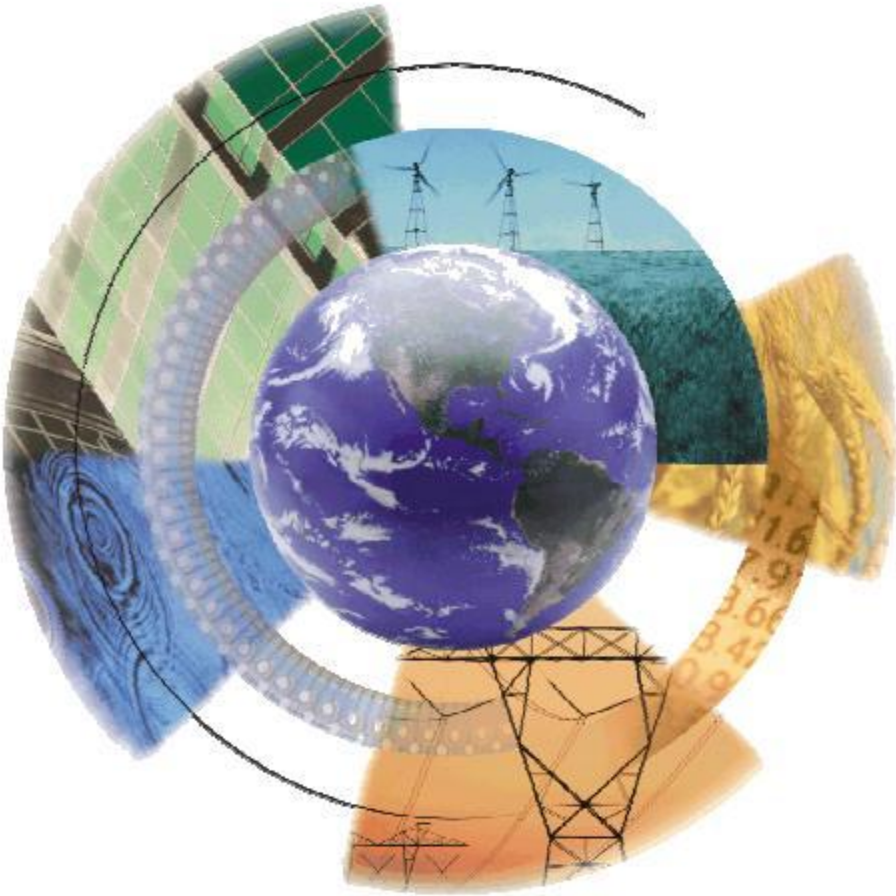
Commodity Markets Intelligence Series



How to master (OTC) Clearing for Energy Companies

October, 2012

Introduction

The move to clearing of standardised over-the-counter (OTC) derivatives represents a significant change in the energy trading business. For clearing houses it is the largest opportunity to expand their businesses in history, but for energy companies it will be very challenging to master this change.

On 27 July 2012 the final text for Regulation on wholesale energy market integrity and transparency (EMIR) was published in the Official Journal of the European Union. EMIR will introduce significant changes to the OTC derivatives market by mandating central clearing for standardised contracts. Next to financial counterparties the clearing obligation will also apply to non-financial counterparties such as energy companies who exceed certain thresholds. It is there for crucial that you formulate a strategy to adapt to this new business environment.

Mandatory clearing means a structural change in the foundations of the market infrastructure for OTC derivatives. These changes will have multiple effects on participants in the European electricity and gas markets.

It will for instance revolutionize the credit function at energy companies. Collateral management and not counterparty risk could become the new focal point for credit teams. Rather than being concerned with what counterparties owe them, credit departments will now have to be more concerned with what they owe to exchanges and clearing houses. They will have to forecast margin requirements and work much more closely with the exchanges, front office, treasury and other risk departments to optimise the use of cash for margins and OTC interest-free credit lines.

This is just one example of how your business processes could be impacted, but there are many more issues at stake.

In this highly practical and essential report we will give you an in-depth insight into the operational, legal and risk aspects of using OTC clearing and we will discuss possible strategies to make your company clearing proof.

Key Take Aways

After reading the report you will have a thorough understanding of:

- How to formulate a strategy to adapt to the new regulations for yourself, your team, your department or your entire organisation
- What technology change will be required
- The global activity in clearing energy derivatives, and the OTC market infrastructure
- All the operational, legal and risk aspects of using OTC clearing

Our Clearing Expertise

Kasper Walet has more than 25 years of experience in the clearing aspects of energy commodity trading. and With his company Maycroft he has advised energy companies, banks, trading houses, exchanges and clearing houses and large industrial companies from all over the world. For writing this report Kasper has tapped on his rich experiences of the many years that he walked around in the energy commodity industry and his unique practical and theoretical knowledge about all the relevant clearing issues.

Overview Contents

Costs imposed by OTC Clearing through a CCP

- Margin and liquidity risk
- Netting and reliance on short-term funding
- Excessive standardization
- Adverse selection

Potential problems mandatory clearing

- Legal and regulatory uncertainty
- Concentrations of risk in CCPs
- Systemic risk and moral hazard
- Competitiveness considerations

Clearing and Settlement

- Clearing
  - Central Counterparty
  - Clearing Members
  - Standard Products
  - Margin System
  - Direct vs. indirect clearing
  - Integrated vs. separated clearing
- Settlement
  - Netting (of cash flows)
  - Standard process
  - Straight Through Processing
  - Central bank money
  - Delivery with TSOs and registries

Membership

- Clearing Members
  - Minimum capital requirements
  - Member obligations
  - Monitoring & stress testing
- Non Clearing Members
- Application process
- Contractual relationship
  - Clearing Agreement
  - NCM agreement
- Customer protection and segregation

Margining System

- Margin calculations
  - Initial Margins
  - Variation Margins
- Cross margining
  - Netting
  - Perfect spreads
  - Inter-commodity spreads
  - Margin savings diversified portfolio
- SPAN
- Collateral
- OTC margining vs. CCP-clearing
  - Main differences,
  - What needs to be implemented when starting with OTC margining

Default Resolution Protocols

- Default management process
- Position transfer to other CM
- Risk Capital and financial safeguards
  - Margins
  - Clearing Fund
  - Insurance
  - Equity
  - Others

Default scenarios CCP

- What happens if a CCP goes bankrupt
- What happens if a GCM goes bankrupt
- What happens if a major NCM goes bankrupt
- What could energy company do in these situations to prevent any major (financial) harm

Settlement Process

- Settlement process
- Daily Settlement process
- Margining
- Reporting
- Contractual relationship
- Fees

Increasing importance of Collateral management

- Revolution in Credit Risk Management
- From Counterparty Risk to Collateral Management
- Liquidity
- Post collateral on open positions
- Trade reconciliation process
    - Challenges energy commodities
    - Valuing physical assets
- Standardization trade data
    - Role EFET

Impact and actions; how to prepare your company

- Develop a clearing strategy
- Impact on Hedging Strategies
- Accountability, Chance Management and Compliance

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 Masters degree in Law from the University of Utrecht in 1987. He startedhis 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 and the Carbon Market.

Kasper has given numerous seminars, workshops and (in-house) training sessions aboutboth 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, Slovenia, Czech Republic, Malaysia, China, India, Belgium and the Netherlands.

For LNG Kasper for instance provided consultancy and training services to LNG and gas companies like Malaysia LNG, other energy companies and investment banks, besides we did an extensive feasibility study for an European exchange to the possibilities to list LNG derivative contracts.

Kasper will be a guest lecturer at both the Hult International Business School and the Ulsan National Institute for Science and Technology in South Korea in 2012.

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