

FSA Compliance issues for the energy sector

David Marshall at GEA looks at the ongoing impact of FSA regulation for energy and oil market participants and offers some useful insights on best practice for compliance and risk management.



The public perception of how financial regulation has evolved over the past two decades may sometimes be compared, perhaps a little unfairly, to some of the plots from the early black-and-white Buster Keaton movies. Such comic storylines regularly involved a swift escape by a clearly-identifiable crook dressed in striped jumper,

mask and over-the-shoulder bag marked 'SWAG', pursued vainly over the horizon by dozens of hapless uniformed Keystone Kops, pistols firing in the air and truncheons waving menacingly in all directions.

High profile incidents of financial fraud and other wrongdoing have typically brought regulatory investigators and enforcement bodies into a similarly unwelcome and reactive media spotlight. Well after the wrongdoer has departed the scene, leaving a trail of default and devastation for the rest of the financial community to deal with, the hue and cry picks up, with investigative committees, new controls and clampdowns to ensure that whichever offending manhole-cover allowed the swag-carrier to escape with his ill-gotten gains is firmly closed off. At least until the next one opens.

Whilst the risk of fraud and malpractice remains ever-present, the Buster Keaton era of financial regulation may well be nearing its end. More astute industry observers cannot fail to have noticed that the old cops-and-robbers movie script has subtly altered over the past few years. One significant change is that nowadays regulators don't necessarily wait for the risks to appear in procedural gaps or flawed controls. Any such flaws are generally viewed as failures waiting to happen, and negligence by omission is itself a disciplinary offence.

When it took overall control of the regulatory framework in late 2001, the Financial Services Authority introduced a series of controls directly aligning senior management roles and responsibilities with many of the readily-identifiable risks relating to financial market, regulatory and corporate wrongdoing. The range of investigative and disciplinary powers available to the regulators in addressing these matters is not to be underestimated.

Those directly affected by the FSA Regulatory regimes for Energy or Oil Market Participants (or even the Listing Rules for Stock

Exchange quoted companies) are no exception to this. Many such operators will already be aware of the increased emphasis on effective corporate governance, backed up by comprehensive risk management. This is the culture the FSA wants to establish across all the various sectors under its regulatory remit, and it will reward those who get the message - mostly by leaving them in relative peace to get on with it - and punish those who persistently fail to do so with fines, bad publicity and, as recently intimated over non-compliance with International Financial Reporting Standards, suspension of securities. (See earlier article on compliance with IFRS, page 11, current edition of this newsletter.)

The FSA undertook a review last year of the Energy & Oil Market Participation Regimes, looking at the standards of controls and risk management in the firms subject to them. They reported two principal findings:

1. Levels of understanding of compliance with FSA requirements appeared deficient within some of the firms responding to the reviews.
2. More worryingly, perhaps, the FSA concluded there was a potential risk that some firms might be undertaking unauthorised activity, particularly in energy trading for speculative or investment purposes.



The overall conclusion from this and other developments is that the 'light touch' regime is likely to become more prescriptive in the relatively near future. The FSA wrote to the Chief Executives of all Oil and Energy Market Participants in October last year to establish a dialogue aimed at improving standards of compliance and risk

mitigation within these professional markets. Global Energy Advisory would urge all CEOs to consider this seriously, as changes in the existing EMP & OMP regimes are almost inevitable. As an unwelcome parallel, a 'light touch' regime formerly applied to the management of occupational pension schemes. The Maxwell scandal altered the risk attitude in that sector almost overnight.

Good compliance, however, is not all about bad news. If we change the emphasis from 'How do we avoid the pitfalls?' to 'How do we reinforce or improve our compliance without spending a large amount of money?', then we can turn on a more positive

note to some of our core propositions at GEA. Firstly, there needs to be an industry-wide acknowledgement that regulatory attention is going to focus more significantly on the energy sector in the near future. There are simply too many pressure points and drivers (including European directives) for this not to be the case. Secondly, those who act early and anticipate the increasing burden of responsibility are less likely to face the prospect of last-minute and potentially haphazard organizational changes. Finally, experience suggests that early adopters of regulatory change may well enjoy some potentially long-term competitive advantages, vis-à-vis their less organised counterparts.

All very well, one may conclude; lots of commonsense in adopting a structured rather than a piecemeal or reactive approach to regulatory changes. If this is accepted, then what are we suggesting firms actually have to do on the compliance front? After all, there are many new regulatory regimes to comply with, from International Accounting Standards to the Sarbanes Oxley Act. Audit firms and consultants will no doubt pass on lots of advice about helpful new procedures and internal controls to help comply with each and every one. GEA seeks wherever possible to avoid wasteful, duplicative or even conflicting initiatives and approaches. Our solutions are risk-management-orientated from beginning to end. Furthermore, we believe that compliance itself should essentially comprise a single integrated risk-management process within the firm.

Very few compliance failures start out as such: in practice they are almost invariably due to business risks which have never been adequately identified, recognised or taken seriously by the firm. So we don't advocate an extra layer of bureaucracy per se: we start out with the idea that the firm wants to manage its business effectively and improve or enhance existing procedures and controls that work reasonably well. If compliance is a function or a product of good corporate governance and risk management, then it never need move away from that remit and it will always be under control – both as a cost overhead and a business risk.

Let's look at the framework we start from and build on to. Our approach to compliance at Global Energy Advisory is to provide our clients with something more akin to a Swiss Army knife, rather than a toolkit. If we help establish processes and controls to make an energy trading business IAS 39 compliant, the same processes can and in our view should work to help achieve Sarbanes Oxley, FSA and other compliance objectives. They don't need to be reinvented or updated every time.

Similarly, if we consider for a moment all those parties who have a vested interest in firms demonstrating high standards of compliance and risk awareness, it very quickly becomes obvious that if the firm surpasses regulatory and audit expectations, it should similarly prove successful in meeting due diligence

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enquiries from bankers and corporate financiers. There's no great rocket science here – people like well-run firms, and a good compliance story is a strong argument for investing or lending with greater confidence.

Looking further forward, it may be that today's gold stars for strong corporate governance, compliance and risk management will become tomorrow's prerequisites for doing business in the first place. Taking a view expressed the British Standards Institute last year:

'In 20 years our successors will look back aghast at the way we treat risk management now. In 20 years, risk management will be as embedded in our systems and processes as quality is today.'

(Nicki Dennis, Head of Risk Market Development, British Standards Institute. 'Is Risk the New Quality?' Enterprise Risk, Feb 2004)

This quote was given in the context of the financial services industry, but there's no reason it couldn't apply equally to an energy trading specialist or a large-scale power supplier to heavy industry. In the same way as a major manufacturer couldn't survive in today's market without organisation-wide quality management and control, the business environment for firms lacking adequate internal compliance and risk management structures may not be so benign or forgiving in 20 years' time.

Perhaps the regulators are doing us a favour by proposing risk-related capital requirements via Basle II and MiFID. Firms that persistently lose money through failures in their compliance and risk management design may well be steering towards a hard landing.

Global Energy Advisory

Global Energy Advisory comprises seasoned experts in the global energy market: entry criteria are a



minimum of 20 years' experience in related disciplines. At the core of our expertise is one of the most sophisticated middle offices, which offers proprietary modelling to enable us to unveil and quantify global commodity market uncertainty. We then draw on our team of senior advisors and eight consultants to complement and enhance our modelling scenarios, providing unrivalled clarity in an uncertain energy future.

Fast Track System Development

Our solutions company – Global Energy Solutions – works closely with Microgen plc, one of the City's



leading business software companies, to offer clients a clean, efficient and fast track delivery. Microgen's Aptitude business process management and business rules framework enables us to advise on best practice price risk management, implementation and control, as well as fast, comprehensive and controlled implementation of company-wide risk systems.

Together, GEA and GES can assist you with:

- energy mergers & acquisitions.
- strategic energy policy.
- energy asset valuation and optimisation.
- Trade book and risk management audits.
- IAS 39 accounting methodologies.
- energy market regulation and compliance.
- global energy market cross-commodity consultancy.