POWER TRADING REBUILDS

Energy Trading in the Post-Enron World

GUEST OPINION

The New York Mercantile Exchange, Inc., launched off-exchange clearing services in response to the disarray of the merchant energy markets that followed the collapse of Enron Corp. It was the first major initiative of the Exchange to use the regulatory flexibility granted by the Commodity Futures Modernization Act of 2000 (CFMA), and has developed into one of the financial services industry's most recent success stories.

By James E. Newsome

The marketplace learned a hard lesson from the failure of Enron, — a major over-the-counter (OTC) market maker — that doing business with a large-sized trading partner does not guarantee immunity from counterparty credit risk. It was a lesson that was also taken to heart as seen by the growth last year in Exchange clearing services. Volume submitted solely for clearing through the NYMEX ClearPort electronic platform, the Internet-based portal for Exchange clearing services, totaled 14.3 million contracts in 2004, a 138 percent increase from the prior year.

Overall, it was the best year ever for Exchange performance. Total volume grew 18 percent to a record of 169.5 million contracts across all venues – open outcry, after-hours trading on NYMEX ACCESS, and NYMEX ClearPort.

NYMEX ClearPort lists a slate of approximately 130 energy futures contracts that replicate popular OTC transactions, including contracts for crude oil, refined products, natural gas, coal, and electricity. The contracts can be competitively traded or transacted off-exchange and submitted solely for clearing, although a small number are listed for clearing only. These traditional OTC products were brought into the clearinghouse of a regulated exchange for the first time, which establishes the identity of participants, a transaction audit trail, daily position surveillance, and credit security.

The importance of such market transparency became overwhelmingly evident when the bankruptcy of Enron raised concerns about the financial strength of other energy firms and the breadth and depth of counterparty credit exposure in the marketplace. In the aftermath, other energy trading companies lost credit ratings, their stock prices plummeted, and they were beset by a liquidity crisis because parties lacked confidence in each other's abilities to perform transactions. New mechanisms were urgently needed to address these issues.

The petroleum and natural gas contracts on the NYMEX ClearPort slate include outright and basis contracts. They are closely tied to the core energy futures contracts for light sweet crude oil, heating oil, gasoline, and natural gas that trade via open outcry since the settlement prices of the NYMEX ClearPort contracts are based all or in part on the settlements of the floor-traded contracts.

The success of the NYMEX ClearPort platform and slate has brought new transparency to the coal and electricity markets, too. In power, for example, the regulatory flexibility of the CFMA coupled with demand from the marketplace led to a rapid expansion of the electricity complex to 26 contracts, including financially settled futures contracts, an options contract, four price index contracts, and three physical delivery contracts. Geographically, the power slate covers markets in the northeastern United States from New England to Virginia and key areas in the Midwest and West. Electricity open interest totaled approximately 110,000 contracts in late March.

In another expansion of the Exchange markets, direct trading of the benchmark energy and metals futures contracts commenced via NYMEX ACCESS from the key Asian market centers in Japan, Hong Kong, and Singapore. The contracts are available for trading during the 18 hours that the New York trading floor is closed but includes the Asian business day. Electronic trading also commenced during 2004 from Switzerland, complementing the existing vigorous activity from London.

The vitality of the Exchange's markets and their acceptance in trading centers around the world are a reflection of the confidence that market participants have in the trading forum. Participants in the energy markets take the risk of counterparty default seriously, which is mitigated by the financial controls and market surveillance exercised by the Exchange. In a relatively short period of time, the Exchange has substantially expanded the opportunities for market participants — both in the domestic OTC energy markets and to participants around the globe.

James E. Newsome is president of the New York Mercantile Exchange.