



A CommodityPoint Whitepaper

Dodd-Frank and the New Age of Regulation in Energy Markets

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1. Introduction - Global regulation of commodities and derivatives markets coming like a freight train

In the period since the collapse of Enron in late 2001, the global energy commodities markets have undergone tremendous change, including: the entrance of new participants; the rise of new markets, exchanges, and derivative products; increased demand for energy products spurred by global economic expansion, particularly from the emerging and accelerating economies of China and India; and new legislative mandates that have reshaped fundamental relationships amongst both energy and non-energy commodities. These developments have fundamentally changed the markets, impacting not only the supply and demand dynamics, but have spurred the development and widespread deployment of new trading strategies in which a commodity's value has become less about its utility and more about its volatility.

These new market fundamentals created unprecedented price increases across the energy commodity complex, and in particular the crude markets, with rapid price escalation taking hold in early 2007 and increasing unabated until the third week of July 2008. At that time, the markets began a free fall initiated by the emerging credit crisis that spread from the US to Europe, spawning a global recession that has significantly reduced industrial throughput and demand for all commodities. The full effect of this market collapse (in which bellwether crude prices declined more than 75%) is still emerging. Clearly however, the impacts that have been seen to date are far reaching and lasting, and have resulted in increased public and regulatory scrutiny into markets that had previously been somewhat "dark" for many.

Increasing public awareness of these markets and their impact on investors and consumers alike has brought new political pressures on governments around the world to rein-in the actions of traders that were perceived to be taking unfair advantage of and potentially manipulating the financial and commodities markets.

1.1 US Regulatory Overview – Moving Targets

Multiple federal entities have historically had some potentially conflicting jurisdictions over the energy commodity markets, including the FERC, FTC and the CFTC. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July of 2010, an ongoing

process is being put in place that will further clarify what the future regulatory requirements will be for companies transacting in the physical and financial energy commodity markets.

Though the Dodd-Frank legislation is primarily aimed at the financial services industry, the legislation has significant implications for companies that transact in energy commodities. The new law provides the CFTC far-reaching authority to regulate the major energy markets - not only the organized exchanges, but also activities in the over the counter (OTC) markets.

As indicated in the CFTC's "Proposal to Set Position Limits in the Energy Futures and Options Markets¹," regulators have been looking at the futures and derivatives markets for four commodities: Henry Hub natural gas, New York Harbor No. 2 heating oil, light sweet crude (WTI) and New York Harbor gasoline blendstocks. With adoption of the final rule in October, 2011, the CFTC has set trading limits for these commodities with the stated purpose to "prevent burdens that could arise from excessive concentration in the futures and options markets."

For companies trading in these commodities, the implications vary depending on both the scale of the trading activities and the purpose of the trades. Companies that trade specifically for bona fide hedging purposes have been provided an exception, applicable at a trade by trade level, from many of the regulations that would cover "Swap Dealers" or "Major Swap Participants" as they are defined in the Dodd-Frank Act. Nonetheless, while many energy market participants will fall within this category of "hedging only," all trading entities will be required to produce reports and documentation in order to confirm their status in one of the three categories

For those companies that do fall within the "Swap Dealers" or "Major Swap Participants" categories, the regulations will include:

- New capital and margin requirements for non-bank "Swap Dealers" and "Major Swap Participants."
- Additional reporting requirements for "Swap Dealers" or "Major Swap Participants" as are required by the CFTC, including highly granular daily trading records.
- In order to "limit the concentration of positions and promote fair and orderly markets," through the new legislation, the CFTC has set aggregate position limits across all contracts

¹ <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/energyrulefactsheet.pdf>

in the regulated commodities, although those limits will not include swaps utilized strictly for bona fide hedging purposes.

- The new laws clearly envision that most swaps will be cleared through one of the established markets; however, for those that are not cleared through clearing institutions, and do not involve either a "Swap Dealer" or "Major Swap Participant" (both of which will generally be required to report the transaction), the law will require that the transaction be reported to a "swap data repository," and if that is not possible for whatever reason, the swap will have to be reported directly to the CFTC.

As noted earlier, a key driver of the regulations is an attempt to prohibit market manipulation. Much of the new law focuses on prohibiting the "delivering, or causing to be delivered through the mails or interstate commerce, by any means of communication whatsoever, a false or misleading or inaccurate report concerning . . . market information or conditions that affect or tend to affect the price of any commodity."

Rule Making Progress has been Slow but is Proceeding

As originally envisioned, the CFTC was given one year to establish the new rules regarding the specific definition and enforcement of this language, and though the progress to a final regime has been delayed, on December 20, 2011 the CFTC finalized rules for two crucial sections of the regulations: Part 43 "Real Time Public Reporting of Swap Transaction Data" and Part 45 covering "Swap Data Recordkeeping and Reporting Requirements."

Part 43 rule provides that a registered Swap Execution Facility or Designated Contract market must transmit, "**as soon as technically practicable**", swap transaction and pricing data to a registered swap data repository, immediately after a publicly reportable swap transaction has been executed. The other rule, Part 45 states that for every swap executed on a Swap Execution Facility (SEF) or Designated Contract Market (DCM), that entity must report all swap creation data, "as soon as technologically practicable" after execution.

For those companies that are designated as "end-users" under the CFTC's classification standards, there has been an assumption by many that the rules would not apply. However, it is important to understand that end-users are provided an "exception" not an "exemption," meaning that each swap must still be reported either through the SEF or DCM, or directly to an SDR. The record keeping rules also still apply, meaning that all data associated with the trade

must be maintained (including both electronic and paper records) for 5 years after the expiration of the trade and retrievable by the company within a maximum of 5 days.

Market participants will be required to report economic data related to the creation of the swap, including all financial terms and confirmation data. The reporting related to the swap must also continue for the life of the transaction, with updated details, providing enough information that the swap can be continuously valued by a third party. The rules for reporting differ depending upon the classification of the market participant, the mode of transaction and, in cases of non-cleared transactions, the classification of the counterparty to the swap.

As of this writing, the CFTC has established an October 14, 2012 compliance date for reporting swap data for Swap Dealers and Major Swap Participants; and a January 12, 2013 date for other market participants.

1.2 European Overview

European regulators are moving toward a near mirroring of the DF regulations currently being formulated in the U.S., with EU rulemaking aimed at curbing 'speculative' trading in commodities and derivatives as well as to improve the transparency and risk management of the OTC derivatives markets.

The prospective new rules, first outlined in the September 2010 draft release of the European Market Infrastructure Regulation (EMIR), also seeks to establish rules for central clearing exchanges and trade repositories. While the shape and form of these eventual reforms remain somewhat unclear, there is some progress being made.

In February of 2012, the relevant EU bodies agreed on much of the final language of EMIR, outlining goals and scope, though not providing clarity as to actual reporting requirements (form, data, etc.) or the thresholds for determining which companies must meet the emergent standards. While the EU has set an end-of-year 2012 deadline for implementation of the centralized clearing and reporting requirements, there is considerable doubt that the deadline will be met.

In a related regulatory development, the EU passed the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) in December 2011 which, when operating in concert with EMIR, will have further impacts on traders in the EU energy markets.

The intent of the REMIT legislation is to ensure that market manipulation is not occurring within wholesale energy markets and the price that retail customers pay is reflective of the true supply/demand balance in the energy markets.

The primary focus of the new regulation is to prevent wholesale energy trading based on insider information and specifically covers physical power and gas, including transportation/transmission and any derivative products. The scope of the legislation includes both exchange based trades and over the counter (OTC) deals. Interestingly, and owing to the global nature of their markets, coal and crude are excluded from the rules.

In the effort to prevent insider trading, the EU has established new rules requiring the full public disclosure of any insider information they may have related to the activities of affiliated parties or business in which they own or control. The REMIT rules also prohibit any attempts to influence market prices for any reason in the covered markets. These rules specifically cover false rumors or publishing of false data.

Though some progress has been made in formulating new regulatory regime in Europe, there continues to be much uncertainty regarding the final rules. However, the reach of U.S. legislation and regulations is impacting trading firms in Europe. U.S. regulators have increasingly become more aggressive, paying less attention to borders on the basis that 'illegal' or improper trading activities outside of the U.S. can still have an impact on US markets. This has resulted in many trading firms having to take steps to comply with US legislation and regulation despite not having trading operations in the US.

Though European rulemaking has started somewhat slowly, clearly the European Commission has set an aggressive timetable for implementation of new market rules and regulations. The publishing of the final EMIR and the enactment of REMIT should serve as a clarion call to market participants to move quickly toward a technical infrastructure that can provide the necessary reporting and surveillance capabilities that will be required to be in compliance.

1.3 Asian Markets

The situation in Asian markets is slightly different. Many of these markets are still emerging and remain national and somewhat immature despite their rapid growth. Rules vary from country to country and there are some signs of increasing regulation and oversight, but by and large it is

further off and less certain than in the U.S. and Europe. Some traders are taking advantage of that fact by moving operations to Asia. For example, Credit Suisse has expanded its Asian trading operations to ‘capitalize on demand growth and tightening regulations in the West.’ Many other banks are doing the same as are hedge funds who are shunning increasing regulation in the U.S. and Europe for the lighter regulation in Asia.

2. The Five Truths

Given these global regulatory developments, here are conclusions that can be taken as near certainty:

2.1 Transaction Reporting will be required

Companies will likely be called upon to report trading activity to regulatory bodies with a frequency and level of detail as never before. This may apply across the energy portfolio for power, gas, crude, coal, and other commodities, and may also require reporting to multiple agencies in multiple formats.

2.2 Position reporting will be required

Aggregated position reporting, beyond the transactional reporting, will also be a requirement, similar to above.

2.3 Surveillance processes will be seen as best practices

The increased focus on market manipulation will no doubt force Executive Boards of firms engaged in commodities and derivatives trading to require their trading units to beef-up (or establish if not already in place) systems and personnel to monitor trading activities, ensuring that hedges are properly matched and limits are strictly maintained.

2.4 Forensic Analysis will need to be implemented in an efficient manner

Because of increased regulatory oversight (2.1 and 2.2) and self-oversight (2.3), firms will need to be efficient in their processes and systems so that case analysis is not costly or burdensome -- since it is likely to be called for with greater frequency. This is likely to include the ability to answer the question “What did the trader know at the time?” – including the ability to reconstruct information on market prices, trades, and positions at a given date and time.

2.5 Requirements will change and evolve

Given the wide reach of the legislation, potentially conflicting jurisdictions of the various regulatory agencies and the political gamesmanship that now surrounds financial and commodity markets, rules and reporting requirements will change and evolve. As a result, whatever trading systems are currently being used to capture and maintain positions will need to be adaptable to the changes and provide reporting facilities that can supply the data and information necessary to remain up to date with reporting requirements.

3. How to Prepare

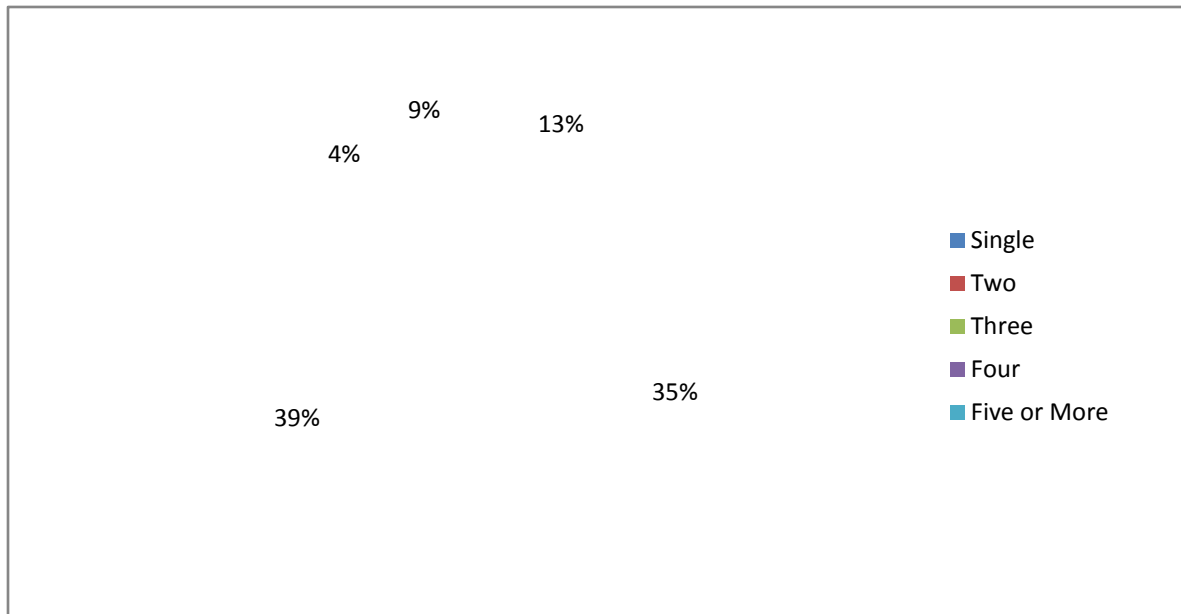
3.1 Identifying and filling the Gaps

CommodityPoint research has consistently illuminated the problems faced by trading organizations in the area of CTRM system capabilities in managing, in an efficient and cohesive manner, the complexities of commodity trading.

CommodityPoint's Risk Management in Energy Trading Study², released in Nov. 2009, highlighted a continuing problem in the area of those technologies that support commodity trading. Respondents to the survey were asked to describe the type (homebuilt, spreadsheet, commercially supported) of system or systems they utilized for managing their risk positions. While the majority of respondents indicated they utilized commercially developed and supported packages, there are still a large number (around 45%) of companies using internally developed or spreadsheet-based solutions, either exclusively or partially (in combination with commercial software packages), to manage their trading. Of the companies that utilized at least one commercial package, the majority of those have deployed between two and three separate systems and a small minority three or more separate systems.

² CommodityPoint report, "**Risk Management in Energy Trading**", November, 2009

Figure 1: Number of Solutions Installed to Support Risk Management



This reliance on multiple systems creates several serious exposures for those companies as new rules and regulations evolve and take effect:

- Spreadsheets are not secure or auditable, and are prone to user error.
- Constant reconciliation of multiple data sources is required in order to ensure accuracy of data across the multiple platforms.
- Complex integration links amongst systems are prone to failure and require expensive and time consuming rework as end point systems are upgraded.
- Generating consolidated reports from multiple systems is complex, time consuming and prone to error due to differences in data structures, database types and semantic differences in the manner in which information is captured and stored in the various systems.

Given increased regulatory scrutiny, these issues are more pressing than ever as they show that many firms have inadequate processes and supporting systems in place to effectively manage the upcoming regulatory and oversight needs.

Further validating the concerns related to managing business in this new environment of increased regulatory scrutiny, in the 2009 CommodityPoint study, "*Changes in Commodity Markets – Impacts on Traders and Software*," market participants were polled to find out what they viewed as their most pressing concerns, both in terms of market conditions and ability to manage their business, after the commodities collapse in July 2008.

Of nearly 30 issues identified (ranked on a scale of 1 to 5, with 5 being of the greatest concern), the ability to generate relevant, timely and accurate reports from their CTRM systems occupied 3 of the top 9 issues of the respondent group. Of the top 15 issues, at least 10 were related, in some way, to limitations of the respondents' CTRM systems.

Table 1 – Top 15 Issues in Trading & Risk Management - All Respondents³

Risk Management	4.38
General Market Liquidity	3.94
Understanding Factors behind Price Formation	3.88
Portfolio Management	3.82
Reporting - Ability to retrieve data from systems	3.79
Reporting – Availability of adequate business intelligence tools	3.70
Credit Scoring	3.54
Reporting - Speed of reporting	3.53
Data Management	3.49
Errors and Omissions in Entering and Tracking Trade Data	3.46
Margining	3.40
Audit Trailing in Energy Trading & Risk Management Software	3.37
Lack of Integration in Business Systems	3.35
Rising cost of production (if relevant)	3.29
Need for better Workflow and Approvals in Business Software	3.08

Clearly for this respondent group, and for the industry as a whole, weaknesses in the technology infrastructures that support their activities present serious challenges, both commercially and in terms of addressing the requirements of a new, aggressive and evolving regulatory regime.

³ CommodityPoint report "*Changes in Commodity Markets – Impacts on Traders and Software*", 2009

3.2 Companies operating in this new environment will need:

- A unified view of positions, trades, and exposures across the entirety of their multi-commodity businesses. Loosely coupled silos of information and data will create commercial and regulatory exposures that can threaten the survival of a trading business.
- A unified view of counterparty credit for financial and physical assets and transactions, including logistics.
- A single, secure, reliable software system and technology infrastructure to support their business as well as its regulatory reporting and surveillance processes.
- A cost effective way to meet this new set of needs -- as potentially daunting as Sarbanes Oxley -- in a more efficient way.
- A platform that can be used by a company's executive team to monitor performance and the status of compliance.

Companies like Allegro Development offer energy trading and risk management software that dramatically improves an energy company's ability to efficiently handle the burden of these new requirements while improving overall business performance and efficiency. Allegro's software system provides leading architecture and a component based approach to deliver a broad set of physical, financial, logistics, and operations components for energy market participants. These business process components are truly integrated (versus a set of acquired software technologies that are "integrated" in name only) and readily extensible to handle each firm's unique business requirements. Best of all, based on the language in the Dodd-Frank legislation, all the information that energy companies will be required to track and report – trades, positions, prices, audit trails, approvals, alerts, and history – can already be handled out-of-the-box in the Allegro system. We encourage you to visit www.allegrodev.com to learn more.

4. Conclusion

The exact shape of regulatory reform is still in flux. But leading firms will recognize these broad strokes and put in place processes and systems now so that they are in the best possible position to capitalize on the new market structures and rules as they emerge. Firms ignore this trend at their peril, as they may find the costs of compliance with manual systems or outdated systems as intractable, and may

even be forced to exit markets, leaving opportunity to others. But there is no need for that, since effective solutions exist today -- like Allegro's leading ETRM system.

About Allegro

Allegro is a global leader in energy trading & risk management solutions for power and gas utilities, refiners, producers, traders, and commodity consumers. With more than 27 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 agile solutions to manage risk across natural gas, power, coal, crude oil, petroleum products, emissions, and other commodity markets, allowing decision makers to hedge and execute with confidence. Headquartered in Dallas, Texas, Allegro has offices in Calgary, Houston, London, Singapore, Sydney, and Zurich, along with a global network of partners. www.allegrodev.com

About CommodityPoint

CommodityPoint is the industry leader in providing Commodity Trading & Risk Management (CTRM) research, analysis and advisory services. Our services bring insight into business issues, trends, processes and technology, to utilities, energy companies, banks, brokers, funds, investors and vendors that enhance their competitive position and support critical business decisions around the wholesale commodity trading markets. Our team provides expert analysis of market trends and, in particular, the technologies and applications supporting those that participate in regional or global commodity markets.

With offices in Europe and the US, and backed by an experienced research team, our organization provides an unparalleled view of the marketplace. **CommodityPoint** is a division of leading energy and utilities analyst and consulting firm, UtiliPoint International, Inc.

Other Resources

The CTRM Blog – <http://www.ctrmblog.com>

CommodityPoint – <http://www.CommodityPoint.com>

TRM Products and Services Online Directory – <http://www.trmdirectory.com>

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