

# Oil and Gas Investor

## WHITE PAPER: HEDGING COMMODITY RISK

**Allegro**<sup>®</sup>

*A White Paper sponsored by Allegro Development Corp.*

### Hedging commodity risk provides stability and predictability

Proven software systems help you comply with complex hedge accounting.

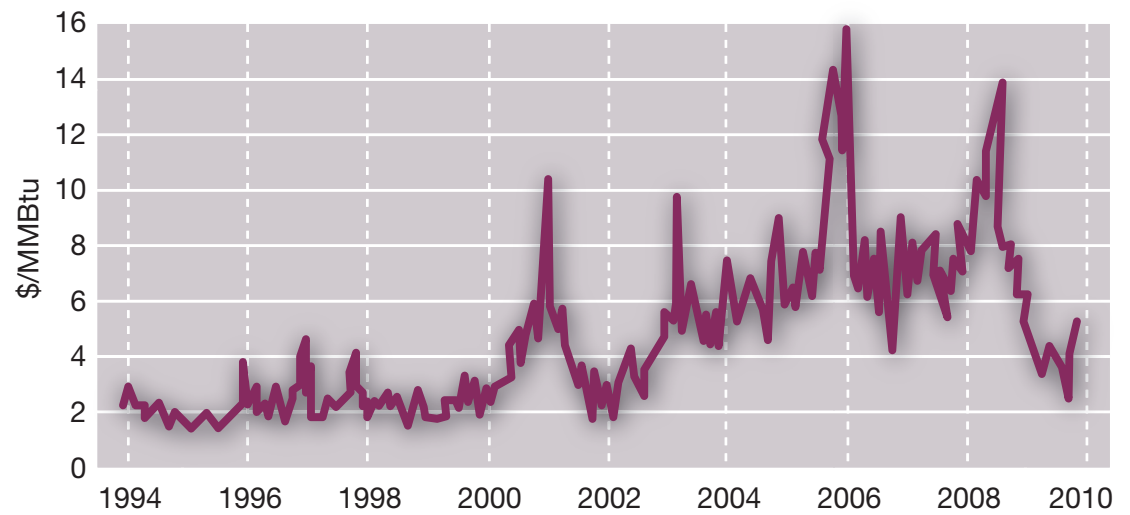
**V**olatile energy prices, and the need to smooth the ups and downs of quarterly earnings and budgets, demonstrate the need for buyers and sellers of commodities to hone their hedging skills to manage energy price risk.

Producers and buyers alike have learned, some the hard way, that while hedging can protect against an adverse move in market prices, it can also preclude the opportunity to benefit from a favorable market move. Hedging is about balancing risk appetite against the unknown upside and downside in market timing.

Hedging benefits the energy customer and the provider: Customers gain some insulation against price volatility, and energy providers can stabilize their cash flows, which is vital in the capital-intensive energy business.

In finance, a hedge is a position established to offset exposure to price fluctuations, with the goal of minimizing one's exposure to unwanted commodity-price risk and to allow price transparency and standardization. Hedging allows participants to lock in a specific price or range of accepted prices, regardless of how much prices for that commodity may fluctuate in the current, or spot, market.

#### Daily Natural Gas Futures Contract



Source: U.S. Energy Information Administration

*Extreme price volatility since January 2006 makes hedging and hedge accounting a wise decision.*

There are many specific financial vehicles to accomplish this, including forward contracts, swaps, options, many types of over-the-counter (OTC) and derivative products, as well as future contracts.

For energy companies and commodity end-users that cannot afford to guess wrong on price, huge volatility swings coupled with complex hedge-accounting rules present a challenging scenario that must be addressed efficiently.

All are subject to the risks of documentation headaches, errors and restatements. Such hassles and risks have prompted some chief financial officers, whether selling or buying, to rather risk price volatility than

designate derivative instruments as hedges for accounting purposes.

This is a decision that could place the wellbeing of the company in jeopardy.

"To alleviate the complexity and risk of dealing with hedge accounting, companies look to solve two basic needs: analyzing the past and future effectiveness of their hedges, and insuring compliance with U.S. and international regulatory accounting requirements," says Eldon Klaassen, chief executive officer of Allegro Development Corp., a leading provider of energy trading and risk management (ETRM) solutions.

While much of the energy industry has returned to the relative safety of trading

around assets and marketing activities, markets are still characterized across all energy commodities by increased price volatility.

## Qualifying for hedge-accounting treatment

Companies hedge to mitigate the risk of volatility of items like interest rates, foreign exchange rates, and most importantly --- commodity prices. Hedging can take a lot of forms, including physical hedges, where the actual risk item is bought and sold in anticipation of rising or falling rates or prices. But, mostly it involves financial hedges, where some type of financial instrument is being bought and sold (usually derivatives) to hedge against those risks.

Hedge accounting is not a requirement for companies, but can be a wise financial decision. Companies that don't use hedge accounting face the issue of derivative gains or losses, which can hit earnings. The resulting income swings would mostly defeat the purpose of using a hedging strategy. But by using hedge accounting, this volatility can be mitigated to a large extent.

How does a company ensure that its hedges qualify for hedge accounting treatment?

The most burdensome requirement is that the derivative's results must be expected to be highly effective in offsetting the changes in fair value or cash flows associated with the risk being hedged.

This means a company must use some generally accepted/approved analytical or statistical methodology to test how the hedge has performed in the past and how it is expected to perform in the future. ASC 815 (formerly Financial Accounting Standards No. 133) and IAS (International Accounting Standards) 39 set guidelines on the effectiveness threshold that must be met for the hedge to be "effective," thus qualifying it to be treated with hedge-accounting methodologies.

Another challenge when hedging? Doing the reporting necessary for compliance. These items have to be captured or reported:

- the hedged item (underlying exposure such as a commodity, interest rate or foreign exchange exposure);
- the hedging instruments (financial derivatives being used to offset the underlying exposure);

- the nature of risk being hedged; and,
- documentation of how the hedging instrument's effectiveness in offsetting value changes in the hedged item will be assessed.

The extreme complexity of energy organizations, markets, transactions, contracts, and accounting rules generate special challenges in complying with Sarbanes-Oxley, as well as with applicable accounting standards. Private companies face similar challenges ensuring accurate internal audits and proper governance. The overarching issue is embedding compliance into business processes throughout the organization -- and doing so quickly and cost effectively.

Under current accounting standards, getting the accounting treatment is complex. Achieving this goal requires close coordination between hedgers and financial reporting professionals who, in addition to managing the accounting process, are responsible for drafting hedge documentation that serves as prerequisite for qualifying for hedge accounting treatment.

Reporting can be extremely onerous, time-consuming and prone to inaccuracy without using some type of reporting and compliance tool. Therefore, key to a company's hedge trade strategy is the use of some type of analytical tool that will help ensure its hedges are effective --- and accurately reported to the authorities.

## Transparency from front to back office

Transacting in commodity markets requires real-time trading solutions that enable traders to instantaneously react to market opportunities. Energy trading and risk management (ETRM) solutions must also provide rapid deal capture, trader decision-support tools and superior market insight so the hedger can identify arbitrage opportunities.

The challenge is finding an integrated solution that meets the various needs across a company. The solution needs to provide: the ability to measure and report in real time the complexity (all commodity and derivative types) of a portfolio, maintain curves and forecasts, and manage deals (physical and financial) from capture to confirmation, to invoice and general ledger.

ETRM solutions provide a transparent view of complex portfolios consisting of physical, financial, and natural positions

across all commodities, including crude oil, fuels, natural gas, coal, refined products, and power. With the right ETRM solution, managers can optimize business processes around the physical movement and delivery of commodities--and the risks associated with these activities. It's crucial to be able to enhance the effectiveness of settlement, accounting, and reconciliation processes.

Comprehensive ETRM solutions, such as those provided by Allegro Development, should deliver a single platform with the ability to view all exposures and risk analytics, capture transactions, execute logistics, manage positions, perform settlement and accounting functions, and meet compliance requirements.

By fully integrating all data and processes into one platform, companies can hedge more efficiently and they will enjoy transparency across the front, middle and back office.

## Information systems must be adaptable

Greater regulatory compliance requirements will prompt companies to report trading activities with increasing frequency and detail. Aggregated position reporting -- not just individual transactions --- will have to be reported.

Companies participating in derivatives trading will need systems to monitor trading activities, ensuring that hedges are properly matched and limits are strictly maintained. Systems must be able to reconstruct information on market prices, trades, and positions at a given date and time, so that companies will be able to answer this question from regulators: What did the trader know at the time?

Because of still-evolving regulation, and processes ensuring a more active regulatory environment, trading systems must be adaptable to ongoing changes to remain current with reporting requirements.

Established providers of trading and risk management systems, such as Allegro Development, are able to provide the infrastructure, monitoring, audit, and reporting capabilities that market participants will need for compliance. ■

# OTC market face new oversight and rules

The Over-the-Counter (OTC) market, which had largely been unregulated, soon will be subjected to new federal regulations and oversight dramatically affecting how energy commodities are traded.

The OTC market, which is commonly used to manage, or hedge, risks will be regulated by the Commodity Futures Trading Commission, which has new authority resulting from passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or simply the 2010 financial reform law. The law gives a network of regulators more power to dismantle troubled firms. The legislation was named for its sponsors Senator Christopher Dodd, a Connecticut Democrat, and Representative Barney Frank, a Massachusetts Democrat.

The CFTC is charged with imposing limits on the number of contracts a single trader can hold, setting margin requirements and deciding which trades will be processed, or cleared, through third-party clearinghouses. The CFTC historically has served as an independent agency that regulates commodity future and option markets, including raw materials such as oil and natural gas, and agricultural crops.

New rules provide for mandatory central clearing and exchange trading of certain swaps, real-time reporting of trades, registration and regulatory oversight for swap dealers and other entities maintaining substantial positions in swaps, called "major swap participants." It also sets positions limits and rules intended to prohibit the manipulation of commodity markets.

The bill was signed into law July 21, 2010, with most provisions of the Act effective a year later. The major thrust of the law was not directed at energy markets or derivatives, but instead on the creation of a network of federal agencies, headed by the US Treasury, to oversee financial system risks. The law also creates a new agency to monitor consumer financial products.

Despite its length --- more than 2,000 pages --- the legislation creates much uncertainty and ambiguity as key elements have been delegated to regulators to work out over time, with the legislation serving as an outline. Provisions concerning OTC oversight are addressed in the law in Title VII.

After passage of the law, stakeholders clamored for more clarity. The CFTC said in September that it expects to issue proposed rules to implement the law by Thanksgiving. Still to be resolved is the definition and interpretation of terms such as swap dealer or major swap participant, as well as terms for end-user exemption. Definitions are important in determining the level of governmental oversight and reporting requirements.

"The law has been passed but many of the details have been left to the CFTC to interpret. Those interpretations will be critical to the energy industry, particularly as it relates to the end user exemptions and disclosure requirements," said John England, partner, oil and gas leader, Deloitte & Touche LLP.

The most significant take-away is that the law gives the CFTC power to regulate over-the-counter derivatives, England said

Matthew Magidson, chair of the derivatives practice group for Lowenstein Sandler PC, offered a description of the new regulatory framework for swaps. "The new regulatory framework has three basic elements. The first is the reporting of swaps. There will be aggregate reporting requirements for swaps, regardless of the size of the user and whether or not the transaction is cleared. So now, not only will all cleared transactions have to be reported, but also all un-cleared transactions. The second is the concept of central clearinghouses designed for clearing derivative transactions. For example, if you enter into your trade with your normal counterparty, it is then given up to a clearinghouse; the clearinghouse backstops the risks in the marketplace. The clearinghouse is made up of a pool of members who are dealers, who together provide some additional security. Lastly, cleared transactions are supposed to be executed on a swap exchange facility. However, I think we need to wait for the regulations to have a clear picture of exactly what that means."

Derivative contracts in which one of the counterparties is not an end-user will be subject to mandatory clearing. An end-user is generally defined as using the contract to hedge, or mitigate, commercial risk, as opposed to a speculator. An end-user cannot be a financial entity. Entities that are defined as swap dealers, or major participants in the swap markets will be required

to register and submit minimum capital and margin requirements.

The U.S. Chamber of Commerce, alongside other trade groups, has been pushing regulators to ensure a "strong, clear exemption" for so-called "end-users" of derivatives. The financial law provides an exemption for companies that use derivatives to hedge business or commercial risks rather than for speculative purposes. But it is up to regulators to spell out the full details of the exemption.

The business groups argue that without the end-user exemption, companies could be forced to post billions of dollars in margin to cover the risks in the trades. They argue the requirement would tie up capital and limit their ability to invest in other parts of their businesses.

CFTC Chairman Gary Gensler is an advocate of commoditizing the OTC market to reduce the risk of another financial meltdown. "The Wall Street reform bill will --- for the first time --- bring comprehensive regulation to the over-the-counter derivatives marketplace. Derivatives dealers will be subject to robust oversight. Standardized derivatives will be required to trade on open platforms and be submitted for clearing to central counterparties," he said when the bill was signed into law.

More than 200 entities, ranging from banks to energy traders, could be classified as "swap dealers," Gensler said in a September speech. He said the estimate was based on International Swaps and Derivatives Association membership records as well as information the CFTC has gleaned from numerous meetings. The rules would require the banks participating in the OTC market to set up separate entities, with their own capital. The rules could reshape the markets, reducing the role of large dealers.

The International Swaps Dealers Association issued a statement that said that the new bill could cost businesses about \$1 trillion in capital and liquidity requirements. It said that about \$400 billion would be needed as collateral that corporations could be required to post with their dealer counterparties to cover the current exposure of their OTC derivatives transactions. ISDA estimates that \$370 billion represents the additional credit capacity that companies could

need to maintain to cover potential future exposure of those transactions.

Proponents of the new regulations argue in favor of the need for more transparency. Without transparency it was difficult to assess the degree of risk financial institutions faced because many of the transactions did not pass through standard markets and were not tracked. Some have blamed inattentive regulators and the derivatives instruments themselves as being contributors to fueling a financial crisis that led to the worst recession since the Great Depression.

Congress sought to regulate the \$615 trillion OTC derivatives market, including swaps, after the trades complicated efforts to solve the financial crisis when regulators and market participants couldn't easily determine how interconnected banks had become through the contracts.

Pritchard Capital Partners noted that energy industry insiders "are up in arms" over new disclosure rules. The rules order resource companies to reveal royalties, bonuses, and other payments. ExxonMobil Corp. and other international oil companies believe this level of transparency will hurt competitiveness of US integrated and E&P companies by providing competitors with specific terms of pending transactions. Inversely, the law potentially helps smaller companies work their way into concessions formerly dominated by major integrated companies, according to the Pritchard Capital report.

In arguments to the CFTC, a group of energy companies that included BP, ConocoPhillips, and Vitol, objected to the prospect that the CFTC will regulate commercial energy companies as swap dealers. Although commonly not viewed as dealers, many commercial energy firms and end-users engage in a significant volume of swap transactions. Often, these trading activities are a significant part of the business of a commercial energy firm. Such firms are better characterized as traders, the group said.

U.S. companies that use commodities derivatives believe the new rules will increase their costs of hedging --- and companies in Europe expect a similar result from forthcoming European Union regulations, according to a survey conducted by Greenwich Associates, a consultant company. The survey included 40 "end-user" companies that regularly use derivatives for hedging purposes.

Most companies expect an increase in

hedging costs regardless of the final outcome of the still open question about whether the new law will require "end-users" to post margins on swap transactions that are not centrally cleared.

"Two-thirds of study participants say rules requiring banks and non-bank financial institutions to centrally clear all derivatives transactions will increase their own costs," says Greenwich Associates consultant Andrew Awad. "To some extent it's inevitable: if banks are forced to lay off their own risks through centrally cleared transactions and are subject to a range of new capital, margin and record-keeping requirements, the additional costs will

be passed through to their commercial clients."

Seventy percent of corporations say they expect mandated central clearing to have a negative impact on their ability to effectively hedge commodities exposure. In addition to margin requirements for central clearing, commodity hedging users said the standardization of contracts would sharply reduce their flexibility. Despite the negative impact on costs, almost all of the companies surveyed expect central clearing to be effective in mitigating counterparty risk.

Richard McMahon, executive director of finance and energy supply for the Edison Electric Institute, says, "We've estimated that

## End-user view: The case of Southwest Airlines: hedging is "insurance"

**H**edging isn't just for commodity producers. Large buyers, or consumers, have found that hedging of products essential for their businesses can provide some needed stability and predictability to a large cost item.

Southwest Airlines (SWA) was a pioneer in hedging among airlines, which had been held captive by the huge price swings in jet fuel. The airline cites its hedging program as a major factor in its ability to remain profitable in the past decade, despite the volatility of oil markets.

The Dallas airline first dabbled in hedging when prices spiked in the early 1990s, but did not get systematic about it until 1999. Before the oil-price plunge in 2008, the airline estimates that its net savings on fuel, resulting from its hedges, were about \$4 billion. When oil prices fell and the airline was forced to take hedging losses for 2009 totaling about \$245 million, SWA officials noted its overall long-term hedging success. They concluded that "not to hedge would be foolish."

"We treat hedging as 'insurance' against volatile fuel-price swings, which otherwise we have no control over," says Ray Schuster, Director of Financial Reporting for SWA. "The airline does not hedge to make money necessarily, but rather as a means to reduce the risk of losing money if the price of oil goes up. You don't want to go into a situation where prices are totally beyond your control. We wanted to build a business plan where we have some level of predictability on what costs would be," Schuster says. SWA has modified its hedging strategies, or tools, now primarily using call options.

"That's our favorite way to hedge right now," Schuster says, "because it offers protection against rising prices, but allows the company to pay market rates if prices remain low. "We used call options a lot in the late 1990s, but then they got too expensive as oil prices rose. In the last two years, we used a lot more collars, which combine options contracts, providing protection from rising prices, but more risk if prices fell," he explains.

"We've always used simple methods of hedging, a combination of options, collars and swaps. Hedge accounting is more complicated than it used to be and reporting requirements are more stringent, but we try not to let the accounting drive our business decisions."

SWA's treasury department manages price risk and hedging activities associated with jet fuel purchases through utilization of software products developed by Allegro Development, a leading provider of energy trading and risk management (ETRM) solutions. ■

the amount of money saved in not having to post margin with clearinghouses, for the average utility, is between \$250 million to \$400 million, per year. That's the cash flow impact of having to put margin deposits down on clearinghouses."

AES Corp., a global electric power company with generation and distribution businesses, in a filing to the Securities and Exchange Commission, said: "Even if the exemption (for end-users) is available, the enactment of the Dodd-Frank Act could still have a material adverse impact on the Company, as the regulation of derivatives (which includes capital and margin requirements for non-exempt companies), could limit the availability of derivative transactions that we use to reduce interest rate, commodity and currency risks, which would increase our exposure to these risks. Even if derivative transactions remain available, the costs to enter into these transactions may increase, which could adversely affect the operating results of certain projects; cause us to default on certain types of contracts where we are contractually obligated to hedge certain risks, such as project financing agreements; prevent us from developing new projects where interest rate hedging is required; cause the Company to abandon certain of its hedging strategies and transactions, thereby increasing our exposure to interest rate, commodity, currency risk; and/or consume substantial liquidity by forcing the Company to post cash in support of these derivatives.

CFTC's Gensler dismisses the argument that the new rules will cost derivatives customers more. He notes that large derivatives dealers, mostly large financial institutions,

have estimated that they could lose billions in revenues because of the new rules. That is billions of dollars that customers could save by getting better pricing on their derivatives trades.

The law firm of Mayer-Brown LLP reported that some investment banks are moving away from the practice of proprietary trading of commodities markets in anticipation of more stringent rules. Proprietary trading is the practice of financial institutions investing their own money, as opposed to trading on behalf of clients, in search of profit. Mayer-Brown noted that J.P. Morgan Chase and Goldman Sachs have given notice that their proprietary trading operations will soon be shut down. Still, demand for commodities derivatives remains strong, and buyers and sellers will continue to need market liquidity to perform their trades, regardless of where that liquidity comes.

"Some markets could see a temporary lull if other banks follow the lead of these large firms, and there are worries about the loss of liquidity in some sparsely traded products. But a permanent reduction in speculative activity isn't in the cards. Hedge funds and other investment groups are expected to fill some of the void, and analysts are hopeful that rules will still allow for banks to serve their clients," Mayer-Brown wrote.

"Opponents of tighter regulation of oil and other commodities markets claim that the loss of liquidity from banks could bring down total market liquidity to a level insufficient to meet demand from traders. Those who support new regulations argue that even without the participation of large banks, the market will provide adequate liquidity to meet demand," the report said.

Former U.S. Treasury economist, Dr. Samuel Van Vactor, now president of Economic Insight, Inc., said: "US energy markets face a new regulatory framework arising from the failings of the financial sector. Trading costs will rise, threatening liquidity. However, many key elements of the Wall Street Transparency and Accountability Act have been passed on to regulators. The true nature will emerge only with time. The Act does little to streamline oversight activities, while the biggest problem may prove to be 'regulatory creep.' So far, the Dodd-Frank Act simply outlines broad policy. Next various agencies and commissions will implement the Act. Ultimately, the law courts will have a hand in interpreting its provisions. Anyone who reviews the Act will appreciate its significance; ultimately, however, no one can predict its consequences."

Ensuring that derivatives regulation will remain a fluid, ongoing process, was the creation of an Energy and Environmental Markets Advisory Committee. That committee will conduct public hearings, issue reports, and make recommendations to the CFTC. It is intended to be a forum for stakeholders – energy sellers, end-users, exchanges, and regulators --- to discuss matters of concern regarding markets and regulation.

Regardless of the outcome, what is clear today is that energy companies will likely need to report trades, closely track positions, implement comprehensive audit processes, and adhere to reporting requirements like never before. Fortunately, technology providers, such as Allegro Development, can help companies efficiently handle the burden of new requirements. ■

## “Shale shocked” E&Ps hesitant to lock in low natural gas prices

**S**tunned by a plunge from the historically high oil prices of early 2008 --- and even more dramatically for natural gas --- most oil and natural gas producers that hedged 2010 and 2011 production said they were playing defense to provide price stability and predictability and to avoid uncertainty associated with volatile commodity markets.

Those producers locked in acceptable prices, or ranges, rather than risk huge losses, should they be wrong in the hope that their prices would rebound.

But, sensing an end, or at least easing, of the recession, some producers are reluctant to leave money on the table, and have cut their percentage of hedged production. The percentage of hedged 2010 natural gas production was 43%, compared to 22% of 2011 production, as of mid-September 2010. Estimated 2010 crude oil production was hedged at a rate of 40%, compared to estimated 2011 production of just 25%.

Averages, however, are missing as the percentages vary from 0% for some producers to a high of over 80% of 2010 produc-

tion for others. Even the high percentage producers, however, sliced their hedged natural gas production.

According to a Sept. 20 report from Morgan Stanley Research North America, the most hedged natural gas producer in 2010 and 2011 was Pioneer Natural Resources, with percentages of 82 and 78, respectively, with crude oil hedged even more, 91% to 98% respectively.

Most notably, Anadarko Petroleum Corp.'s percentage of hedged 2010 natural gas production was 75%, but its 2011 production is just 22%. Anadarko's oil hedge percentage was 65% in 2010 and 59% in 2011.

Among independent E&Ps with estimated natural gas 2011 production of at least 40% are: Pioneer, Range Resources Corp., Newfield Exploration Co., Ultra Petroleum Corp., Denbury Resources Inc., and Bill Barnett Corp. Those with at least 50% of 2011 estimated crude production hedged are: Range, Plains Exploration and Production, Pioneer, Denbury, Anadarko, and Newfield, the Morgan Stanley report said.

The U.S Energy Information Administration in September lowered its 2011 spot margin natural gas price forecast to \$4.76 per thousand cubic feet, down 22 cents from its previous outlook. The EIA said gas prices bottomed out at around \$2.50 in 2009 as production from shale plays ramped up gas production.

Southwestern Energy, a leading producer of natural gas from Fayetteville Shale (Arkansas), credited its hedging program from preventing huge losses. Southwestern, in its second quarter conference call, said its strong hedging position lifted the company's average realized gas prices by approximately 58 cents per thousand feet to an average price of \$4.27.

"We currently have approximately 87 billion cubic feet of our remaining 2010 projected natural gas production hedged through fixed price swaps or collars at a weighted average floor price of \$6.26 per Mcf. This represents a little over 40% of our expected production in the third and fourth quarters," the company said during its earnings conference call.

Southwestern has increased its hedging position in 2011 and 2012. It has 92 billion cubic feet of its 2011 forecasted gas production hedged at an average floor price of \$5.61 and approximately 80 bcf of its 2012 forecasted gas production at a floor price of \$5.50 per Mcf. Southwestern CEO Steve Meuller said the company would accelerate shale production, when prices rebound.

While most producers say their hedging strategy is to play defense, Chesapeake Energy says its strategy is "offensive." Chesapeake said its strategy has created more than \$5 billion in gains over the last decade. During the first three quarters of 2010, Chesapeake sold more than 70,000 long-dated call options in a bet that natural gas prices would remain below about \$8 per thousand cubic feet between the years 2013 and 2020. During the first three quarters of 2010, actual natural gas prices fluctuated from a low of about \$3.90 to a high of almost \$6.

Citing the difficulty in predicting prices, analysts say most oil and gas companies limit their hedging to a much shorter time-frame, usually one to two years.

But, Chesapeake says its rationale is simple: if gas prices

remain below \$8, it keeps the price the options sold for and never pays additional money to its counterparty. If gas prices go above the \$8 benchmark, Chesapeake will have to pay the difference to counterparties, but that costs will be offset as it benefits from the sale of more expensive gas to the broader market.

E&P companies are also noting a de-coupling of oil and natural gas prices, which traditionally had a strong correlation, based on their energy value. The energy value of a barrel of oil is roughly equivalent to about six thousand cubic feet of natural gas. Because of that basic rule of physics, prices have been highly correlated over the years. Traditionally, oil prices, as measured in dollars per barrel, tended to be in a range of 6 to 12 times natural gas prices, as measured in dollars per million British Thermal Units (BTUs). With mushrooming natural gas production spurred by shale gas, compared to oil production, that ratio of oil prices vs. natural gas, has at times during the past two years, blown out to more than 20 times. Producers who didn't hedge, nor anticipate a steep drop in natural gas prices caused by shale gas production, were "shale shocked."

The unusual pricing of the last two years reflects two factors: First, there has been a dramatic expansion in domestic natural gas suppliers that has driven down prices. Second, there is a limited opportunity for energy users --- utilities, businesses, and homeowners --- to switch from oil to natural gas. Low natural gas prices have prompted some E&P companies to focus more on oil production and less on natural gas.

The de-coupling of oil and natural gas has created headaches and opportunities, and has added to the risk of trying to predict commodity prices --- making hedging more essential.

Philosophies regarding hedging differ among producers. Some companies have the philosophy that they want to play the commodity market in search of the big upside potential, while others may give up such potential in order to lock-in a reasonable profit.

Many reserve-based lenders require their borrowers to hedge a minimum percentage of their estimated production in order to reduce the impact of commodity price fluctuations on the borrower's ability to service the loan.

Some venture capitalists require their investment targets to hedge in order to curtail commodity risk, while others discourage hedging because it limits "upside potential." Corporate managers frequently use hedging to stabilize cash flow to be confident they can cover fixed operating expenses. ■

## **About Allegro Development**

Allegro is a global leader in energy trading and risk management solutions for power and gas utilities, refiners, producers, traders and commodity consumers. With more than 26 years of deep industry expertise, Allegro's enterprise platform drives profitability and efficiency across front, middle and back offices, while managing the complex logistics associated with physical commodities. Allegro provides customers with flexible solutions to manage risk across gas, power, coal, crude, petroleum, agricultural, emissions and other commodity markets, allowing decision makers to hedge and execute with confidence. Allegro has recently been recognized as the Energy Risk Software House of the Year and received The Energy Business Awards Gold Award for Excellence. Headquartered in Dallas, Texas, Allegro has offices in Calgary, Houston, London, Singapore and Zurich, along with a global network of partners.

To learn more about Allegro's hedge accounting functionality, visit  
[www.allegrodev.com/regulatory-compliance/hedge-accounting-and-reporting-solution](http://www.allegrodev.com/regulatory-compliance/hedge-accounting-and-reporting-solution)