ENERGY AND COMMODITIES

THE CHANGING LANDSCAPE FOR U.S. UTILITY MARKET PARTICIPANTS
Introduction

For participants in the U.S. utility space, it goes without saying that the landscape for competitive, or non-regulated, utility markets is in transition. How rapidly the change is taking place is debatable, but everyone from generators to retail vendors are evaluating their business models in order to ensure the appropriate strategies, assets and business processes are in place to survive, and thrive, in the coming years.

This paper will touch on challenges facing non-regulated utilities in the U.S., with a special emphasis on retail service providers that may be facing considerable challenges in preparing for business process change, enacting systems to support new and enhanced operations, and perhaps ultimately preparing for significant changes such as mergers and acquisitions.

Key areas discussed include data and operational risk, counterparty risk, commodity risk and operational efficiency.

The transitioning market

For U.S. utility market participants, the competitive landscape for non-regulated entities and retail service providers is evolving rapidly, from new market conditions that demand product and service innovations to evolving business models that involve enhanced operational systems.

The overall U.S. utility business model is changing from one of large, centralized generators that own and operate entire power systems, ranging from generation plants, to transmission and distribution systems, to a business model involving more distributed generation and more vendors offering innovative products and services.

How decentralized the industry has become can be derived from the fact that out of the roughly 3,200 power utilities in the U.S., only a small fraction of that number is still vertically integrated to include generation, transmission and distribution. Additionally, while the major investor owned utilities, or IOUs, do own generation, transmission and distribution, very few of the publicly owned utilities, or POUs, own their proprietary generation or transmission. In fact, over the last decade, the number of investor-owned utility companies in the U.S. has dropped from about 70 to roughly 50, and the trend is expected to continue. By the end of this decade, industry analysts predict that the number of investor owned utilities will shrink to a group of less than 40 companies.

Driving this transitioning market is a variety of factors, both technological and financial. From a technological perspective, the falling cost of deploying distributed generation is seen as one of the potential key game-changers in the market. A relatively new abundance of fuels such as natural gas are helping drive distributed generation at an increasing pace. Financially, the low price of natural gas, a somewhat sluggish economy and growing regulatory compliance concerns are factors that affect both providers and consumers alike.

A perspective on the challenges utility market players face and the opportunities that stem from better risk management, smarter operations and more efficient business processes.
One of the more debated challenges that utilities now face is dealing with demand-response technologies and programs along with curtailment service providers, or CSPs. These technologies and providers offer programs that let customers reduce their power consumption at peak times in return for lower electricity rates. Some customers operating under demand response programs will voluntarily reduce their power consumption when the utility requests them to in order to help the utility reduce their peak load demand. Some customers that work with a curtailment service provider may cut their power usage when advised by their CSP in order to reduce their overall power costs. While demand response is just one of the reasons why power consumption is decreasing overall, the result is that utilities don’t profit on peak power generation.

One item that’s not being debated is while the various challenges facing the utility industry may have different implications, they all adversely impact utility companies’ revenues, investor returns and even a company’s credit quality, which can adversely affect the cost and availability of capital that utilities desperately need for new infrastructure.

**Challenges for retail energy service providers**

The challenges facing these competitive market investor-owned utilities also indicate that the accelerating consolidation we’ve seen in the retail power market over the last few years will continue. Traditional public utilities and large independent retail suppliers continue to look for ways to expand their retail customer base. At the same time, smaller independent providers are looking for ways to grow via investor capital infusion, mergers or even seeking buyers to acquire them. Today, there are still over one hundred retail energy providers in the competitive deregulated markets, so indications point towards much more activity around retail consolidation.

Still, the retail power market is viable and growing. Today, about twenty percent of the U.S. utility power market is provided by a retail electricity supply, and that number is growing by about two percent each year. While there are roughly a few hundred retail suppliers in the market today, about half of the retail electricity market is owned by fewer players than can be counted on one hand, such as Direct Energy, TXU Energy, Reliant Energy and Just Energy, and those big retailers are in the process of picking up the smaller players.

The retail market today arguably has too many players competing in it, with more than 200 utility retailers across the U.S., and over half of those in Texas alone. About one quarter of the players now have revenues in excess of $100 million. Consolidation of retail marketing is being driven by several factors such as the increasing need for capital investment brought on by regulations as well as a challenging economic environment. However, there is a finite amount of capital and resources available to smaller providers, so the potential to realize significant operational savings is a key factor as consolidation opportunities are evaluated and the industry is attracting the attention of both strategic and financial investors.
The next step for energy retailers
With little movement to deregulate new markets, energy retailers are differentiating their services to gain and retain customers in existing markets. Capacity and reliability are a constant concern, along with growing regulatory requirements, escalating costs, tightened credit and collateral requirements, exponential data growth and increasingly sophisticated markets.

In this rapidly transitioning market, retail power marketers are essentially faced with one of two options. Option one is to continue to grow organically in scale and footprint by expanding into more geographies and regions in a quest to acquire more retail customers. This will take valuable capital and may require investors, as in order to invest in the systems they will need to institute proper controls to be more efficient.

Perhaps even more important, these investments may be required to show the investors a business that is being run on sound business processes backed with appropriate systems for regulatory control, billing, risk management and more. The second option is to merge with similar retailers in other geographies, which in all reality involves one of the potential merger candidates buying the other one, or sell to a larger retailer.

The second option, much like the first, may also require the smaller retailer to adopt those same advanced processes and systems in order to satisfy potential buyers that they are buying a viable entity with robust, well-managed business operations, and not just a raw customer base.

With those considerations in mind, let’s take a deeper look at the processes and systems that can significantly enhance a retailer’s ability to grow, as well as ensure they possess the underlying structures investors look for.

Risk management
Arguably all risk management can be tied back to a company’s data management and the associated operating risk. As noted earlier, not only are systems with processes and controls that can be validated critical to the growth of a company, but in the case of the utility consolidation trend, these are also critical as investors peel back the covers on a company’s viability and integrity.

Data integrity is a central theme in data management, and the lack of it automatically reduces the value of an organization. Additionally, as companies look for investors and potential acquisition partners, the ability to show that the company is operating on a credible, and valuable industry accepted system that provides security and controls, can be key in obtaining investor confidence. It goes without saying that a company operating on spreadsheets and email may be cast in a poor light in terms of worthiness for investment.

In the case of utility companies, centralized systems of record are a necessity not only to improve operational efficiency, but especially needed to provide "one version of the truth" in the data integrity for overall controls, on security, reporting and audit through the entire lifecycle of critical data elements such as contracts and deals. Centralized systems of record provide considerably easier information management enforcement while at the same time provide economies of scale for infrastructure. When required, change management can be more easily managed in these types of systems, and business processes across departments or units can be more easily automated.

Data integrity and operational risk
There are several key elements in considering the value and need for quality operational risk and data integrity as it pertains to the retail utility provider, and perhaps the most critical is the “full-deal lifecycle” concept, or in other words, the ability to track deals and any changes or edits throughout the entire lifecycle. Arguably, this is one of the most key concepts in auditable data integrity. From the initial inception of a contract all the way through invoice and cash, the ability to monitor deal obligations throughout the deal lifecycle is of immense value. Not only is the ability to have an auditable, integrated stream of data crucial for integrity, there is considerable value in being able to do pro-active analysis such as data mining to be able to understand the forward needs of your customer base. For example, knowing how much power certain clients use in certain periods and how much natural gas certain clients consume can be extraordinarily important in developing gains in operational efficiency.

How do investors evaluate the operational efficiency and data integrity of a company? There are several red flags investors look for that can be indicators of poorly managed business processes, and ultimately bad data integrity.

A perspective on the challenges utility market players face and the opportunities that stem from better risk management, smarter operations and more efficient business processes.
High A/R, or accounts receivable, balances may indicate issues with counterparty credit management and billing issues (see Counterparty Risk). Abnormally high fees from penalties can indicate issues with timely reporting to regulatory agencies. An ongoing record of spikes in supply price may be an indication that the company is not managing its supply risk appropriately. Also, high turnover, short retention or high cycle-through of customers can be indications that customer management systems are inadequate, causing incorrect invoicing, missing data to back up charge calculations and more.

**Counterparty risk**

Counterparty credit worthiness and the associated credit risk they bring is an ever-increasing problem for retail energy providers. When economies are down and in turmoil, it’s becoming increasingly important for companies to be able to effectively manage acceptable levels of credit risk and terms of payments with their customers. Without the appropriate tools to effectively perform credit monitoring, analysis and reporting, it becomes inordinately difficult for companies to manage current and future exposure, bad debt expense and efficient cash flow.

When evaluating business processes and systems to support counterparty risk, several functional areas are key to ensuring effective counterparty management. The most basic requirement is the ability to maintain collateral positions with the counterparties receiving credit. Through that process, credit managers can determine and maintain the payment terms for each counterparty, manage the allocation of credit and executed collateral, and ultimately calculate and maintain probabilities of default and recovery rates.

With collateral position management in place, a company can also understand the current exposure to risk in the portfolio, including the sources of exposure, the concentration of exposure, and, if necessary, what mitigation strategies may be appropriate.

Beyond the more basic counterpart risk capabilities a system may offer, many companies choose to employee advanced portfolio analytics that provide the capability to manage actual and potential counterparty credit migration processes. The key benefits of such a system is that it can provide statistical simulation methods that calculate extremely valuable data such as Credit Value at Risk (Credit Var), the Potential Future Exposure (PFE) of a credit portfolio, and perhaps the most valuable piece of information in the form of expected and unexpected losses.

**Commodity risk**

As noted earlier in this analysis, energy price volatility is the mortal enemy of gas and electric utilities. Unmanaged risk in this area can be not only irksome to both clients and regulators in terms of unwanted price hikes, it can also mean potential failure of the retail enterprise as a whole (see sidebar: How unmanaged market risk caused the demise of smaller vendors in the retail market).

**HOW UNMANAGED MARKET RISK CAUSED THE DEMISE OF SMALLER VENDORS IN THE RETAIL MARKET**

The polar vortex that hammered the nation early in 2014 triggered a record consumption of natural gas and sent prices on an erratic ride.

While large retail suppliers may have the financial wherewithal to weather a storm like the polar vortex, many retail suppliers are considerably smaller, and their very existence can depend upon implementing rigorous risk management controls.

For some smaller suppliers, the polar vortex was a death sentence. In fact, just weeks after the polar vortex drove prices to record levels, a supplier announced that it would cease operations and no longer provide power to its residential and commercial clients.

While most power purchases for these suppliers may have been hedged, just enough were unhedged to cause the demise of some companies when wholesale prices spiked.

One small retailer recently noted that the company was too exposed on the wholesale energy market during the unprecedented polar vortex and saw price increases of 500 percent. The hedges in place weren’t enough, and ultimately the company did not have the financial resources to weather the enormous spot market prices.

Risk management in the utility industry, especially in the form of managing erratic and spiking power prices, is critical and requires judicious use of hedging strategies. Ultimately, for the suppliers with deep enough pockets to have weathered the storm of hugely inflated natural gas prices, the polar vortex has generated new interest in more robust risk management in terms of hedging.
In an effort to keep the collateral damage of price volatility to a minimum, utilities can typically engage a wide range of hedging instruments and strategies, either on established commodity exchanges or through over-the-counter markets, to assist with the management of potential volatility of their physical supply, and subsequent price spikes.

While price spikes can happen due to a variety of supply disruption, one of the more common events is weather, such as the extreme cold in the northern U.S. early in 2014, more commonly known as the Polar Vortex. By employing processes and systems that help manage commodity risk, energy retailers can better prepare for weather-related market volatility.

These systems can provide companies with the ability to forecast future demand and react quickly to unforeseen events like severe weather. By utilizing trade and usage information in a centralized system, historical data can analyzed to forecast future utility demand. It’s with this demand forecast data that a company can then develop various scenarios to stress demand versus supply and determine if they are within acceptable risk tolerances. If they determine they are not, then hedge strategies can be employed to offset the risk.

Given that weather can be a volatile force unto itself, energy retailers will need to continue to develop hedging strategies. However, using hedging for commodity risk management is not without risk itself in terms of regulatory risk. If a utility deems that hedging is necessary, then it goes without saying that governmental acts such as Dodd-Frank and CFTC trade oversight will require a company to ensure their trading and risk management capability is adequate.

More on regulatory risk concerning Dodd-Frank and utilities

Even though it’s been a few years since the enactment of Dodd-Frank, there continues to be some amount of uncertainty about how the act and the related CFTC-implementing regulations affect retail electric utilities. Given this, retail utilities still need to maintain constant supervision on certain specific retail utility transactions.

The CFTC has issued several rules and interpretive guidance notifications that clarify the extent to which it will regulate the activities of electric and natural gas utilities. For the most part, retail utilities can rely on a variety of exemptions and no-action determinations to avoid the full regulatory burdens of Dodd-Frank.

However, the CFTC’s general anti-fraud and anti-manipulation authority, and similar prohibitions under Dodd-Frank, continues to apply. This especially should be noted as exemptions that apply to retail utilities typically require review on a case-by-case basis as they are determined by the facts and circumstances of each transaction.

While the applicability and nuances of Dodd-Frank and CFTC oversight is complex with regard to utilities, it typically boils down to how utilities use financial tools to hedge risks associated with providing retail service. In other words, many utilities use financial instruments to mitigate the price volatility of the commodities needed to provide service. Given that these financial instruments include exchange traded futures contracts and energy derivatives, it is imperative that appropriate systems are in place to manage that risk.

Operational efficiency

Thus far we’ve covered business critical items that can be deemed as foundationally important to the ongoing existence of an enterprise such as risk management around data integrity, operational risk and regulatory risk. Operational inefficiencies can impede the execution of business strategy and efforts to deliver greater customer value. Maintaining service levels becomes more difficult as businesses grow. Consequently, achieving transparency into critical performance data becomes extremely difficult. Like triaging a patient, items such as these may need to be addressed perhaps to ensure the very life of a business.

However, going beyond mere survival, for an enterprise to grow and thrive in a competitive environment, gains in operational efficiency are paramount for cost savings and obtaining additional revenue from every corner of the organization. Without a doubt, some of the most significant gains in operational efficiency can be obtained from improving cumbersome, antiquated business processes, many times run on spreadsheets and email, with intelligent, automated systems that allow companies to leverage data they already have.

It’s been estimated that well over eighty percent of firms use spreadsheets for various forms of planning, budgeting and forecasting. This problem is exacerbated by the fact that those functions may be pulling data from spreadsheet-oriented day-to-day financial business processes. Errors aside, the amount of time spent on manual data gathering and combining data from disparate systems and spreadsheets can be inordinately excessive. The lack of an automated process that streamlines and centralizes financial processes is not only risky; it greatly hinders the ability to make forward-thinking decisions based on real-time financial data.

When companies are evaluating how best to improve their operational data efficiency, a key phrase comes into play that can significantly help in deciding how and where to concentrate their efforts.

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Business process management

Business process management, or BPM, is essentially a management discipline that focuses on improving corporate performance by managing and optimizing a company's business processes. Sometimes also called process optimization, it is an effort to analyze and design business workflows that integrate people, data, systems and networks in order to gain efficiency wherever possible, while at the same time supporting those critical risk management items.

In the retail power vendor market, companies utilize business process management to meet key business objectives such as improving customer service to retain and attract customers, execute new products and services, standardize business processes across multiple business areas, and reduce the amount of manual work being expended to improve cost effectiveness.

Conclusion

Perhaps the greatest value of centralized, integrated and optimized business process systems such as Aligne is the ability to provide an enterprise with an overall integrated management solution one that provides a complete holistic approach across strategic, operational, regulatory and financial functions.

The value of business process solutions such as this lie in their ability to integrate corporate systems such as deal capture, contracts administration, risk management, as well as back office accounting systems. Visibility and reporting of critical data for day-to-day financial analysis including a wide variety of additional risk exposure analysis is extremely valuable and necessary to comply with regulatory agencies and to provide timely reporting of financial data. The ability to greatly enhance the overall risk management functions of an enterprise is becoming an imperative for retail utility vendors in these transitional markets.
About FIS’ Solutions for Energy

FIS’ energy solutions help energy companies, corporate hedgers, hedge funds and financial services firms to compete efficiently in global energy and commodities markets by streamlining and integrating the trading, risk management and operations of physical commodities and their associated financial instruments. Through real-time data, connectivity and analysis, FIS’ energy solutions help customers achieve transparency and regulatory compliance, address end-to-end transaction and operational lifecycles, and meet time-to-market needs with flexible deployment options.

About FIS

FIS is a global leader in financial services technology, with a focus on retail and institutional banking, payments, asset and wealth management, risk and compliance, consulting and outsourcing solutions. Through the depth and breadth of our solutions portfolio, global capabilities and domain expertise, FIS serves more than 20,000 clients in over 130 countries. Headquartered in Jacksonville, Florida, FIS employs more than 55,000 people worldwide and holds leadership positions in payment processing, financial software and banking solutions. Providing software, services and outsourcing of the technology that empowers the financial world, FIS is a Fortune 500 company and is a member of Standard & Poor’s 500® Index. For more information about FIS, visit www.fisglobal.com