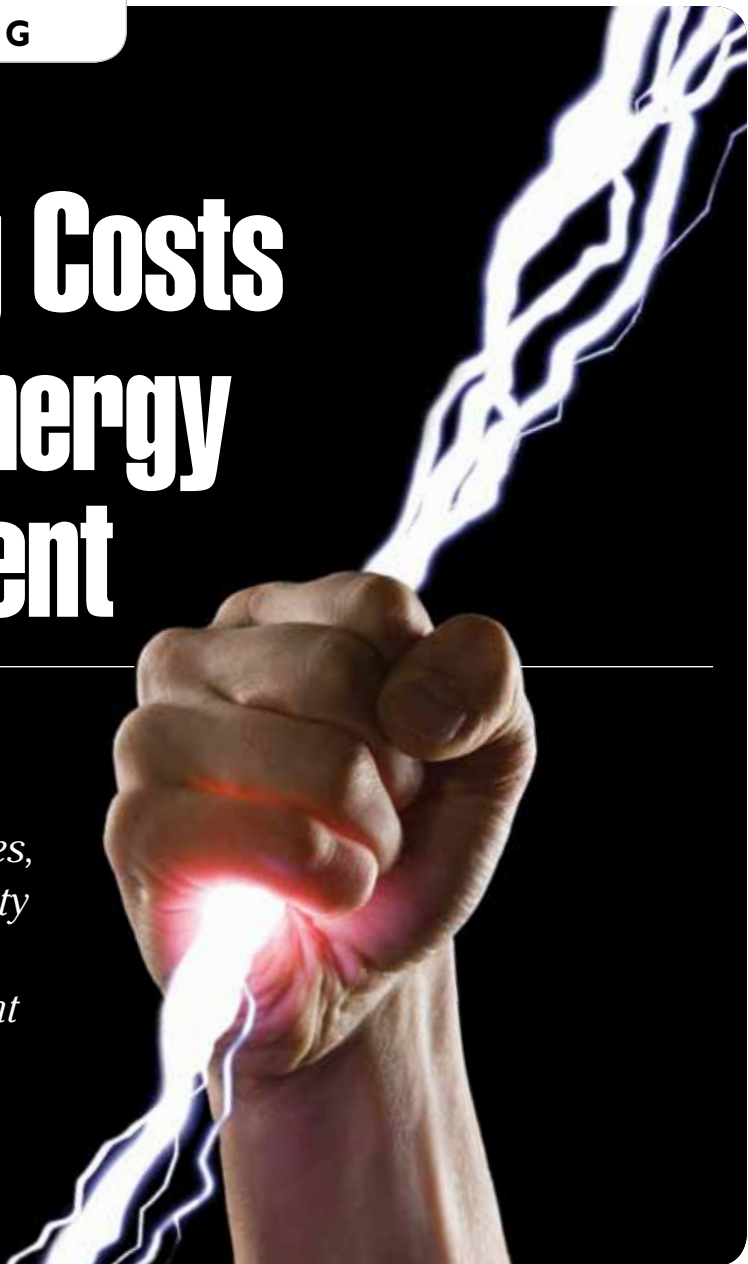


Controlling Costs Through Energy Procurement

Deregulation presents opportunities and challenges, and volatility in the electricity and natural gas markets makes a sound procurement plan crucial.



By Bob Wooten

Electricity and natural gas are likely the most volatile commodities anyone will ever procure for an organization. Electricity and natural gas price volatility is very apparent when compared to other commodities such as gasoline and the S&P500 (see graph on page 24). Not surprisingly, attempting to purchase energy through a bid or

RFP is like playing “Pin the Tail on the Donkey.” However, in addition to your being blindfolded, the donkey is also running around the room! Such is how many public procurement professionals feel when tasked with addressing their jurisdiction’s energy needs for electricity or natural gas contracts.

As more states deregulate their electricity and natural gas supply, opportunities and challenges increase to control these costs. For the typical jurisdiction, energy accounts for a very large percentage of the overall budget. Energy efficiency is one way to reduce spending on electricity and natural gas. However, the first and foremost method to control energy spend is to focus on the actual cost of the commodity itself. Therefore, the purchasing professional has a huge role to play in controlling and managing the energy budget for his or her jurisdiction.

Make a plan

Energy’s volatility makes it crucial that there be a sound plan in place to address how and when to purchase this commodity. The first step in designing a comprehensive energy procurement plan is to

understand a jurisdiction's cost exposure and risk tolerance. A starting point is to look at the current contract. Understand how it is structured and how the price affects the organization. For example, you will want to understand whether the price is fixed, meaning you pay this price regardless of market conditions, or if it is an index price that is tied to a moving published index.

Many governmental entities need the budget certainty that only a fixed price contract can deliver. However, these discussions should be held with the entire stakeholder team so that other types of contract structures are understood. If the governing body determines that contracting a certain portion of its energy usage on an index basis will deliver significant savings without jeopardizing the overall budget, then further analysis of such an approach may be warranted.

The second step is to actually develop the procurement plan based on the agreed-upon approach from step one. This initial development is done with the understanding that any plan must have a feedback loop and be structured so that the plan can change constantly and adapt to growing needs in the jurisdiction. All the stakeholders should sign off on the plan, including purchasing, facilities, finance, real estate and others. Only when a plan is agreed upon should you move forward to the next step.

Step three is actually implementing the plan. This is when you will achieve extremely important feedback

that should contribute to the continual assessment of the energy procurement plan itself. Implementation means to use the developed strategy to go into the marketplace and procure power needs, resulting in an actual contract with a supplier of electricity or natural gas. Most governmental entities either go through some type of competitive solicitation process or use a pre-

procured intergovernmental cooperative contract. Any procurement process must be in sync with the state's applicable procurement laws. As with any other purchase, it is important to maximize efficiencies and effectiveness. There are three key factors a purchasing professional must rely upon to implement an energy procurement plan. The factors are market intelligence, understanding the right price and knowing how to interpret the underlying data.

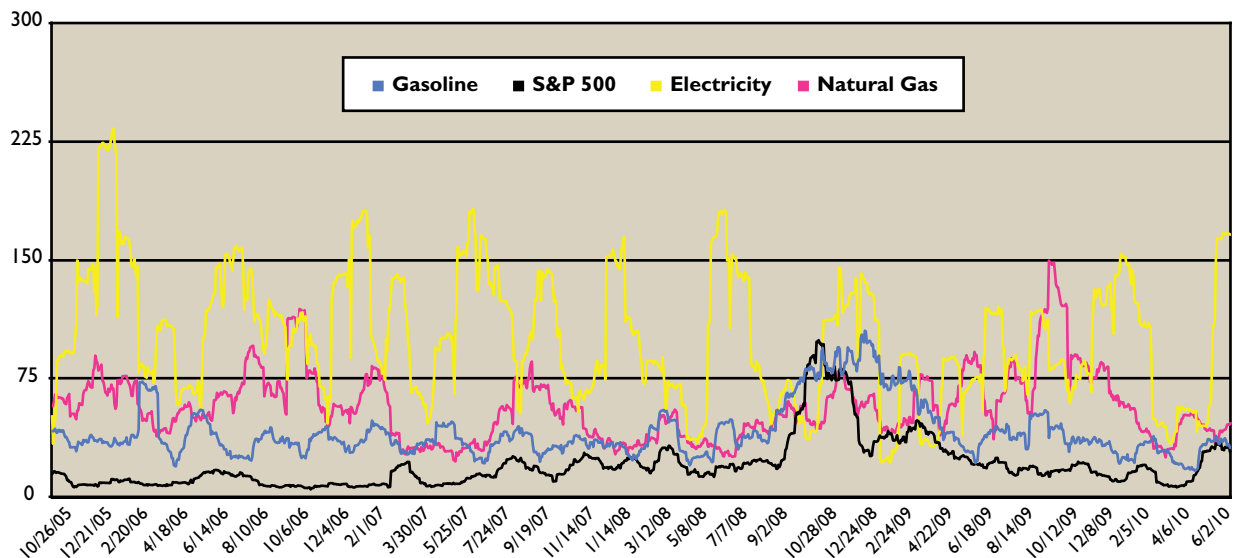
Market intelligence

To procure and negotiate a contract for energy requires a thorough understanding of the market factors that determine the price and dictate how that price has moved and will move over time. We have already seen that electricity and natural gas are two of

the most volatile commodities to procure. The price that a jurisdiction will pay for electricity can change dramatically from one day to another and from one hour to the next. In times of high volatility, a purchasing manager may be prepared to sign a contract at noon, but by the time he or she sends in the signed contract at 3 p.m., the price may have increased. Understanding

The amount of power expended and the time during which it is used are key factors to determine the price that one jurisdiction pays compared to another jurisdiction.

Energy Volatility



Electricity and natural gas have shown greater volatility than gasoline or the S&P500 over the last several years.



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market dynamics also increases the probability that a price is contracted during a favorable window in the market; that is, when underlying wholesale costs are low, thus leading to a good contract price.

Energy commodities such as electricity and natural gas are first purchased by suppliers on the wholesale market, then sold to actual end-users of the power. If you understand how the wholesale price is determined, you stand a much better chance of negotiating the best rate. It's like going to a car dealership to negotiate the price of a new car. If you know the price the dealer paid for the car, you are better able to determine if you are paying a fair price to buy it. Without this knowledge, you can only spend more time comparing prices from multiple dealers, and in the end you have only determined that you are paying the best price among those three or four dealers.

The same is true with electricity. Even if a competitive bid or RFP is issued, you are only making your decision based on prices from those bidders that chose to respond. You do not know if any of those bidders has really offered a price in accordance with the underlying wholesale costs. So the question arises, "How does someone gain access to this wholesale market information?" True intelligence only comes from direct involvement in the wholesale markets where the institutional players do transactions. Power generators, suppliers, banks and hedge funds are a few of the players that are constantly buying and selling power on the wholesale market. These transactions are the basis for determining the price of wholesale power. There are published indexes that display a small portion of wholesale transactions; however, the majority are done independently of published indexes and are consummated by wholesale brokerage firms.

The "right" price

Once a purchasing professional understands the underlying costs of power, the focus then becomes the price itself. The temptation is to treat power like other commodities and sign a contract at the lowest price. However there are many factors that can make the "best" price become the "worst" price. You need to have a thorough understanding of the supplier you are contracting with so that you know how responsive they will be to customer service issues. In some cases, you can spend so much time resolving problems with a supplier that you have eaten away at the actual price savings you have secured with the commodity.

The terms and conditions of the contract itself can have a very direct impact on the price a jurisdiction will pay over the life of a contract. Many power contracts contain penalties for over- or under-usage, compared to a pre-established baseline. If you contract for a low price that also specifies a very narrow range of usage, the penalties for over-usage may far outweigh a higher price with less restrictive terms. Payment terms can also lead to potential penalties, so they must be discussed thoroughly before entering into contract.

It's always good to keep in mind that the cheapest price many times comes with a large amount of fine

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print. Any contract must be completely vetted, as well as the background and experience of suppliers themselves. Only after evaluating all factors can you be sure you have arrived at the "right" price for your jurisdiction.

Know your data

Just as important as wholesale market factors is an understanding of a jurisdiction's unique energy usage. This means understanding your usage of power – both how much power is used and for how long it is used. The amount of power expended and the time during which it is used are key factors to determine the price that one jurisdiction pays compared to another jurisdiction. Two cities may use the same amount of power, but if one city uses it more consistently than another, they will pay less.

First, usage data must be captured. There are many off-the-shelf programs available for this purpose, as well as many customized applications. However, all the data in the world is meaningless unless you can understand how to read and interpret your energy usage. To best utilize knowledge of your data to develop and implement a sound energy procurement plan, you need to determine your jurisdiction's unique energy fingerprint. When you approach suppliers to negotiate a contract, you hold the power if you understand your usage data. The reverse is also true. If the supplier understands your usage patterns and you do not, there is a better chance key factors leading to the right price will be left on the table.

Utilize an expert

It may appear that staying on top of all the factors to develop and implement an energy procurement plan is a full-time job. It is, in fact, a full-time job. Returns are based on the amount of time you put in throughout the life of the procurement project. If a purchasing professional decides to look at the market a week before issuing a bid, chances are the resulting price will reflect that level of effort. More and more governmental entities, as well as private sector organizations, are therefore turning to professional help. The use of a professional consultant or firm to understand these factors more than pays for itself in most cases in terms of negotiation of better rates and a more favorable power contract. The right expert can become an extension of your jurisdiction. Look for an outsourced energy management firm that works on your behalf and looks after the best interests of your jurisdiction.

Addressing all the pieces of this puzzle on an ongoing basis ensures that your jurisdiction is in a great position to capture savings when available. You will also be able to control costs in rising markets to protect your energy spend and overall budget, thus allowing you to focus on other pressing matters.

About the author

Bob Wooten is director of strategic solutions for Tradition Energy, where he manages energy procurement for many multi-national corporations with activities spanning facilities throughout the United States and Europe



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