



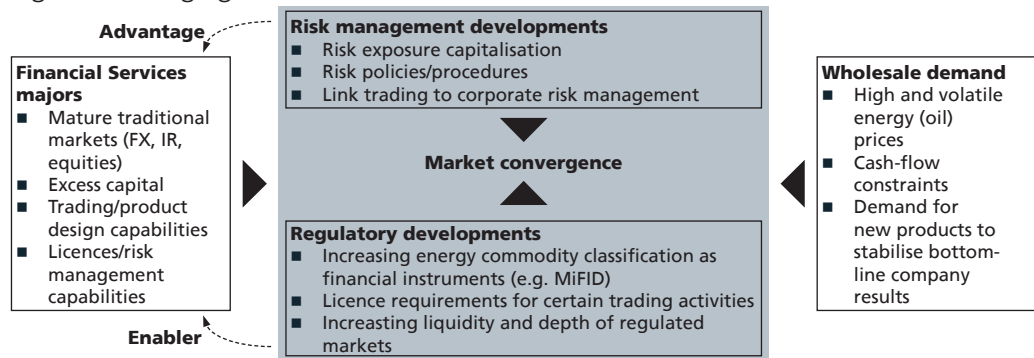
## Energy Market Convergence: Time to review trading strategies, risk management and operations

In the late 1990s energy trading was booming. Innovative products and services were developed and traded amongst traditional players and new market entrants. In some markets (notably power) a combination of innovation rapidly outstripping controls, and market design failures ultimately led to the demise or near demise of a number of major industry participants. In the aftermath, the allure of energy trading waned in a number of these markets as many participants lost appetite for all but plain vanilla transactions. For example, futures trading on Europe's largest power exchange Nordpool fell by almost 50% from 1,020 TWh in 2002 to just 545 TWh in 2003. In the current global climate energy trading is experiencing resurgence. High and volatile energy prices are re-fuelling demand for sophisticated products and services and shifts in technology are making the ownership of production assets more accessible to new market entrants. Financial services giants with excess capital have renewed appetite for energy investments, and regulators in certain markets are stepping up their efforts to increase levels of competition and customer protection. For incumbent energy majors, these developments necessitate a review of existing trading, operations and risk management strategies.

## Energy trading: Future market convergence

A combination of forces is reshaping today's energy trading markets (see Figure 1 below). Energy price volatility is fuelling demand for new customer products and services, regulatory changes are levelling the playing field between banks and energy majors, and risk management developments are providing additional security to all market participants. Together these forces look set to shift the balance of power between incumbent providers and new market entrants.

Figure 1: Changing market forces



### *Wholesale demand for sophisticated energy products/services is growing*

Underlying oil prices exceeded \$75 per barrel for the first time in April 2006. The knock-on impact has been an increase in energy costs for the industrial sector of between 30 and 40 percent. Against a background of energy security and uncertain future energy prices, demand is growing for more sophisticated energy products and services to supplement traditional contracts. Such customer products include: embedded option energy contracts that enable the organization to limit, or to profit from, future energy price volatility, integrated contracts (e.g. gas supply contracts linked to aluminium prices) and discretionary portfolio management services aimed at optimising energy consumption.

### *Financial Services majors are reinvesting in energy assets*

Having scaled back or even exited the market post-Enron, major investment banks are exhibiting renewed interest in the global energy markets. Merrill Lynch's acquisition of Ennergy-Koch in 2004 is a striking example of such a change in strategic direction. There are three primary reasons for this renewed interest: traditional fixed income and equity cash markets are maturing and exhibit diminishing profit margins; regulatory developments (see below) are levelling the playing field; and most major banks have significant excess capital which must either be profitably deployed or returned to shareholders. At the same time, the continuing low interest rate environment is fuelling demand for, and making cheap funds available for, the financing of infrastructure assets. With the emergence of new investment vehicles the trend amongst financial services firms to invest in energy assets looks set to continue.

### *Regulatory developments are levelling the playing field*

Recent energy market regulations - for instance the European Markets in Financial Instruments Directive (MiFID) - seek to achieve two primary goals: on one side, to facilitate energy market competition by increasing market depth and liquidity; and on the other, to protect end investors. The former is leading to a convergence between the energy and financial markets, with an increasing proportion of both physically-settled commodity derivatives being classified as financial instruments and requiring licences to trade. The latter places stringent new requirements on energy traders to capitalise risk exposures, to disclose the risks in their portfolios and to implement sound risk management and controls processes.

### *Risk management developments are increasing market security*

The growing volume and increased sophistication of traded energy commodities, and the regulatory developments outlined above, will necessitate the development of enhanced risk management capabilities for many market participants. These developments include more advanced credit, market and operational risk calculation tools, refined risk management policies and procedures and the establishment of linkages between trading risk management activities and the broader corporate risk management agenda. These enhancements are essential to ensuring the security and long-term viability both of those firms participating in future market developments as well as for the overall market system itself.

### **How Oliver Wyman can help**

The implication of these changing market forces is the need to re-examine existing energy trading strategies, risk management practices and operations. For incumbent energy majors this means re-assessing the future development of the wholesale trading markets and for financial institutions, this should include a fundamental review of the benefits of 'physical' market participation. Oliver Wyman specializes in risk management and strategy consulting. We support energy majors, global investment banks and commodity-intensive companies in respect of energy trading in the following areas:

#### *1. Trading strategy*

We assist energy trading firms in deciding in which markets they should compete, understanding what it takes to successfully compete and in developing trading strategies that are consistent with both their risk appetite and with their overall corporate strategy. This includes forecasting demand and profitability for existing or emerging commodity instruments, evaluating the threat posed by both traditional and new (notably Financial Services) market participants, specifying risk appetite for trading activities (including portfolio balancing, proprietary and third party trading), setting trading limits and policies and enhancing our client's trading, product development and risk management capabilities. Additionally we support commodity-intensive corporate clients in developing and implementing effective commodity hedging strategies to facilitate the management of their earnings volatility.

#### *2. Trading operations*

We support firms in the design and development of trading operations that not only meet required standards (e.g. MiFID best execution, pre- and post-trade transparency and order execution requirements) but that operate efficiently and that fully support the specified commodity trading strategy. We assist energy trading firms in improving the effectiveness of trading operations, redesigning the client coverage model, performance evaluation and incentives and benchmarking/streamlining support functions. The drivers for such a review typically include changes in market demand, competitive pressures, increasing profit demands of corporate shareholders and compliance requirements associated with new regulation.

#### *3. Risk management*

We enable firms to enhance their risk management capabilities through construction of tools to support exposure management, risk capitalization and reporting, and the development of new risk management processes/organization. Such capabilities are a critical component of an organization's ability to create shareholder value, rather than being merely a means of meeting compliance requirements. As energy derivatives are increasingly commoditized and treated as financial instruments, many energy traders are facing stringent new risk management regulations (e.g. the Basel II Capital Accord, MiFID) already well developed in the financial markets. We can support energy trading firms in rapidly upgrading their current capabilities both in order to meet these new regulatory demands and in order to integrate these activities into their broader corporate risk management agenda.

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