



Key Challenges Facing CTRM Users

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"Whosoever desires constant success must change his conduct with the times."

— Niccolo Machiavelli

The wholesale energy and commodities trading markets are just like every other market, constantly embroiled in change. Supply and demand balances influence commodity prices, but emotional traders, who may have little understanding of the utility of the commodities they transact, actively seek out and potentially exacerbate price volatility. An increasingly globalized economy makes commodity market dynamics difficult to understand even for the most seasoned trader, and even harder to predict. Emerging regulatory regimes vary in intensity and enforcement from country to country. Constantly shifting and increasingly complex (and often fragile) multimodal supply chains, necessary to convey commodities from established and emerging sources to a multitude of markets, require constant monitoring and recalibration to ensure profitability from one day to the next. It all adds up to complexity.

Though these and numerous other shifting business challenges can be difficult and costly to address, it is the reality of the times. The best commodity traders, regardless of the commodity, actually thrive in dynamic markets, seeing opportunity where others see threats. Nonetheless, even for the most successful companies, the ability to meet these challenges and raise above them is dependent upon having the right people, processes and systems in place.

For companies that utilize commodity trading and risk management (CTRM) software supplied and supported by a vendor, the challenges and risks are not only related to the markets themselves, but also to those vendors on which they rely for

About ComTech Advisory

Commodity Technology Advisory is the leading analyst organization covering the Energy and Commodity Trading and Risk Management (E/CTRM) technology markets. We provide invaluable insights, backed by primary research and years of experience, into the issues and trends affecting both the users and providers of the applications and services that are crucial for success in markets constantly roiled by globalization, regulation and innovation.

their critical systems.

At Commodity Technology Advisory (ComTech), we look at technology from the top-down and the bottom-up – that is we analyze the impacts of market change on the critical CTRM systems that are necessary to operate in the complex wholesale commodity trading markets, and also closely watch and analyze the challenges faced by the companies that supply those systems. With this perspective in mind, we've identified a number of changes that we believe may pose significant near term challenges for the companies that rely on commercially supplied CTRM systems.

"The only constant is change, continuing change, inevitable change...that is the dominant factor in society today. No sensible decision can be made any longer without taking into account not only the world as it is, but the world as it will be." - Isaac Asimov

An Ever Expanding Software Category

The evolution of the software category from ETRM to CTRM is reflective of a growing market for software products that assist companies not only in managing their energy commodity activities and exposures, but the wider adoption of the concepts and, in many cases the software itself, to manage virtually any traded commodity, including agricultural products, softs, metals, and ores. With the run up in all commodity prices prior to the crash of 2008, and the subsequent unpredictability of prices and volatilities, every company that procures raw materials, is energy intensive, and buys, sells or distributes finished products in competitive markets has found itself needing to manage its price exposure and reduce costs in the supply chain. This has significantly broadened the market for CTRM solutions and has additionally created a new category of product that incorporates CTRM with supply change management, yielding Commodity Supply Chain Management (CSCM) solutions.

Of course, this is great news to the larger vendors that have the capabilities to address multiple commodities as it dramatically increases the total addressable market perhaps by as much as 500-600% by some estimates. In particular, Triple Point and OpenLink have been at the forefront of this movement, supplying solutions to a number of global players that transact in multiple commodity classes. Other large technology companies, such as SAP, have similarly seen the opportunities in the expanding definition of CTRM and are moving in from the supply chain management markets, building out capabilities to address the needs of their customers that also have commodities trading groups.

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There are, however, a number of challenges here for the existing users. Firstly, any existing vendor that wants to enter the broader CSCM space will need to invest time, money and effort in developing new functionality or make acquisitions of that functionality and integrate it into their existing platform. This is a significant task and could potentially redirect development and support dollars away from the traditional CTRM functionality – where there is still much work to be done. In other words, some vendors will invest in solving a new business problem before solving the old one. However, this has always been the case in this software segment. Secondly, each commodity supply chain is different in detail requiring vendors to acquire and maintain expertise, increasing costs and therefore risk. Failures should be expected and market participants rely on systems provided by vendors pursuing a broader market in CSCM, or even those seeking to grow their commodity coverage, should be constantly engaged with their vendors to ensure their interests are properly represented.

Merger & Acquisition

M&A activity between the vendors in the software category continues. Most recently, EKA acquired EnCompass Technologies but there have been some sizable transactions in the recent past such as Triple Point's purchase of WAM, OpenLink's acquisition of SolArc and Brady's acquisition of System Alternatives International for example. ComTech expects further consolidation as vendors seek to expand their footprints in chunks as the market continues to expand.

Mergers and acquisitions within the CTRM space can have a very profound impact on end users – but not necessarily entirely negative. On one hand, it may remove useful niche solutions from the market, signal end of life for an implemented application or create uncertainty around future support of a mission critical application. On the other, it can present end users with a broader array of functionality from a single supplier and ease maintenance and support issues. For the vendor, M&A activity also has two sides. It can speed the vendor's ability to get to market with a broader footprint helping it to sustain and grow its business. It can also create product strategy, internal development and support issues that distract the vendor from its current client obligations and development efforts necessary to address the needs of a changing market.

Regulation

With the market collapse in 2008 and the subsequent financial crisis, the G7 nations committed themselves to gaining better insight into, and control of, the

financial markets. Though not initially a direct target of new regulation, the energy and commodity markets were swept-up in the new regulatory schemes drawn up by legislatures and regulators in the US and EU. Though significant time and effort has been put into developing these new rules, many of these regulations are still poorly defined making it extraordinarily difficult to fill in the required detail around implementation and reporting. This lack of clarity has made developing the necessary compliance functionality and related processes difficult for vendors and end users alike, despite the continued insistence by regulators that such capabilities must be in place in the very near future.

Additionally, there is the very real risk that the urgent push to regulate commodity and other markets through what could turn out to be poorly conceived, and overly invasive regulations, could in fact damage the industry. The unintended consequence could be reduced liquidity as companies exit highly regulated markets, either by reducing the scale of their operations, or by shifting their geographical focus to less stringently regulated areas. In fact, this trend has already been observed as some banks and other operations have moved their centers of operations for certain trading functions to less regulated Asian markets.

A further threat to the industry via these regulations is the increased need for capital. One main thrust of the regulation is around credit risk but the way in which the legislation are designed will increase capital requirements for virtually every player in the market. One has to ask where will this capital come from and at what cost?

Although not strictly regulation, economic concerns are driving increased taxation and this too, may be a challenge that could reduce the overall market size. The EU proposed a financial transaction tax, which will levy a proposed 0.1% on derivative transactions and 1% on equity transactions. Eleven EU countries are moving ahead with the proposed tax but here is the killer - the tax will be charged not just on transactions that take place within the 11 countries, but on any transactions that involve shares or bonds issued by them. That would lead to a situation in which, say, a broker in America and another in Singapore trading in the stock of a European company listed on an exchange in Hong Kong would each have to pay a tax in Europe. There have also been several attempts at similar legislation in the US.

"Uncertainty is the only certainty there is, and knowing how to live with insecurity is the only security." -John Allen

Summary

For the end user, the trading and risk management business problem is almost

certainly growing as they face challenges in terms of supporting changes in the business and regulatory environment. Increasingly adaptable and flexible platforms are required from vendors or IT along with viable and cost effective support and maintenance solutions. It is our view that end users also often need guidance in tracking the solutions marketplace, understanding exactly what is available and at what cost. As the industry moves fast in terms of business requirements, solutions must keep pace. It is increasingly difficult to track all the change and to understand how vendors have responded.

ComTech Advisory offers services to all sides of the industry that can reduce time scales, costs and risks. We provide clients with the most accurate and up-to-date market knowledge, ensuring the best use of valuable resources and assets in order to meet current and emerging market needs. With our background in both trading and technology, we understand the issues faced by clients and, through the creation of high value deliverables, address their immediate and long-term needs. We have specific services and deliverables for end users, technology and service providers and market investors to help them define the business problem and solve it in a rapidly changing industry environment.

"Change before you have to." - Jack Welch

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