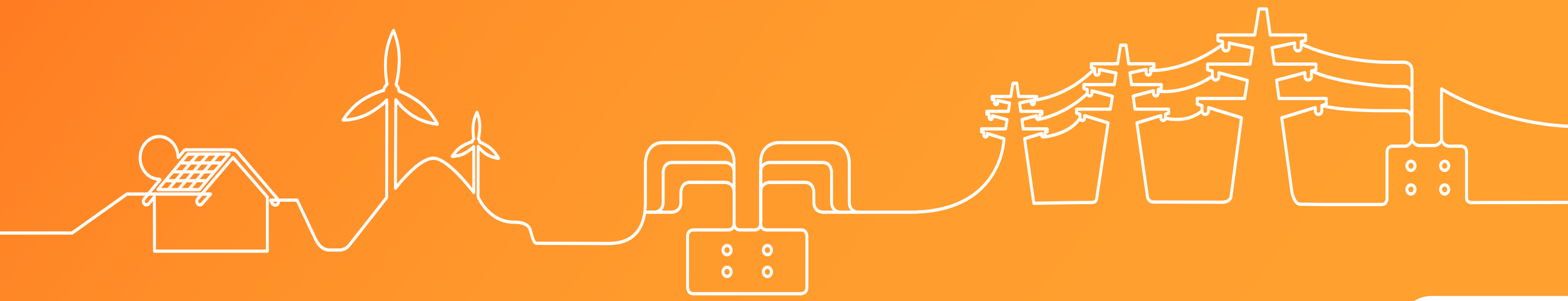
e-guide

Considerations for generator hedging strategies



EDF ENERGY

Considerations for developing hedging strategies

Without a conversation about your circumstances, it would be unwise to suggest a 'set menu' hedging strategy for your generation. However we can start helping you develop a hedging strategy for your generation by outlining some of the key factors to consider in discussions with PPA providers.

This guide provides a brief overview of some ways to set your budget, what may drive your approach to achieving that budget, and risks to consider hedging along the way.

1. Budgeting methodologies

The first thing to consider is the level of revenue you want to achieve and how that target is derived.

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Last year + X%

A basic but perhaps too simplistic method is to take the revenue you achieved last year and apply a multiplier that is acceptable to the company. This method is attractive because it's easy to apply and points to growth in earnings. However it may not reflect reality, especially considering the volatile nature of wholesale energy prices.

B

Operational output target

A more sensible approach is to consider the energy output the organisation is capable of achieving from its generation facilities. This is better if the target is based on a reasonable forecast that considers the factors that determine output such as maintenance schedules, fuel reliability, weather conditions, availability and costs.

C

Market reflective

This is a more difficult but robust method. You will need to consider the forecast output of your generation and a range of price forecasts for the energy market that, ideally, can be updated at certain points through the term of your contract.

2. Key drivers for your energy revenue

Related to your budgeting methodology is your company's preferred approach to realise its energy revenue. This range of options describes some common approaches.

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Budget certainty

The most important outcome is that there is a high degree of certainty about revenue you will derive from each unit or fixed block shape of your energy generation. This is likely your chief priority if your project is financed by a third party rather than internal enterprise funds. You may be concerned about protecting your business from a fall in wholesale energy prices to ensure repayments are met. The downside to protecting yourself from a downturn with a 'fixed price' option, is that you are likely to miss the upside of an upturn.

B

Market reflective

Your objective is to show the revenue achieved from your energy generation is reflective of the current energy market price. One reason this approach may be right for you is if your company also imports significant volumes of electricity on flexible rates. It can make sense to align the prices at which you buy and sell power. An indexed contract will provide a route to achieve this. You will need to be comfortable with the risks attached to variable revenues.

C

Optimise opportunities

Generally speaking, more experienced generators producing sizeable volumes of power are more likely to be actively involved in the market and selling their power. Defining a trading strategy and managing a contract that enables a flexible approach to selling power requires an adequate level of ongoing resources to support this approach and manage the risks involved.

3. Risks to consider hedging

Your style of managing your energy sales, whether active or less involved, will affect your hedging strategy. There are various ways to define your hedging strategy which include who you sell your power to, when you sell, and how much power you commit to selling.

A

Counterparty credit risk

What is the likelihood of the organisation(s) you sell to not keeping up their end of the bargain – paying you on time or paying you at all? You will need to consider how financially stable and credit worthy they are. Their track record in paying on time may be a more important consideration if your generation project is externally financed.

B

Energy price risk

When should you sell your power to achieve your revenue target? Should you sell your annual output in one go to achieve a defined price, or adopt a phased approach that enables you to optimise your revenue in a moving market? These decisions apply to your certificates as well as electricity output. For instance, you may choose to sell your ROCs for a fixed price agreed at the start of your PPA, or you could agree to sell them at a value based on the buyout price which is normally determined shortly before each compliance year. The market value of LECs is also variable, so choosing when you sell can affect the value you achieve. Another issue is which trading period or index to select. For instance, do you nominate day-ahead or month-ahead, and can you change your nomination should you decide to do so given market conditions under an active management style?

C

Volume or operational risk

With some PPAs you commit to producing certain amounts of power at certain times. There can be costs associated to not fulfilling those commitments if your plant suffers an outage - planned or unplanned. So a key consideration is your level of confidence that you will be able to meet your forecast output. For instance, biomass fuelled CHP plants face feedstock availability risk. They should assess how reliable the supply of their particular feedstock is and what may disrupt that supply. Once that is understood, they can assess how cost effectively their PPA will enable them to deal with planned and unplanned changes to their output.

Ready to talk?

Please get in touch if you would like to explore how different PPAs can support you hedging the risks relevant to your generation activities and revenue targets. You can call us on 0845 525 0029 or email us at export@edfenergy.com.

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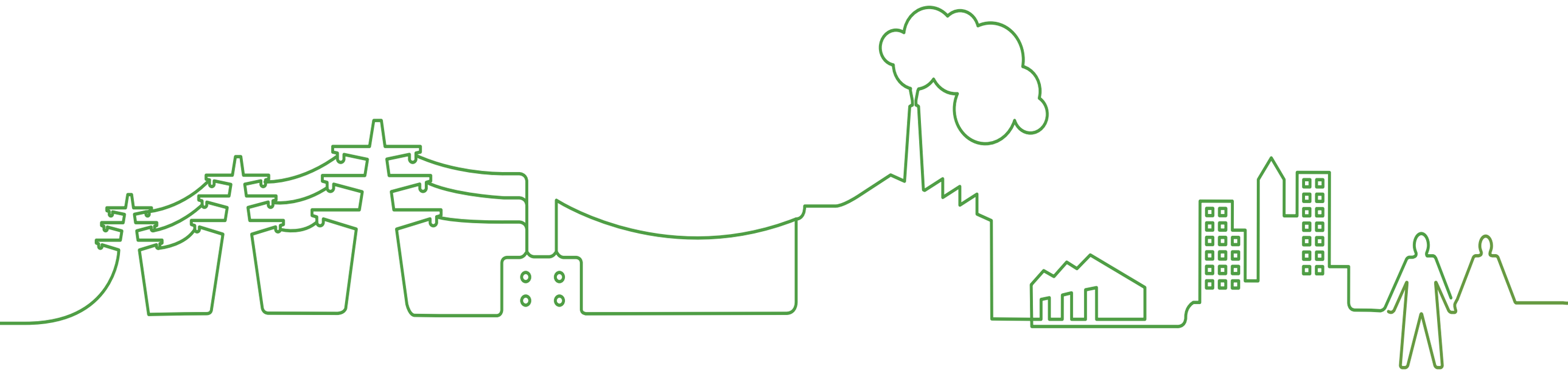

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