

For U.S. Natural Gas Marketers and Traders, Hard Business Design Choices Ahead

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The U.S. natural gas marketing and trading sector has undergone enormous change since the collapse of the asset-light merchant model in the early 2000s. Not only have investment banks, hedge funds, and other firms entered the fray, but there also has been a fundamental shift in the business designs of top marketers. The most recent collapse of certain credit markets and a restructuring of Wall Street are now creating new challenges. To succeed in the next generation of gas marketing, managers will have to make the right business design choices, including asset-based investment strategies, and determine the best way to align their organizations around new market realities.

Competitors in the U.S. natural gas marketing and trading business face three major challenges today that have been exacerbated by the recent credit market collapse:

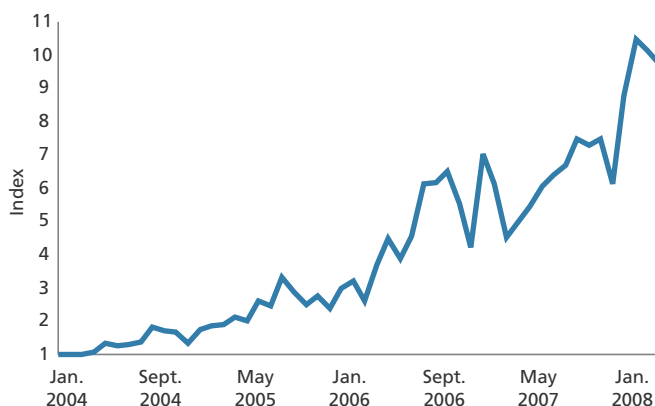
New market dynamics. The emergence of electronic exchanges and bulletin boards over the past five years, notably Intercontinental Exchange (ICE) and Natural Gas Exchange (NGX), has added transparency and liquidity to the marketplace, making it more difficult for marketers and traders to maintain their profits based purely on strong customer relationships. As shown in Exhibit 1, ICE trading activity is estimated to have increased by close to 1,000% over the past four years, leading to lower per-trade margins.

The recent financial crisis and tight credit markets have had a significant impact on this broad industry trend. Trading volumes have dropped significantly for some locations and tenors, on concerns over counterparty risks and lack of access to capital, illustrating the continuing importance of strong customer relationships.

Market dynamics have also been impacted by the credit concerns, intensifying the need for an investment-grade credit rating as an ante to the game. Despite recent downgrades in credit rating for Constellation, Nabors, and BP, as of November, 2008,

Exhibit 1 **Increasing use of exchanges and bulletin boards**

ICE trading activity, commissions indexed to Jan. 1, 2004



Note: Includes gas and power transactions.
Source: ICE.

over 90% of the top 25 marketers still had an investment-grade credit rating from S&P. The requirement to maintain an investment-grade rating is limiting the types of firm and business models that can effectively compete in this sector.

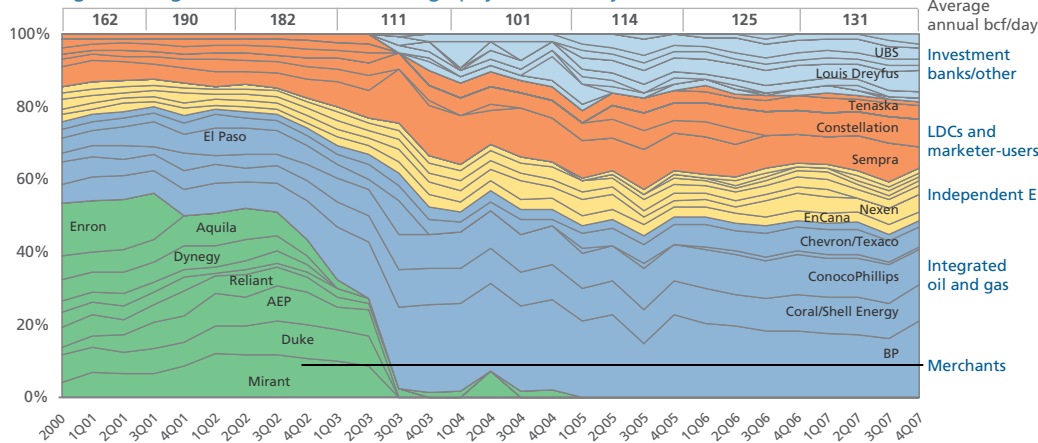
Shifting customer priorities. The turbulent market volatility of the past few years has prompted customers to seek out gas marketers that can offer price stability through creative risk management products and services and that have a strong credit rating to back their contracts. This is especially true for large industrial customers that rely on consistently priced gas to maintain profitability, and independent power producers (IPPs) and other power generation customers that seek to lock in gas prices (and thus their spark spread). As a result, firms such as Constellation, Sempra, and several investment banks have differentiated themselves based on their capability to develop structured products. While these competitors have had success using this approach, recent difficulties at companies like Constellation highlight the critical need for strong governance structures, controls, and risk analytics as a complement to a structured-products-focused model.

Customers also increasingly value reliable access to physical supply, a need that will likely intensify in this era of tight credit. Despite the existence of markets and exchanges which have effectively provided access to supply at some price, customers are placing an increasing value on reliable access to physical supply, and on marketers that are integrated and asset-heavy. These asset-heavy players have also benefited from the presence of assets on their balance sheet requirements, through the associated creditworthiness they can confer.

A changing competitive landscape. In part because of the trends described above, competitors owning physical supply, including independent exploration and production (E&P) firms and integrated majors, have begun to dominate the marketplace. In addition, some firms focused on financial products and solutions, such as investment banks and hedge funds have established a firm market foothold. Although some of these financial institutions are under

Exhibit 2 Since the collapse of leading merchant marketers, asset-heavy producers and financial institutions have stepped up to fill the marketing void

Leading natural gas marketers, total average physical BCF/day



- Potential impact of financial crisis**
- Significant short- to medium-term decline in share
 - Limited impact overall, but some company specific issues (Constellation)
 - Large upside potential resulting from increasing importance of supply and short-term troubles with investment banks
 - Limited overall impact; business model not likely to make a return to prominence

Note: Volumes represent North American physical natural gas sales and exclude financial transactions.
Source: NGI's Daily Gas Price Index, company reports, Oliver Wyman analysis.

extreme pressure from the financial crisis, this is more an indicator of the need for excellent internal controls and risk governance structures than a sign of flawed value propositions. Many new entrants, including independent E&Ps and international players, are now looking to take advantage of integrated margins or further trading opportunities, leading to a more fragmented competitive landscape (Exhibit 2).

The combination of these challenges has made the natural gas marketing and trading business much more competitive over the past five years, and placed intense pressure on trading margins and profitability. Changing customer priorities have also elevated the need for innovative products and services, which has altered the competencies and skill sets required by top marketing and trading organizations (Exhibit 3).

Exhibit 3 Implications of current market challenges

Market challenges

Implications for marketing and trading firms

Emergence of electronic exchanges and bulletin boards

- Increasing market liquidity and transparency devalue customer relationships
- New and more complex modes of competition needed to differentiate marketers and traders.

Credit market turbulence/Counterparty credit issues

- Strong balance sheet has become an ante to the game—asset-heavy companies advantaged by strength of balance sheets.
- Creditworthiness of counterparties has become significantly more important on both sides of the trade.

Emergence of new types of competitors and increasing competition

- Fierce competition has pressured profitability of basic back-to-back trades (markets are more fragmented and more competitors are competing for the same business).
- Competitors beginning to differentiate themselves along two dimensions—risk management/structured products capabilities and/or supply control

Increased perceived importance of access to physical supply

- Has allowed for the emergence of independent E&Ps and integrated majors as primary suppliers to the market
- Requires that new and emerging competitors partner for supply or otherwise address customer supply concerns through asset investment (midstream or LNG)

Increased importance of risk management products and services because of market volatility

- Investment banks and risk management specialists have increased the sophistication of structured product offerings to better meet customer needs.
- Players without this capability have struggled to differentiate themselves and can also be exposed to higher risks.

Source: Oliver Wyman analysis.

The traditional business design in this sector centered on establishing a strong, proprietary customer relationship, and that has been partially devalued by these new competitive realities. Success today requires that competitors extend their business designs through a series of discrete choices. Strong customer relationships will still be critical to the business, particularly through the current financial crisis, but will need to be complemented with other forms of differentiation and highly effective risk management governance and analytic capabilities.

Choosing the Appropriate Strategy

There are six components of a robust business design for U.S. natural gas marketing and trading: customer targeting, geographic market focus, offer and value proposition, value capture/profit model, strategic control, and scope of activities and assets. These components are complemented by the risk management policies and procedures, organizational design, and corporate culture of the marketing and trading firm.

In making these business design choices, executives should address several questions:

- Which customer segments are the most profitable and deserve the most focus?
- Which structured products and services does each customer segment desire?
- What are the core capabilities or points of differentiation and strategic control that should be emphasized: Quality of balance sheet? Access to proprietary information? Ownership of assets? Brand and reputation for security of supply? Strength of customer relationships?
- Which midstream and upstream assets, if any, will be necessary to develop a marketing and trading edge?
- Which risks is the business willing and able to retain, what levels are acceptable, and what controls will this require?

Customer targeting and geographic market focus.

Should the business be viewed purely opportunistically (value is generated from individual marketers and traders that identify situational trades and deals), or can business design choices be made to more systematically generate value? We believe that a marketing and trading firm should start with a deep understanding of their current or target customer base. Customer segments vary greatly in profitability and servicing requirements, with profitability per trade or transaction usually increasing when working with smaller and less sophisticated customers. The clear tradeoff here is in available volumes and administrative cost per transactions, while the customer set targeted will have clear implications across the other five areas of business design outlined below.

Closely related to customer selection is the choice of geographic focus. Companies can pursue regional models based on localized expertise or scaled-up national models. Different geographies contain different customer segments and these business design choices need to be consistent. For example, generating capacity tends to be clustered based on proximity to demand centers and hydrocarbon feedstocks. Competitors focused on those regions need to be particularly knowledgeable regarding those customer types.

Offer and value proposition

Targeting a specific customer type also impacts the mix of products and services that should be offered and the skills and capabilities that must be available to the customer. As an example, local distribution companies generally seek out providers based on such factors as their ability to manage storage capacity, whereas wholesale customers (other marketing and trading firms) may value aggregation services and pure volume plays. Regarding the scope of products traded or marketed, many companies can leverage their competencies and their proprietary information base across multiple commodities, increasing margin potential compared to those focused only on natural gas.

Value capture/profit model

Traditionally, value was generated in marketing and trading by matching supply and demand and extracting a pass-through service or management fee. With the emergence of exchanges and market transparency, this method of value capture eroded and margins decreased. More often these days, competitors have to capture value through arbitrage opportunities (across time, geographies, and commodity types), portfolio optimization margins (through the establishment of scale and diversity in the use of transportation, logistics, and asset positions), or enhanced risk-management services.

Strategic control

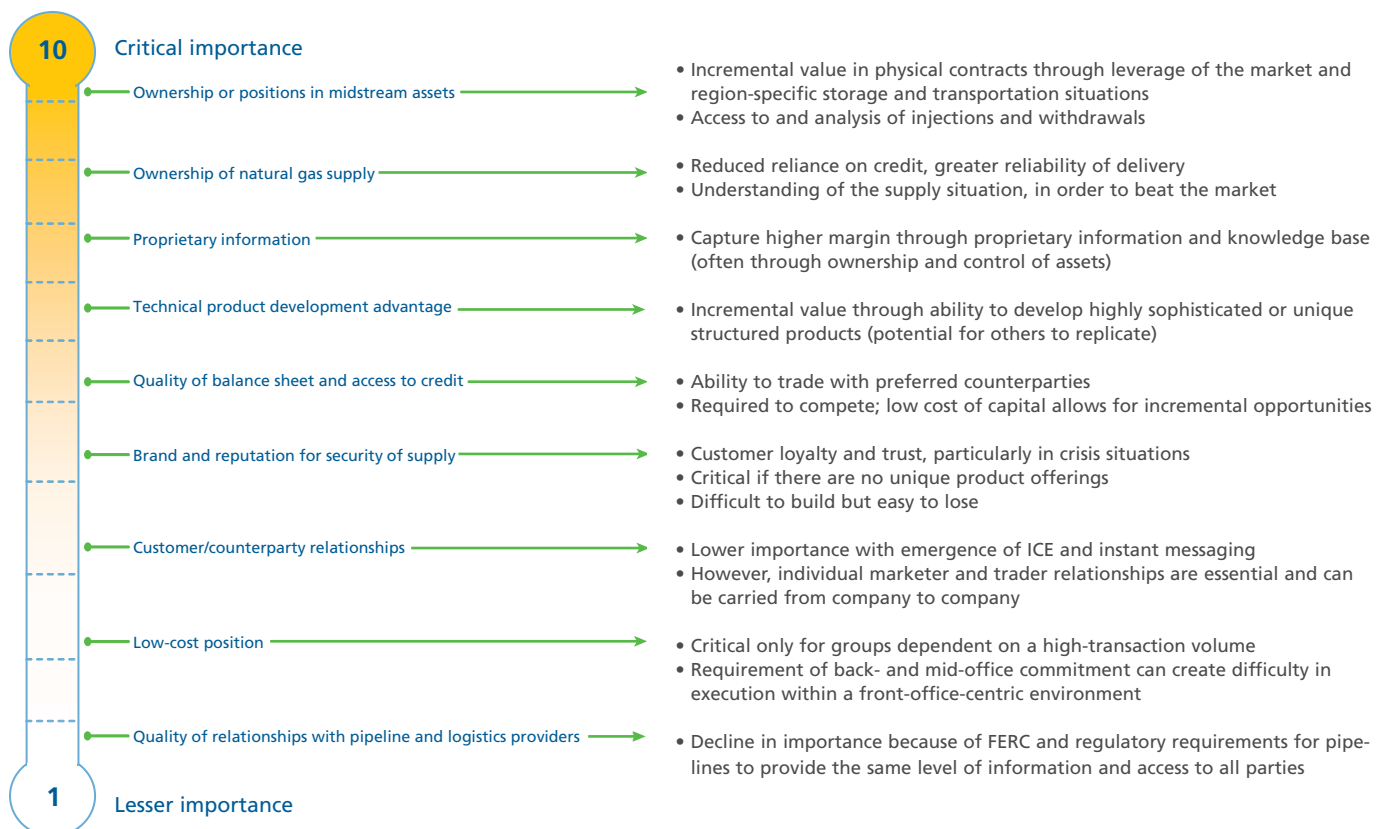
A marketing and trading firm needs to choose the right points of strategic control that over time can protect profit streams from being poached by competitors or powerful customers. Oliver Wyman analysis shows that access to supply, control of midstream assets, and risk management capabilities are the most effective forms of strategic con-

trol in the business, while other forms such as a low-cost back-office are less powerful (Exhibit 4). Asset-focused strategies have proven particularly effective in today's market environment, given the prevailing credit challenges and counterparty risks. Outright ownership or long-term access to key assets can also increase a marketing and trading firm's perceived value as a counterparty.

Scope of activities and assets

Executives must make choices regarding the levels and types of residual risk, the mix of financial and physical trading, the use of hedging, and the range of physical operations that can be integrated within the marketing and trading business. These decisions can result in completely different corporate risk profiles and newly defined organizational design, governance and control, and business process requirements. Given the recent market changes and challenges, we believe that these requirements will be central strategy execution differentiators for successful market participants.

Exhibit 4 Potential methods of strategic control



Source: Oliver Wyman analysis.

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Yesterday's business designs will no longer prevail in the natural gas marketing sector, given the ongoing shifts and recent shocks in market, customer, and competitive dynamics. Tomorrow's business designs should strive to gain differentiation through two avenues in particular. The first is superior internal risk management and structured products capabilities. Changing customer priorities are putting a premium on achieving price and physical security, requiring the development of more complex structured products. The margins associated with basic back-to-back trading have shrunk, and there are increasing challenges in establishing and maintaining any competitive advantage. The extensive use of structured products requires a strong risk management competency and clearly defined and controlled governance systems.

The second avenue is asset control or ownership. This stems from growing customer preferences for highly reliable supply, which can only be offered by companies with E&P (or LNG import) capabilities and control of midstream infrastructure. These ownership or secure lease positions will also lead to incremental margins, while allowing marketing and trading organizations to keep their finger on the pulse of the market and to improve their standing as a creditworthy counterparty.

Making the right set of choices along one or both of these directions raises the odds of building a winning business design. Each direction has its own implementation challenges, but these are well worth undertaking, as those firms that delay in confronting these choices will likely fall by the wayside. ❖

About Oliver Wyman

With more than 2,900 professionals in over 40 cities around the globe, Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm helps clients optimize their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is part of Marsh & McLennan Companies [NYSE: MMC]. For more information, visit www.oliverwyman.com.

The firm's global Energy Practice covers oil and gas client issues across the entire value chain, from oilfield services and E&P through marketing and trading and downstream fuels. Oliver Wyman has a broad base of experience in energy marketing and trading, having worked very closely with many of the top industry players. The firm provides strategic advisory services, strategy and business design development, organizational structure and marketing/trading process design, and risk management and governance.

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