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ENERGY MARKETS
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Risk

By NATHAN SHEIK

Beyond Analytical Tools

In this volatile energy market, millions of dollars and man-hours are spent implementing sophisticated risk management applications. Although the focus is often on the software applications being deployed, risk management needs to mean more than just calculating VaR and PaR, managing credit limits and reporting.

Risk management goes beyond a piece of software; it is a methodology that includes internal controls as well as trained staff, well-understood documented policies and procedures, and the right business culture. Everyone involved in the business has to be trained, equipped and motivated to support the overall risk management methodology in order to gain the benefits of improved visibility, better-informed decisions and ultimately a better bottom line.

The approach to implementing a comprehensive end-to-end risk management strategy will involve:

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- Defining your business processes. This includes the process purpose, objective, owner, inputs, outputs, beginning and ending, risks and mitigating controls. Based on these defined business processes, develop detailed procedures to implement them. These must include consideration of backup plans or work-arounds—what to do if the defined process fails.
- Training your people to execute the processes. Instill in them a culture of high ethics and the discipline to execute the processes effectively and transparently.
- Implementing a scalable, flexible transaction management infrastructure (TMI) to enforce the same rigor and discipline on the data involved in the business processes.
- Integrating and deploying risk management applications that fit your business processes. These applications must use common protocols to access the data in the TMI, to guarantee that the results they produce are based on the best and latest information available.

The cornerstone of a risk management strategy ensures integrity of critical system information, and this is the role of the TMI. In a complex business that processes thousands of transactions per day, capturing, valuing and reporting every aspect of those transactions, including their impact on the organization's relationships and contractual obligations with its counterparties, is critical to success. Data processing that relies on having each group enter information into its own systems, manually transfer the information between groups, and then try to make sense of the chaos at the end of the day will not stand up to the increased demand for accountability, accurate timely reporting and quick decision-making in a marketplace that grows increasingly complex with each new regulatory decision and industry shift. The risk is not limited to lost opportunities; it also includes unknown exposures to credit and market risks, and operational penalties when trying to make decisions without good visibility into critical business information.

CONTROLLING EXPOSURE

In order to control financial and physical exposures, the TMI must support straight-through processing in its trade capture, deal valuation, risk measurement, reporting, scheduling, metering and settlement capabilities. And these must be robust enough to handle all business from long-term structured transactions through day-ahead and next-hour markets. A properly implemented automated TMI captures information from across all business units into a single repository feeding the entire enterprise to ensure that the right amount of power is moved to the right place for the right price. This single source of transaction information imposes rigor and discipline on the information, managing it from cradle to grave and allowing the individuals, groups and departments within the organization to function as an integrated enterprise rather than isolated islands. As the organization scales up, the TMI can and must scale with it, to provide the basis for growing the business without sacrificing the decision making support that made it possible to grow in the first place.

By providing comprehensive ongoing visibility into the information, the TMI helps optimize positions and accurately assess delivery obligations, so that companies can hedge more effectively and manage associated risks. Even with the best mathematical tools, the most advanced algorithms and the brightest minds, inaccurate data will lead to inaccurate analysis and ultimately to incorrect and costly decisions. When the TMI works in unison with a suite of risk management tools, physical assets can be optimized, contracts can be better leveraged, and exposures can be minimized. The risk manager can see immediately where they stand with a given counterparty at any given time, and quickly turn business over to settlement. This is not limited to end-of-day or end-of-month reporting; the TMI needs to constantly evaluate and proactively inform its users in real time—where real time is two to 10 seconds.

All industry participants can benefit from implementation of risk management strategies. ■

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