

## RISK MANAGEMENT AND HEDGING

To ensure the ultimate viability of any operation, one of your primary responsibilities is to protect against unsustainable cost increases and volatile pricing. When these cost and price-sensitive issues are related to natural gas, you can limit the impact on the company by hedging New York Mercantile Exchange (NYMEX) natural gas futures prices. You can think of hedging as something akin to car insurance. Car insurance helps you avoid the potential costs of a car accident; natural gas hedging helps you avoid the potential costs of gas price surges!

By hedging, companies enter into a transaction that fixes some or all of their future gas needs at a defined, set price. A hedge is essentially a forward purchase that locks in gas prices over an extended period. Remember though, a well planned and executed hedging strategy is not designed to beat the market, but more to smooth out market volatility over time and limit upside risk. A hedge program provides a high degree of certainty going forward about what you will be paying for your natural gas. It is no guarantee of savings against a volatile and often irrational market.

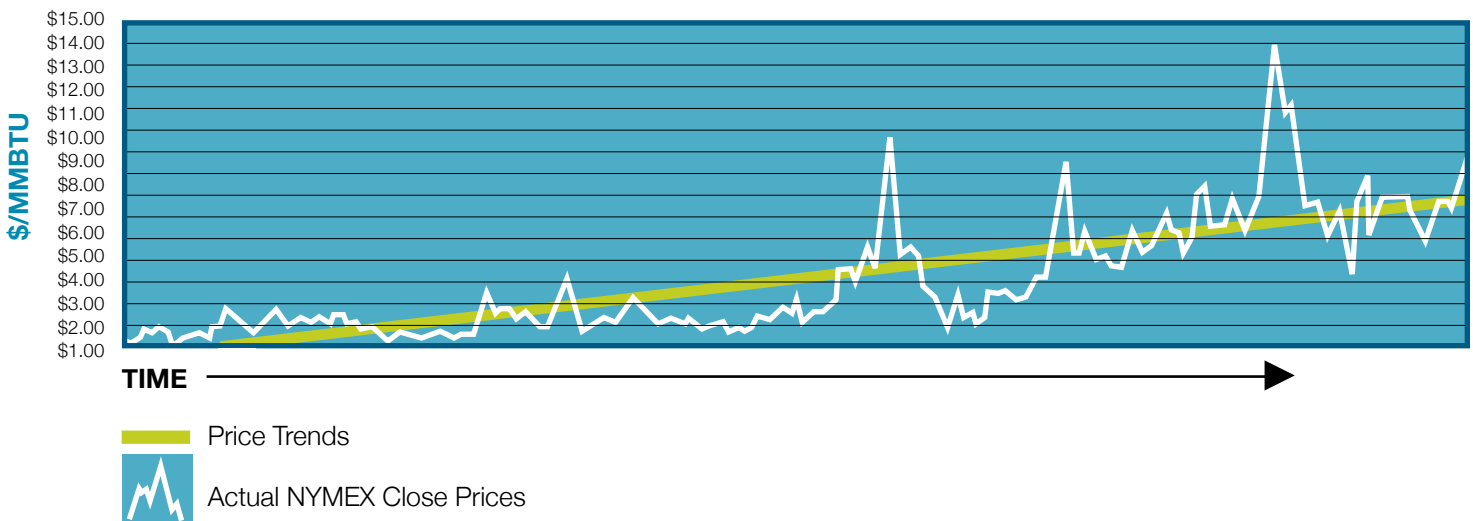
If you buy natural gas and you make no effort to fix prices, either whole or in part, then you have a profile that exhibits an unlimited appetite for risk. Prices can and have gone to historic levels if unchecked. Unhedged buyers are naturally "short" in the market; they have to buy at market prices. The market is dangerous to short buyers. Compare NYMEX historical prices to the trendline over the same period. Those sharp peaks over the years were built by unhedged, short buyers!

## WHY HEDGE?

There are varieties of reasons why companies may want to fix the price they pay for natural gas. Companies hedge in order to:

- **Manage risk:** Hedging, or fixing a price, provides the pricing certainty required by many companies and shields them from dangerous market price spikes.
- **Limit cost volatility:** Wildly varying month-to-month gas costs can wreak havoc on cash flows, budgets, and plans.
- **Adhere to budgets:** Fixing a price may allow you to lock in costs at or below a prescribed budget level.
- **Leverage a good buying opportunity:** A drop in the market may provide the chance to fix gas prices at a level you consider attractive.
- **Lock in a bargain (when forward prices are lower than today's):** Future months and years may be less expensive than the current market. Assuming continued historical price escalation of 8-10% annually, these future periods may prove to be huge bargains.
- **Stem the effects of inflation:** At the U.S. long-term inflation average of 3% annually, a price 5 years in the future effectively has a cost of roughly 14% less in today's dollars. Devaluing the current futures price may result in prices that are substantially below current near-term market.

NATURAL GAS PRICING TRENDS OVER RECENT YEARS



**HOW DO I PLAN A HEDGING STRATEGY?**

Crafting a well-designed strategic hedging program that reflects the needs of your company is easy with the help of EnergyUSA. We help you determine your overall risk profile as well as identify the program’s desired outcome. We then devise a strategy that meets your objectives while limiting your upside market risk. Answering these general questions establishes your risk profile:

1. What are you more afraid of—fixing prices and then watching prices fall, or not fixing prices and watching those prices increase?
2. How much time can you devote to energy risk management?
3. How big is energy’s share of your bottom line?
4. How much risk are you comfortable accepting?
5. What is your goal—meeting or beating your budget, last year’s actual, beating the market, beating the LDC’s sales rate, etc.?

Keep in mind that you **MUST** act and think differently in a Bear versus a Bull market.

**FREQUENTLY ASKED QUESTIONS**

**HOW DOES HEDGING ACTUALLY WORK?**

Once you have a strategy in place, hedges are filled according to what the market allows, within the guidelines of your strategy and plan. When a hedge order is filled, the market price is locked in at that point. You will receive a confirmation of the order with the price, volume, and term of the hedge.

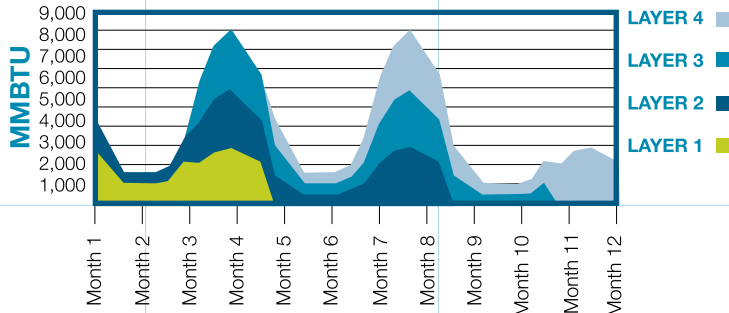
**HOW DO I PAY FOR THE HEDGED GAS?**

As a customer, you do not pay for the gas until it is actually used during the month hedged. However, in the event the market should fall dramatically below hedged levels, we may require “margin calls” from the customer. These are essentially interest-bearing payments that make up the difference between the hedge and current market.

**CAN I DO PARTIAL HEDGES?**

Yes, EnergyUSA encourages customers to layer hedges over time as a viable risk management strategy. There is no additional fee for this service and we never add on extra costs for partial contract orders. A typical layering strategy includes a total of 4 layers over 2 ½ years.

**TYPICAL LAYERING STRATEGY**



**WHAT CAN HAPPEN IF THE MARKET PRICE CLOSES HIGHER THAN THE HEDGED PRICE?**

Congratulations! You as the customer pay the hedged price and save the difference between the hedge and market prices. This is the optimum outcome—managed risk and prices below market cost.

**OK, HOW ABOUT IF THE MARKET PRICE DROPS BELOW THE HEDGED PRICE?**

It is inevitable at some point that a particular hedge may actually be higher than the market. You must remember at these times what the purpose of the strategic hedging program is. The hedge eliminates volatility; provides a known, fixed price into the future; and limits your exposure to price spikes. There can be times when these hedge benefits lead to slightly higher costs within a volatile market.

**HOW WILL I KNOW IF THE STRATEGY WAS SUCCESSFUL?**

Did you meet the objectives established in the strategic plan? If so, the plan was successful. Remember, success does not mean “beating the market” at all times.

**ANYTHING ELSE I SHOULD REMEMBER?**

Yes, you may be asked to defend your strategic strategy after the fact. It is important to keep careful track of:

- What you did.
- Why you did it.
- When you did it.

This should keep second guessing to a minimum.

**CONTACT US!**

Nobody knows where natural gas prices will go in the future. Therefore, you need to protect yourself and your company. Hedging is the safest and easiest way to do that. Contact the EnergyUSA team for more information on hedging and other risk management opportunities for your company.