bakertilly

Hedging and Business Interruption Losses

Presented by:
Justin Crick, Partner
Jack Torpey, Partner

1 November 2023

Aim of the session

1. Hedging?
2. Why relevant in the Energy Transition
3. Potential BI implications

What is Hedging?

What is Hedging?

Risk management tool ➔ provides increased cash flow certainty

Process of transferring risk to another party and protecting the organisation

Aim is to protect against the consequences of a negative event / "fix the price"

Increased volatility increases the potential 'value' of a hedge

Forward contract v Financial Hedge

	Forward Contract	Financial Hedge
Description	A contract between two parties to buy or sell an asset at a specified price on a future date.	The action of managing price risk by using a financial derivative to offset the price movement of a related physical transaction
No. of transactions	Single transaction	Two separate transactions
Characteristics	Private agreement between two parties	Hedge traded on exchanges (commodity, stock, etc.)
Example	*Agree to sell generation at fixed price to guarantee future revenue*	*Hedge the future price of raw material to avoid future price increases if purchased today*

A financial hedge

T-6 → T-0

Current price - £200/MWh → Price declines → Sales value reduces to £100/MWh

Physical sale (£100/MWh) +
Financial hedge (£100/MWh) =
Sales value per T-6 (£200/MWh)

Hedge at current price - £200/MWh → Price increases → Make gain on hedge of £100/MWh

Naturally Hedged Businesses

- Some companies do not hedge as they consider they are naturally hedged

- Alternative management strategy - does not require complex financial instruments / accounting etc

- Examples include:
  - Where feedstock and selling price are highly correlated
  - Purchasing goods in the same currency as the sales

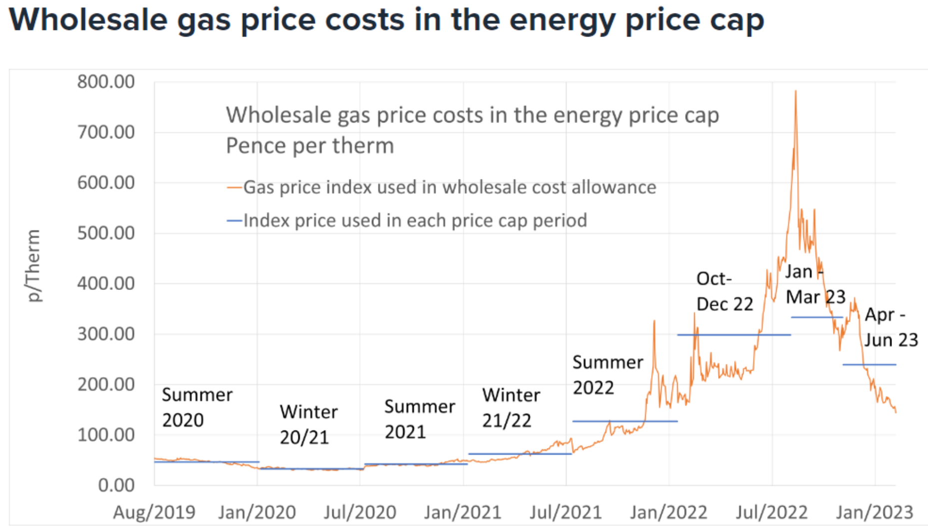
Hedging and Business Interruption Losses

What can go wrong...

- Bulb had *"rolling 6-month hedging"* for gas purchases but fixed term sales-contracts for customers of 1+ years

- Mismatch when wholesale gas and power prices increased in 2021/22

- Purchase costs exceeded sales price



Accounting for Hedging

- **Management accounts:**
  - Do not need to comply with accounting standards
- **Financial accounting – Can be complex (IFRS 9 - Financial Instruments)**
  - Hedge may need to be revalued, with the profit/losses recognised in the P&L
  - Profit / loss from the hedge and the underlying hedged transaction may occur in different accounting periods
- Review exact accounting treatment on a case-by-case basis

Hedging and Business Interruption Losses

Why relevant in the energy transition

ELECTRIC POWER | ENERGY TRANSITION | LNG | NATURAL GAS | METALS — 22 Mar 2023 | 11:08 UTC

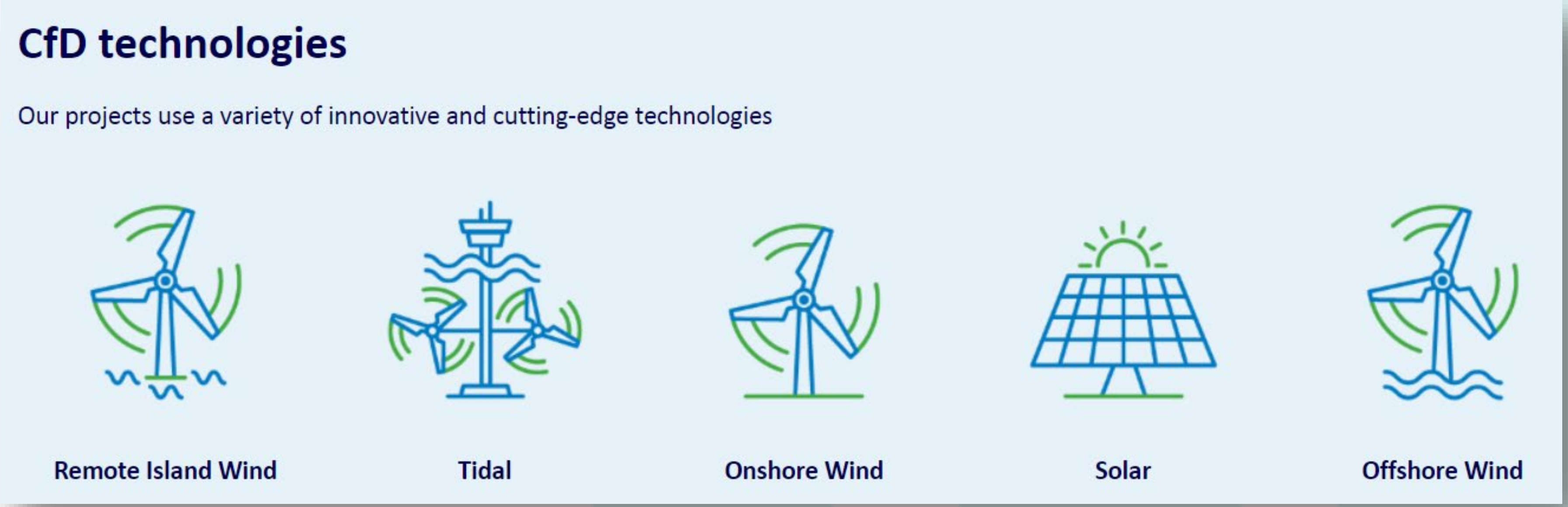
Commodity price volatility 'here to stay' amid geopolitics, energy transition challenges: Trafigura CFO

Concerns for suppliers

- New capacity
- Existing capacity
- High Capex
- Price volatility
- **Require revenue certainty**

Contract for Difference (CfD)

- Incentives required to attract investment in renewables
- CfD – a contract between a low carbon generator and the Low Carbon Contracts Company (a government owned entity).
- Developers paid a flat (indexed) rate over a 15-year period
- Provides protection from volatile prices – effectively a hedge



Hedging and Business Interruption Losses

Potential BI Implications

1. Definition of revenue
2. Cost of unwinding a forward sale
3. Intercompany issues

Definition of revenue

- Boilerplate wording along the lines of:

> *"Revenue shall mean the amount paid or payable to the Insured for **goods sold and delivered** and for **services rendered** in the course of Business at the Premises."*

- Is hedging a good or service?

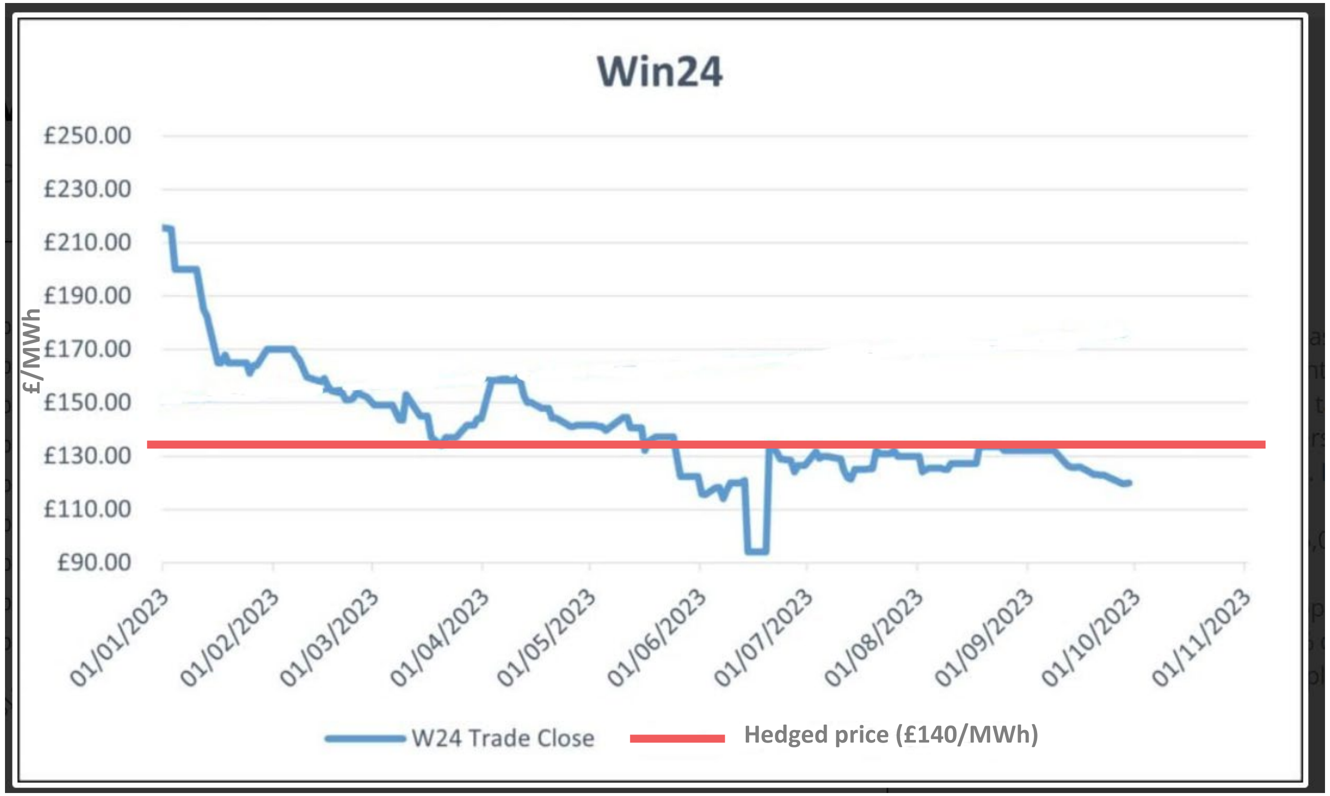
- Have seen more bespoke wording which widens the definition to incorporate hedging

Cost of unwinding a forward sale

- Three options:
  1. **Purchase replacement product ➔** incur cost to satisfy obligation
  2. **'Buy-back' the position ➔** incur cost to avoid obligation
  3. **Take no action ➔** incur charge from counterparty - failure to perform
- Questions:
  - Does the cost avoid a loss of turnover / is it an ICW?
  - Is the cost to avoid a penalty?
  - Does it meet the definition of AICW? Any exclusion?

Value of unwinding hedge

- Date of Loss: 1-Jan-23
- Date of delivery: 1-Nov-23
- Hedged price: £140 / MWh

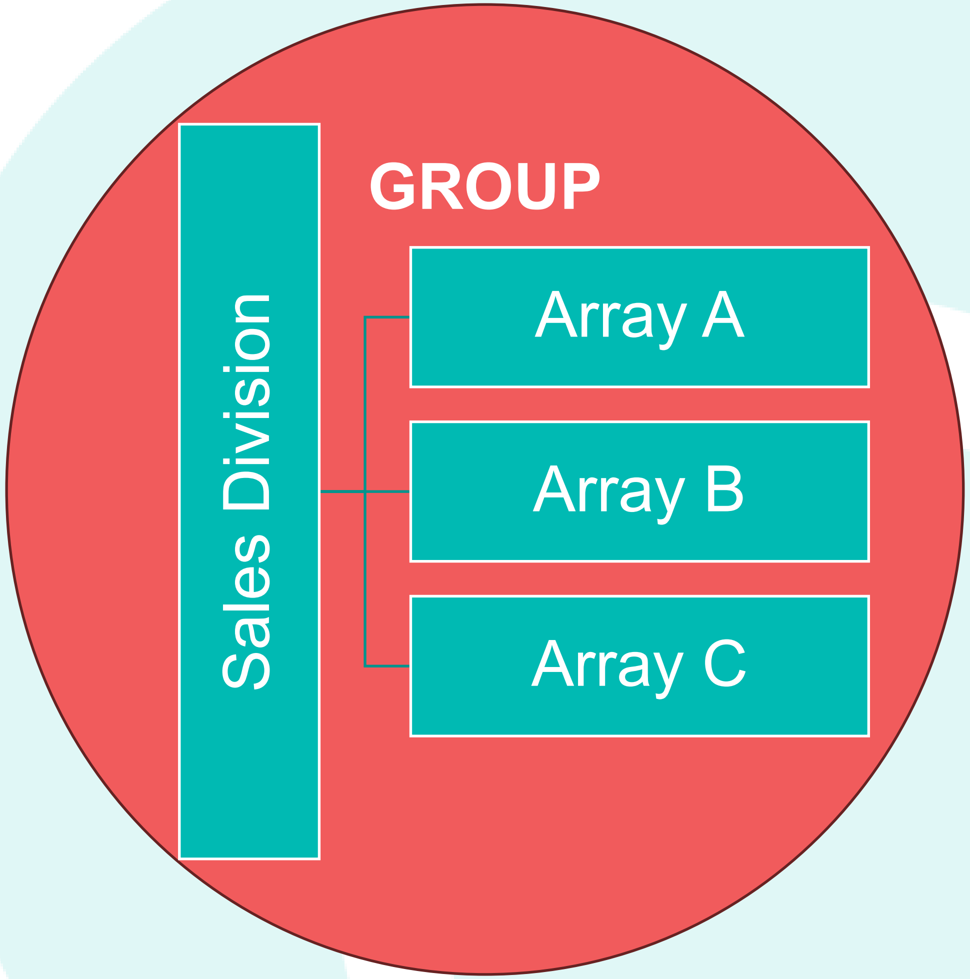


Source: https://www.catalyst-commercial.co.uk/wholesale-electricity-prices/

- Hindsight is a wonderful thing…but the Insured does not have this.
- Its options:
  - Buy 100% replacement power 'now'
  - Do nothing
  - Or something in-between
- Clear, transparent and early communication required between all parties

Intercompany issues

- Generating units (Arrays A-C) sell to sales division at fixed price
- Sales division sells to the market - price volatility risk at sales division
- Often separate legal entities
- Need to ensure wording and declarations fit the business as a whole



Summary

- Hedging - risk management tool
- Important in the energy transition to ensure consistent returns
- Need to ensure the BI wording reflects the requirements of the business to avoid an expectation gap

Disclaimer

Baker Tilly assumes no guarantees as to the accuracy of this data, which is collected as of specific dates and can also change at any time.

The information should not be used as the basis for any decision without prior professional advice and careful contextual analysis.

Baker Tilly is not liable for damages arising from any decisions that third parties may take on the basis of this information.

bakertilly