

Supplier Credit: A Precious Commodity

The financial strength and stability of a retail electricity supplier has tangible benefits for customers. Credit rating impacts at least two components of the relationship.

- 1) Default provisions and the obligation to pay the termination value of the contract in certain situations
- 2) Customer service and back office support

Termination Value

There are two outcomes if a retail supplier defaults. The customer realistically finds itself paying in one scenario, and is legally obligated to pay in the other.

In fair contracts, when a supplier defaults and the market goes up, the supplier must pay the termination value to the customer. In reality, a supplier who defaults is probably in such financial dire that the customer is one of many parties waiting for a settlement. The customer may be forced to purchase more expensive default/last resort service from its electric utility, purchase electricity directly from the spot market or enter into a more expensive contract with another supplier. In this situation, a customer has suffered economic harm as a direct result of a supplier's poor credit and inability to perform.

If a supplier defaults and the market goes down, the customer must pay the supplier the termination value of the contract. The logic behind this

language is that the supplier must unwind its hedging or supply agreements at an economic loss.

These obligations on the part of the two parties are common in most retail supply agreements, yet not always intuitive or commonly known.

The Rudden Energy Index is a leading source of financial information on utilities and energy companies, tracking 93 energy stocks. According to its Dec 2004 figures, 25% of these companies had credit ratings that were below investment grade. Companies with lower credit ratings have reduced negotiation strength in trading, could be inclined to take more risky positions, and ultimately suffer financially.

Customer Service

Lower collateral requirements enable investments in innovative products or back office systems that ultimately serve customers.

A supplier with good working capital can offer tiered products that deliver a price discount in one term, then recover the margin in a later term, helping customers meet an internal hurdle rate. Working capital can also be applied to build scalable front-mid-back office systems that facilitate



A supplier default can suddenly ruin what appears to be an advantageous electric supply contract.

timely and accurate changes to customers accounts, such as the addition or removal of meters.

Another sign of financial strength is an enrollment guarantee that keeps customers whole during transition periods should a site fail to be

Knowledge Is Power

In the new energy market, information is the most important commodity. Strong market knowledge and rigorous supplier qualifications will be an end user's first line of defense against the potential supply risks associated with energy.

Does the seller own or control any generating assets or gas production?

How big a player is the supplier in the market?

Will the supplier agree to liquidated damages for non-performance?

Does the supplier offer risk management services?

Is the supplier a player in all energy markets?

Is the supplier a good source of market knowledge?

Does the supplier offer both short and long term agreements?

Does the marketer have appropriate back-office capabilities?

Source: Purchasing, March 1999

During the next six to 12 months there remains considerable concern current market conditions are a precursor to a wave of consolidation that could see the number of retail suppliers reduced to 10 or so in the 16 deregulated states by 2011. Some argue that like the telecommunications and cell phone sectors...the retail electricity market will become more service oriented, rather than price driven.

MegaWatt Daily, 10/31/05

enrolled for any reason that is the fault of the new supplier.

Conclusion

A good electric supply contract outlines the following:

- Price, quantity and duration
- Provisions describing when the agreement may be terminated or modified by the parties

- What constitutes a default of either party's obligations under the agreement and what remedies will be available if either party defaults

However, a customer's ultimate security in an energy supply agreement could lie in the financial strength of the supplier.

Evaluating Small Private Suppliers

Small private companies have a high failure rate. In fact, about 90% fail within the first five years for reasons ranging from bad management to competition, poor timing, insufficient capital and incompetent execution.

Private companies aren't required to report their financial data, so it's much more difficult to separate fact from fiction. In fact, when you talk to the management of a private company, you'll usually hear lots of optimism, such as "We plan to go public in six months," "Business is booming," and "We'll land some major contracts." You need to be objective and find out as much as possible to make a smart decision.

Even though private companies don't file with the U.S. Securities and Exchange Commission, you can still get lots of useful information on the company. First, go to the company's Web site and look for the section usually called "About Us." Read the press releases. There's typically a

section called "In the News," which has links to recent stories written about the company.

Online resources:

Hoover'sOnline (www.hoovers.com)...a comprehensive database of private U.S. companies. A Hoover's private company profile will show officers, competition, market position, history, financial data and products and services.

Dun & Bradstreet (www.dnb.com)...a leading provider of background information on private companies that offers Business Background Reports.

You also can take the more traditional route and research the company in the business section of your local library, obtaining information from business directories, magazine articles, newspapers and other publications.

Source: *Bloomberg Press, 2001*

Credit Ratings: What It Means

A credit rating is an important measure of the financial health of a company. It gives an indication of performance in absolute terms. It also makes it possible to compare a company's credit worthiness against other companies in similar markets or industries worldwide. It gives an indication of how a company is expected to perform in the future and whether it is well placed to repay its debts and meet its overall financial obligations.

The Criteria

Standard & Poors credit ratings for Industrials and Utilities are based on the following criteria:

Business Risk

- Industry Characteristics
- Competitive Position
- Marketing
- Technology
- Efficiency
- Regulation

Management

Financial Risk

- Financial Characteristics
- Financial Policy
- Profitability
- Capital Structure
- Cash Flow Protection
- Financial Flexibility

For more information about credit ratings, visit:

<http://www2.standardandpoors.com/>

Standard and Poors Utilities Credit Ratings (Oct 25, 2005)

AEP	BBB
Ameren	BBB+
Centrica	A
ComEd	BBB+
Consolidated Edison	A
Constellation	BBB+
Entergy	BBB
First Energy	BBB
Great Plains	BBB
Reliant	B+
SUEZ	A-
TNP	BBB
TXU Corp	BBB-

Privately-held retail electricity providers are not rated. Representative companies include: Cirro Energy, 5 Point Power, Spark Energy, Just Energy, Tara Energy, and MPower Retail Energy

S&P Credit Rating Hierarchy

- Investment Grade
- AAA
- AA
- A
- BBB
- Non Investment Grade
- BB
- CCC
- CC
- C
- D