

# Small Gas Buyers Work To Mitigate Price Increases



By Dr. Jack Mason, President, EnergyWindow, Inc.

**A**s natural gas prices have more than doubled — from \$3-\$4 per MMBtu to \$6-\$8 per MMBtu in the last two years — businesses relying on natural gas to power or heat their operations are struggling with increasing operating costs. Large companies with significant buying power have had less trouble gaining the attention of suppliers - and corresponding access to competitive pricing for natural gas. But many national companies with large numbers of smaller facilities have not been as fortunate. Because of the relatively small consumption per individual facility, these companies typically are not on a supplier's radar. This may represent a missed opportunity for natural gas suppliers to serve a previously inaccessible market need.

Together, these smaller businesses form a substantial pool of energy needs that merit a closer look from energy suppliers, particularly since many of these customers are high-quality, highly qualified prospects with excellent credit ratings.

Pooling — or aggregation buying — offers significant opportunities both for natural gas suppliers and buyers. It is just a question of how to do it, so that both parties truly benefit, and the associated costs of business development for the supplier and procurement for the buyer are manageable.

## Limitation Of Aggregation

Traditional aggregation purchasing has serious limitations. There's no question that an aggregation purchase pools buyers and typically results in better pricing for participants. The disadvantage to this approach is that every participant must accept the same price and terms. Those terms don't always fit with each company's financial model and individual needs. Quite often, the traditional aggregation buying model means some participants get better prices than others because of contract structure, consumption magnitude and profile.

This is where innovation that stems from necessity — or sheer frustration — comes into play. Why pursue a pooling, or aggregation, buying model that carries serious disadvantages? Why not develop a new model for aggregation buying that provides both flexibility and the benefits of aggregation purchases without the limitations?

## New Market

Now, there is a new market for suppliers composed of companies with hundreds or thousands of small facilities. The whole idea of a new collective purchasing model came to fruition because of the large number of inquiries from companies that fit this description. Individually, their facilities had relative-

ly low gas consumption and therefore, relatively little buying power. But it became clear that pooling the needs of these smaller energy users resulted in a gas purchase large enough to capture suppliers' interest and make pursuit of these customers economically feasible.

## PowerPurchase

To meet the needs of this new breed of customer, an energy purchasing model called PowerPurchase™ emerged. It offers the benefits of aggregation buying combined with the control and flexibility of an individual, direct buy — and the freedom to structure contracts with terms and pricing suitable for each company. The ultimate goal was to leverage the collective purchasing power of chains with many small facilities and present a single request for bid for large amounts of natural gas.

The first PowerPurchase event was implemented in 2004. Results included the following:

- More than 15 companies (all national chains) opted to participate.
- Close to 3,000 requests for bid were prepared and offered to 47 energy suppliers in 35 utility territories and seven U.S. states in September 2004.
- Participants were presented with opportunities to save more than \$2 million on more than 1.5 Bcf of natural gas, valued at more than \$10 million.

## Online Procurement

Online energy procurement is the key to the success of this new, hybrid, natural gas aggregation purchase. Online energy procurement technology not only speeds the process of building requests for quotation (which can involve gathering and providing to bidders more than 50 data elements per facility), but it also speeds the auction process and provides an easy, apples-to-apples comparison of offers from competitive suppliers. If done manually, this process would require a number of weeks to implement.

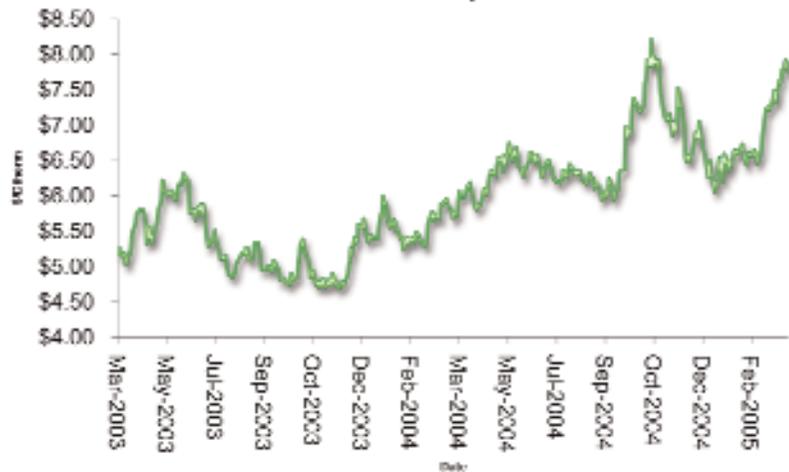
However, specialized energy procurement technology tools can:

- Streamline the process of gathering the data one needs for the bid,
- Organize and present it in various formats to suppliers,
- Minimize the effort and time spent by suppliers to obtain and analyze it,
- Set clear, easy-to-use decision guidelines for buyers, and
- Minimize the time required by supplier and buyer to submit and evaluate bids.

Automatic, or proxy, bidding can reduce the time spent by suppliers in submitting and managing bids. The use of maximum and reserve prices for the bidding can reduce the time buyers must spend managing the bidding. In this way, suppliers instantly can determine the buyer's approximate price expectations.

In addition, the understanding is that, unless the winning bid is below the reserve bid, buyers are not required to negotiate with the winning supplier. This provides buyers with some

NYMEX Henry Hub Natural Gas Futures  
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assurance that they will get competitive bids that provide at least a minimum economic benefit without tipping their hands. These features, along with email notices of bidding activity, mean that neither suppliers nor buyers need spend significant amounts of time submitting and observing bidding. The result is lower total procurement and business development costs, in aggregate and per account.

### Pricing Analysis

One important question for many small, commercial business gas customers is on what to base the decision to accept the lowest bid that most conforms to your stated requirements, and how to have reasonable confidence that acceptance will yield savings compared to what they would pay for default service from the local distribution company (LDC). The greatest fear, for many of these more risk-averse buyers, is to be "second guessed" by their bosses, regarding their buying decisions.

In this approach, indexed pricing, which parallels the LDC default price, which, in turn, is set monthly or quarterly in most states, can provide buyers with some level of confidence that their decision will be justified. To do this, first obtain historical monthly default gas supply prices (typically available on the LDC or public utility commission Web site). Then, calculate the monthly difference between those prices and the appropriate index (most often, NYMEX Henry Hub settle price). Then, calculate the expected value (mean) and standard deviation for those differences over a period of one or two years (exact multiples of 12 months to account for cyclical effects).

Finally, apply an appropriate statistical distribution to determine the implied basis (in this case, an all-inclusive adder) value at which an indexed price is likely to produce savings relative to the default price. The buyer then can set the maximum, or starting price, at a level at which expected savings start to accrue, and set the reserve price at a level that will yield sufficient expected savings and with a sufficient confidence level that savings will be positive in any given month. This provides a reasonable threshold for the buyer to determine when to take the competitive deal, or when you should stick with the default LDC service.

This analysis also provides suppliers with a simple model for determining in which markets they can achieve adequate margin, while providing value to buyers.

### Challenges

One challenge was the length of time required for many of the first participants using the PowerPurchase approach to review and negotiate contracts with winning suppliers. Because the bidding was conducted on a day in early September 2004, the impact of Hurricane Ivan on prices beginning in mid-September exacerbated this effect. Many buyers had limited experience with gas contracts and no in-house standard gas contracts.

As a result, buyers missed savings and suppliers missed revenue in three ways: 1) the value lost during the period of negotiation, 2) the value never released because some deals never closed, and 3) the opportu-

nity to "trigger" (a customary option in indexed price deals) fixed lower prices during a period in early September 2004 when prices were relatively low.

However, a solution is available. The North American Energy Standards Board (NAESB) standard gas contract is generally acceptable to most suppliers for retail transactions. By asking new gas buyers' legal departments to review and accept this standard in advance of the first time used can further reduce the procurement effort, cost, lost savings and lost revenue in subsequent natural gas procurement events. And the several options available within the standard contract still allow some flexibility of terms for buyers.

### Summary

While current natural gas market conditions are causing frustration and rising operating costs for America's businesses, it has been the catalyst for businesses to seek out options for better natural gas pricing, has encouraged the development of innovative and more efficient energy procurement models and produced potential new expanded markets for natural gas suppliers and marketers. **PE&GJ**

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