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Energy Trading—It's *Déjà Vu* All Over Again

Recent events in the financial markets have the flavor of the failure and fall of Enron. Back in November of 2001, Enron failed and utilities were scrambling to unwind their exposure to the company. It took weeks and months before the deals were unwound, with many companies having significant exposure. Many utilities exited futures trading and decided to focus on asset-backed trading; some exited energy commodity trading altogether.

Since then, companies like Constellation, Sempra, and AES have continued to trade energy commodities actively. According to the Wall Street Journal, 20% of Constellation's profits last year were from commodity trading. A number of former Enron employees helped to build Constellation's trading operations and the company continued to invest to keep its energy trading infrastructure modern. Since then, Constellation has built an impressive trading desk. Then came the financial crisis. When it sought the buyout, Constellation did not believe that it had the available collateral — financial backing required to trade in the market — to support its trading activity.

Now, some of the biggest investment banks in energy commodity trading — Morgan Stanley and Goldman Sachs — are becoming bank holding companies. Both companies have built formidable trading desks and also acquired physical assets associated with energy. These companies provided essential liquidity for the recovery of the energy markets after Enron and they were relatively free from regulation. Now, no doubt there will be heavy regulation of both of these entities. This will likely be in the form of regulation raising the collateral requirements for deals.

Lack of liquidity is likely to stifle the trading activity that we have seen in recent years. It is also likely to stifle the speed and volume of deals. In addition to lack of liquidity, the crisis in confidence in counterparties — even the biggest, strongest counterparties may fail — is likely to have a huge impact on the trading of energy commodities. Cleared trades and transparency will be the order of the day.

Our View

The only good news these days seems to be that companies like Constellation were able to understand their exposure within a day and take immediate action. Energy companies might be looking back now, wishing they had invested more in enterprise risk management capabilities.

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But, in all honesty, it would have been hard to predict the financial crisis that is facing the United States today.

From a trading perspective, Energy Insights expects more companies to move away from financial and toward physical trading, away from speculation towards hedging. Unfortunately for vendors of energy trading and risk management (ETRM) software and services, until the uncertainty settles — and this will likely take a year or two — companies will not be rushing to invest in ETRM. Add to that that their capital resources will be limited. The ETRM market is likely to see a downturn similar to that after Enron.

What companies will be looking at are more ways to understand and limit their risk. That could be a way to strengthen hedging capabilities. More likely, companies will be looking at ways to reduce controllable risks, such as delivery risk. What money there is for capital investment in IT from an ETRM perspective will likely go to developing stronger logistics visibility and capabilities. It will also go to tuning models for the black swan — an improbable event, but with huge consequences.

The ETRM market is currently made up of a dozen or so players that are relatively small, given the rest of the software industry. Energy Insights expects further consolidation in the industry as market opportunities tighten. It would be a logical for the ETRM vendors, especially those serving utilities, to end up being acquired by the large ERP players in the market. Oracle is a case in point of a company that has done a large amount of acquisition in the utility vertical.

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