Green Hedge Funds:
The New Commodity Play

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ENERGY HEDGE FUNDS have been mostly a North American phenomena until this year with the vast majority located in the New York metropolitan area. However, our continuing research into the secretive world of energy hedge funds is revealing evidence of a next wave of interest in Europe as well as an extension of the commodity trading platform into green markets.

Specifically, this involves carbon trading, renewable energy credit trading, ethanol trading and emissions trading. The approach, like in all emerging markets with little price discovery, is to find arbitrage opportunities and a mis-match in pricing. This can be as simple as going long carbon in the hope that its value rises over time and as sophisticated as playing the 'regulatory arbitrage' of 'shorting' renewable energy credits in one state and 'buying long' in another. (Some 19 states have Renewal Portfolio Standards in the US).

In the Green Hedge Fund market, taking on the regulatory risk takes some degree of both government policy and market knowledge to be successful. Other green venues include biofuel trading such as ethanol and other plays in biomass for power generation.

The more traditional hedge fund approach has been equities. Here, one newly launched green fund (New Energy Fund LP in New York) is a pure alternative energy play with investments in both the US and Europe. The current high and sustained fossil fuel prices should start driving a move to alternative energy generation globally, and in the past six months has focused much attention on the US venture capital sector on funding investment in alternative energy.

Alternative energy includes not only wind and solar but also biomass, ethanol, distributed generation plays such as fuel cells and microturbines. One other emerging technology play is the rising interest in photovoltaic nanotechnology that may make radical improvements in electricity generation from the traditional 8 to 10% efficiency to 15% and much higher. Hedge funds that trade only long/short equities are beginning to dabble in the alternative energy sector. As far as we know, start up New Energy Fund LP is the only pure alternative energy hedge fund. There are others that may have a portion of their energy portfolio in alternative energy. Some energy hedge funds intend to be involved in renewable energy project finance on a selective basis as well – where they may fly solo or club deals.

Another reason for this new flurry of activity is that the returns for all 8100 plus hedge funds during 2004 were very unimpressive – at around 8%. Hedge fund investors demand more and now like the energy arena. Private investors, not institutions, are starting to extend their investments into emerging environmental financial markets. Some energy hedge funds were up 40-50% last year and one is rumoured to have been up 100% and returned money to investors in October (but we cannot confirm that). Other more conservative energy hedge funds are looking for 15%+ returns on a sustained basis. It's the more entrepreneurial funds seeking higher returns that are interested in the environmental or Green Trading arena.

The more developed environmental financial markets for sulphur dioxide (SO_2) and nitrous oxide (NO_X) trading have also attracted some hedge fund interest, as well as Wall Street interest in the recent past. It is not well known but commodity powerhouse Morgan Stanley is now the largest emissions trader in the SO_2 markets – the largest most developed market of its kind in the world. Wall Street firms have told us that they will wait for more liquidity in carbon markets before jumping in but their purchase of generation assets has already given them both a 'carbon footprint' as well as an emissions footprint. Highly successful Houston based energy hedge fund Centaurus has been known to trade both SO_X and NO_X markets and are making good profits. NO_X emissions, used to reduce urban ozone emissions, traded as high as US$ 40,000 per ton in the Houston/Galveston NO_X markets last summer.

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The more mature SO_2 markets for acid rain reduction got an adrenalin boost in North America last year when coal burning increased due to the high cost and under supply of more environmentally friendly natural gas. With recent trades staying at the US$ 700 per ton level for SO_2 allowances, the market has now indicated that gasification technologies for coal may now be economic. With a carbon reduction regime a certainty in the US – despite the present stance of the Bush Administration – Integrated Gasification Combined Cycle (IGCC) projects have proliferated in the past several months with about 20 such projects in the pipeline. Last spring there were none.

Hedge funds are known to trade the California RECLAIM market for SO_2 and NO_X reductions there. They are highly successful due to confusion over the rules and a proposed tightening of air quality standards in Southern California.

Despite the lack of the Kyoto stamp, there are developing carbon markets in the US as well as Europe. Trades of over 1 million tons have taken place with Gulf Coast utility Entergy in December 2004. More CO_2 trades are in the pipeline with a link to carbon sequestration and enhanced oil production that uses 'commodity' CO_2 for oil field projection through CO_2 injection. There is also increased activity and higher prices on the Chicago Climate Exchange (CCX) due to market changes in Europe.

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It is now rumoured that about 10 carbon hedge funds are in formation in both the US and Europe. Their launches are primarily due to the implementation of the Kyoto Protocol (February 16th) and the launch of the EU Emissions Trading Scheme (ETS) on January 1st. Carbon is trading at about US$ 2 per ton in the US on the CCX (way under market value). But the green hedge funds are a little smarter than that. They are looking at carbon arbitrage plays throughout the world. Their trading strategy is basically buy now at low prices and sell those credits in the future.

In the EU, while we saw over 9,000,000 tons of carbon trade in January 2005, it should be noted that global carbon emissions per year top 24 billion tons of CO_2. The beginning of a global carbon market is now emerging with all the attendant risks of emerging markets i.e., little price discovery, low liquidity and wide arbitrage opportunities. It's the trading arbitrage mindset of the funds that is driving this change. One green hedge fund manager told us that an investor asked him if he was an environmentalist. He replied that he was a trader. The investor said, "Good. I'll give you the money." This is a pure trading mentality not an altruistic way of saving the world. That's what traders do. Seek arbitrage opportunities and exploit them. They have now found them in the global carbon markets.

I recently met with investors in New York who invest in as many as 70 different hedge funds. They are investing in green trading markets because they basically see it as a diversification play for their fund portfolios. They like opaque prices and high returns. The downside risk is that the knowledge base of fund traders is limited in these emerging commodity markets since it requires both an industrial knowledge of trading but also a regulatory policy knowledge of government. For these are not true commodity markets but hybrid markets where governments and supranational bodies set the standard and industry reduces its emissions footprint over time. In the US SO_2 market, the federal government has set up a 35 year regime for sulphur dioxide emissions reductions through to the year 2030.

And contrary to the popular opinion in Europe that the US is doing nothing because of its opposition to the Kyoto Protocol, in fact the US is moving to more stringent standards on SO_X and NO_X (it already has the most stringent in the world), but also will be controlling mercury levels using market-based trading solutions. Furthermore, every manager of a US power plant, industrial facility or other stationary source of pollution knows that a carbon regime is forming. In fact, 28 States in the US have some sort of GHG initiative underway. The funds, being pure traders, will also exploit the carbon rules between States as they are doing in renewable energy markets.

More recently, two more 'green hedge fund' plays are underway. One is to trade sugar as a surrogate for ethanol trading as these markets are more developed. This will bring in soft commodity giants such as Cargill and Louis Dreyfus. The other new interest that is following carbon market development (although still nascent) are water hedge funds. Here they trade long-dated water rights in the Western US to start as water is now becoming a commodity, 10 years after Enron's ill fated foray into water trading through Azurix, (although not a pure commodity play).

The other interesting point is that the interest in green hedge funds is accelerating from all quarters – including Asia. Investors want returns and are now focusing beyond the energy complex in year 2 of the energy and environmental hedge fund play. All we can recommend is 'buyer beware' since emerging markets have all the attendant risks ■

Best selling author **PETER FUSARO** is Chairman of New York based Global Change Associates and coined the term 'green trading'. He holds the annual Green Trading Summit (www.greentradingsummit.com), co-created the Energy Hedge Fund Center (www.energyhedgefunds.com) and is publisher of Fusaro Focus, his financial newsletter **www.energymediagroup.com**