



Survey: Utility Hedging Gaining Wider Acceptance

RiskAdvisory Conference attendees see greater cooperation among regulators, customer groups and utilities in rate hearings, but more is needed

CHICAGO (November 16, 2005) – Ninety percent of attendees surveyed at the 3rd Annual RiskAdvisory Utility Risk Management Summit indicated that utilities should employ hedging to manage severe volatility of gas and fuel prices. More specifically, 49 percent believe hedging is “very effective,” while 47 percent said it is “somewhat effective.”

The survey – of 51 representatives from North American utility companies, regulatory bodies, financial institutions, marketers and consumer groups – was conducted in Chicago during the two-day conference held November 9 - 10 to discuss how commodity price management should be structured and implemented. Organized and sponsored by RiskAdvisory, a leader in risk management software and consulting, the conference explored issues surrounding the management of energy commodity price risk in regulated and competitive environments.

““In a time of rapidly increasing commodity costs, it seems that industry representatives are gaining more confidence in hedging,” said Leigh Parkinson, Principal Consultant, RiskAdvisory.

“The survey results also indicate an industry change in attitude about regulators’ familiarity with hedging and the effectiveness of ratecase hearings,” Parkinson said. “This could indicate that regulators are demonstrating more familiarity with hedging programs – and a willingness to explore hedging as a risk management option – and could be a result of the increased number of rate case hearings in Canada and the United States. We think this is a good development, as it indicates there is more collaboration between utilities and their regulators.”

Parkinson’s observation is bolstered by the finding that 69 percent of those surveyed think consumer advocates, direct marketers, regulators and utilities can work together to develop hedging programs; an increase from 42 percent surveyed at the 2004 RiskAdvisory Summit. And, in a year-over-year improvement, 48 percent of those surveyed this year think regulators are not qualified to set policies for utility hedging programs. This compares to 67 percent of respondents in 2004 who viewed regulators as categorically unqualified.

“Despite thinking that regulators are mostly unqualified to set policies about hedging, about 69 percent of attendees believe that utility commissions should pre-approve hedging plans,” Parkinson said. “This would seem to suggest that utilities are most concerned about avoiding regulatory risk.”

Survey respondents split nearly evenly over questions of the cost effectiveness of hearings on utilities’ actions to manage gas and fuel cost volatility. 35 percent found the process “cost effective,” 35 percent thought it “ineffective and too costly,” and 30 percent find it “costly but effective.” Last year, 60 percent believed the hearings to be ineffective and too costly.

Ninety-one percent think that jurisdictional commissions should authorize utilities to recover costs that utilities incur while hedging its fuel costs, compared to 85 percent in 2004. In both years, 81 percent of attendees believe regulators view hedging as risk management activity and only 19 percent think regulators view hedging as a speculative activity.

Most conference attendees see value in regulators, consumer groups and utilities having a nearly equal say in choosing the risk profile that utilities should employ to control gas and fuel cost volatility on consumer’s behalf. However, they assign the utility some extra decision-making authority over the actual program that’s executed.

“In all fairness, these results are skewed toward the perspective of utility company representatives, 31 of whom participated in the survey,” Parkinson said. “Compared to last year, there is more confidence in hedging and the ability to agree on a suitable program between the different stakeholders. Nonetheless, there’s still work to be done in developing a more progressive policy process for North American utility industry stakeholders.”

Parkinson added that the Summits have been held because over the past two decades there have been numerous regulatory hearings in North America that have examined the merits of utility hedging programs and the methods that can be used to shield ratepayers from undesirable commodity volatility. Yet there is currently no agreed upon methodology. Participants still struggle to develop an equitable approach that meets the needs of all stakeholders.

“Despite the ongoing exposure of North American utilities and their customers to severe energy price volatility, it is clear that there is still no standardization around the design and implementation of utility hedging programs from region to region,” Parkinson said. “These results are consistent with our supposition that the industry won’t be able to escape a continuing cycle of disappointment and frustration without some sort of process that is more forward looking and prescriptive than the hindsight review processes that are common today.”

Other findings include:

- All 31 utility delegates said their company use hedges, and 70 percent will hedge more (47 percent) or the same amount (23 percent) next year.
- 60 percent employ mechanistic hedging techniques, 10 percent employ price-view hedging, and 28 percent employ some combination of both methods.
- 30 percent have hedging programs whose maximum permitted term is 1-2 years and another 27 percent have programs of six months to one year. Twenty-four percent have maximum permitted terms of 2-3 years and another 19 percent have terms of 3-plus years.
- 58 percent use fixed price purchases as the most common hedging instrument in their risk management program, while 22 percent use a balanced mix of fixed price, outright call purchases and zero premium collars.

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