



Mitigating Risks with Right ETRM Systems Selection

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Abstract

The rapid growth of information technology over the past 20 years introduced the financial and commodity sectors to a new way of doing business. The financial markets saw the tremendous growth possibilities the new technology provided, and subsequently created the online trading platforms. As a result, customers could execute trades from personal accounts without the intervention of a broker. Likewise, the commodity markets saw the great potential of such technology and soon followed suit with straight-through processing of trades – from deal capture to settlements.

The need for Energy Trading and Risk Management (ETRM) applications has seen immense growth throughout the IT boom. Initially these applications were very rudimentary, handling physical commodity deal capture and limited in terms of lack of mid and back office processing capabilities. Today, ETRM applications are robust enough to manage front through back office processing, plus physical commodity scheduling and derivatives trading.

With the need for software applications to manage large volumes of energy trading activity, the selection process of these applications is very critical to a company's margins. This paper discusses the importance of selecting the right software solution to address all trading activities and risk monitoring.

Introduction

The need for ETRM applications and its development has skyrocketed in recent years. These software solutions have simplified once complicated and tedious tasks, with powerful applications that can manage the risks of all energy commodities. Organizations (including non-energy companies) have taken advantage of the ease of use and cross-commodity aspect. Based on specific business needs, compliance and the efficiency with which business is conducted, organizations need to select the right ETRM system. Reduction in overall operating costs and increasing revenues makes a compelling argument to choose the right application(s), which, in turn, have a positive impact on ROI.

Energy companies have not only taken to trading of physical commodities via the ETRM route, but also have taken advantage of energy derivatives, options, swaps and swaptions. This allows all companies willing to do business, in energy trading the ability to do non-physical speculation.

The ETRM application demand has spawned a new industry. With the need for the various applications, the ETRM industry's two main components -- the end user and the developer activity, have grown in tandem. With increased popularity, there has also been an increase in the number of vendors developing ETRM solutions. Each application basically offers the same services, but most are stronger or weaker in certain areas. For example, the bigger vendors offer solutions that handle a wide range of trading activity, while the smaller ones target specific areas. There are some vendors that develop complete front through back office systems, including commodity scheduling capabilities, giving them a distinct competitive edge

over those offering fewer solution options. Therefore, it is critical that a company looking for an ETRM solution to manage its portfolios and risks, carefully evaluates what is required.

Weighing The Pros And Cons

ETRM systems can be distinguished by two different categories; totally integrated systems that deliver front to back office solutions (deal entry to settlements) and risk reporting systems. These risk reporting modules focus on middle office processes such as forward curve modelling, real-time exposure reporting and end-of-day reporting, combining flexible calculations, spreadsheets and various reporting engines.

Their pricing, too, varies depending on licensing, needs and application capabilities. All of this would have a bearing on the selection process. Organizations debate comprehensive functionality versus specialized area of functionality. With two of the more important selection criteria determining an organization's depth of business activity and budget, they must decide whether to purchase front, mid and back office functionality (including commodity scheduling) or stand-alone modules from the bigger or smaller vendors, like risk and real-time reporting.

Generally, larger companies with multiple trading portfolios and across different energy commodities may require a comprehensive front-to-back system, whereas smaller companies with limited trading activity may opt for specialized modules such as energy scheduling, physical deal capture, credit/risk monitoring or accounting.

In recent years, however, even the larger energy organizations have opted for individual modules and interface them with other third-party applications rather than go for an entire comprehensive package from a particular vendor. This trend has created a market where very few vendors develop front-to-back office systems, the vast majority focus on offering a specialized solution. Some of these solutions deal with specific energy products or customized services. For example, a niche vendor may develop a complete ETRM application for refinery risk management, gas scheduling and storage, power transmission management, smart energy, commodity freight logistics or industry compliance.

Time To Cherry Pick

The larger vendors, with their vast functionality, alienate the smaller companies who only need basic risk management capabilities. The question now is: why pay for 100% of a system when only 40% will be used. Organizations, thus, only buy limited functionality from the larger suppliers or a basic risk management system from a smaller supplier.

Once the specific commodity market has been identified, the following key elements must be thoroughly examined for the selection of an ETRM system.



It is important to analyze the extent and depth of involvement in those markets/commodities, i.e. the level of risk management activity and physical speculation such as deal capture, scheduling, risk monitoring and accounting

Research the markets in which business will be conducted, understanding the growth and changes involved

Understanding what system fits best; incorporating several systems modules or a single comprehensive solution

Verify via live demos that a vendor can model very unique business, functional and technical requirements

To Buy Or Build

The conventional approach may seem to analyze the business requirements and processes, and then determine which complete system or individual components best suit the needs. However, this straight forward approach may not work for everyone. Organizations that operate in markets that are not mature due to new market deregulations or limited budgets, may not need to purchase a robust ETRM system or its components, rather they may opt to build a custom-built system from within.

In a newly deregulated market, the volume of business activity may not warrant spending a hefty sum on ETRM applications. As a result a custom-built solution is the best option. A custom-built application, however, comes with inherent risks. It tends to be overly simplistic – usually a spreadsheet-based system that may not be sophisticated enough to handle complex transactions. In addition, it may take a longer time to build as developers try to mimic existing systems, gather requirements and test.

Conclusion

The build-your-own-system approach is clearly advantageous to certain groups, but in today's very dynamic ETRM world it behooves an organization to seek a system that best matches its needs.

In fully matured and deregulated energy markets such as North America and Western Europe, the big ETRM vendors play a major role in servicing the industry. They provide a comprehensive package of various risk management solutions. In the ETRM world, one size doesn't necessarily fit all. Analysis and requirements gathering are the key factors in determining which system or systems will be used for an organization's daily operations.



About the Author

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