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PAGE ONE

How Energy Traders Turned Bonanza Into a Historic Bust

Spurred by Deregulation, Industry Greed And Deceit Unraveled the Nascent Market

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Staff Reporters of THE WALL STREET JOURNAL

With dazzling speed, the energy-trading business sprang up in the late 1990s and seemed to become a \$300 billion bonanza. Just a few years later, it's mostly gone, having collapsed in a flurry of fraud, aggressive accounting and flat-out greed.

How did it happen? Regulatory rollbacks and changes in accounting rules enticed some of the biggest names in the industry to remake themselves from staid utilities and pipeline operators into high-tech traders of contracts for electricity, natural gas and other fuels. Then, things got out of hand.

It's not that energy trading was necessarily a bad idea, says Peter Fusaro, an industry consultant in New York. The trading titans recklessly ruined it. "It became a big casino of making as much money as you could."

The companies looked for extra profits by taking advantage of customers. Trading became a means for fudging financial results.

And a cozy core group of traders in Houston and elsewhere colluded on sham transactions aimed at fooling investors about the volume of activity in the new market. Eventually, the scam began to unravel. In the midst of an energy crisis in 2000, California officials accused avaricious traders of ripping off the state. Questions arose about concealed liabilities at Enron Corp. and dubious gas deals at **Dynegy Inc.**

COMPANIES

Dow Jones, Reuters

[Dynegy Inc. Cl A \(DYN\)](#)

PRICE	1.02
CHANGE	-0.02
U.S. dollars	12/30

[Williams Cos. \(WMB\)](#)

PRICE	2.27
CHANGE	0.07
U.S. dollars	12/30

[El Paso Corp. \(EP\)](#)

PRICE	6.99
CHANGE	0.02
U.S. dollars	12/30

[CMS Energy Corp. \(CMS\)](#)

PRICE	9.06
CHANGE	-0.01
U.S. dollars	12/30

[Reliant Resources Inc. \(RRI\)](#)

PRICE	3.19
CHANGE	0.36
U.S. dollars	12/30

* At Market Close

SPECIAL PAGE

For continuing coverage of corporate-accounting issues go to [Called to Account](#)¹.

Not everyone took this route. But enough companies did that energy trading is in shambles -- one of the swiftest and largest examples of a market boom and bust in U.S. history. Investors in the trading companies have lost billions of dollars on paper, and the entire affair raises serious questions about whether such a complex market

can operate safely without close regulation.

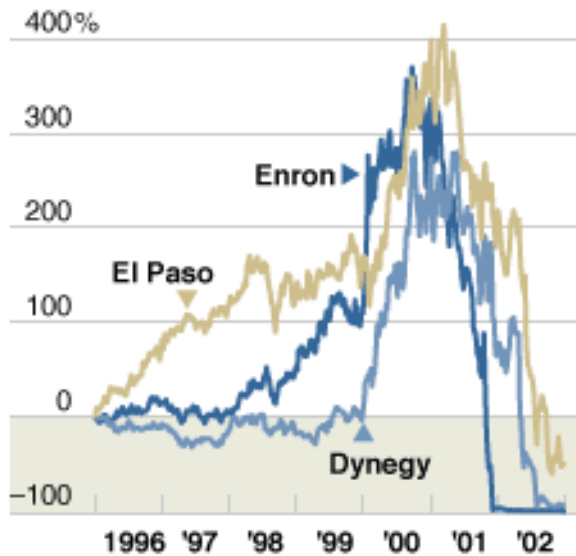
Enron is in bankruptcy-court proceedings, and four of its executives have been charged with or have pleaded guilty to crimes. Dynegy has paid \$3 million to settle civil allegations of securities fraud by the Securities and Exchange Commission, and most of the company's executive team has been replaced. **Williams** Cos. recently agreed to settle with California and pay the state \$150 million over eight years. Several other firms remain under civil and criminal investigation for their dealings with the state.

Not so long ago, supplying electricity and natural gas wasn't so complicated. Heavily regulated utilities that enjoyed local monopolies sold power and gas to consumers large and small. Beginning in the early 1990s, however, federal and state regulations were scaled back, and utilities were forced to open their transmission lines to rivals. The idea was that suppliers and traders would compete for business by cutting prices and moving energy around the country more efficiently. Buyers would obtain stable supplies by entering long-term contracts.

Hundreds of companies jumped at the chance to serve as middlemen in the unshackled market. They ranged from **American Electric Power** Co., a sleepy regional utility in Columbus, Ohio, to Enron, a Houston pipeline operator.

ENERGY FAILURE

Companies that rushed into energy trading saw their share prices soar and then collapse on revelations of dubious deals and accounting. Stock performance since 1996.



Source: Thomson Datastream

Energy trading involves sales of contracts to provide electricity, gas or other fuels over a set period. A central challenge is to figure out how to value the contracts, given the unpredictability of such variables as the cost of power years in the future and weather shifts that affect demand for heat or air conditioning.

Brain Power

Companies scrambling for position in the trading market went after the brain power needed to crunch the numbers representing all of these factors. Williams, in Tulsa, Okla., for example, hired Anjelina Belakovskaia, a Ukrainian chess grandmaster, to help quantify weather effects.

Trading companies also lobbied in Washington for flexible new accounting rules that would allow them to account for anticipated revenue and income from long-term contracts as if the cash were coming in immediately. In 1992, the Financial Accounting Standards Board, an accounting-industry group, signed

off on the switch, as did the SEC. The adjustment helped the companies impress Wall Street with what looked like quickly bulging bottom lines.

General economic conditions favored the energy traders. Electricity prices typically are volatile, changing with the shifting seasons and needs of big industrial and municipal customers. The booming late-1990s economy led to surging demand that further exacerbated sharp swings in the power market. Traders thrive on volatility because they specialize in knowing where to buy their commodity cheap and who will pay top dollar.

Backed by their young trading operations, companies such as Enron quickly signed up some big customers. In 1998, Enron struck a \$246 million long-term deal with the Archdiocese of Chicago to provide electricity and natural gas for churches and schools. Later, Enron signed a \$610 million deal with **International Business Machines Corp.** and a \$600 million deal with **J.C. Penney Co.**

Despite the banner deals, however, it soon became clear to industry insiders that electricity was much more difficult to trade than natural gas. Electricity can't be stored and is hard to transport long distances. Even the brainy number crunchers found it difficult to value over long periods. As a result, trading companies landed relatively few big customers willing to sign profitable long-term contracts.

This problem didn't inhibit the companies from trading shorter-term contracts in the energy equivalent of the pork-belly market. The online exchanges DynegyDirect and EnronOnline exploded. EnronOnline racked up more than \$180 billion in transactions in the first year after its October 1999

launch.

Wall Street took notice. Amid a booming stock market, giddy investment-house analysts forecast stellar earnings for energy traders. Energy-trading stocks soared. Enron's shares rose 78% in the three years after 1996, as investors bought the story that the company and its top rivals were now powered more by intellect than electricity and gas.

But with little regulatory oversight, a Wild West atmosphere quickly developed in Houston. For about three years, beginning in 1998, Enron traders selling power to California utilities artificially increased congestion on the state's transmission lines, knowing they would be paid later to ease the situation, according to a federal plea agreement in October by former Enron trader Timothy Belden. The scheme worked, even though the traders didn't relieve the clogs. Enron traders also dishonestly demanded higher out-of-state prices for certain power supplied to California, the Belden agreement says. In fact, the electricity was generated in California, shipped out and then brought back in.

Other traders tried to manipulate published price indexes used as benchmarks for valuing energy deals. By reporting false price information to the index keepers, traders could inflate the value of contracts they held. In November 2001, Todd Geiger, an El Paso Corp. trader, allegedly fabricated 48 natural-gas trades and sent fake volume and price information by e-mail to "Inside FERC's Gas Market Report," a trade publication that compiles a widely used gas-price index. Earlier this month, federal prosecutors charged him with wire fraud and reporting false market information.

Mr. Geiger, who is no longer with the company, has pleaded innocent. His attorney, George Murphy, says Mr. Geiger is "guilty of working in an industry gone awry" but "has not done anything wrong."

Also this month, Dynegy agreed, without admitting wrongdoing, to pay \$5 million to settle charges by the Commodity Futures Trading Commission that it tried to manipulate price indexes. Both Dynegy and American Electric Power have fired traders who allegedly provided phony data. Williams has acknowledged that some of its traders did the same.

Until such practices came to light, stock prices for the industry's biggest players -- Enron, Dynegy, El Paso and Williams -- continued climbing. Senior executives and traders saw their pay packages balloon, fueling an impressive degree of excess in some quarters of Houston. At one dinner in 1998, nine El Paso traders and brokers racked up a \$13,000 bill at Pappa's Bros. Steakhouse, thanks in part to \$150-a-glass Remy Martin Louis XIII cognac, according to participants.

On another night, a group of more than 15 traders ranging in age from mid-20s to late 30s gathered in a private room at Sullivan's Steakhouse. Over drinks and cigars, several of them, including Mr. Geiger of El Paso, challenged each other to jab steak knives between their outstretched fingers in a show of machismo, according to participants. Finally, one trader gouged himself, bloodying the white tablecloth. He left, cursing, and later got stitches. Mr. Geiger and a few others began throwing knives into the restaurant's wood-paneled wall.

The management at Sullivan's didn't intervene. "It was like an adult fraternity," says Stephen

Fronterhouse, the restaurant's manager at the time. "They were making a ton of money and having a great time."

Many members of that fraternity knew each other well, having jumped back and forth among the major companies. Tight professional and social relationships created a milieu in which traders covered each other's backs in deals that seemed aimed more at increasing the volume of their business -- and thereby creating the impression of an expanding market -- than at achieving substantive economic goals.

CMS Energy Corp. in Dearborn, Mich., played the willing foil in "round trip" trading in which two companies exchange the same amount of power or gas, at the same time, at the same price. Ultimately, CMS's round-tripping with Dynegy and Houston's **Reliant Resources Inc.** accounted for 80% of CMS's energy trading in 2000 and 70% in 2001, the company later said in a statement.

Since the trades canceled each other out, they did little for the bottom line. To bolster their net profit numbers, some energy companies took advantage of the adjusted accounting rules, which allowed them to recognize immediately revenue and income expected in the future.

The accounting rules gave company managers huge leeway in valuing long-term gas and power contracts, leading to more dubious behavior. In December 1999, Lawrence Whalley, then president of Enron's trading unit, asked a group of subordinates to "find" \$9 million in additional profits to help the company meet end-of-year goals, according to a trader and another employee.

The traders came back with a plan to recalculate the value of a 1997 contract to supply Entex, a Houston natural-gas distribution company. Enron had upgraded a storage facility in the interim, and that would allow it to respond more efficiently if weather turned unexpectedly cold, raising gas demand. "We were building a story that would be acceptable," one trader recalls. Enron's auditor, Arthur Andersen LLP, signed off on the changes, the Enron employees say.

Mr. Whalley is now employed by **UBS AG**, which has acquired Enron's trading operations. Neither he nor his lawyer responded to multiple requests for comment. Enron and Andersen decline to comment on the incident.

The energy-trading companies also turned to investment banks such as **J.P. Morgan Chase & Co.** and **Citigroup Inc.** to help engineer some questionable deals. In some cases, the banks extended financing for the future delivery of gas or oil. The energy companies booked the financing as if it were cash flow from operations, even though under ordinary analysis it looked more like debt.

Round-Trip Trades

Often, these arrangements, known as prepays, were little more than round-trip trades: Gas delivered to the banks would be sold right back to the companies, which would start the transaction all over again.

Some bankers involved in these deals were shocked to discover the degree of Enron's dependence on

the tactic. In October 2001, Richard S. Walker, a J.P. Morgan banker in Houston, sent an e-mail about Enron to a colleague, George Serice. "\$5 billion in prepays!!!!!!!!!!!!!!!" it said.

"Shut up and delete this e-mail," Mr. Serice responded. J.P. Morgan and Enron decline to comment.

In April 2001, Dynegy teamed up with Citigroup on a deal known as Project Alpha. Its purpose, according to internal Dynegy documents, was to artificially close the gap that was developing between Dynegy's earnings, which were soaring under the flexible accounting rules, and the company's actual cash flow from operations. It was in part to settle SEC securities-fraud allegations over Project Alpha that Dynegy paid the government \$3 million in September. The company neither admitted nor denied wrongdoing.

By the fall of 2001, the mood in Houston had shifted. Questions about its finances and trading had badly wounded Enron. Zula's, a trendy downtown restaurant, began pegging the price of martinis to the falling price of Enron stock. In December, the company filed for bankruptcy-court protection.

Enron's rivals became increasingly desperate to maintain the appearance of prosperity. At Williams, a group of executives met last spring to discuss a proposal that would help measure future energy prices. Jeff Corrigan, a Williams analyst, handed out a document describing three approaches. Two were technical methods. The third was described as "whatever management declares," according to a lawsuit filed against the company by Williams investors in federal court in Tulsa in October.

"We don't put this on paper," Blake Herndon, a senior Williams executive, said of the third approach, according to the suit, which cited an unnamed employee who attended the meeting. Another senior executive covered his eyes jokingly and said, "I did not see this," the suit says.

A Williams spokesman says, "The company does not comment on speculative allegations." Mr. Herndon didn't respond to multiple requests for comment.

By the middle of this year, it became clear that energy-trading companies had used accounting maneuvers to book contracts for more than what they were worth. Rating agencies began to lower the companies' credit ratings. That tarnished the companies' reputations and made it more difficult for them to find trading partners and more expensive to borrow.

As inquiries into California's energy mess gathered steam, revelations began to pour out about round-trip trades and other abuses. With every bit of bad news, the stock market punished energy traders' shares. El Paso peaked in March 2001 at \$74, but it is now trading at about \$7. Williams is trading at about \$2.30, down from a May 1999 high of \$50. Dynegy's shares, after hitting a high of \$57.50 in September 2000, are now trading at about \$1.

Since late last year, power-trading volume has shrunk by as much as 70%, according to industry estimates. Firms such as El Paso, Dynegy and CMS are ditching all or most of their energy trading to return to their roots as pipeline and utility companies. The four-story trading floor that Enron began building in 1999 is scheduled to close next spring.

What trading remains is being done mostly by major oil suppliers and financial institutions with long experience trading other commodities and securities. Some analysts fear the decline in speculative trading will reduce available information on future energy prices, making them harder to predict. That could deter power-plant construction, tighten power supplies and push up prices.

Energy trading could have been a profitable business without all of the chicanery, says Mr. Fusaro, the industry consultant. "They could have made a lot of money because there was so much price volatility in natural gas and power." But a lot wasn't enough.

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