A Collision on Risks of Energy Trading

By NEELA BANERJEE

Jones Murphy might not have noticed what his colleagues at the Williams Companies were doing if they had not been gloating.

Mr. Murphy, previously a Wall Street executive, had recently been hired as the director of emerging products at Williams's headquarters in Tulsa, Okla., to help manage its trading risks. He was on the company's trading floor when he heard a commotion at the desk of Blake Herndon, director of risk management.

"I went over to ask what was going on," Mr. Murphy recalled of that day in December 2000. "Blake laughed and said they were going to corner the market for natural gas and run it up for December closing, which means delivery in January."

Williams is the second-largest owner of natural gas pipelines in the country, and Mr. Murphy, who is no longer with the company, says he thinks that an examination of trading records would show that the company succeeded in driving up natural gas prices in California.

Executives at Williams dismissed the allegation as impossible. Mr. Herndon said: "It is comical to think that anyone could corner the gas market in California. I think this shows the lack of understanding of how these markets work. These are just not cornerable markets."

In any case, prices spiked in December, when the state's gas-fired power plants were running full-tilt, records of the California Public Utilities Commission show. Mr. Murphy said he was told by Mr. Herndon that Williams probably made "hundreds of millions of dollars" from its strategy. It was at the top of its game.

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Jones Murphy, top right, said he repeatedly warned Blake Herndon, top left, director of risk management at the Williams Companies, that its energy trading risks were excessive. Williams's stock price has fallen 71 percent in the last two years.

But now, Williams is teetering. Its share price has plummeted 71 percent from its high of $48.77 three years ago as investors steer clear of energy companies. It took a $2.05 billion charge against its 2001 earnings because of costs linked to a former communications business that is now in bankruptcy protection. Standard & Poor's lowered Williams's credit rating last week to one notch above junk status, and Moody's Investors Service is reviewing whether it should cut its rating. Williams is scrambling to pare its $13 billion of debt and shore up investor confidence, announcing last week that it plans to sell as much as $1.5 billion in equity and $3 billion in assets over the next year.

Adding to Williams's woes are several regulatory investigations, including one by the Securities and Exchange Commission, and an accusation by creditors of the communications spinoff, the Williams Communications Group, that Williams loaded up the new company with excess debt.

The California attorney general's office is investigating whether natural gas prices were manipulated during the state's energy crisis, which stretched from the summer of 2000 into 2001. But it declined to say if Williams, which controls significant natural gas pipeline capacity into Southern California, is under investigation.

Williams denies that it did anything illegal in California or anywhere else. "There has been any number of investigations, and Williams has fully cooperated," said William Hobbs, president of the energy marketing and trading unit at Williams. "We have provided piles and piles of documents, and no one has come back and said that Williams has done anything wrong."

The company did refund $8 million to California last year as part of a settlement agreement with federal regulators who were investigating whether power was withheld in the state to drive up the price of electricity. Williams did not acknowledge any wrongdoing.

Like the country's other major power traders, Williams has struggled to avoid the taint of malfeasance ever since Enron's problems began to become known late last year. But successive revelations about how many energy trading companies work — from the use of creative accounting to show increasing profits to their use of fictitious trades to fatten revenue — have peeled away the industry's denials to reveal uncomfortable similarities between some other energy companies and the bankrupt Enron.

WILLIAMS has been among the most adamant in asserting that it is nothing like Enron and that it has been unfairly tarred with the same brush. "Williams is, was and always has been the `anti-Enron,' " Williams said in a statement on Friday.

Mr. Hobbs emphasized the difference between his company's practices and the market manipulations that Enron employed. "Williams is not doing those things," he said.

But Mr. Murphy and others who worked for the company, as well as some investors who have taken a close look at Williams's financial statements, assert that it has much more to answer for than the problems already apparent to investors and analysts. Like Enron's, Williams's profits skyrocketed from 1996 to 2001 — by 97 percent for Williams, according to a presentation the company made to analysts last year. But those gains seem to be largely on paper, critics say. They contend that the results were based on the company's optimistic projections about how much it would make on long-term contracts and the practice of booking years' worth of projected profits immediately, through mark-to-market accounting.

The company suffered considerable losses when the California utilities crumbled and when Enron filed for bankruptcy protection, said Mr. Murphy, who was in charge of developing financial instruments to mitigate Williams's trading risks until he was dismissed in December 2001. He is now looking for work.

Williams said Mr. Murphy initially seemed impressive, which is why it hired him. But the company said it later became clear that he lacked understanding of the company's business, and that his "unfounded and evolving criticisms of Williams's energy marketing and trading business emerged only as he realized his employment was in jeopardy and subsequent to his termination."

E-mail messages sent months before Mr. Murphy was dismissed show that he and other Williams employees repeatedly and urgently warned Williams executives that the company had to reduce its trading risks, especially with shaky counterparties like Enron.

But those warnings were apparently ignored, Mr. Murphy and others said. Blinkered by arrogance and an ignorance of the financial sophistication required to trade electricity, critics say, Williams executives thought the company and the deregulated power sector would thrive uninterrupted. Reducing risks, or hedging, takes away from the bottom line, the critics added.

Continued
1 | 2 | 3 | Next>>

Home | Back to Business | Search | Corrections | Help | Back to Top

A Collision on Risks of Energy Trading

(Page 2 of 3)

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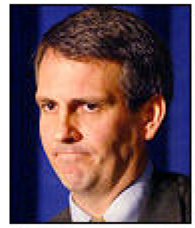
"Not hedging properly is the same thing as inflating profits," said James Chanos, president of Kynikos Associates, a New York short seller, "because hedging has a cost." His company has sold Williams stock short, anticipating further declines.

The latest wave of investor concern and regulatory scrutiny roiling the power industry arises from questions about the ethics and profitability of electricity trading. Enron released memos a few weeks ago detailing methods that its traders used to manipulate electricity prices in California in 2000. Other energy companies have acknowledged that they tried similar tactics, while some — including Dynegy, CMS Energy and Reliant Resources — have said that they had made questionable power trades that inflated revenue. Williams denied making such trades and has not been accused of doing so.



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Enron effectively invented energy trading, and some companies have tried to distance themselves from Enron by playing down the importance of their trading operations.

Last Tuesday, Dynegy executives said most of the company's cash flow comes from hard assets, like pipelines and power generation, not trading. On Wednesday, the El Paso Corporation announced that it would cut its trading operations drastically. Moody's said last week that electricity trading might not be an investment-grade business.

Electricity trading is a riddle to outsiders, given its complexity and the proprietary models that each company uses to value its trades. But as investors and analysts more closely examine power companies, they have come to realize that the mark-to-market style of accounting used for trading gives companies great leeway to inflate profits and that trading may actually be a money loser.

"We have yet to see proved after the Enron collapse that anyone made money in pure trading," said Robert McCullough, managing partner at McCullough Research, an energy consulting firm in Portland, Ore. "They made money in the California crisis, but in

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the absence of that, is anyone making money in trading?"

THAT question is crucial to Williams because energy trading is such a big part of its business. In the first quarter, marketing and trading contributed $271 million to Williams's operating income, or 42 percent, before one-time charges and taxes, the most of any business unit. But a close look at its cash-flow statement shows that energy marketing and trading did not generate cash; Williams, however, said that it did.

The paradox stems from the fact that the cash Williams expects from those contracts might arrive 10 or 20 years in the future, but the profits are booked to the bottom line now, under the mark-to-market accounting that Williams and other energy companies use for their trading operations. Among the largest power traders, Williams had the greatest share of profits — 37 percent — attributable to mark-to-market accounting, according to a February report by the investment bank ABN Amro.

The importance of trading to Williams is evident in an e-mail memo sent on Wednesday to employees of the company's energy marketing and trading business by Mr. Hobbs, the unit's president. In it, he listed steps the company might take to restore its credit rating, which directly affects profitability. "All of these efforts," he wrote, "are designed to increase liquidity, improve cash flows and provide a sufficient enough credit rating for E.M. and T. to realize the tremendous business opportunities that are ahead of us."

Because Williams's energy contracts extend far into the future, the markets for them are illiquid and opaque. In that case, independent accountants say, a company should calculate the value of the contracts based on conservative models and assumptions. The models at Williams, according to Mr. Murphy and others, were designed primarily to show that the company would make sizable profits from the contracts.

"There was the hubris of the deal makers," said one former Williams employee who insisted on anonymity. "They would do a 20-year deal in 2000 and based on the forward curve, mark-to-market says you just made $350 million. You are king; you made a seven-figure bonus.

"But if the deal goes in reverse and starts to lose money, you don't give the bonus back," the former employee added. "You can figure out a way to game the system internally and convince your guys that the price curve should be better."

Mr. Murphy said that traders and marketers — not independent economic analysts — set the forward price curves for power. Traders and marketers have a vested interest in making optimistic forecasts because their bonuses are based on the income they generate for the company.

"They would just make an economic argument for what the price of 40-year power was and draw a smooth curve," Mr. Murphy said. Enron Energy Services engaged in similar practices before the company collapsed, former employees have said.

Executives at Williams denied that they improperly accounted for the profits and potential cash flow from its contracts, citing reports by equity analysts that have called them among the most conservative companies on this count. "There is nothing nefarious or devious about the valuation of long-dated positions through market data," the company said on Friday.

Another accounting approach that Williams used was the so-called competitive deal basis, Mr. Murphy and others said. Future prices for power would be set according to deals competitors were striking or even discussing and on other deals that Williams was negotiating, too. It was immaterial if the transactions actually occurred, as long as the forecast of power prices would show that Williams could immediately book a substantial profit on paper, Mr. Murphy and others said.

"There was a total lack of transparency," Mr. Murphy said. "And there was a desire to keep it untransparent because they were doing this funky competitive deal stuff."

Williams said it uses competitive prices only to validate its economic models, not as the basis for assumptions.

As Williams built its trading business, company executives realized that they needed to manage financial risks in the new electricity marketplace. So in August 2000, Williams hired Mr. Murphy, wooing him from a job as an assistant vice president for the hybrid derivatives group at Bank of

America by promising wide latitude to manage the credit, currency and interest rate risk that the company encountered in trading. If not properly managed, those risks could lead to hundreds of millions of dollars in losses.

Williams portrays itself as the industry leader in risk management. The phrase is ubiquitous in its pitches to investors.

Mr. Murphy saw a different picture. Williams, he said, had failed to reduce financial risks across the board, but when he offered his ideas, he was turned away. An astrophysicist trained at the California Institute of Technology and speaks with a blunt confidence that comes from his education and his New York upbringing, Mr. Murphy was an outsider among the oil-patch veterans at Williams. He recalls being told many times that as a Wall Streeter, he understood little about trading natural gas and power, though firms like Goldman, Sachs are among the biggest in the business.

Mr. Hobbs concurred that Mr. Murphy was an outsider, and said that explains the outlandishness of his accusation about cornering the natural gas market in California. "I think you are dealing with an employee who is not informed," he said, "and that explains why he is no longer with Williams."

Continued
<<Previous | 1 | 2 | 3 | Next>>

Home | Back to Business | Search | Corrections | Help | Back to Top

A Collision on Risks of Energy Trading

(Page 3 of 3)

But Mr. Murphy countered that the company was just not willing to listen to people who questioned the status quo. "They were so entrenched in their ways, and there was such deep ambivalence," he said. "It went against their egos to surrender the power to take care of these risks."

Those risks were alarming, Mr. Murphy said. In September 2000, Mr. Murphy said he noticed that Williams had bet on a fall in interest rates and did not hedge, or set up counterbalancing contracts to neutralize risk, in case they did not drop. Interest rates did fall, and Williams made huge profits. But Mr. Murphy tried, unsuccessfully, to convince Williams that it could not have a position on the direction interest rates would go without mitigating the risk that they might move the opposite way.

"That they're holding such speculative positions, they should have had to report that to investors," he said. "Banks don't let traders run such naked positions — just betting that rates will fall."

In fact, that successful bet accounted for much of Williams's reported 2001 profits from energy trading. In a July 30 e-mail message that Mr. Murphy made available, Zahid Ullah, a former consultant to the trading arm, discussed interest-rate risk with Mr. Murphy and concluded that the sharp fall in rates accounted for more than $100 million in profit for the energy marketing and trading unit last year. That was 7.8 percent of the unit's total profit.

Williams said it does not report results by commodity, which would include interest-rate risk.

In the early fall of 2000, Mr. Murphy said, he also warned the company about the rapidly deteriorating finances of the California utilities to which it had sold power, the Pacific Gas and Electric unit of the PG&E Corporation and the Southern California Edison unit of Edison International. Pacific Gas has since gone

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bankrupt. Mr. Murphy saw that the utilities' debts to Williams were growing, and he thought that Williams should hedge against the risk of their bankruptcy. "But the contention of the higher-ups was that they would get it back," he said. "They told me those companies were too big to fail."

After the utilities crumbled, the company did manage to get back a big part of the money. But in a presentation Mr. Murphy made for the company on Oct. 8, 2001, the total owed to Williams by California utilities was $812 million. The company said on Friday that to date, California utilities owed it $217 million, and that it expects to be paid in full.

In an e-mail message on Nov. 29 to Stephanie Cipolla, the head of human resources at the energy marketing and trading unit, Mr. Murphy wrote: "We're getting up to over a year now, and this money has cost us something like 50 million interest costs on funding the 800 million hole in our balance sheet. I would have hedged that risk for much less than a 50 million bonus, honest."

The company faced the same choices a year later, in the fall of 2001, when Enron began to falter. But the California debacle seemed to have taught Williams nothing, Mr. Murphy said in an interview and in e-mail messages to colleagues.

Mr. Murphy said he pointed out to his superiors that Enron's creditworthiness was eroding. The signs of it were in the yield on the company's debt, which was as high as 16 percent at the time, far higher thanyields of more stable companies. In one November e-mail message, Mr. Murphy recounted "an awful meeting Oct 28th, where I basically fought a lonely battle to hedge, slow pay and otherwise protect the company against Enron's deteriorating situation."

Mr. Murphy said Mr. Herndon and Mike Selman, vice president for portfolio management at the energy marketing and trading unit, countermanded his orders to hedge Enron's credit risk. In an Oct. 26 e-mail message to Rod Sailor, assistant treasurer at Williams, Mr. Murphy said he was nervous about Enron, adding: "Also you said something like, `The stock and their bonds would have to go a LOT lower to consider hedging Enron's credit.' There's not a lot of room left from here to liquidation levels, so are you basically saying you don't want us to hedge at all?"

In his e-mail response three days later, Mr. Sailor confirmed Mr. Murphy's supposition: "Yes, we should be concerned; and yes; we should continue to monitor the situation; and yes, their credit is deteriorating, but right now they're rated higher than we are and are still investment grade."

The company said that no one saw Enron's bankruptcy coming until it was too late, and that by this time Williams had mitigated this risk in other ways. Williams said its exposure to Enron was relatively small compared with that of other companies.

In the fourth quarter of 2001, Williams was owed more than $91 million by Enron, which accounted for a charge of 12 cents a share to Williams's quarterly earnings of $2.35 a share.

Mr. Murphy was offered a demotion in early December. He refused to accept it and was fired.

He said that there was one instance in his time at Williams when he felt that a top executive supported him. Mr. Murphy said that after Andrew Sunderman, the trading unit's chief financial officer, found out about Mr. Herndon's natural-gas tactic, he warned against being too greedy. "Sunderman told Blake and me: `Pigs get fat. Hogs get slaughtered,' " Mr. Murphy recalled recently.

Mr. Sunderman said he would never have talked about natural gas trading with Mr. Murphy.

<<Previous | 1 | 2 | 3

Home | Back to Business | Search | Corrections | Help | Back to Top