

The next quantum leap – bridging physical and financial energy markets

The next hurdle in energy is about improving capital efficiency by bridging the gaps between physical and financial markets, advises Keith Thibodeaux, vice president of sales at the North American Energy Credit and Clearing Corporation

Having experienced several bumps along the evolutionary path, physical energy markets worldwide are on the verge of the next quantum leap – bridging the gaps between physical and financial. Today’s physical energy markets have evolved through rudimentary trading customs and delivery mechanisms that create risk ‘silos’ across the transaction landscape. According to John Flory, president of the North American Energy Credit and Clearing Corporation (NECC): “There is as much as \$120 billion in risk capital, against total deliveries of about \$400 billion, tied up to secure US power and gas markets. Much of this can and should be consolidated.” (See figure 1)

The challenge

The current physical energy markets have created inefficient and costly silos of collateral to cover associated risk. The power regional transmission operators (RTOs), gas pipelines/storage, exchanges and over-the-counter (OTC) market require an energy company to separately collateralise each position independently with multiple counterparties throughout the life cycle of a transaction. These silos operate to strand a large portion of offsetting positions, as well as receivables that could otherwise be utilised to offset other collateral requirements. Furthermore, the sheer number of counterparties with widely divergent credit policies is becoming something of a burden for the average energy marketer. As credit markets tighten and interest rates rise, the situation will only get worse.

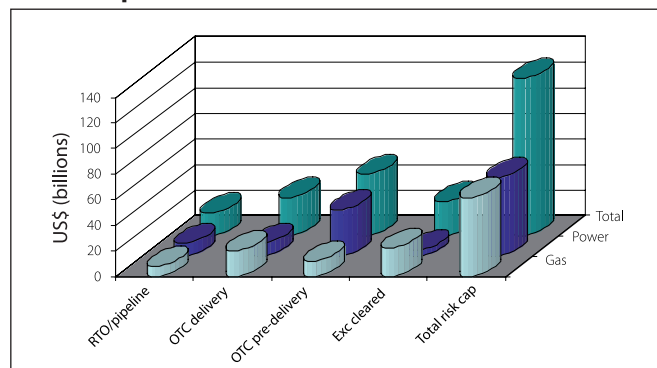
Consider, for example, a natural gas marketer, who – acting as an intermediary between buyers and sellers – enters OTC contracts and/or exchange-traded contracts and goes to delivery through a pipeline or hub. In this case, the marketer is required to post pre-delivery collateral consisting of (1) mark-to-market collateral to each counterparty on both buy and sell OTC contracts; and (2) original and variation margin to each futures contract merchant (FCM) on exchange-traded contracts. When going to delivery, the marketer will post (3) full notional value to each counterparty for OTC purchases in advance of delivery; and/or (4) full notional value of both buys and sells in advance of delivery to each FCM for exchange-traded contracts; and (5) collateral required by pipelines or storage operators.

Power generators using natural gas face an even more onerous situation in that they not only post both with suppliers and buyers, but frequently sit on large stranded receivables at the end of the line.

One possible solution exists today to bridge the silos

NECC provides a means to dramatically reduce credit risk and consolidate collateral through the delivery process. Basically, NECC operates as a market-neutral ‘riskless principal’, wherein it enters matching positions with different counterparties from forward contract through delivery and settlement. NECC’s counterparties can then go through the delivery process with NECC as a single counterparty, thus netting their various positions across the silos, including using receivables as an offset to other margin requirements. Morgan Davies, director of corporate credit for Calpine Corporation and co-chair of the Committee of Chief Risk Officers Credit and Clearing Working Group, stated: “The benefits of physical multilateral clearing for the energy industry are well known, including the potential substantial reduction in credit cost of carry from reduced collateral requirements, lower transaction costs, improved liquidity and a reduction in systemic risk. The ability to net a portfolio of physical power and gas across multiple counterparties provides significant capital efficiencies for a power generator such as Calpine, as well as potentially for the entire energy industry.”

1. Risk capital silos



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