IT Trends, Challenges in Energy Trading

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Last year saw massive volatility in energy and commodity markets, the credit contraction-and the resulting decrease in market participants-and increased regulatory scrutiny. This is the context for 2009 where we can see continual improvements in technology, allowing traders to keep with the pace.

For example, at GFI Group, we see our electronic trading platforms acting as "analog to digital converters" bringing together what historically have been very different liquidity pools within common markets. This is starting to bring greater efficiency, increased transparency and greatly aiding in price discovery.

Decreased latency, smaller application footprints and increased transparency are all leading to more electronic trading. And this is not limited to the traditional "algo" shops: recent technology enhancements are now allowing traditional voice traders access to the electronic world. The voice traders are also enticed with the automation promise of straight-through processing (STP), delivering reduced ticket errors, decreased processing time, and single access points, such as the industry's ConfirmHub joint venture, to multiple execution venues. So what are the major themes for IT in energy trading in 2009?

Hybrid Broking

The energy derivatives markets are coalescing around hybrid broking. For several years, two separate energy markets have existed: an all voice-brokered over-the-counter (OTC) market and wholly electronic exchanges. These markets have thrived independently due to several factors, including the lack of fungibility of the contracts on the multiple energy exchanges, and because voice-brokered markets offered more flexible and customized contracts in terms of size, delivery point, underlying index and so on.

Also, a continuous interaction between trader and voice broker provides greater market liquidity than is possible on screen from an electronic-only exchange.

Although voice-only, electronic-only and hybrid each offers some transparency, only hybrid offers the ease and surety of electronic execution, the comfort that a voice broker offers a trader in fast-moving markets and the near instant access to STP, clearing and bilateral credit checking. But hybrid broking still requires a significant IT investment, whether delivered via a browser-based trading platform, or local server and installed software. Broking firms and traders alike will continue to demand ever better technology, which will only aid the markets by offering more platforms and increased client choice.

Central Clearing

As credit continues to contract, firms are hesitant to use their capital for extending unsecured credit lines to trading counterparties. Instead they are looking for either collaterization of bilateral trades or, more frequently, centralized clearing. This is happening in many OTC markets and energy is no exception. But it is important to make the distinction between clearing houses and exchanges. GFI Group operates in many global OTC markets yet nearly all its energy business ends up being cleared centrally, after having been initially crossed bilaterally. The organizations at the center of this include not only exchanges such as the Chicago Mercantile Exchange (CME)/York Mercantile Exchange (Nymex) but also dedicated clearers, such as LCH.Clearnet.

The IT implication of this is seen in traders' demands for execution platforms that can link to multiple clearing venues-since it seems clear that there will be no single clearinghouse across the diverse energy markets. Moreover, traders are resistant to being locked into any single clearinghouse.

Open trading platforms can switch between clearinghouses. This attractive feature lets trading houses' compliance and risk management teams better optimize their use of capital and collateral.

Improved Liquidity Via Consolidation

Brokerages are increasingly consolidating to offer clients larger pools of liquidity and to make the most of regional strengths. This has also been driven in part by competition from electronic exchanges. For example, GFI has bought two smaller specialist brokers in recent years: Star Supply for oil and products, and Amerex Brokers for U.S. natural gas, power, coal and emissions markets. Trading firms are also consolidating, resulting in ever increasing demands for more market standard communication tools, such as FIX-based application programming interfaces (APIs) across asset classes, improved STP via consolidated feeds offering exchange and OTC confirms from multiple execution venues.

Regulation

Firms like GFI and Amerex have long worked with regulators to aid the understanding of OTC markets and maintain transparency to inspire confidence in the energy markets. Last year's market volatility caused calls for regulatory oversight and we will see this play out in 2009, in multiple jurisdictions around the world.

Many execution platforms, such as Trayport, provide traders with access to both local markets such as power, and more global products such as coal, crude or freight. It will be a challenge for IT departments at smaller trading houses to keep up with the demands from traders for access to these products on in-house platforms and they will increasingly look to market standard solutions. Further compliance, regulation and legislation will add complexity and the need for IT departments and software vendors to respond ever more rapidly.

These many competing demands on technology staff and resources at trading and broking firms will only increase over time. The firms that have the skill and knowledge to convert these challenges into opportunities for increased revenue and client satisfaction will be the ones that emerge the clear winners in this next battle.

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