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When Margins Fall: The Market Life Cycle

Your trading desk and how to manage it.

By Kevin Owyang

Deregulation has prompted many energy industry participants to establish trading functions, with varying degrees of success. While some have been very profitable, others have suffered severe losses.

Most participants agree that when profits are dependent upon commodity prices, a trading organization is necessary to maximize returns. But how to determine the right size and type of trading organization? That will depend on the company's place in the commodity life cycle. Although no formula exists for calculating the right size for a trading organization, their different types may be classified. Therein lies a host of lessons for managing a trading desk.

Profits Up, Then Down

A commodity market's place in its evolution is best described by its degree of efficiency. The market life cycle can be divided into three periods: nascent, developing and mature. During the nascent period, large price inefficiencies exist. For example, during the oil market's nascent period, heating oil spreads were valued improperly compared to the cost of storage. That created a low-risk, profitable trading opportunity.

Over time, price inefficiencies attract more and more trading companies into the markets. Eventually, competition makes pricing more efficient and the market enters the developing period. Earning money becomes more difficult and consolidation occurs as the smaller trading companies with fewer assets are forced out.

During the mature period, competition continues to intensify as intellectual capital is concentrated within a few successful companies. It becomes difficult to sustain trading as a stand-alone profit center and even some large players are squeezed out. Surviving companies typically do not rely on trading profits as their main source of income, but to maximize the value of storage, transportation and/or processing assets.

Energy typifies a mature market. Many Wall Street banks, such as UBS, JP Morgan and Merrill Lynch, have closed their stand-alone trading operations. The remaining participants are integrated companies such as Enron, Dynegy, Williams and my company, KN Energy.

Entrepreneurs Become Managers

In nascent markets, price inefficiencies provide opportunities for big profits. In such an environment, larger deals bring larger potential for profit. Trading companies hence focus on developing relationships with other companies that are willing and able to transact large deals.

Because each deal is lucrative, a small number of deals can provide sufficient income. In such organizations, the most senior trader makes virtually all of the major trading decisions and is responsible for a large portion of the company's income. Success typically depends on entrepreneurial skills and a fluid organizational structure.

In a developing market, the average profitability of each deal decreases. More deals must be concluded in order to maintain overall profitability. It becomes difficult for a senior trader to evaluate and execute all the deals necessary to meet profit objectives.

Market Life Cycle	Management	Strategy
Nascent	Entrepreneurial	Short-term profits Little respect for customers
Developing	Managing entrepreneurs	Short-term profits Exit strategy acceptable
Mature	Multifunctional Cross-Disciplinary	Manage a going concern Develop strategic platform for growth Focus on customer service

To be successful, a senior trader must attract talented individuals to whom he can delegate authority. Typically, these individuals mirror the entrepreneurial style of the senior trader. As a result, the company essentially becomes a conglomerate of nascent market trading companies. Success is based on the senior trader's ability to motivate and develop his entrepreneurial subordinates.

In a mature market, margins narrow increasingly. Several factors force the management style away from entrepreneurialism toward multifunctionality.

New Products. In mature markets, trading companies focus on developing value-added products and services. Success depends on innovating products quickly as well as developing and maintaining customer relationships.

New Relationships. The trading company becomes part of a larger company with assets, or the trading company itself acquires assets. Such combinations are motivated by the fact that trading management can be used to enhance the value of commodity assets. Profits thus depend on building intra-company relationships among those responsible for the acquisition and operations of the assets.

Strategic Fit. Because the trading company is no longer a stand-alone entity but part of a larger organization, it is necessary that the trading company align with the overall corporate strategy. To do so, it must demonstrate a strategic fit with core business operations. Building relationships with corporate leaders, therefore, is essential. After all, even the most profitable trading companies can find their performance unappreciated despite past success. Salomon Brothers Inc.'s bond trading unit, for instance, once a successful operation, was scaled back after it was determined that it did not fit within investor Warren Buffett's strategic vision.

Success in mature markets requires that senior trading officers build the multitude of relationships needed to optimize corporate value. Their ability to function in various situations and interact effectively with people of diverse skills and backgrounds becomes most important.

Victims Become Customers

In nascent markets, opportunity abounds. Strategy focuses on short-term results. Customers, in the truest sense of the word, do not exist. Money is made from exploiting inefficient pricing and hence, customers are defined as "people who allow you to make money from them." Respect for them virtually is nil.

Trading companies in developing markets, because they are managed as conglomerates of nascent market companies, tend to follow the same strategy as those of nascent markets. Focus on short-term profitability remains important—so important, in fact, that given the right incentives, exiting a business is an acceptable strategy. An example is Louis Dreyfus Energy Corp.'s willingness to pull out from U.S. natural gas and power markets following the dissolution of the Duke/Dreyfus venture.

In mature markets, however, trading companies focus on managing a going concern. The company by now has sizable assets and most likely is publicly owned. Exiting the industry, therefore, is not a viable strategy. Customers are considered important because meeting their needs is seen as essential to the company's long-term success. Focus shifts from short-term results to a strategic platform for growth.

Kevin Owyang is executive vice president, risk management, KN Services. He previously held several trading positions at Louis Dreyfus Energy Corp. Owyang holds a B.S. from Sloan School of Management, Massachusetts Institute of Technology. KN Services, a subsidiary of Lakewood, Colo.-based KN Energy Inc., comprises KN's non-traditional businesses such as power generation and telecommunications.