

Growth in energy trading has led to a need for better standardisation of contracts and integration of exchanges and trading hubs. But more needs to be done to simplify and streamline the trading process, says *Wolfgang Ferse*

Raising the standard



Wolfgang Ferse: the future of energy trading depends on standardisation and cooperation

★ The business of European energy trading has not only recovered but also grown significantly since the dark days of Enron's collapse (see box 1). The signs are everywhere: trading volumes on the IntercontinentalExchange/International Petroleum Exchange (IPE) and New York Mercantile Exchange are once again providing liquidity to a larger pool of market participants; new European energy exchanges are popping up in many countries; many large and mid-sized utilities have increased their energy trading and risk management activities as deregulation continues to roll out across Europe; and major commercial and investment banks have also entered or re-entered the energy trading space, along with many energy hedge funds.

This significant growth in trading activities and platforms (exchanges and online hubs) has led to an increased need for a cross-platform and multi-commodity trading facility. Although it is very unlikely that competing energy exchanges and other trading platforms will come together, the standardisation of contracts and technical protocols would grant traders better access to, and integrate their trading activities more effectively with, these

exchanges and trading hubs. To this end, energy associations and software companies are working together to create the conditions for easier and seamless trading.

The growing maturity of market participants, and the markets in which they operate, has called for growing maturity in trading technology. Participants – in particular, large sophisticated trading organisations such as the large utilities and banks – do not have the time to look at a dozen screens and then develop a picture of the trading environment. Instead, viewing information through a central trading mechanism gives them an instant and complete view of the market and the correlation between geographical and cross-commodity prices. In turn, this increases their trading effectiveness through the ability to manage risk better.

As power and gas markets become increasingly pan-European, brokers and exchanges have had to put considerable energy into making the trading process a single and continuous process. Traders will continue to push for integrated market solutions across multiple markets and platforms, including eastern Europe, where many western European traders have substantial interests.

In a recent example of the trend towards integration, the European Climate Exchange (ECX) and Powernext Carbon say they plan to merge their operations to create potentially Europe's largest emissions exchange. The plan will see the two exchanges share a uniform technology platform so that dealers will be able to trade emissions in both spot and futures markets from the same screen. The tie-up of Powernext Carbon and ECX follows the pact in March between SendeCO2, the Spanish-based carbon emissions market, and New Values, a Dutch-based emissions exchange.

Nevertheless, there will continue to be a

1. The recent growth of European energy trading

UKPX: August 2004 volumes: 540 GWh; August 2005: 667 GWh (up by 23%)

APX Gas UK: August 2004 volumes: 6,989 GWh; August 2005: 8,596 (up by 24%)

Powernext: Day-ahead traded volumes 2003: 7,480,000; 2004: 14,180,000 MWh (up by 90%)

Nymex: Record 21,572 e-miNY futures contracts traded on June 2, 2005. On the same day, e-miNY crude oil futures contracts also hit a record high of 19,645 contracts traded.

Record 222,051 contracts cleared through Nymex ClearPort June 14.

International Petroleum Exchange (IPE) volumes 2003: 33,341,244 million lots; 2004: 35,540,758 million lots (up by 6.6% – (seventh consecutive year-on-year volume increase). The IPE's Brent crude and gas oil futures contracts overall trading records of 25,458,259 and 9,355,767 lots, respectively, during 2004, with both contracts establishing new levels for electronically traded volumes.

multiplicity of platforms. It will therefore be important to standardise the processes that underpin trading relationships. The European Federation of Energy Traders (EFET) is actively pursuing a number of initiatives in this area, and sets out its priorities in its recent review, 'The Past and Future of Energy Trading' (see box).

Also, several projects on business process optimisation are being considered that will lead to improvements in efficiency and the reduction of cost and operational risk.

This work will focus on a number of key areas. These will include increasing harmonisation of payment dates to ease cross-commodity payment netting and cross-currency netting; conducting benchmark studies among back-office personnel; and introducing new and better standards for electronic data exchange between traders.

The electronic deal confirmation matching (ECM) project is the first of a series of projects to be launched by EFET. The ECM open standards were a result of an agreement by seven of Europe's largest energy traders and were designed to reduce cost and risks. Once ECM is operating, the same (confirmed) data can be used for nomination or scheduling, invoicing, clearing, and so on. It also creates the basis to implement a straight-through-processing system and save a significant amount of money – especially when other players in the energy industry develop in the same direction.

The standardisation of electronic data exchange is likely to be one of the main areas of work for the future, as it has the potential to deliver significant cost savings and a reduction of operational risk, says the EFET review. To make this possible, traders and other market

participants need to agree on standard codes and procedures.

The philosophy of EFET is to create open standards and to take a European approach instead of multiple national approaches. "There is a unique window of opportunity now to cooperate and book significant results and potentially large savings," says EFET.

The International Swaps and Derivatives Association (Isda) is also working to encourage greater integration. The North

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European Federation of Energy Traders

American Gas Annex and Canadian Addendum, published by Isda in November 2004, are designed to document trades involving the purchase or sale of physical gas on a spot or forward basis, or options on physical gas in the US and Canadian gas markets. It permits users to bring such trades under the Isda Master Agreement architecture and to elect to incorporate existing credit support arrangements. The annex also allows market participants to document trades in a manner consistent with the approach taken by the North American Energy Standards Board (NAESB). Isda has also published a long-form confirmation for trades in EU Emissions Allowances, designed to facilitate trading under the EU Emissions Trading Scheme. The long-form confirmation enables firms to use their Isda Master Agreements and, later this

2. Standardising trading relationships

The European Federation of Energy Traders (EFET) is currently working to standardise trading relationships in the light of the abundance of disparate trading platforms. Traders can then access any market regardless of the trading software they use. In its recent review, 'The Past and Future of Energy Trading,' EFET sets out its priorities. The document says the use of EFET-standardised contractual documentation by participants in traded energy markets throughout Europe has been very high. Going forward, EFET plans to focus on the following key tasks:

- ★ Updating and revising the existing master contracts when prudent and necessary
- ★ Potentially consolidating the existing master contracts into a master

physical commodity-type agreement that could be used to trade numerous different wholesale physical commodities and products

- ★ Increasing the number of countries for which EFET has obtained legal opinions for the gas and electricity contracts, and the CPMA
- ★ Extending the scope of legal opinions to include and address enhancements in the underlying master document – for example, to address emission trading, collateralisation, and possibly unique aspects of regional trading, dealt with in specific market appendices
- ★ Developing harmonised appendices for additional European gas hubs, as well as for existing liquid trading points
- ★ Coordinating with other EFET committees, taskforces and working groups on legal aspects and areas of concern to the EFET members.

year, to use the 2005 Isda Commodity Definitions to trade EU allowances.

Isda has also published documentation that permits the incorporation of UK Grid Trade Master Agreement (GTMA) terms into trades documented under an Isda Master Agreement.

The GTMA Annex is designed to document trades in the UK physical power market and

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relates to the Grid Trade Master Agreement published by the Futures and Options Association. Isda has also updated the 1993 Isda Commodity Derivatives Definitions and related 2000 supplement, which addresses the mechanics of a wide range of cash-settled commodity transactions; and includes revised commodity reference prices and a series of sub-

annexes with provisions for weather derivatives and physically settled commodities.

Some trading participants are striking out into radically new territory by increasing the footprint of electronic trading. For example, in April 2005 the IPE closed its Brent and gasoil futures and options pits to take advantage of electronic trading. Since 2002, the IPE has progressively turned its business toward electronic trade execution and prepared members and market users to trade electronically.

One thing is certain: many challenges await trading participants, exchanges, and brokers. The ability to solve those challenges will in part depend on the ability of the trading systems to simplify and streamline the trading process. Both energy associations and software companies alike must work in tandem to create an ideal trading environment. [ER](#)

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