Reprinted from DISCOVERY
THE QUARTERLY NEWSLETTER OF KOCH COMPANIES
JANUARY 2009

Koch Supply & Trading

Former Georgia-Pacific chairman and CEO Pete Correll once said Koch Industries "could possibly be one of the largest and best-managed companies you've never heard of."

Steve Mawer, the Houston-based president of Koch Supply & Trading, faces a similar challenge when introducing people to KS&T.

"At best," joked Mawer, "most people – including a lot of Koch company employees – assume we're just trying to buy low and sell high."

Many also assume that most of KS&T's work supports asset-based Koch companies, such as Flint Hills Resources, which operates refineries and chemical plants.

"That's a very important part of our business, but by no means all. We work with hundreds of customers outside Koch companies' asset base."

Mawer believes it's important for other Koch company employees to be aware of what KS&T does and why.

"If employees aren't aware of or don't understand us, we may miss opportunities to create value or, even worse, we may destroy value."

Threefold focus

Charles Koch, KII's chairman and CEO, includes trading among the six core capabilities that represent KII's greatest competitive advantages.

Trading – which Koch says encompasses "point of view, strategy development, buying and selling assets, optionality, risk management [and] execution" – is considered essential for creating superior value.

"Because trading is a core capability of Koch Industries, it is exercised across all Koch companies in a variety of ways," said Mawer.

"Here at KS&T, we apply our trading mentality to do three things: The first is to work with other Koch companies, especially Flint Hills Resources.

"Our specialized knowledge can help FHR optimize the purchase of certain feedstocks and help market some of FHR's products. We also provide them with our point of view about national and global markets.

"Our second focus is providing risk management solutions for various customers," ranging from small producers who want to hedge their metals production to multinational giants such as General Electric.

KS&T created the first jet fuel hedge/swap for a major airline and has done similar work for several U.S. trucking companies. Hedging allows these firms to lock in future fuel costs. That can be a huge benefit, especially in environments – like last year's – with unprecedented price swings.

Inside the black box

Proprietary trading, KS&T's third focus area, "is essentially an intellectual pursuit," said Mawer. "So it can be difficult to describe verbally. For many, it's 'black box' stuff and sometimes difficult to understand."

Proprietary trading comprises both physical trading and paper trading.

Physical trading involves the purchase and transportation of commodities such as crude oil or gasoline. "For example, in 2002, we arranged the first-ever delivery of Russian crude oil to the U.S. Strategic Petroleum Reserve."

KS&T often purchases Russian fuel oil, which is then shipped to other facilities for blending. "We've leased storage tanks near Houston that allow us to custom-mix components for our customers."

Blending is a big business for KS&T. "We are probably the largest merchant gasoline blender in the United States," said Mawer, "and one of the largest incremental suppliers of gasoline."

Koch Shipping, Inc., charters an average of 400 tanker ships per year.

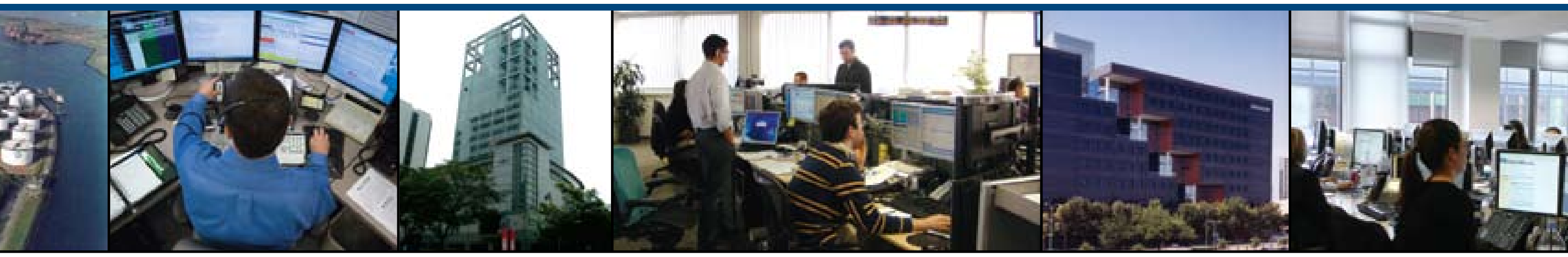
Mawer estimates at least half of KS&T's physical trading business is international. "We not only have blending tanks in Houston, we lease tanks in Scandinavia, Singapore, the Netherlands and elsewhere."

International growth

Many people assume that energy markets are heavily weighted toward the U.S. In reality, only one-fourth of the world's energy business is in North America. Half is split between Europe and the Far East, with the remainder spread across the rest of the world.

"The globalization of energy markets has been a big driver in moving us to participate everywhere, not just the United States," said Mawer. "Having global offices is key to our ability to watch the world and gain knowledge."

Doug Beach, head of trading for Europe, calls KS&T's recently opened Geneva office "a great success" that is already expanding. "The gas, power and emissions trading experiments of our London office have been very successful, too,



so there's great growth potential there as well.

"In general, we're seeing more growth in Europe than Asia because European markets are more open."

KII's chief risk officer, Michael Hofmann, contends that "KS&T is effective because its employees constantly interact in a way that allows all of them to make globally informed decisions. "They act as a global team, not just a group of regional offices.

"By looking at global supply and demand trends – rather than just local or regional markets – they can do a better job of trading for KS&T and contributing to KII's knowledge."

What's more, explained Hofmann, "KS&T benefits global markets by providing price signals that help others make decisions. Those price signals help direct commodities toward their highest-value use.

"Price discovery (through signals) and liquidity are essential for markets. The breakdown of those factors contributed to the collapse of financial markets last year," Hofmann said.

Paper trades

KS&T's "paper" or non-physical trading involves financial products tied to a wide variety of commodities as well as emissions credits.

"The paper side of what we do is very analytical," said Mawer, "but it's hardly ever 'Gee, oil is going up so let's buy some.' Less than 10 percent of all the risk we take is tied to commodity prices going up or down."

Instead, KS&T tries to understand the relationships of commodity prices between locations, time frames, product types or differences in prices – such as those between crude oil and refined products.

In keeping with Market-Based Management®, KS&T applies specific mental models and strategies to its trading operations. "We have a unique opinion about how the world works," said Beach, "and how members of a value chain want to interact."

Even in an age when information is transparent and readily available, Beach believes different customers will have different behaviors. "We try to anticipate those individual behaviors so we can help those companies meet their needs.

"Our competitive advantage is that we have a specific understanding, built through research and experience, that gives us above-average knowledge of how commodity value chains work."

Mawer and Beach point to BP and Goldman Sachs as a way to compare and contrast trading strategies.

"BP," said Mawer, "built some of its advantages over time by owning dozens of refineries. Their point of view has been formed by broad-based and direct participation in refining markets.

"Rather than buying dozens of physical assets, we take a more intellectual approach. We try to assess how markets and customers need things, which leads to a tighter focus."

"Companies such as Goldman Sachs," added Beach, "put a lot of effort into building large workforces to cover entire markets for customers. Our approach is to understand just a few critical parts of the process."

How does it work?

If there's a serious shortage of fuel oil in a certain location, one way to address that issue is for a supply company to send a shipment of fuel oil. This may take several days or even weeks.

As Mawer explains, KS&T's approach is more proactive.

"In the paper market, you can look two months out and sometimes see a high probability of a shortage in a particular location. If we believe there won't be enough product, we may buy futures for delivery there.

"This sends a market signal that actually increases the flow of product to that location now, which helps prevent a crisis in two months."

> ***"We create value in ways that are often less obvious but just as real."***
> ***– Steve Mawer***

Regulators who want to restrict or ban paper trading often overlook such benefits.

"For example," said Mawer, "we work with many ethanol producers that can't borrow enough money in today's credit markets. They want to sell forward (a paper trade involving future production) as a way to help raise capital.

"If the U.S. government takes away that option, it will severely limit an industry they say they want to promote."

Awareness

Although KS&T is seldom in the news, it did gain notice last year for its decision to buy surplus crude oil and store it on tanker ships.

"As the market became gridlocked because of capital requirements," explained Mawer, "there was a surplus of oil because fewer firms were buying. We became a market for that surplus oil, because we were willing to store it until a time when it will be more attractive.

"What that did was provide a cushion to the market that helped ensure a continued flow of product. That's a lot of what we do. We keep systems – and money – flowing.

"Our goal," said Mawer, "is to create a lot of real, long-term value – not just for Koch companies, but for our customers and communities." ■