Energy Trading, Without a Certain 'E'

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HOUSTON - FROM the windows of the trading floor at Centaurus Energy, you can see the glittering tower where Enron once had its headquarters with the crooked "E."

But this is no Enron. Created by John D. Arnold, Enron's former wunderkind trader of natural gas, Centaurus is part of a new breed of low-profile hedge funds that dabble in energy.

Enron, once the country's seventh-largest company, introduced its modern trading floor on national television and boasted of its ambition to be the world's leading energy company, only to collapse spectacularly in 2001 and set off a wave of investigations into corporate malfeasance.

Centaurus eschews most publicity and operates out of the eighth floor of a nondescript building near a highway, its glass doors tinted with light blue to prevent visitors from seeing what happens inside.

When Mr. Arnold, 31, created Centaurus in 2002 with $8 million of his own money, the energy trading industry was on its knees, incapacitated by the fraud and irrational exuberance at Enron. Since then, Centaurus has amassed $1.5 billion in assets under management and has hired big-name traders like Greg Whalley, a former Enron president.

The industry that Enron made infamous -- energy trading -- is springing to life again.

Volatile energy markets and record-high commodity prices are prompting renewed interest from investors eager to play in the sector. That has pushed banks and a growing number of hedge funds to hire more energy traders and brainy quantitative minds to back their bets on energy prices. In Houston, New York and London, a scramble for top trading talent has ensued that rivals the cutthroat hiring frenzy of the late 1990's.

"The whole market is hot right now," said Justin Pearson, managing director of Human Capital, a search firm based in London for energy traders. "Everybody is talking about expansion."

And helping to lead the industry's resurgence are traders from Enron like Mr. Arnold, who is not under any legal scrutiny, and those from other companies who lost their jobs after the 2001 blowup. Most have landed on their feet at banks, hedge funds or oil companies like BP and Chevron.

BUT with that revival come questions from some financial market analysts about whether energy trading will be better able to withstand another potential meltdown. While banks have stepped in with their superior balance sheets, credit ratings and trading skills to fill the liquidity void left by Enron, the latest ramp-up in trading has also been marked by an air of secrecy underscored by the proliferation of hundreds of hedge funds that are speculating on everything from crude oil to electricity in both regulated and unregulated markets. Many funds are being aided by investments from banks, which are also buying up distressed power plants and other remnants of the collapsed sector.

At least two funds suffered big losses last summer. And some industry officials question whether the funds are contributing to higher energy prices, or at least stoking more price volatility.

"The government can't assure the public that the over-the-counter market isn't being manipulated," said Randall Dodd, director of the Financial Policy Forum, a nonprofit group in Washington that studies the regulation of financial markets.

The resurgence of energy trading comes as investigations continue into the conduct of traders during the years when Enron ruled. Federal officials in Houston and San Francisco have charged 22 traders at six energy companies, including Enron, with crimes. So far, 12 have pleaded guilty or have been found guilty of trying to manipulate markets or falsely report trades to industry publications. The Commodity Futures Trading Commission, which regulates futures exchanges, has settled 30 cases with individual traders and energy companies accused of trading shenanigans, ordering a total of $298 million in civil penalties.

Traders at Enron were among those who took advantage of California's poorly constructed deregulation law and helped to bring about the state's energy crisis of 2000 and 2001. They concocted schemes to manipulate electricity markets and to maximize Enron's profit, using names like Fat Boy and Death Star to describe the strategies. Some bantered casually in 2000 about how they were "stealing" from California and sticking it to "Grandma Millie" by overcharging for power, according to audiotapes of their conversations that have been made public.

Ultimately, Enron's failure was not tied directly to the actions of traders, who made hundreds of millions of dollars for the company. But company traders were speculating on energy prices -- despite the company's assurances to the contrary -- and aggressive accounting of risky long-term energy contracts made Enron even more susceptible to a blowup.

The taint of scandal and shame can still be felt today in Houston. The days of excess, when young traders held sway at the steakhouses and nightclubs downtown, celebrating their trading success while California suffered, seem long gone.

"We don't really discuss what we do," Mr. Arnold said recently while standing on the Centaurus trading floor. "We're not like T. Boone," he added, referring to the legendary Texas oilman and commodities trader T. Boone Pickens, whose views on the natural gas market had just been broadcast on CNBC on a flat-screen television hanging above the trading floor.

While having little of Enron's braggadocio, Centaurus derives much of its strength from its collapse. More than half of the 17 traders at Centaurus once worked at the company.

After joining Enron out of college in 1995, Mr. Arnold was credited with booking $750 million in profits for Enron in 2001 by trading natural gas contracts. He was 26. He was rewarded with an $8 million bonus, the largest paid to any Enron employee in 2001.

But some rivals were skeptical about just how good a trader Mr. Arnold was. He has said that about $150 million of the $750 million in 2001 trading profit had resulted from his role as market maker in gas trades on Enron Online, the company's Internet trading platform. Some traders have said that Enron Online was dominant enough to enable Enron to set market prices. And, they add, his big 2001 followed a rocky 2000 in which he lost more than $200 million.

Few doubt his trading abilities these days. Mr. Arnold started Centaurus in August 2002 with three employees trading out of a single large room with a kitchen. Today, the company employs 36 people, including a full-time meteorologist. It has been closed to new investment for two years. "He is in a league of his own," said Peter C. Fusaro, co-founder of the Energy Hedge Fund Center, an online information center created last year to monitor the sector.

"He went out and proved everybody wrong," said Jim Schwieger, a former natural gas trader at Enron.

Even as Mr. Arnold has become wealthier, he has tried to remain low-key. But last year he attracted some unwanted attention when he demolished a historic home in the stately River Oaks section of Houston. Preservationists bemoaned the loss of the 77-year-old property, known as Dogwoods, valued with its land at $4.9 million, saying that Mr. Arnold acted insensitively. He declined to discuss the situation; a new home is being built there.

MOST of the energy traders who lost their jobs have found banks and hedge funds eager to hire them during the industry rebound. Mr. Schwieger, 52, spent 23 years at Enron and was laid off shortly after publicly criticizing Kenneth L. Lay, then Enron's chief executive, at an employee meeting in October 2001, shortly before the company imploded; Mr. Lay is scheduled to stand trial on fraud and conspiracy charges later this month. Last June, Mr. Schwieger joined Citigroup's growing energy trading team in Houston.

Vincent J. Kaminski, the former managing director of research at Enron -- who warned his superiors at Enron of dangers the company faced -- heads a team of quantitative gurus supporting Citigroup's traders.

Wall Street banks are notoriously fickle about their commitment to commodities trading. But the eye-popping profits earned by the market leaders, Goldman Sachs and Morgan Stanley, have spurred other banks to get into the game. In 2004, Goldman and Morgan Stanley earned about $2.6 billion combined from commodities trading, most of that from energy, according to Sanford C. Bernstein & Company in New York.

Even UBS, the Swiss bank that inherited 600 employees from Enron's former trading operation in Houston but whittled down that number to just 70, has revived its interest in building a stronger trading team and is hiring again.

In February 2002, shortly after Enron declared bankruptcy, UBS took over Enron's natural gas and power trading operation and Enron Online. With little volatility to trade around, UBS started firing traders and switched off the Internet trading platform. By May 2003, it had closed the Houston operation, which was in Enron's new tower across the street from its former headquarters, and moved the remaining traders back to its trading base in Stamford, Conn.

Today, the 40-story tower where Enron's traders worked briefly is owned and occupied by Chevron. What had been a sixth-floor trading room the size of a city block is now filled with exploration and production geologists and geophysicists working in earth-tone cubicles, said Mickey Driver, a spokesman for Chevron. The oil company has its own energy traders scattered on other floors.

Even as UBS has started to build its trading business again, it has been bitten by a furious wave of poaching. Last summer, Louise Kitchen, a former trader at Enron who helped to create Enron Online, bolted from UBS to Deutsche Bank, where she joined Mark Ritter, her former boss at UBS's Houston operation, who left in May. The new hedge funds are sucking scarce talent away from the banks. At least 450 hedge funds with an estimated $60 billion in assets are focused on energy and the environment, including 200 devoted exclusively to various energy strategies, according to Mr. Fusaro of the Energy Hedge Fund Center. New funds arrive on the scene with barely a whisper, without brochures or Web sites. In London, hedge funds are quietly sprouting up in Mayfair town houses, Mr. Fusaro said.

Investors in some hedge funds continue to be dazzled by annual returns of close to 100 percent. That is far better than the best exchange-traded funds -- Energy Select Spyder and Vanguard Energy Vipers, which returned 35 percent in the first nine months of 2005 -- and natural-resources mutual funds, which averaged a 31 percent return in the same period last year.

But not all hedge funds are stars, or even on par with exchange-traded or mutual funds. A sampling of 30 hedge funds by the Energy Hedge Fund Center, for example, showed an average return of 25 percent in 2004 and only 9 percent in the first nine months of 2005 -- far worse than the average for mutual funds, which tend to charge much smaller fees and take smaller risks.

With higher returns comes bigger risk-taking, and some firms have taken a bath recently. Two hedge funds in the Chicago area suffered big losses last summer largely from wrong bets on energy commodities like natural gas; prices rose strongly in the fall as demand strengthened and Hurricanes Katrina and Rita disrupted supplies from the Gulf of Mexico.

One of the funds, Citadel Investment Group, lost at least $150 million and the other, Ritchie Capital Management, more than $100 million. Citadel's head of energy trading, Scott Rose, resigned in September. Despite the losses, Citadel's "energy business has rebounded strongly in the fourth quarter," the company said in a statement. Justin Meise, a Ritchie spokesman, declined to comment. Some lawmakers and consultants argue that the government has done little to shore up the energy markets most susceptible to manipulation. The Federal Reserve relaxed rules in 2003 so that commercial banks like Citigroup could take possession of physical commodities like oil in storage tanks, something that broker-dealers like Goldman and Merrill Lynch could already do. The move allowed the banks to serve as dealers in commodities derivatives, financial contracts whose value fluctuates according to the price of an underlying commodity like oil or electrical power.

"It is an effort by banks to move into the terrain that Enron abandoned in their bankruptcy," said Mr. Dodd, the director of the Financial Policy Forum. "This is moving that risk into our core financial infrastructure, so the consequence of a failure becomes even larger."

As early as October 2002, less than a year after Enron declared bankruptcy, the Commodity Futures Trading Commission started to write rules exempting commodities hedge funds from regulatory oversight. Some in Congress, including Senator Dianne Feinstein, Democrat of California, have expressed concern about the potential for manipulation in the over-the-counter derivative markets. But efforts to bring more scrutiny have failed, with the likes of Alan Greenspan, the departing Federal Reserve chairman, arguing against regulation. Mr. Greenspan has contended that hedge funds add liquidity to the market.

A debate continues to rage about whether hedge funds are contributing to higher energy prices.

The funds are borrowing as much as 10 times what they invest in some trades, analysts and traders say, contributing to short-term volatility that has complicated the energy purchases of many large energy users.

"There's a tremendous amount of fear and frustration out there," said Arthur Gelber, president of Gelber & Associates, an energy consulting and advisory firm in Houston that manages the energy purchases for some 20 utilities and chemical companies.

Dennis Knautz, the chief executive of Acme Brick, a company in Fort Worth that makes bricks for residential construction, said that excessive trading by hedge funds is artificially pushing up prices for natural gas and making it tough to hedge his energy costs, which make up as much as 40 percent of the company's manufacturing costs.

STUDIES by the New York Mercantile Exchange and the Commodity Futures Trading Commission have disputed the notion that hedge funds are having an undue influence on pricing or volatility. Mr. Fusaro and many traders have scoffed at the studies, saying that they focused only on certain months, missing price run-ups. Hedge funds and other accounts are holding 47 percent of open futures contracts on the New York Mercantile Exchange, up from about 20 percent in 2004.

Mr. Arnold, for his part, said he has not "seen any correlation between the increased hedge fund participation and volatility." In general, he said, "the more market participation and liquidity, the more efficient and less volatile a market is."

But the soaring price changes have made some veteran traders nervous. "The intra-day volatility is just huge," Mr. Schwieger said. "When I was at Enron, it was nothing to be 2,000 contracts long or 2,000 contracts short. Now I would be terrified to be 500 long or short. Because that means I could lose $5 million. That terrifies me."

There is one conclusion that few would challenge: hedge funds are driving up the price for top trading talent. Bonuses were up 50 percent, on average, in 2005 for traders, compensation specialists say, and banks were paying traders as much as $5 million in total compensation, with top traders at trading houses making more than twice that much.

The scramble is so intense that some firms have been paying bonuses months in advance and guaranteeing two years of bonuses regardless of whether the traders actually deliver profits, Mr. Pearson said.

Traders like Mr. Arnold can earn well more than $10 million a year, compensation specialists say. Hedge funds typically offer top traders a management fee of up to 2 percent of assets and a "performance fee," generally a 20 percent cut of profits, to operate a fund. Mr. Arnold declined to discuss his compensation.

Younger traders, especially, are lured to hedge funds by the casual work environment and the chance to make money on their own. Mr. Arnold was offered a chance to go to UBS and was approached by other banks, but he decided to start Centaurus instead. "I liked the idea of being able to shape an organization as I saw fit," Mr. Arnold said, "rather than wrestling with an entrenched bureaucracy."

At National Energy Trading, a small hedge fund founded in Houston in early 2004 by Michael Whalen, a former natural gas trader at Mirant and Cinergy, the atmosphere was übercasual on a recent trading day. Mr. Whalen, in jeans and a long-sleeved purple T-shirt, sat in front of four computer screens. He bantered calmly on a microphone with brokers in New York, Houston and Louisville, Ky., while trading instant messages with more than a dozen other brokers. Gift baskets filled with wine and Champagne and a football were scattered on the floor.

"I would take this any day," said Mr. Whalen, 35, adding that there was "no politics" and "no bonus time."

"We trade for ourselves," he said.

But the past is never too far behind for some energy traders. Even as he builds his fund, Mr. Whalen has yet to resolve charges from the futures trading commission that he reported false trades and tried to manipulate natural gas markets in 2000 and 2001. He declined to comment about the case.

Some traders accused of improprieties have been forced to sell their homes and cars and have sunk into depression.

"These are regular folks who found a niche and were good at it, and it blew up on them," said George S. Glass, a psychiatrist in Houston who is treating a few traders currently under legal scrutiny. "They feel singled out" for what they considered "normal practice at the time in their industry," Dr. Glass added. "They will probably always believe that."