



The New Game of Energy Trading

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Energy trading and risk management is just not the same anymore. Oil markets this fall detached themselves from the fundamentals. The reason is that the new wall of money trading global energy markets is much bigger and deeper than anyone knows, and move markets to extreme prices which are detached from basic market fundamentals of supply and demand. The market is now signaling a shortage and there isn't one. The investment in the global energy sector has attracted more diversification of investment (read global wealth) into the energy sector and exacerbated price movements. Our noble energy economists will examine this phenomenon in future years but the fact is that energy markets are changing once again and expect more price volatility to come. After all, it's volatility as well as prices that trader's trade.

What's Going on Out There

While hedge funds get the headlines, it's the investment banks that win the end game. They have the capital base and global footprint that dwarfs any hedge fund. The banks are now entering a new phase of energy market development in the key energy centers of New York, Houston, Singapore and London as well as Tokyo, Dubai and continental Europe. They are entering the physical energy business as price discovery is continuing to disappear from the NYMEX trading floor and there is a need for information that the physical market provides. The banks will buy more physical energy assets such as oil and gas storage, pipelines, power stations and the like. They will trade around those assets. And we are beginning to see the convergence of the physical and financial markets to a degree not yet understood. Price swings will be wilder and already have been. The energy market of today is full of more risks than one can imagine from even four years ago. There is programmed trading running black boxes which exacerbate trends. Simple technical analysis and stochastics have given rise to artificial intelligence. That genie is out of the bottle and wreaking havoc with some hedge fund managers but not the banks. It's called capital base and most hedge funds trading the energy commodity complex don't have that base. My thesis is very simple: investment banks win with their superior risk management talent, trading acumen, capital base, and ability to create more business opportunity with their clients. That is, they will provide the outsourcing solution to many

corporate companies who can't or won't hedge in these volatile markets. The name of the game is money and oil is a fungible commodity today. Carbon (CO₂) is becoming the new asset class and may be bigger than oil markets tomorrow. Once again the banks prevail in that market by providing liquidity, credit support, financial engineering such as origination and structured finance, and asset management.

How the Sub Prime Debacle Impacts Hedge Funds

There is also the linkage of energy markets to the subprime market which is not well reported or understood by the media. The continuing subprime mortgage crisis has impacted energy hedge funds more than imagined. Today there are over 200 energy commodity hedge funds according to trackings in our Energy Hedge Fund Center (www.energyhedgefunds.com) with more new commodity trading funds entering the market each month. Because many energy and natural resource funds have short-term liquidity lock up provisions of 45 to 60 days, there has been an avalanche of redemptions from hedge fund investors. Some of the energy hedge funds have lost up to 20 percent of their AUM. The investors have not lost interest in the energy sector but need the access to cash to stem losses and meet market calls in the continuing subprime fiasco. How much money is leaving the energy hedge fund sector? The damage has been done to existing hedge funds. As far we know, these early redemptions have not hurt new hedge funds launches for both energy commodity and green hedge funds.

The continued interest in the energy sector by institutional investors is evidenced by the large amount of assets trading in the energy commodity complex. While sitting down with two hedge fund managers recently, I quizzed them on the amount of capital in energy commodity trading. I basically asked if money in the sector was 18 to 20 times NYMEX. Each replied, "At least that much!"

The problem is that this entirely new wall of money is disrupting energy trading strategies. August and September trading for many energy hedge funds has been negative. The reason has been that all this volume of money has distorted trends. The market today is not following fundamentals at near \$90 per barrel with talk of \$100 per barrel by Thanksgiving. It seems likely that long, only program trading is beginning to dominate the energy trading complex and will continue to heighten volatility.

Some analysts think that this is because the new commodity investors are ignorant of the commodity complex but still want exposure to the sector. In effect, some of this is "hot money". The entry of all these new investors have pushed markets higher. The downside risk is that money can head for the exits faster. Some of that pullback is happening now with little impact on energy markets. That will continue in October and November as the dreaded subprime mortgage resets have begun and the large money center banks have raised \$100 to \$200 billion to tide them over. While that does not sound like much money, it is only the tip of the mortgage iceberg mess and the leverage in derivatives is larger than one thinks.

The question then becomes can the commodity complex survive this fast moving money anxiety? One of the hedge fund managers, who has traded commodities for 30 years, is so stressed out by the inability to function in these new markets that he may 'call it a day' next year. The point is that so much dumb money has entered the energy markets that it

could exit quickly, leading to a market panic. Savvy investors need to keep monitoring the energy trading and energy hedge fund complex aggressively and not passively follow their rote checklist. The times are continuing to change and the markets are unforgiving. Energy trading is now entering an accelerated phase of market maturation, and since commodities typically trade six to twenty times the underlying physical market which is \$5 trillion dollars, we are now looking at a global energy commodity market of \$30 to \$100 trillion dollars. Fungibility will do that. We now enter a time of accelerated market risk which will create great wealth and decimation of the historic energy trading infrastructure. Get set for a new rise of energy trader. One who may become the buccaneers of today. Those that can't adapt, perish.

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