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the new risk management imperative

By Michael Schwartz, Triple Point Technology

Ask 10 people about the future of the commodities and energy markets and you will get 10 different responses. The long-term economic consequences of government bailouts and stimulus packages are far from clear, and predictions about what will happen to prices vary enormously.

Amidst these huge uncertainties, there are several things about which we can be sure. Firstly, commodity price volatility is here to stay. Crude oil prices surged in July 2008 to a record \$145 a barrel and then dropped to about \$33 in December. Today, oil trades around \$70 a barrel.

Secondly, the recession has made everyone take a closer look at credit. Credit risk managers use to triage potential counterparties into three groups – definite yes, definite no and everyone in between. Today, there is no chance that a potential counterparty will be automatically accepted; everyone is either rejected or sent for assessment.

Finally, the markets will be more closely regulated. How this final point plays out is anybody's guess, but there's no denying the growing importance of accounting standards that require additional transparency into valuations and accounting methods such as IAS 39, FAS 133, FAS 157 and FAS 161.

We are now entering a period in which an advanced understanding of enterprise risk management principles and practices, supported by a state of the art technology infrastructure will determine who survives and who perishes in this new, harsher environment.

Leading analyst firm Gartner has backed up this scenario by developing its first ever Magic Quadrant¹ for energy trading and risk management software. This is a clear indication that energy and commodities firms should take a serious look at how they could transform their operations by investing in more sophisticated enterprise systems and moving away from using a complex web of disparate software solu-

tions and spreadsheets.

Corporations with business processes that lack transparency are at substantial risk without even knowing it. There is no escaping the fact that trading is a complex process. The workflow of a single trade crosses several departmental boundaries including trading, credit, scheduling, risk management, hedge accounting and settlement, to name a few, and touches multiple systems. Of course, while everyone does their best to coordinate across the organization, it's almost impossible and very time-consuming to navigate the tangled web of systems and spreadsheets.

It's notoriously difficult to get an accurate, real-time overview of the fast-moving, volatile and highly complex energy and commodities markets. When individual departments become isolated, their stovepipes of data and uncommunicative systems make it impossible to get a clear picture of the corporation's global exposure. Consequently, firm-wide risk is substantially increased.

Here at Triple Point Technology, our discussions with industry participants indicate that spreadsheet dependency is still a huge problem. One individual explained: "Many systems don't automatically interface with each other and we have to manually re-enter data that already exists in one system...." Another said: "We use multiple systems to perform a specific function and the reconciliation of separate systems wastes a lot of time." While another said: "We rely heavily on spreadsheets... many times we use our enterprise solutions as just the system of record."

These kinds of conversations are supported by more comprehensive research. A University of Hawaii study showed that 91 percent of audited spreadsheets contained errors. KPMG has found that 78 percent of models had no formal quality controls, with errors in terms of inputting, logic, interface and cell range.

And that is just research based

on fairly basic, uncomplicated spreadsheets containing relatively straightforward data. Just imagine the level of errors contained in highly complex spreadsheets containing curve management, complex pricing formulas and detailed physical supply chain schedules as used in the energy and commodities trading business.

The potential consequences in terms of risk and compliance issues could be huge. Firms that rely solely on spreadsheets are likely to be basing key decisions on out-of-date or incorrect data. If spreadsheet culture was dangerous two years ago, it is absolutely lethal now.

Firms wishing to succeed must deploy a real-time enterprise trading and risk platform that integrates management of the four key risk areas set by the Committee of Chief Risk Officers: market/price risk, operational risk, regulatory risk and counterparty credit risk. This creates a seamless risk management process that is no longer dependent on a patchwork of disparate systems and spreadsheets. Instead, all departments and risk areas are integrated into a single, highly functional system that creates useable information for proactive decision-making.

What's more, all necessary data should be collated into a management dashboard to provide executives with an accurate picture of the company's exposure at all levels, enabling them to measure performance against any given set of key performance indicators.

The financial impact of getting risk management wrong can be huge. The demise of former masters of the financial and energy markets are a testament to how easy it is for even the biggest names to fall from grace. Yet many companies have still not embraced the imperative for integrated, enterprise risk management, and they do so at their own peril.

¹http://www.gartner.com/DisplayDocument?doc_cd=131166