

Finding the Risk Hidden in Your Energy Contract

10 Terms & Conditions You Need to Know



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Introduction

For many organizations, the energy supply management process focuses primarily on the controllable aspects, such as timing purchase decisions, wholesale market risk management, and competitive sourcing procedures like sealed bid or reverse auctions.

Too often, however, we find that this focus comes at the expense of risk analyses within the energy contracts themselves.

In this whitepaper, we cover how changes in the energy market over the past 10 years have introduced more risk, and aim to help you understand how your organization can manage risk in the energy supply management process.

Most importantly, we break down the 10 most important terms and conditions in your supplier agreement that you will need to know to accomplish this, and explain why the lowest price may not always be the best option.

What's Changed: Evolution of Energy Contracts

Ten years ago, energy price components were predictable; they were stable or manageable through financial instruments. Retail suppliers offered “fixed for floating trades,” taking on wholesale market risk for a premium.

At that time, a retail supplier's ability to stand behind a fixed-price contract hinged on its ability to manage the hedge through risk management and market insight. That reality has changed.

Increased Competition

A significant rise in the number of competitive retail suppliers, coupled with a growing broker and consultant market share, has driven down supplier margins considerably. In the last five years alone, the number of retail suppliers and brokers/consultants has grown more than 50% in most markets. With smaller margins available to protect their hedges, suppliers generally self-insure their positions through conditional premiums, or they manage them through various “contract-outs” in the terms and conditions of their customer agreements.

Market and Regulatory Changes

As the retail supply market tightened, rapid and significant changes to the energy generation mix, transmission, and distribution networks gave rise to a growing assortment of new cost components: transmission and capacity charges, renewable portfolio standards, balancing charges, and ancillaries. While some changes may support commodity prices, and others may depress them, they all cost money for energy providers, which ultimately leads to an increasing collection of pass-through charges in your energy supply contract. For many customers, pass-through charges actually outweigh the energy prices themselves.

The rise in the amount and complexity of pass-through costs has been driven by a variety of factors, including:

- > **Technology advancements:** The rapid growth of distributed energy resources (DERs) like combined heat and power (CHP), on-site solar photovoltaics (PV), and behind-the-meter energy storage is forcing utilities to adapt to a more decentralized system. The emerging multi-directional network is a fundamental shift in transmission and delivery structure, and it creates new costs for grid operators.
- > **Regulatory pressure:** The emergence of climate-focused regulations and incentive programs have helped intermittent renewable sources like wind and solar earn a significant share in the generation mix. This intermittency requires operators to make additional investment in grid stability and reliability, which they recoup through new balancing and capacity charges passed through to customers. State-level regulations further add to new costs on end-user supply contracts through renewable portfolio standards.
- > **Infrastructure needs:** According to the US Energy Information Administration (EIA), nearly 70% of the United States' transmission lines and power transformers are 25 years old or more. This aging infrastructure requires expensive updates and maintenance. In addition, integrating power from renewable generation located far from urban demand centers requires investment in new long-distance, high-voltage direct current transmission lines.

Takeaway: Energy Contract Evolution

Ultimately, there is more risk in today's energy contracts. The questions at hand are “who's wearing it? And at what cost?”

Ten Terms and Conditions You Need to Know

Prices are easy enough to sort and stack, but each price is laden with different risks. When evaluating supplier agreements, it is important to consider the supplier's financial and physical backing (how good is the supplier's credit?) and customer service (how timely and accurate are their bills?)

Additionally, the contract terms and conditions in any given supply agreement fundamentally affect the value of that agreement. Two different contracts offering the same price for the same volume with the same start and end dates in the same location may look very similar, but the terms and conditions may in fact make them as different as apples and oranges.

Not every supply contract will include all 10 of these terms and conditions, but each will contain some combination. Understanding these terms will enable you to manage risk, more effectively manage red lines, and more rapidly capitalize on opportunities in the market.

1. Auto-renew and Holdover Rate

When evaluating an energy supply contract, it is critical to pay attention to any auto-renew clause or holdover rate. These terms dictate your liability when the contract period ends.

Auto-renew language is less common in today's contracts, but is particularly burdensome. When an energy supply contract includes auto-renew language, the supplier can extend your contract for 12 months or more after its expiration at a rate you did not approve. That risk may offset an otherwise attractive price.

More often, a contract will stipulate a holdover rate. This term also dictates your liability when a contract period ends, but does not enroll you in a new contract without your consent. Instead, the holdover rate will allow the supplier to continue serving your energy after the contract expiration date. Holdover rates include all pricing components, including energy, capacity, ancillaries, supplier fees, and supplier margins. They also fluctuate according to market conditions and can be very costly during summer or winter months. The more information disclosed in that holdover rate, the better you can evaluate its risk

2. Billing and Payment

There are three different billing methods: utility-consolidated billing, supplier-consolidated billing, and dual billing. Your

energy supply management partner should discuss these billing options with you before drafting an RFP.

- > **Utility-consolidated billing:** Customers have the option to let the utility consolidate supply and distribution costs in a single bill. Under utility-consolidated billing, the customer pays the utility and the utility pays the supplier at a discounted rate. Suppliers will often factor in slight premiums for these arrangements to compensate for the utility discount.
- > **Supplier-consolidated billing:** Customers have the option to let the retail supplier consolidate supply and distribution costs in a single bill. Under supplier-consolidated billing, the customer pays the supplier and the supplier pays the utility. Customers that enroll in contracts where the supplier consolidates the billing take on the risk of late payment penalties if the supplier does not pay the utility on time.
- > **Dual billing:** Customers also have the option to pay separate invoices to their supplier (for energy) and to their utility (for the transmission and distribution of that energy). Dual billing may offer modest savings opportunities in some regions, and significant savings opportunities in others. Administrative costs increase, however, as multiple bills need to be processed.
- > **Purchase of receivables (POR):** This refers to the premiums a customer will pay for consolidated billing, which vary by location and utility. Con Edison in New York City, for example, has one of the highest POR rates in the country. A contract that consolidates billing in Con Ed may cost thousands more than one with separate supplier and utility invoices. In states like Maryland and Pennsylvania, however, POR rates are minimal and suppliers will offer consolidated billing at no additional charge.

3. Cancellation/Termination Language

Every energy supply contract will include some provision that allows the supplier to cancel or terminate the agreement. It is important that you understand the circumstances that may cause a supplier to cancel a contract, and what recourse you have.

Most often, suppliers will reserve the right to cancel an agreement if the customer's usage is too high, too low, or in response to significant market/regulatory changes. In this event, the customer will need to secure a new contract at whatever the market price is.

4. Limited Liability

Limited liability clauses protect retail suppliers when they cancel or terminate a supply agreement. Suppliers will be as vague as possible in defining their liability, so it is of critical importance that you confirm that there is no limit to actual damages.

We often see contracts that limit actual damages to the customer's largest monthly invoice during the previous 12 months, or something similar. These stipulations carry significant risks.

Instead, we strongly recommend that the supplier's liability should be the positive difference between the market price and the contracted price, multiplied by the remaining volume.

[Absolute Value (Market Price — Contract Price)] x remaining kWh

5. Termination Fees

Energy supply contracts can include steep penalties for customers that terminate a contract. While a customer can most often add an account to a contract (or drop one from a contract) without significant fees, suppliers are less likely to negotiate their termination fees. Because these clauses are generally non-negotiable, we believe they should have the least influence on a customer's decision process.

6. Material Usage Deviation

Material change is typically considered a 25% shift in consumption (either up or down) over a period of three months. These changes most often occur when a customer changes production schedules, requires extended maintenance on heavy machinery, or adds or subtracts meters from an existing account. Customers that invest in behind-the-meter distributed energy resources must also consider the impact of those resources on their consumption patterns.

In most cases, suppliers will work with customers if the customer notifies them in advance of any known consumption changes. As material deviation language differs from supplier to supplier, however, it is important that the customer know how it is defined. Some contracts look at material change at the portfolio level, others at the site level. Ensuring that your usage profile, product structure, and contract terms are all in alignment will minimize the risks of material deviation penalties.

7. Bandwidth (“Swing”)

While material deviation clauses protect suppliers from prolonged consumption changes, bandwidth (otherwise referred to as “swing tolerance”) protects them from sudden or temporary consumption changes. Significant weather changes, for example, can cause expensive consumption and price spikes.

Most power contracts allow for at least 25% swing (either up or down), but this term can be negotiated as needed. Many suppliers offer either 100% or unlimited swing, and thus a consultant can take a strategic approach to structuring customer RFPs to test pricing with different swing tolerances.

We often advise customers to think of bandwidth as an insurance policy. Because a customer will typically face real-time energy prices when they exceed their swing thresholds, we ask them how much they are willing to pay to protect against unforeseen consumption changes.

8. Add/Delete, Assignment, and Substitution

Add/delete, assignment, and substitution are all different clauses that let a customer modify the accounts in a contract. Each has a different purpose and application.

- > **Add/Delete:** Large organizations and municipalities that frequently need to add or remove utility accounts from an existing contract should pay close attention to add/delete clauses. Suppliers will typically work with the customer to add or remove specific accounts from a contract, but many include language limiting the volumetric changes of any adjustment.
- > **Assignment:** Commercial real estate companies that frequently transfer buildings to new entities should pay close attention to assignment clauses, which stipulate the conditions under which a contract can be transferred to a new entity. A basic understanding of the assignment process and requirements may expedite the lease or sale of commercial property.
- > **Substitution:** Substitution clauses allow the customer to replace similarly sized accounts within the same utility zone. Customers planning to close production at one facility and move to a new location in the same service territory, for example, will benefit from this clause.

9. Credit

Most suppliers will evaluate a customer's credit in their price calculations. To do so, they will consider different factors, including billing type (single billing, dual billing), DUNS numbers, and Federal Tax ID numbers. If a supplier does not immediately approve the customer's credit, the supplier may require financial documents, parental guarantees, or upfront cash deposits to engage the customer.

Your energy supply management partner should advise on the creditworthiness of the suppliers competing for your business; they should also consider your own credit when recommending the best method to market—whether that be an open auction, sealed bid auction, or direct supplier negotiation.

10. Capacity and Transmission Tag Changes

Many risk-averse organizations elect “fixed-price” contracts to minimize their exposure to volatile prices. While a fixed-price contract limits an organization's ability to manage energy costs over time, it does offer some budget security.

However, not all fixed-price contracts are in fact fully fixed.

Capacity and transmission charges levied by the system operator ensure grid stability. These charges, known as tags, already make up as much as 40% of the total energy cost for some organizations, and they are trending up.

To manage the risk of rising capacity or transmission tags, suppliers will typically offer four different types of “fully-fixed” contracts:

- > Contracts where the price will not change, regardless of changes in capacity or transmission tags
- > Contracts where prices will not change if capacity tags change, but do adjust for incremental transmission tag changes
- > Contracts that limit the size of transmission or capacity tag adjustments
- > Contracts where all capacity or transmission tag adjustments are passed on to the customer

It is important that your energy partner fully explain what portions of your energy supply agreement are fixed and which are subject to adjustment.

Takeaway: Price ≠ Value

Suppliers can use the terms and conditions in supply contracts to shift market and regulatory risk onto the buyer. Thus, a contract featuring an attractive price may include stipulations that make it unfavorable for the buyer.

Leverage: How Much You Have and How to Execute

Retail energy suppliers often maintain different versions of their supply agreements. They may present one version when they work directly with a customer and a very different version when working with a broker or consultant. They may even vary their agreement terms and conditions from consultant to consultant.

For example, we work with our supplier network to ensure that the terms and conditions in the customer agreements that we solicit include some basic customer protections. It is incumbent upon us as consultants, then, to advise our clients on the difference between basic protections and valued terms.

Some contract terms and conditions are negotiable; some are not. Some carry significant risks, others less so. Ultimately, your leverage in soliciting a new energy contract comes from two levers: knowledge and scale.

Supply Contract Knowledge

Your energy broker or consultant needs to stay on top of evolving supply contract language trends. They should explain the value of different swing tolerances. They must explain the impact of capacity and transmission tag changes. They need to help you weigh price against liability limits.

The better you understand the mechanisms a retail supplier uses to manage their risk, the more you are able to assess your own.

Supply Scale

To be frank, retail suppliers often look at different brokers and consultants as channels. The more customers the broker/consultant has, the more valuable the channel. This gives consultants with large books of businesses more leverage to negotiate favorable terms and conditions for their customers.

Takeaway: Not all contracts (or partners) are created equal

There are a number of items to consider when evaluating an energy supply management partner: market knowledge, industry expertise, experience, availability, technology, service, price, and so on. Two other critical criteria which customers tend to overlook are the number of suppliers a partner works with and the frequency with which they transact.

Managing Energy Contract Risk

Supplier competitiveness is the result of multiple factors, including their positions (which change daily), business models, and even short-term incentives for their sales teams.

As a result, we frequently see supplier price differences exceed \$0.0005/kWh, and often by as much as \$0.0015/kWh or more. It absolutely pays to have multiple suppliers compete for your business. The logic is straightforward—you cannot predict which supplier will offer the best pricing on a given day.

However, the inherent risk in any energy supply contract makes simple price-to-price comparisons impossible.

A \$0.001/kWh difference adds up to \$10,000 annually for every 10,000,000 kWh you use. But when the supplier's customer service record and the contract terms and conditions are evaluated in tandem, that \$10,000 premium might look like a very cost-effective insurance policy against rising capacity/transmission tags, bandwidth charges, risky holdover rates, or even the supplier terminating the agreement.

Ultimately, the quality of a price is not distinct from the paper it's written on. Be sure to evaluate these key terms and conditions in your next supply agreement.

To discuss how to manage risk in your organization's energy supply management process, contact our team of experts.