Long Term Fixed Price Contracts:
Are They Really The Best Option for Cities?

Texas Coalition
for Affordable Power

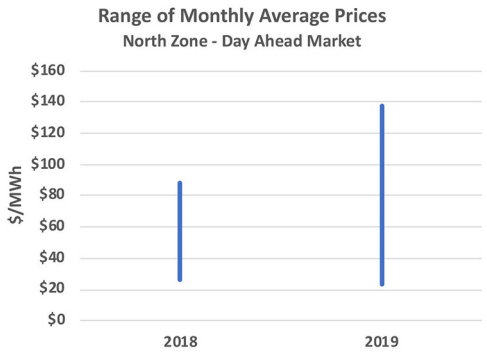
Over the past few years TCAP has seen a number of political subdivisions secure their future electricity needs using a long-term fixed price contract. These purchasing decisions are often times based on the rationalization that the price being offered under the new contract is cheaper than the price being paid under the current contract. Since the new contract is cheaper they will lock that new price down for as long as possible. But is that really the best available option moving forward? Let's start this discussion by taking a quick look at City goals for electricity procurement as well as the goals of energy sellers, both REPs and brokers. Each party's goals can be similar in some ways, and very different in others. These differences can result in cities unintentionally spending more for electricity than they thought.

CITIES

Cities are very budget conscious and typically have the primary goals of cost certainty, good customer service and a competitive energy price. Cities need cost certainty for future budgeting needs. Cities do not want to explain to their citizens why they are paying more for energy supplies than is necessary. But, comparing the price of power for a new future contract against the price of power they are paying today is a false comparison at best. While securing a lower price is a good effort from a city budgeting perspective, it is not the best measure to use for choosing a new supplier contract. What the city was paying is not nearly as important as what price is currently available to the city. And comparing price includes consideration of all costs to serve, not just the base price per kWh. Finally, customer service must be a consideration.

Cities regularly rely on an RFP process to procure energy. However, energy procurement is unlike other commodities purchased by cities, such as police cars or office supplies. The Texas electric market is unique and pricing changes daily, sometimes on a very substantial basis. As the graphic shows, the price of power in ERCOT can vary wildly over the course of a year. The timing of when energy is procured is just as important as what is being procured and for how long. For all of these reasons, and more, the legislature was wise to exempt energy procurement from the RFP process requirement for cities.

Beyond price, providing electricity to a city also involves an important service component. Billing, working with the seller to add, delete or change service, or getting a problem reported for repair are all included in this service component. Accepting poor service to achieve a low energy price is hardly a bargain. And a long-term contract with poor customer service can seem like an eternity. TCAP has also noticed that cities often pay more for electric contract features and services that are often not needed. One easy example here is paying more to achieve a wide usage bandwidth in the contract. The bandwidth is the range of usage over which a contract price will hold. Usage above or below this bandwidth will typically be at a market-based price. Cities often pay more for wide bandwidth contracts when, in reality, most cities usage does not vary that much from year to year. Why pay more for a service you do not need?



Finally, cities also prefer stable contract relationships versus having to constantly change suppliers and establish new service and billing relationships. In summary, cities need to balance stable service needs with competitive price needs.

SUPPLIERS

Energy Sellers, REPs or Brokers, are focused on securing long-term revenue streams with stable margins. Their preference is to have customers contract with them for as long as possible. The risk to REPs in this approach is that long term fixed price agreements also lead to long term fixed margins. And operating costs change over time, mostly increasing. This puts pressure on REPs to keep internal costs as low as possible. Since employee costs can be substantial contributor to operating costs it can be a area often looked to in controlling these costs. Sellers often use outsourcing to avoid hiring employees and control internal costs. It is important to note that an overzealous desire to control costs can result in a reduced attention to customer service.

Brokers are a common way used to outsource marketing a REP's products, since the broker is typically paid on a commission basis from the REP versus the fixed salary costs of an employee. The commission is typically paid on a per kwh of usage basis that is hidden in the energy price as well as any additional broker fees that may be added for additional services provided to a city. So brokers, like REPs, have a natural incentive to see the buyer sign up for as long a term as possible, maintaining their commission payments well into the future. Finally, it is important to note that brokers will typically only show the buyer offers from REPs they have a brokering relationship with. So, while a broker may say they will find the lowest price, what the buyer really sees is the lowest price from the parties they get paid to market on behalf of.

There is no substitute for knowledge and cities should learn all they can about how the ERCOT electric market works, the various parties involved in the market, including their motivations, as well as the various terms and conditions of electric service contracts and what they mean. If this is not possible, the city should find someone who can help them in this area and who maintains a fiduciary type relationship with the city, concerned primarily in satisfying the best interests of the city.

LESSONS FOR CITIES LEARNED FROM TCAP'S LAST PROCUREMENT

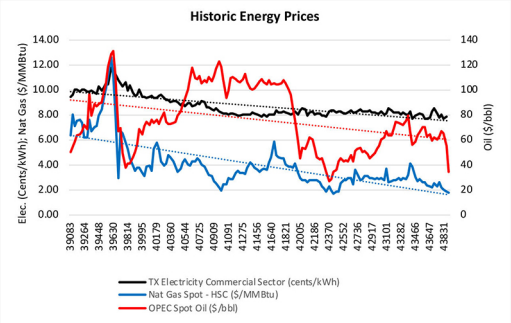
During TCAP's last renewal a number of contract terms were considered. Starting with a three-year fixed price, TCAP observed the following pricing options:

Contract Term	Price Increase over Lowest Price Option
3 Years	0.0%
5 Years	+3.5%
7 Years	+10.8%
9+ Years	+17.2%

TCAP determined that the adding of 3.5% to the contract price to capture that favorable price for an additional two years was a prudent move. Paying almost an additional 11% to capture an additional four years was a lot riskier. If prices

rose significantly, fine. But if prices were stable or fell over the term, these contract prices would not look so favorable. And adding over 17% to go out to nine years was riskier still. A few TCAP members decided they would rather pay the additional premium to lock-in a longer term and left TCAP to sign up for terms from seven to over 9 years. As it turns out, market prices for these far-out years actually fell and these former members now find they are in a long-term fixed price contract that in many cases is significantly higher than market prices. And they will be in that contract for many years to come.

ENERGY MARKETS HAVE BEEN CHANGING

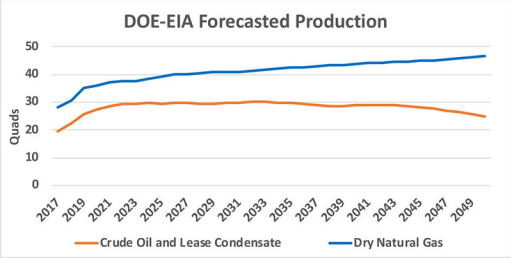


In order to contract effectively the buyer should have a reasonable grasp on where energy markets have been and where they appear to be heading. With the advent of fracking for oil and gas wells, the entire energy market structure changed. The United States has moved from a net energy importer to the largest producer of oil and natural gas in the world. As the graphic shows, since fracking activity exploded in 2008, the prices of oil, natural gas, and electricity have all been trending down.

But what does the future hold? While none of us know with certainty where future markets will go, The Department of Energy predicts continued high production of both oil and natural gas out through the end of their current forecast period of 2050.

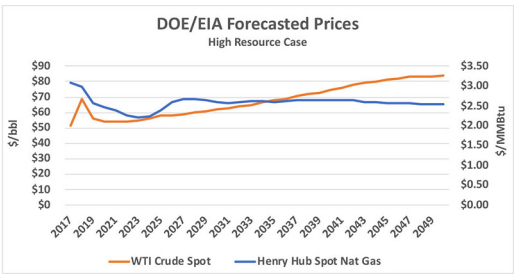
Plentiful supplies, both domestically and internationally, will serve to keep prices stable and low for both oil and natural gas. Nationally, these trends are also expected to keep electric prices stable to slightly declining.

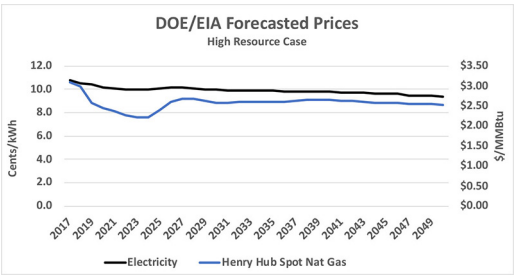
Nationally, our energy future looks very positive. A strong supply outlook should serve to support low stable energy prices for years to come.



Traditionally, electric prices in Texas have tracked natural gas prices. This is due in part to an abundance of natural gas supplies in Texas making it a primary fuel source of generators in the state. This is changing somewhat as Texas has invested heavily in intermittant renewable generation, mainly wind powered generation to date, but now including an increasing solar component.

Much like the nation, Texas electric prices in the ERCOT market have also been trending down in the past few years. There has been some recent upward price volatility, mainly a reaction to a large amount of coal fired generation being removed from the system with little advance notice. This removed much of the spare generation capability the system needs to serve customers in high demand situations. But the market has been replacing this lost generation capability and expects to be back to comfortable levels of excess generation reserves by 2021. This should help dampen the recently experienced upward price volatility moving forward and restore the stable low pricing conditions the market enjoyed prior to these generators leaving the grid.





In addition, new technologies continue to bring new opportunities to the electric market and batteries are now gaining traction in the ERCOT grid. With their ability to store energy during times of lower demand and release it during times of higher demand, batteries should also help serve to smooth both peak

demand needs and price volatility as they become more prevelant on the future grid.

Downward trending energy prices in fossil fuels and electricity should continue moving forward, a positive situation for energy end users.

CONTRACTING FOR RETAIL ENERGY

So what does all of this mean for contracting for energy supplies? First be aware that there are risks in any procurement approach. While there is often a desire for a known price, the spot market has traditionally been the cheapest market for electricity in ERCOT over time. But, with wholesale prices that can trade up to $9.00/kWh, short term price volatility can be a budget killer. So many end users opt for a more stable energy price. But for how long? Future market fear can push many buyers to sign long term fixed price agreements, which could end up costing the buyer more money and being in a contract that is far above the current prices. The point to remember is that all approaches and options carry risk. Some are bad for the buyer if future prices increase and some are bad for the buyer if future prices decrease. But one thing is always true. The longer into the future you make a decision to fix your energy price, the risker that decision becomes.

So what should cities do? Let's start by taking a quick review of the benefits and risks of differing approaches.

LONG-TERM FIXED PRICE CONTRACT

A long term fixed price contract has two primary potential benefits. One is future price certainty. There is no certainty that a fixed price that looks attractive today will be market competitive or even a reasonably acceptable price in later years. Second is future supplier certainty. Not having to set up a new supplier and learn how to interact with that supplier to perform routine functions such as outage control, setting up new accounts, etc. is certainly a positive.

The risks of a long term fixed price contract are that the price to secure pricing far into the future may be significantly higher than future market prices available to the buyer. Secondly, future customer service may suffer due to the contract or company being sold to a new company, the contract being assigned to a new party or the company ceasing to exist.

SHORT-TERM, SPOT-MARKET-PRICED CONTRACT

A spot market based priced contract also has benefits and risks. On the benefits side, as noted earlier, the spot market, averaged over time, has shown to be the cheapest way to procure energy in the ERCOT market. But market prices in ERCOT change every fifteen minutes and can swing wildly based on a number of market conditions. Prices in ERCOT, which have typically been under $0.05/kWh for a fixed price contract the past few years, can rise up to $9.00/kWh duing the right combination of peak demand and supply scarcity conditions. That's an 18,000% increase from the fixed price contract. Even a short period of time, say under 3%, at these prices can easily triple a typcial electric bill for a month. That being said, a scenario like this rarely occurs, but it can happen, and did in some areas of Texas in 2019. Smaller forms of price volatility do occur often, making budget planning under a spot market based contract difficult at best. Unless a buyer has a very large cash reserve a pure spot market contract may not be their best option.

BALANCING NEEDS

At one extreme end of the contracting spectrum is a pure long term fixed price contract that offers the maximum amount of price stability. However, it can often be more expensive than other options and offers little to no flexibility to take advantage of emerging price opportunities that could save the buyer lots of money. At the other extreme end are pure spot market priced contracts that, when averaged over time, have been shown to be the cheapest way to purchase energy, but expose the buyer to potential wild swings in energy prices from month to month, making stable budgeting difficult to impossible.

Cities need to find the balance betweeen these two extremes that best fits their need for some degree of price security and need to maintain a market

advantageous price. Additionally, Cities need to learn the workings of the Texas competitive electric market, and adopt procurement strategies that afford the best opportunities to capture competitive pricing. Cities also need to secure market advantageous contract terms and conditions, and maximize the chances of executing a favorable contract that provides excellent service and allows the City to take advantage of market opportuntities. As mentioned earlier, this becomes a burdensome process under the traditional RFP process.

Cities also need to devote time to review the contract for service offered by suppliers. These contracts can vary significantly in their terms and conditions and there may be provisions in a contract that can result in additional costs to buyers that may not exist in other contracts. A careful review and comparison of contracts can avoid future service problems or additional costs.

TCAP HELPS FIND THE BALANCE

TCAP has always been an innovator in strategic procurements in the Texas competitive electric market by providing competitive pricing with favorable contract terms. TCAP has been looking at the how the abundant supplies of energy that have discovered in the past few years have impacted the future outlook for energy in both Texas and the United States, and the contracting practices of cities not within TCAP. We have been using our findings to develop a new approach to energy purchasing designed to meet the unique needs of cities and political subdivisions.

TCAP's had developed an new innovative approach for energy procurement we call the SHP program which we are offering to members for our next renewal. The TCAP SHP program provides a city a known fixed price prior to budgeting required for a new fiscal year. The program is designed to meet the service needs of cities while providing secure power supplies at a more competitive price, maintain the flexibility to take advantage of emerging favorable pricing opportunities while avoiding the risks and additional costs associated with long-term fixed price contracts. Our analysis shows the new program can unlock even greater savings opportunities for cities while maintaining fiscal year budget stability and providing superior customer service.

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Bill Starnes, partner at ReSolved Energy, is TCAP's resident expert on Texas' unique electricity market. Bill is responsible for TCAP's electricity procurement strategy and management, market analysis, and is the author of multiple position and white papers on the topic.