

Financial Strength on the Energy Market

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1. Four basic questions – what, why, how and why!!?
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What is hedging?

- ✓ “Hedging is the active usage of financial instruments to protect current or future positions from the risk of fluctuation on financial markets”

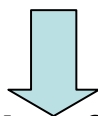
Hedge does not mean speculate

– **an unhedged position is a form of speculation**

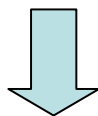
Why do companies use hedging?

THE VALUE OF MARKET VARIABLES IS AFFECTED BY FACTORS BEYOND THE CONTROL OF THE MAJORITY OF SOCIETY

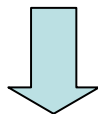
Fluctuation in market rates works on the company margins



The size of the margin affects competitiveness



Competitiveness affects market share



Market share affects profitability

What forms of hedging does the bank offer?

The basic risks that are hedged are as follows:

- ✓ **Currency**
→ ensuring risks arising from exchange rate movements
- ✓ **Interest**
→ risks arising from interest rate movements – FRA, IRS, options, etc.
- ✓ **Commodity**
→ this is where it all began (agro-commodities), and now oil, diesel, heavy metals and most recently electricity and gas

Why is electricity so unique?

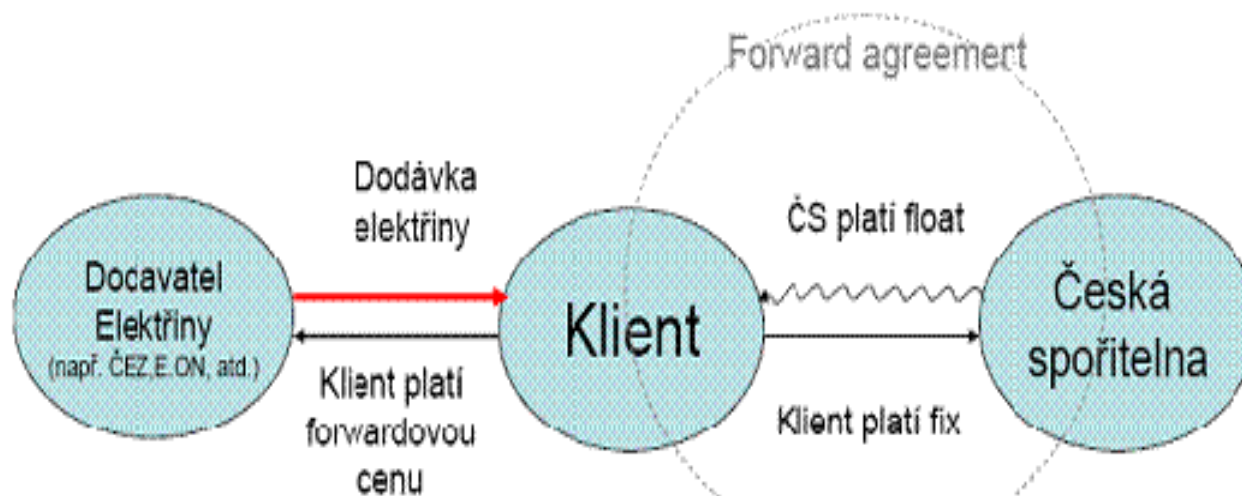
Although it refers to “traditional” financial derivatives:

- ✓ **Electricity cannot be stored**
→ when I buy more oil, it simply remains in the “barrel”
- ✓ **The most important part is the consumption diagram ...**
→ from the perspective of the diagram price, every company would want to produce/consume the same amount 24 hours a day
- ✓ **... and the most expensive are variations in consumption**
→ either I pay them directly in the price or *ex-post* with higher/lower consumption

The price of electricity can be hedged

How does a financial derivative (forward) for electricity work?

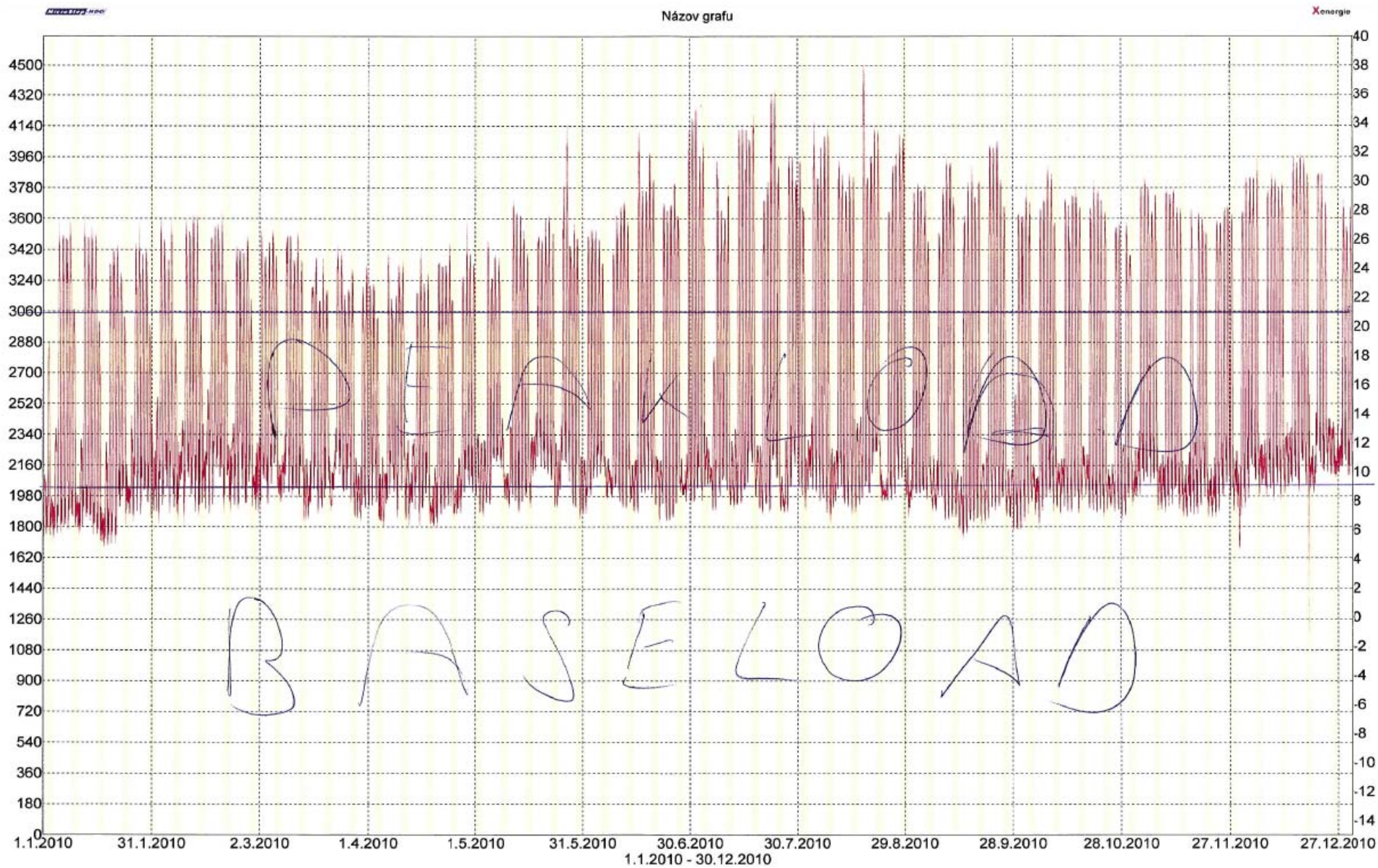
- ✓ Financial derivative for electricity without “electricity” (= with no physical supply)
- ✓ In combination with the purchase of physical electricity it meets 2 basic client requirements – security and flexibility
- ✓ The target group of businesses/clients – companies with high electricity



For example:

A possible increase in the price of electricity would be compensated by a positive “balance of the derivative operation”

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Current usage possibilities of derivatives

You are considering purchasing electricity

- ✓ **Using a forward**
→ at the moment the electricity client buys for the “year ahead”, it is possible to hedge the price using a financial derivative (forward). This must be concluded prior to the actual purchase of the physical electricity. Example: I am considering purchasing electricity for 2011 or 2012, but I don't know exactly how much I will need. Or perhaps I am not sure if the price will drop further and so I don't want to commit to purchasing physical electricity I cannot back out of and then participate later at a lower price. In contrast, I can sell a financial derivative at any time.
- ✓ **Using a swap**
→ the client decides to buy electricity on the spot (day-ahead) market. In that case, the option to hedge the price in advance is offered directly using a financial derivative (swap). The spot price is of course more volatile (that is why the option is offered to hedge the price with a derivative), but at the same time I don't need to worry about variations in consumption, because one day in advance (= day-ahead) I know almost exactly how much electricity I will need.

You have already purchased electricity

- ✓ This version assumes you have already purchased electricity (including agreed/fixed price) and using a financial derivative you have the option of restructuring the contract price in individual periods, e.g. “expensive” purchased physical electricity for 2011 can be distributed over two years (2011 and 2012), when I pay the average price.

How will you benefit from hedging with a financial derivative?

Benefits of a financial derivative

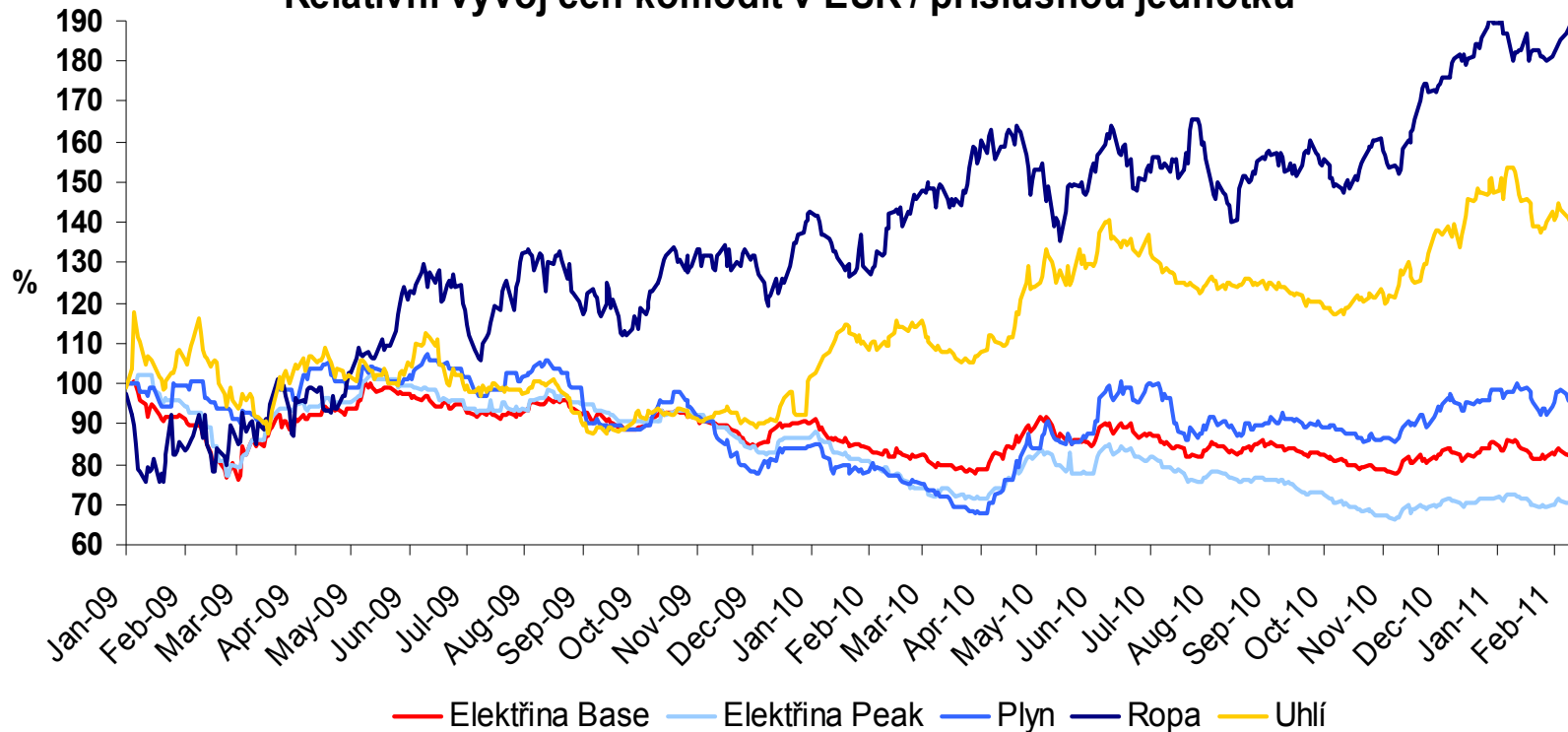
- ✓ **Reducing volatility of energy cost items**
→ electricity consumption accounts for a large portion of company costs
- ✓ **Greater flexibility in purchasing electricity**
→ financial derivatives inherently offer several ways to react to the development of electricity prices
- ✓ **Hedging a price without having to estimate the actual consumption of electricity**
→ variations in consumption have no direct impact on the hedging price
- ✓ **Simplifying cash flow planning**
→ a “hedged” price means stability and better cost control
- ✓ **Undemanding on “changes”**
→ when purchasing a financial derivative there is no condition to change the electricity supplier or method of purchasing electricity

It cannot substitute the supply of physical electricity however!

Relative development of commodity prices

Electricity prices have become detached from the development of oil prices; they are copying the development of gas and coal prices much more → it is logical, the most electricity is produced from these commodities.

Relativní vývoj cen komodit v EUR / příslušnou jednotku



Source: Bloomberg

When is it a suitable time for hedging?

Of course, when the price is “down”, but ...

- ✓ **Words such as hedging, insurance, etc. are not used primarily to create profit**
→ profiting on financial hedging means that I will pay more for the purchase of a physical commodity
- ✓ **Gradual hedging averages out the price**
→ we recommend that clients buy in several steps, which again serves to reduce the risk
- ✓ **The price of electricity in the last 5 years is between EUR 43 and 92 per MWh**
→ now it is around EUR 50 per MWh

Thank you for your attention

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