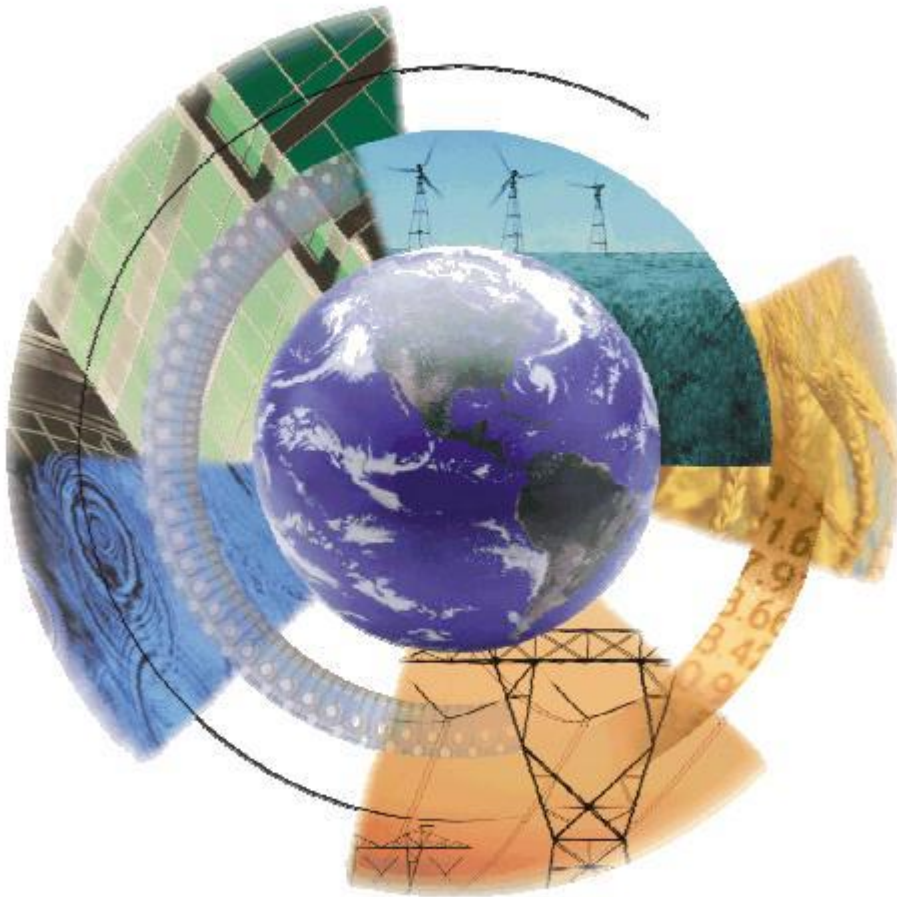




Commodity Markets Intelligence Series



Best Practice Guide
Risk Management Framework and Governance
for
Energy Trading

Introduction

There is a lot of uncertainty about the future direction of the electricity and natural gas markets today. As a result price volatilities will increase, offering good opportunities, but also many challenges to energy traders. To survive in this exciting and competitive environment an effective trading and risk management strategy is crucial.

In essence trading is a risk management discipline. When business processes and structures are substantially less than optimal, the inability to account properly for risk- return trade-offs means that money is left on the table or that returns are in fact generated by taking much greater risk than is explicit.

To allow you to check whether your company is well established and ready to take up these challenges, I have prepared for you a Guide titled 'Best Risk Management and Governance Practices for Electricity and Natural Gas trading'. These best practices are based on my more than 25 years of experience gained from advising numerous large to small sized energy companies from all over the world.

The guide is designed to serve the needs of companies in various stages of implementing a risk management framework and could serve as a high level implementation guide or as a checklist of good practices.

It would be my pleasure to further discuss with you how my advisory services would be beneficial to you and your company.

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Your Commodity Risk Management Partner

About the Author



Kasper Walet has 25 years of experience and extensive knowledge on a practical and theoretical level about all the aspects related to trading, derivatives and risk management in the commodity industry.

Kasper received a Master's degree in Law from the University of Utrecht in 1987. He started his career at the NLKKAS, the Clearing House of the Commodity Futures Exchange in Amsterdam. Kasper was appointed as Member of the Management Board of the Agricultural Futures Exchange (ATA) in Amsterdam at the age of 31. While working for the Clearing House and exchange, Kasper became an expert in all the aspects of trading and risk management of commodities.

In 1997 he founded his own specialist-consulting firm that provides strategic advice about (energy) commodity trading and risk management.

Kasper has advised government agencies such as the European Commission, investment banks, major utilities and commodity trading companies and various exchanges in Europe, CEE countries, North America and Asia. Some of the issues he has advised on are the development and implementation of a Risk Management Framework, investment strategies, trading and hedging strategies, initiation of Power Exchanges (APX) and other trading platforms, the set-up of (OTC) Clearing facilities, and feasibility and market studies like for the LNG, the Coal, the Carbon Market and for Power Purchase Agreements.

Kasper has given numerous seminars, workshops and (in-house) training sessions about both the physical and financial trading and risk management of commodity and carbon products. The courses have been given to companies all over the world, in countries like Japan, Singapore, Thailand, United Kingdom, Germany, Poland, Turkey, UAE, South Africa, Nigeria, Slovenia, Czech Republic, Malaysia, China, India, Belgium and the Netherlands.

Risk Management Framework and Governance

I Risk Policy

1.1 Risk Management Policy

- 1.1.1 Risk profile
- 1.1.2 Risk document
- 1.1.3 Control

1.2 Risk Profile, Appetite and Tolerance

- 1.2.1 Definitions
- 1.2.2 Role of each in Risk Management process
- 1.2.3 How to establish; a step wise approach

1.3 Risk Capital Allocation

- 1.3.1 Business performance evaluation vs. capital allocation
- 1.3.2 From corporate Risk Capital to trading desk level
- 1.3.3 Risk Capital and Risk-Adjusted-Return-On-Capital (RAROC) Concept

1.4 Governance and Organizational Structure

- 1.4.1 Top Down Approach
- 1.4.2 Role of the Board of Directors
- 1.4.3 Role of the Executive Committee
- 1.4.4 Role Risk committee
- 1.4.5 Chief Risk Officer
- 1.4.6 Corporate Risk Management
- 1.4.7 Segregation of duties
 - 1.4.7.1 Front, Middle and Back Office
- 1.4.8 Delegated responsibility

1.5 Other Components Risk Policy

- 1.5.1 Organizational Structure; support functions
- 1.5.2 Business unit risk management policy components
- 1.5.3 Risk Measurement
- 1.5.4 Risk Limits and Guidelines
- 1.5.5 Risk Analysis and Reporting
- 1.5.6 Commercial Compliance Program
- 1.5.7 Key Performance Indicator (KPI)
 - 1.5.7.1 KPI Framework
 - 1.5.7.2 Key KPIs for Risk Management

Sample 20 pages Risk Policy Document

II Risk Management Processes and Controls

2.0 Deal Life Cycle

2.1 Deal Execution

- 2.1.1 New Product Development
- 2.1.2 Trading, Contracts, and Asset Management
- 2.1.3 Origination, Structuring, and Pricing
- 2.1.4 Price Curve Development
- 2.1.5 Trade Entry
- 2.1.6 Logistics
- 2.1.7 Deal Management

2.2 Deal Validation

- 2.2.1 Validating a Deal
 - 2.2.1.1 Validation, valuation and approval Deal Structure
 - 2.2.1.2 Validation of Deal Entry
- 2.2.2 Reconciliation
 - 2.2.2.1.Exchange reconciliation
 - 2.2.2.2.Position Reconciliation
- 2.2.3 Confirmation
- 2.2.4 Contract Management

2.3 Risk Management

- 2.3.1 Daily Risk Monitoring
- 2.3.2 Price Curve Validation
- 2.3.3 Risk Control and Analysis
 - 2.3.3.1 Marking Transactions to Market
 - 2.3.3.2 Market Valuation Methodology
 - 2.3.3.3 Calculating Profit and Loss
- 2.3.4 Managing Risks
 - 2.3.4.1 Capital at Risk
 - 2.3.4.2 Market Risk
 - 2.3.4.3 Credit Risk
 - 2.3.4.5 Liquidity and Funding Risk

2.4 Settlements

- 2.4.1 Actualization
- 2.4.2 Settlements
- 2.4.3 Reconciliation

2.5 Management and Financial Reporting

- 2.5.1 Risk Reporting
- 2.5.2 Internal Financial Reporting

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