BY JOHN D'ALEO

Revival in Energy Trading?

AN INTERESTING PHENOMENON has been propelling the energy markets in recent months: financial firms and private equity funds are trading and investing heavily in energy. This activity seems almost a stealth operation, moving below the radar of the public eye while emerging as an incredibly profitable business line for these firms in the volatile landscape of energy trading.

Some believe this started during one of the market's most distressed times, when Warren Buffet swooped in to purchase the struggling assets of cash-strapped energy-trading companies in late 2001. Whatever the catalyst, the volatility of energy commodity prices provides tremendous profit opportunities for those with the right trading strategies, the ability to monitor their risk exposure properly, and the understanding of their positions at a moment's notice. Niche equity funds within the space have nearly doubled in value over the past year alone, averaging an 80% increase, and Goldman Sachs, the investment world's acknowledged leader in the energy game, reported revenue in its trading unit of $1.87 billion for the third quarter of 2004 compared with $879 million in the same quarter last year. This growth was fueled by its growing energy-trading business.

With increasing frequency, we continue to hear of financial firms expanding their energy trading operations/purchasing energy assets. Major banking firms have expanded or are currently in the process of expanding their trading activities in Continental Europe, and some of these banks are even prepared to tackle the challenging requirements of physical settlements. Merrill Lynch & Co. has agreed to acquire the energy-trading operations of Entergy-Koch LP, and Louis Dreyfus acquired some of ConocoPhillips's storage and pipeline assets, a natural gas liquids pipeline system, and a liquefied petroleum gas terminal from Exxon-Mobil Corp. In short, financial groups are banking on energy as a long-term investment and as a business where they can leverage their core strengths to profit within the current and emerging energy commodity markets.

Given the spotty history of financial firms' commitment to the energy markets, are they going to be successful in this current effort? There are structural practices and protocols deeply embedded in the capital markets business that easily carry over into the energy commodity space. Such practices, including their rigorous range of internal and external controls; their understanding of the need for the deployment of straight-through-processing systems (prior to trading) that provide accurate, real-time and comprehensive position and risk information; and strong balance sheets based on diversified asset portfolios that result in the highest of credit ratings, all play a part. With the volatility of these markets, the constantly evolving nature of energy products and the way in which they are traded, and new forms of energy on the horizon, the infrastructure and mindset that these financial institutions have in place are critical success factors. However, in order to become and remain profitable and committed players in this space, they must be ready and willing to deal with the logistic requirements that are very unconventional from a bank's perspective.

One thing that is common to all companies involved in the energy markets, whether they are financial or traditional, is they require a streamlined technology platform that they can leverage across the range of new and existing energy commodities, whether physical or financial. They need openness, flexibility and the ability to grow as they diversify and as new products and markets emerge. The energy trading business is evolving such that companies are increasingly seeking straight-through-processing systems that enable them to successfully capitalize on converging and emerging energy markets. The first company to have all its ducks in a row has the ability to profit most.

For financial firms, in particular, a uniform, cross-market platform and a flexible, scalable IT system facilitate quick entry into new markets. They give firms an enormous competitive edge and an enhanced ability to meet regulatory requirements. Firms can see positions from both the financial world and the commodity space on one platform, generate uniform risk reporting, provide global accounting and consolidate settlement information. The result is a streamlined organization with tight controls and the ability for quick and accurate trading information and management oversight. With the array of new products and new markets, old and new entrants alike can benefit from aligning disparate systems into a common, cross-market platform. All firms are, or should be, looking for straight-through-processing (STP) systems that provide these advantages.

Given the challenging environment of energy trading in the last few years, this latest trend is a welcome sign for everyone involved in the energy markets. Combined with the likely scenario in which energy prices will remain volatile because of global supply and demand imbalances, financial firms may become committed players in the energy space. ■

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