from the utility to take pulses off the meter. Make sure you understand what all of the costs of the bid are."

do that. You just have to develop a good relationship with them," says Emerson Drakes of United Technologies.¹⁸ The length that suppliers are willing to go is a matter of customer service level. One energy manager for a computer manufacturer told us that his company's gas provider went so far as to hold weekly conference calls for the energy management group to provide market updates and recommendations.

The large computer manufacturer's energy manager says, "We do our homework so that we understand the utility. We find out what their business drivers are: Are they short or long on capacity, do they need peaking power, etc. Then we make a proposal and offer them something to help their situation and see if we can reduce our rates at the same time."

negotiated for a lower rate. "We do our homework so that we understand the utility. We find out what their business drivers are: Are they short or long on capacity, do they need peaking power, etc. Then we make a proposal and offer them something to help their situation and see if we can reduce our rates at the same time." Doing your homework is an important part of the negotiations. Preparing your case with actual data from utility rate filings and a proposal of what you specifically would like in terms of rate restructuring can help improve your negotiations.¹⁹

If friendly negotiations bear no fruit, then you might consider picking up a bat and playing hardball. There are various techniques that can be used to elicit a more favorable response from the utility. One method is to threaten to build self-generation, although this doesn't usually work unless you can show the utility that you really are serious. If your company is large enough, you might be able to garner direct transmission service, thereby bypassing utility distribution costs. You also might consider moving operations to a neighboring utility's territory to get a response from the incumbent. One gas transmission company knew that all of its pumping stations could be located at multiple spots along the pipeline. So it approached each utility and asked what kind of rate it would be offered if it moved its pumps into or out of the utility's territory (depending on whether or not the pump was currently in that utility's territory). Once it got rates from each one, it simply placed the pumps in the territory of the utility offering the best price.

Many of our interviewees also advise that energy managers be aware of their company's total relationship with the utility before engaging in hard rate negotiations. Sometimes your relationship with the utility is more symbiotic than you might think. Don King of Kaiser Permanente was preparing to negotiate rates directly with a large utility when he found out that the same utility spends 10 times as much on healthcare with Kaiser as Kaiser spends on energy with them. When he met with the utility CEO, King says, "I walk in the door and the CEO shakes my hand and says, 'I've got this all figured out. I'm going to give you free electricity; you just give me free healthcare.'"²⁰

Audit Your Bills

Simply making sure your facilities are on the best rate from each utility may seem a bit rudimentary, but in a large company with many facilities, it can save a significant amount of money. Jonathan Swann of The Limited says that in regulated territories, "We get power from the host utility and then use bill and tariff auditing to make sure we are paying as little as possible."²¹

Evaluating Your Procurement Efforts

When evaluating how well your procurement efforts have gone, be sure to distinguish between the performance of the energy manager and the performance

of the risk strategy. The performance of the energy manager should be measured by his or her ability to carry out the risk strategy and the associated goals. Gary Graham of Jones Lang LaSalle says that when he approaches management with information on performance, “I show them that I executed the risk-management plan that we agreed to perfectly. If we are all on the same page up front and they know what the risk of the strategy is, then there shouldn’t be an issue with my performance.”²² If the energy manager does not implement the strategy as agreed or doesn’t do it in an effective manner, it should be evident to management as they review the decisions that were made.

Companies may want to evaluate their risk-management strategies periodically to ensure that they are getting acceptable results. Mark Leyboldt of TI notes that when talking to management about his company’s risk-management strategy, “They know about the strategy we planned, they know about the contracts we signed, they know what they think we all expected—and when the unexpected happens, they typically ask why we didn’t do something different.”²³

One way of evaluating your risk strategy is to look back at what would have happened had the company settled for pricing that offered more or less risk (**Figure 3**, page 16). Tad Nordstrom of Ball Corp. uses this tactic: “I typically go to management with three or four different potential strategies for our quarterly meetings and we choose one based on current market conditions, our forward view, and our budgets. On an annual basis we go back and compare our chosen strategy with market performance for evaluation purposes.”²⁴ This effort can be made easier by having your supplier provide multiple prices at each offer, each one representing a different risk level.

Many energy managers also have specific goals that are associated with the company’s risk strategy. Jon Ervin of Hospital Corp. of America, for example, has two goals: First, to reduce price volatility with nonregulated energy commodities, and second, to save at least 10 percent over the otherwise available regulated rate.²⁵ Many energy managers have a goal of saving a certain percentage compared to the regulated default rate. This can be evaluated by comparing expenditures relative to what they would have been under the otherwise applicable regulated rate. The regulated rate offers a good baseline, because it represents what would have happened had the energy manager not existed.

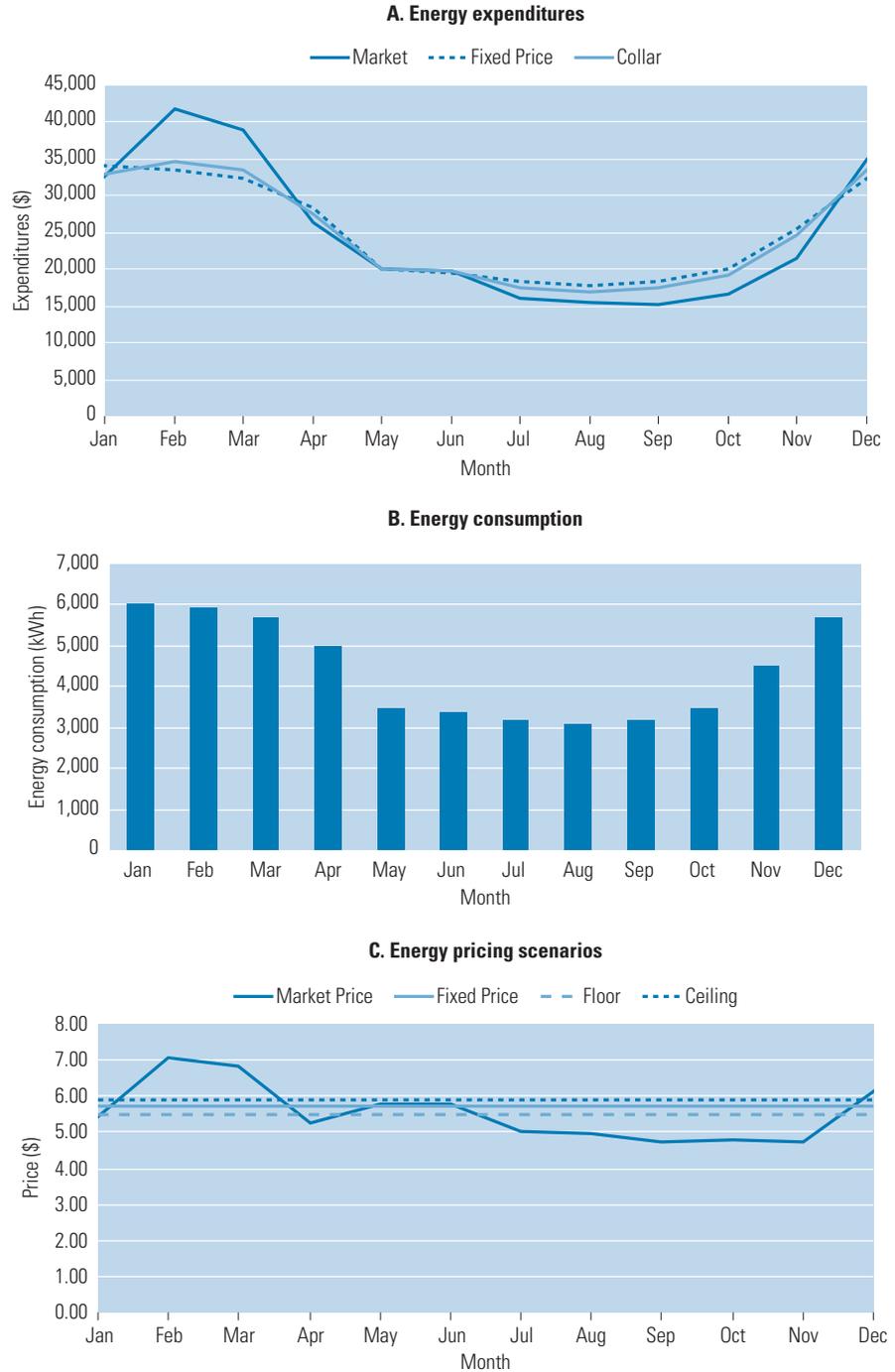
However an energy manager chooses to evaluate procurement efforts, it is important to remember that we all are at the mercy of the market and regulatory alterations. Says Jim D’Orazio of Jones Lang LaSalle, “I want to be measured on my risk-management skills, not on my market prognostication skills.”²⁶ Absent an actual crystal ball of mythic abilities, no single person can truly predict future prices.

Don’t Forget to Verify

After contracts have been implemented, many energy managers stress the need to verify that the billing is occurring at the right price at the right facilities. Tad Nordstrom of Ball Corp. reports that bill verification is “huge—we check every bill to verify that it is in accordance with our hedges.”²⁷ It is not uncommon for facilities to be left out of the proper new billing or for the billing to be at something other than the contracted price. There may also be mistakes in billing communication with the local utility, such as being billed twice for energy: once by the utility and once by the deregulated provider.

Figure 3: Comparing performance to pricing terms

Given the following fictional energy prices, expenditures, and consumption circumstances, the third graph shows the corresponding expenditures under each pricing scenario: market, fixed-price, or collared. Management and procurement teams may want to review such data using actual numbers to determine how their risk strategy performed.



Note: kWh = kilowatt-hours.

Source: E SOURCE; data from interviewees

Conclusion

More than likely, corporate energy procurement is not going to get less complicated in the coming years, and commodity prices are not likely to be less volatile over any long-term period. The regulatory environment, on both the state and federal levels, continues to vex the industry, and natural gas supply issues are still in question.

With this in mind, effective energy procurement operations will become more and more essential to large companies with significant energy expenditures. There are still opportunities for cost savings through a well-executed effort. Knowing your company and knowing as much as possible about energy commodity markets are the most important aspects of a good energy procurement operation. Only after an energy procurement team has accurately defined corporate needs and understands how those needs can be delivered within the confines of the markets can it design and execute an effective strategy.

Notes

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- 3 Don King (April 29, 2004), Director of Maintenance Operations/Consulting Services, Kaiser Permanente, Oakland, CA, 510-625-2615, don.king@kp.org.
- 4 The Annual E SOURCE Energy Managers’ Survey, conducted online and at the 11th Annual E SOURCE Energy Managers’ Roundtable, San Diego, CA (April 12–14, 2004).
- 5 Neil Kolwey, “Gas Procurement Strategies for Volatile Times,” *E SOURCE Corporate Energy Managers’ Consortium, CEMC-4* (May 2002).
- 6 Lindsay Audin (May 7, 2004), President, Energywiz Inc., Croton on Hudson, NY, 914-271-6501, energywiz@aol.com.
- 7 Energywiz Inc., from www.energybuyer.org (accessed May 7, 2004).
- 8 Jon Ervin (April 26, 2004), Manager of National Energy Programs, Hospital Corp. of America, Nashville, TN, 615-344-1116, jon.ervin@hcahealthcare.com.
- 9 The Annual E SOURCE Energy Managers’ Survey [4].
- 10 Don King [3].
- 11 Emerson Drakes (April 28, 2004), Supply Chain Management, United Technologies, Farmington, CT, 869-678-4636, emerson.drakes@UTC.com.
- 12 Mark Leypoldt (April 26, 2004), Energy Manager, Texas Instruments, Dallas, TX, 972-927-3042, m_leyoldt@ti.com.
- 13 Jonathan Swann (April 29, 2004), Senior Manager of Energy Savings, The Limited, Columbus, OH, 614-415-7562, jswan@limited.com.
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- 15 Peter Funk, “Mitigating Risk in Power Purchase Contracts,” *Energy User News*, v. 25, no. 8 (August 1, 2000).
- 16 Lindsay Audin [6].
- 17 Jon Ervin [8].
- 18 Emerson Drakes [11].
- 19 Lindsay Audin [6].
- 20 Don King [3].
- 21 Jonathan Swann [13].
- 22 Gary Graham, Energy Manager, Jones Lang LaSalle, in discussion from the 11th Annual E SOURCE Energy Managers’ Roundtable, San Diego, CA (April 12–14, 2004).
- 23 Mark Leypoldt [12], in discussion from the 11th Annual E SOURCE Energy Managers’ Roundtable, San Diego, CA (April 12–14, 2004).
- 24 Tad Nordstrom [2], in discussion from the 11th Annual E SOURCE Energy Managers’ Roundtable, San Diego, CA (April 12–14, 2004).
- 25 Jon Ervin [8].
- 26 Jim D’Orazio, Energy Manager, Jones Lang LaSalle, in discussion from the 11th Annual E SOURCE Energy Managers’ Roundtable, San Diego, CA (April 12–14, 2004).
- 27 Tad Nordstrom [2].