

**NYMEX CLEARPORT<sup>SM</sup> :**  
***A COMPREHENSIVE APPROACH***  
***TO ENERGY RISK MANAGEMENT***

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***Joint FERC/CFTC Technical Conference***

***CREDIT ISSUES IN THE ENERGY MARKETS:***

***CLEARING & OTHER SOLUTIONS***

***February 5, 2003***

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# Energy Market Developments

- Enron Collapse and Financial Weakness of Merchant Sector
- Dramatic Increase in Credit Risk Recognition
- Significant Reduction in Leverage and Liquidity of Market Participants
- More Demanding Financial Statement Reviews with Rating Changes
- Credit Standards Governing OTC Transactions are not Uniform

# Financial Sector Overview of Merchant Energy Sector-Solutions

- **Moody's** - Energy Merchant Sector needs "the establishment of a clearing system that would provide Liquidity, Transparency and a more efficient transfer of Credit Risk"<sup>1</sup>
- **S&P**- Energy Merchant Firms "must now mark-to-market derivatives associated with hedging strategies."<sup>2</sup>
- **Fitch Ratings** - "A wave of financial stress and credit downgrades affecting wholesale energy marketers and power generators has triggered demands for security under trading contracts and long-term power and gas supply contracts"<sup>3</sup>

1. Reprinted by permission. Moody's May 2002 "Moody's View on Energy Merchants"

2. Reprinted by permission. Standard and Poor's June 11 2002. "Updated Approach for Rating U.S. Energy Trading and Marketing Firms"

3. Reprinted by permission. Fitch Ratings August 12, 2002 Global Power North America Report

# Financial Sector Overview of Merchant Energy Sector-Problematic

- Dramatically Heightened Sensitivity to Credit and Performance Risk and Lack of Price Transparency
- Substantive Reduction in Counterparty Confidence
- Commerce Becoming Significantly more Capital Intensive
- **Net Result**: Chill, Bordering on Freeze, in Commercial Activity
- Since Their Peak, the 10 Largest Energy Merchant Firms Have Lost Combined Market Capitalization of Almost \$300 Billion

# Bilateral Counterparty Credit Issues and Costs

- For example, one consequence of Enron's bankruptcy filing is that the company's trading counterparties who are owed money on a favorable position might not be able to collect more than a few cents on the dollar when all is said and done, while at the same time, they may very well have to make good on funds they owe Enron for an adverse position, even if the gains and losses largely offset each other when taken at full value.
- A fear of repetition has created the "6 bid @ 4" syndrome

# **Role of the Exchange Clearinghouse**

- Guarantee of Clearing Member Financial Performance
- Trade and Position Processing
- Risk Management
- Business Continuity in the Event of a Default
- Portfolio Margining Reduces Capital Requirements

# Safety Net – What Stands Behind the Clearing Promise of Performance?

- A Guaranty Is Only as Sound as the Guarantor
  - Policies in Place to Avoid a Default
    - Performance Bond Based on Risk
    - Variation Margin to Limit Price Exposure to One Day
    - Capital-Based Position Limits
    - Market and Financial Surveillance (SRO Function)
    - CFTC's Oversight

# Safety Net – What Stands Behind the Clearing Promise of Performance?

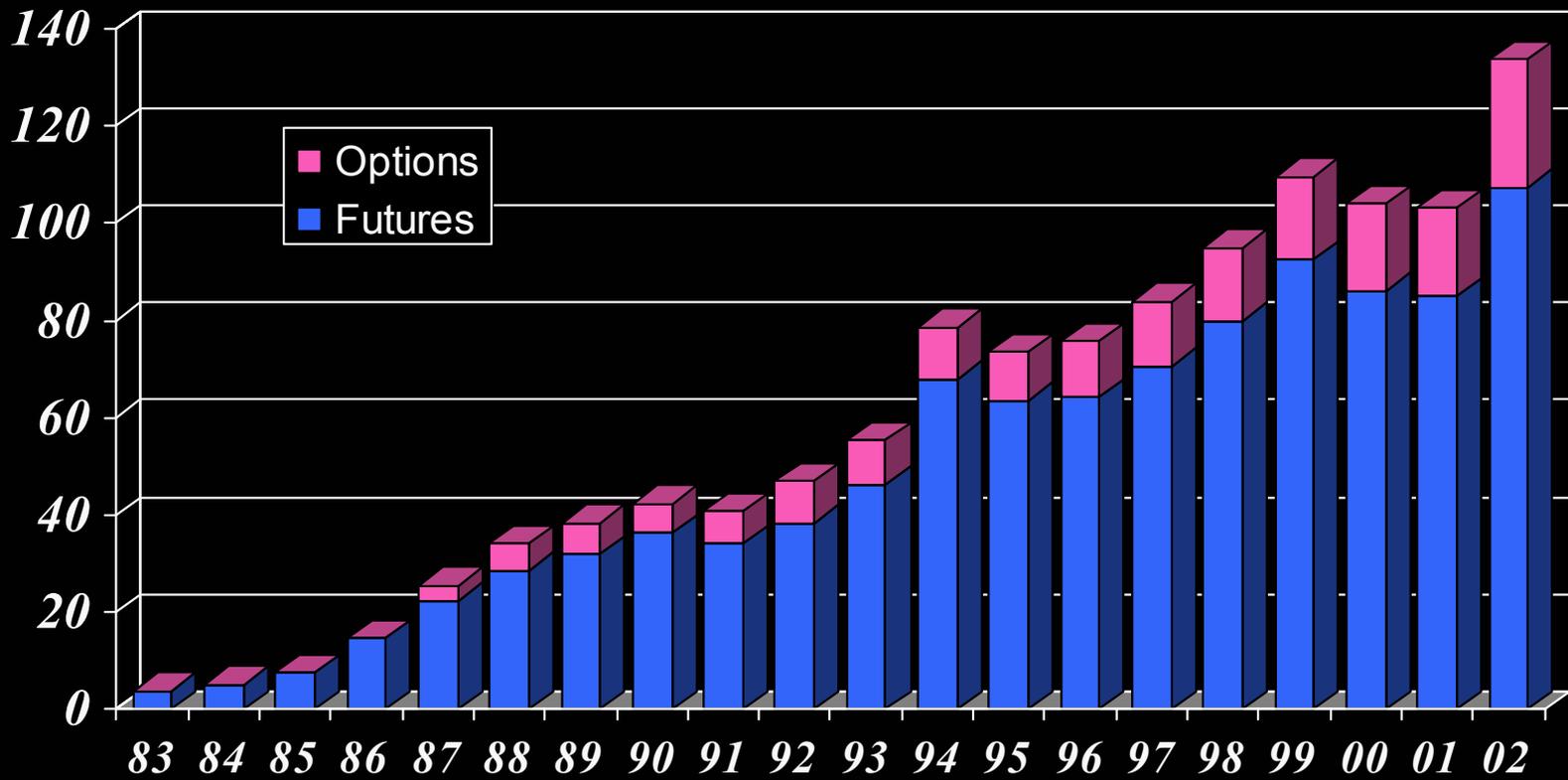
- In the event a clearing member defaults, the loss is restored through the “safety net system”
  1. That clearing member’s assets
  2. Exchange funds as determined by the board of directors
  3. Payments from the Exchange Guaranty Fund
  4. A pro-rated assessment of other clearing members based on their capital
  5. Within each clearinghouse, the customer’s risk is mitigated, not eliminated. A defined counterparty risk exists between the customer and its clearing firm.

# New York Mercantile Exchange Energy Clearing History

- We Have Experience and Expertise in Energy Marketplace Management since 1978
- 131-Year History in Commodity Markets
- World's Largest Physical Commodity Futures Exchange
- Have Overseen Thousands of Energy Deliveries, including in Power

# Total Volume of Exchange-Traded Contracts

(Million Contracts / Year)



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# Exchange Performance Through Substantial Disruptions

- **Drexel Burnham Lambert**
- **1986 Oil Market Crash**
- **1990-1 Persian Gulf Hostilities**
- **Metallgesellschaft**
- **August 1992 Hurricane Andrew**
- **February 1993 WTC Bombing**
- **Winter 2000-01 Natural Gas Market Price Spikes**
- **September 11, 2001...**
  - Not Quite Business as Usual, But We Restarted Our Business Against All Odds
- **Enron and Energy Merchant Sector Issues**

## **NYMEX Clearport<sup>sm</sup> Clearing- Background**

- Under Prior Statute Clearing of OTC Trades Was Prohibited
- The CFMA Separates the Regulation of Trading from the Regulation of Clearing and Allows for the Clearing of OTC Trades
- The Exchange Started to Act as a Designated Clearing Organization on May 31, 2002, for Trades Executed Away from the Trading Floor

## Current Status

- Product slate includes: natural gas, power, crude oil, and petroleum.
- Through the NYMEX ClearPort<sup>SM</sup> clearing site, the Exchange has processed 940,000 contracts with a notional value exceeding \$9 billion.

# **NYMEX Clearport<sup>sm</sup> Clearing Is Providing Substantial Relief**

- Mitigation of Counterparty Credit and Performance Risk
- Reduction of Operating Capital Demands
- Reduced Collateral Requirements via:
  - Portfolio Margining [i.e. power positions become less expensive when spread against gas (Spark Spread)]
  - Freeing-up of collateral with netting of off-setting positions against ALL counterparties.
  - Current OTC business can be converted to offset against hedges that already exist at Exchange.
- Increases Number of Market Participants and Confidence in Other Market Participants

# Our Clearinghouse Is “Open Access”

- We Accept Trades that Were Executed through Trading Systems, using Voice Brokers, or Directly between Principals
- Through the NYMEX Clearport<sup>sm</sup> electronic trading platform, 34 futures contracts traditionally associated only with OTC markets can now be traded and cleared as regulated futures.
- Hope to add most or all of the additional 23 contracts currently offered for clearing only

# Exchange Clearing Mechanics

## Settlement for NYMEX Clearport<sup>sm</sup> Clearing

- Forward curve established each day for settlement purposes (2:30 p.m. ET mark) for Contracts with Open Interest
  - *The forward curve is based on real transactions from actual participants and brokers*
  - *The Exchange does not have a commercial bias in settlements or settlement data*
- Settlements represent the collective view of those most familiar with fair value at a given time.

# Enhancements

- Since launch
  - RAV is now a real time process to ensure confidence that a deal is actually cleared.
  - Implemented ease of automated features to streamline trade input.
  - Expanded Hours
    - 7:00 p.m. ET Sunday until 2:30 p.m. ET Friday (with 45-minute processing break each day)