<u>Magazine Article Written for Kyle Vann, then-CEO of Entergy-Koch LP and published in *World Energy* magazine</u>

The Role of Trading in Markets and Enterprise

By Kyle Vann

Unfortunately and unfairly, the trading profession has earned a negative reputation in the views of many. Traders often suffer from the stigma of ill-gotten gain and greed and may be perceived as being as nothing more than opportunists. Media coverage of the California power shortage issue has served to reinforce trading's negative connotation in the eyes of the public. Moreover, trading is widely considered an activity of simply moving money around–a zero-sum game–adding no value to markets or to society.

To the contrary, trading provides significant value to markets and market participants. In fact, it is absolutely essential to the evolution of free markets. Virtually every company that exists stands to benefit by scrutinizing its business from a trading perspective, gaining an understanding of the options embedded therein and discovering a means to monetize them. Like any other business capability–operations, development, marketing manufacturing or processing–trading possesses critical success factors that can help a company create a sustainable competitive advantage.

The Role of Trading in Markets

According to the Austrian economist, Joseph Schumpeter, "the capitalist economy is swept by a 'perennial gale of creative destruction…a gale of innovation.'" Early in the 20th Century, Schumpeter theorized that *creative destruction*–the systematic letting go of the familiar while simultaneously creating something new–is a crucial tool that organizations must embrace in order to thrive in a changing world.

Schumpeter taught that expectation is the enemy, creating a mindset of how things "should" be, limiting our vision and locking us into old routines. Routine, he deduced, is a snare that guarantees a myopic perspective, and that broadening one's perspective means being deliberately, continually prepared to embrace change and seize opportunities.

If Schumpeter's theory of creative destruction is true, then trading may well be the most potent instrument in any business organization's strategic armory. Trading drives market evolution because traders play a leading role in identifying and extracting the value inherent, though often not apparent, in the market structure. Traders accomplish this with strategies that range from arbitrage to point-of-view position taking.

Traders are like the oil that lubricates the free market. They are agents in an active role of creative destruction–always looking for a way to do something more profitably.

Trading can be defined as engaging in the managing and transfer of risk. All companies have risk, whether it is market, credit, legal, customer or regulatory risk. For example, as the natural gas and power industries have initiated de-regulation, the energy trading business has grown dramatically. Some companies have made conscious decisions to scale back their unregulated risks and focus on regulated transmission and distribution businesses. Others have embraced managing not only their own risks, but the risks of others, as well, in order to generate profits. The latter companies have become energy merchants.

This is the essence of a trading marketplace–one that allows a company to swap unwanted risks in order to adjust its portfolio to suit its own particular risk appetite and corporate goals. This evolution is not only to the benefit of specific companies, but also to the marketplace, in general, and ultimately to the consumer.

Instead of wiles and intuition, they relied on technology to find oil where it hadn't been found before... The buzzword in the oil business today is "discipline;" risk is scorned as steady profits have trumped the big score. Its newest multi-millionaires come from... energy giants [who specialize] in trading energy instead of drilling it.

Texas Monthly, September 2001
"Where Are They Now?"

To be effective at trading, a company must be able to analyze opportunities and identify, quantify, structure and manage its intrinsic risks profitably. Advantaged trading is not based on instinct or hunches–it is a knowledge-driven activity, and the crucial knowledge that is imperative to shrewd trading is imbedded throughout the value chain.

Successful traders employ a wide range of analytical systems to identify critical knowledge and create value. They analyze fundamental supply/demand data and measure risk using sophisticated mathematical modeling and scenario analysis. They develop buy/sell signals using fundamental and technical indicators to suggest times at which contracts should be entered or liquidated. Portfolios then are diversified and structured to achieve a favorable reward on risk capital.

Trading is a mix of art and science. At the end of every day, the skillful trader knows precisely where he stands from a profit/loss standpoint. A trader continually assesses which risks to hold and which ones to mitigate or eliminate. A company with an

effective trading capability benefits from a discipline that helps it to understand its risks from a highly enhanced perspective and to be completely accountable for its decisions.

There are two major and well-defined trading philosophies: fundamental trading and technical trading. A *fundamentalist* believes that supply and demand factors set the price and direction of market prices. He researches information on inventories, changes in the nature of the consuming market, factors affecting supply and delivery, weather, rumors, liquidity and a multitude of other data and factors. Aggressive fundamental trading requires a great deal of study. The *technical* trader relies strictly on price information. This type trader believes that all of the fundamental factors either are integrated into current price patterns already or are being signaled by them. The trading strategy known as "contrarian" is a subset of these strategies. Although a trader may claim to adhere to one of these philosophies, in reality, most traders practice combinations of each. One thing common to successful traders in either of these camps, however, is disciplined risk taking.

Markets typically evolve in the following pattern: 1) physical trading begins with pricing linked with supply; 2) futures trading begins with a hub or benchmark; and 3) over-the-counter (OTC) trading of instruments related to the benchmark develops different grades, geographic locations and options. Today, a new dimension has been added–the electronic marketplace. Over time, these activities create liquidity, improved price transparency and lower transaction costs in the marketplace. More importantly, however, these activities provide the mechanism to move risk from one party who desires to reduce or remove it to another party who sees potential gain in assuming that risk at the right price. The subjective values of these customers are satisfied in this marketplace by the assistance of the trading community.

Trading Drives Innovation

In a very real sense, trading is a discovery process–an archaeological unearthing of the authentic components of the marketplace. Trading drives innovation in product development for risk management products and services to the ultimate benefit of every segment of the value chain–explorers, producers, processors, transporters, marketers and end-users.

As a market evolves, trading companies develop market innovations that satisfy customer needs in a unique way and create high margins. This profit driven activity is very similar to the R&D activity of product development companies. These innovations are imitated over time, and competition drives the margins lower, to the ultimate benefit of the customer. This evolution improves the effective abilities of companies to purchase risk products specific to their needs at affordable prices. The most recent innovation of this type is weather derivatives.

According to the U.S. Department of Commerce, weather affects 70% of American companies and as much as 22% of America's $9-trillion Gross Domestic Product (GDP).

Profits in industries as diverse as energy, agriculture, retailing, manufacturing and real estate, among others, can be impacted–often significantly–by unanticipated trends in temperature, rainfall or snowfall. Weather derivatives offer companies an innovative, flexible way to manage that risk and protect profits by transferring some of the risk to another party in exchange for a premium. The first weather derivative contract in the United States was written in 1997; just four years later, almost 5,000 weather contracts have been transacted, according to the latest comprehensive study of the weather market conducted jointly by PriceWaterhouseCoopers and Washington-based Weather Risk Management Association (WRMA). To date, these deals have covered about $7.5 billion of total exposure. The market is expected to grow to at least $300 billion within a few years, with typical deals ranging from $2 million to $30 million. This is a prime example of how trading companies create innovative products that are not a "zero sum game," permitting companies to manage difficult risks and improve financial performance.

> *Mother Nature is neither benign nor cruel, at least on average.*
>
> (Unknown)

In addition to creating innovative products, trading companies continuously improve market liquidity and price transparency, thereby optimizing decision-making options for companies. An excellent recent example is the proliferation of on-line exchanges. Coupled with user-friendly on-line customer services, these exchanges permit customers to increase control of their risk profiles.

How Your Company Can Benefit From A Trading Mindset

All businesses are a portfolio of options. A trading mentality and discipline are needed to identify these options, analyze them in terms of risk versus reward, monetize them and manage them in a way consistent with the philosophy of the company's ownership. The knowledge of options pricing improves decision making on capital projects and enhances ongoing business decision making, in general.

Trading is a critical business capability, equal in importance to operations excellence, project development, production management or marketing. It should be integrated into a company's overall business strategy. While not all companies have the ability to develop an effective in-house trading capability, they can ally with a trading company, especially if market volatility is a critical earnings issue.

This is particularly true for regional utility/LDCs that are affected by national/global market factors and regional weather patterns. These companies have valuable asset positions with considerable optionality. A key role for management is to assess the risks and options embedded in its asset positions, determine which risk positions should be retained and which risks should be reduced or eliminated. It is also important to

understand the risks borne by the utility's customers and determine what type of risk products may be valuable to both the customer and the company. Finally, management needs to determine the best strategy for managing this risk portfolio. For many companies, building a world-class trading capability in-house is not possible. In such companies should ally with a trading company on an asset-management basis.

In today's marketplace, the culture and discipline of trading is an increasingly critical addition to a company's thinking and decision-making processes. It is a culture that requires making all decisions to market on a daily basis, demands discipline in risk/reward analysis and is characterized by an entrepreneurial bent. The best trading companies have a culture of risk management throughout the organization, which promotes debate and challenge concerning the company's risk position. Such companies also have the discipline to admit that they are wrong and take the appropriate action well before a risk becomes a major problem. This trading-based mindset will be even more critical as the energy business deregulates.

Keys to Success for Trading Companies

Access to Analysis

Since trading is a knowledge-driven activity, a trading company must possess superior fundamental, quantitative and risk analysis capabilities. Fundamental analysis is the basis for developing a point of view on the market that differs from the current market structure. Quantitative analysis is critical to understanding and structuring complex derivative relationships, managing risk and developing new products. Risk analysis is vital to identifying and managing the risk of the portfolio and communicating key information regarding authorities and stress scenarios. Finally, it is imperative for a company to possess world-class mid- and back-office personnel and accounting systems to support its trading business.

Access to Assets

A trading company can either own or lease assets, or it can ally with an asset owner. Asset classes that are important to trading companies are storage, transportation and swing processing/generation capacity. Assets provide real-time information on fundamental drivers of the business and physical optionality. A trading company can operate without assets, and an asset company can operate without trading, but combining the two creates the most value. As mentioned earlier, building a trading business is not plausible for most companies, due to regional limitations, scale or a lack of capability. Likewise, some trading companies do not possess the operating capability or desire the capital intensity of an asset business. In such cases, forming a partnership between an asset company and trading company on a profit-sharing basis may offer optimum value. This relationship allows the asset company to concentrate on its own areas of expertise, while the trading company focuses on its command of trading, to the benefit of both.

Access to Customers

Successful trading companies have excellent origination (marketing) organizations that help customers manage risk and capture new opportunities. Traders offer hedging and structured risk products to customers. These transactions provide valuable feedback to trading on longer-term transactions that are not transparent in the marketplace and help the trader manage long-dated market risk. Customer groups also are critical to the product development process.

Product Development

Product development is critical to the viability of a trading company. Trading margins for products decline over time, consequently, a successful trading company must reinvent itself continually. Innovation in this area is what separates world-class trading companies from the pack. To be successful, a company must have top-tier talent in quantitative analysis, structuring and origination.

Multi-national/Multi-commodity

As markets evolve, they change from regional to national to international and from single-commodity to multi-commodity. Examples include the crude/products market and the gas/power/residual/coal market. The successful trading company must be able to manage risks in all these arenas, in addition to other related risks, such as transmission, credit, transportation and emissions trading.

Other Keys to Success

Trading companies must compete for top intellectual capital, and they must have competitive compensation systems. Moreover, basic moral values such as humility, teamwork and honesty–important within any organization–may be even more so within a trading company.

The Bottom Line

Trading is critical to the evolution of markets. By providing companies with a way to hedge their risks and giving them the freedom to deal with more financial assurance, traders facilitate the making of business ventures that, otherwise, might not be realized. Trading gives companies an added essential tool in their decision-making kit that enables them to create more value in the marketplace.

Trading adds value across the value chain. Trading companies are primary innovative points in the industry and the key drivers of risk product development. By bringing the best knowledge to bear, traders catalyze new approaches, risk products and new sources of profit within every segment of the value chain. These improvements extend ultimately to the consumer.

Trading can create sustainable advantages for companies through valuable alliances. Those advantages are likely to elude the grasps of companies that fail to recognize the increasingly critical role of trading in the competitive marketplace. As markets deregulate, the smart money is on the companies that are astute enough to develop, acquire or ally with a knowledgeable trading company.