

Energy Purchasing Choices, by Carla L. Romita

The Mann Report, June 2006

At this time of year, many coop boards and building managers are formulating their energy budgets for next winter's cold weather. A careful fiscal manager will want to consider what type of pricing arrangement is appropriate for the particular building and circumstances. Due to the unprecedented volatility of energy markets in recent years, many owners and managers wonder whether it would be prudent for them to fix their prices when contracting for their energy needs. Some boards and managers insist that fixed pricing is the only way they will purchase energy, but others prefer to float with the market. Which one of these approaches is right? In fact, each one may be the right approach—depending on your circumstances. The key to making the right decision is a thoughtful, careful analysis of the needs of your building and its residents and a clear understanding of the obligations a purchaser undertakes in these contracts.

A fixed price contract guarantees the purchaser a single price for a specified volume for the entire contract period. This type of product is an attractive choice for building managers or owners who want or need to insulate themselves from price fluctuations experienced in a volatile market. The most obvious objective of the fixed price contract is to protect the purchaser against the price increases that occur in a rising market. Another important benefit that can be achieved from entering into a fixed price energy contract is the certainty that it provides, which permits the property owner or manager to maintain established budget objectives. Although the owner or manager has no control over the total volume used by the building (that depends on the weather), the cost per unit of energy (fuel oil gallons or natural gas therms) will not change for the time period covered by the contract.

It is, however, extremely important to understand the risks associated with purchasing a fixed price energy contract, which is a *commitment* to pay the agreed-upon price. When the market is rising, fear that prices will continue to rise may lead some owners or managers to lock in a fixed price at a very disadvantageous point in time. This very scenario occurred in late summer and early fall 2005, when crude prices reached \$70 a barrel and many feared the prices would not stop rising. Owners and managers who locked in fixed prices then committed themselves to pay very high prices. While they may have experienced temporary relief from their fear of continually rising prices, their relief turned to dismay as the market fell back and prices began to recede. Purchasers who locked in high prices were obligated to continue paying those high prices notwithstanding the downward trend of the market.

In today's extremely volatile energy markets, no one can predict the bottom or the top of the market. Fixed price contracts can guarantee only one thing: price certainty. They do not and cannot guarantee that you will save money. If an owner's or manager's top priority is certainty, a fixed price contract is an appropriate choice.

Energy purchasers who wish to buy at competitive market prices and participate in savings when prices decline should consider floating price arrangements. While some owners and managers might consider this approach to be risky, a floating price arrangement is, in fact, no more risky than a fixed price contract. The risk of the former is that prices will rise; the risk of the latter is that prices will fall. Oil and natural gas are traded on commodities exchanges and the pricing of these energy products is subject to global supply and demand changes and the profit-making activities of energy traders worldwide. The only certainty about energy prices is that they will move up *and* down. Purchasers who wish to participate in downward price trends need to consider floating price contracts.

Some energy users have taken advantage of an excellent strategy to moderate the impact of price volatility: the ability to burn both oil and natural gas. For these dual fuel buildings, a fuel switching or BTU-equivalent pricing product may be beneficial. These dual fuel products allow savvy building owners and managers to take advantage of their fuel switching capabilities by availing themselves of *relative* price trends between the two markets. By offering the purchaser the choice of burning the currently cheaper fuel, while at the same time selling contracted volumes of the more expensive fuel back into the market at a profit, a dual fuel purchaser can significantly reduce overall fuel costs.

A reputable energy supplier will offer you access to professionals who are experienced with these products and can explain the advantages and disadvantages of each. That puts you, the building owner or manager, squarely in position to make an informed choice.