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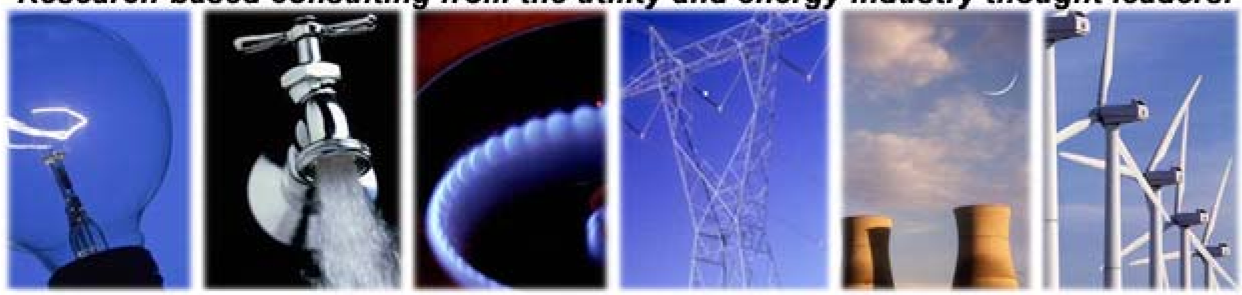

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Energy Comes Into Focus for Hedge Funds

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Until recently, energy trading and risk management was basically a “cottage industry” comprised of energy companies and banks engaged in energy project finance. But all that is changing.

We have seen the coming and going of Enron and the energy merchants and we have heard much about the “flight to quality” of energy trading. The reality is that gas and power trading both took a big hit from which they are only now beginning to recover, with gas trading reaching $375 billion in notional value, according to gas consultant Ben Schlesinger (Table 1). 2005 will be very different. So what has changed?

Table 1: Explosive Growth Expected in All Areas of Energy Trading

COMMODITY	2004	2010
Crude Oil	$1.5 trillion	$6 trillion
Gasoline	$50 billion	$500 billion
Heating Oil	$100 billion	$1 trillion
Jet Fuel	$50 billion	$200 billion
Residual Fuel	$20 billion	$40 billion
Natural Gas	$250 billion	$1 trillion
Coal	$ 5 billion	$250 billion
SO2	$10 billion	$50 billion
NOX	$1 billion	$10 billion
CO2	$1 billion	$100 billion
Renewables	$1 billion	$100 billion
LNG	0	$100 billion
Tanker Rates	$1 billion	$10 billion
Petrochemicals	$1 billion	$10 billion

Source: *FuscaroFocus*[1] Newsletter and Global Change Associates Inc.

In 2004, we saw the entrance of many energy hedge funds into energy commodities trading spurred on by the promise of better returns as energy prices rose. But this was primarily a U.S.-based phenomenon. The hedge fund assault on the energy industry and energy trading is now broadening at a rapid pace. We have now identified energy hedge funds in Canada and, from our on-going research and the launch of the Energy Hedge Fund Center Web site (www.energyhedgefunds.com), we are seeing another major center of hedge fund activity: We are detecting the rapid movement of monies in Europe into energy trading.

Europe, and to a lesser degree Asia, will be the focus of much energy hedge fund activity next year in oil trading. For example, we have learned that there will be a pure energy commodity index launched around Feb.1, 2005, that is European in origin and will be sold to investment banks and family monies on a proprietary basis. That means no retail.

It will be a big winner because the focus of the funds is on oil and oil products and next year promises to deliver the perfect storm in the petroleum product markets with supply tightness overwhelming all the yelping about OPEC production cuts. Folks, crude oil ain't petroleum products! We have considerably tighter fuel specifications to deal with in the United States and a global supply market that is about to get rocked with more price volatility than ever before.

But don't blame the hedge funds. They are only a sign of a woefully under-invested energy market that has suffered neglect for decades. They are true trend followers and they are attracted by tightening supply/demand along with ongoing potential disruption through terrorism and other unforeseen events. Contrary to what you may read elsewhere, they aren't the underlying cause of rising energy prices. The hedge funds see the writing on the wall as a result of the lack of real investment in the energy complex combined with increasing demand. And this is at a time when their traditional alternative investment strategies and markets haven't performed well. They are armed with ever increasing amounts of investor's cash looking for a market.

Looking in from the outside, they see the inevitability of supply tightness and the prospect of rising prices and volatilities. In fact, they just know a good bet when they see one.

After almost six months of ongoing research into the funds and after meeting with some of the funds at the "hedge fund hotel" in New York, we now have a clearer picture of the emerging energy hedge fund market. They will continue to play in the long/short energy equity patch, trade oil and gas futures, trade OTC coal (which has become a global market), and trade physical power and short-term electricity futures and derivatives. They will buy oil and gas reserves in the ground in North America and elsewhere, as the supply problems will continue for many years. They will buy distressed generation assets, aggregate and trade both renewable energy credits and carbon. In short, they are focused on the entire supply chain of the energy complex. It is ripe with risk, uncertainty, price volatility and profits.

For the hedge funds, investment banks and other alternative investors, energy is the next big thing. Whether it is the availability of distressed and/or cheap assets for sale that can be leveraged through a master limited partnership vehicle for returns of 6-8 percent to the unit holders, or the possibility of betting on future energy commodity prices, there has never been a better time. Hedge funds are now among the largest providers of debt financing to the old energy merchants! New funds are being created to invest in mixtures of energy company equities, commodities futures and distressed assets. We can now identify close to 300 energy focused funds and we know that the true number is much higher.

To put this in context, hedge funds generally this year have returned on average just 8.6 percent through November 2004. That is why the energy hedge funds, which are returning more than 40 percent and up over the same period, are the next new thing.

Meanwhile, the recriminations have already started with various politicians and energy industry figures crying "foul." By placing the blame for raising energy prices on "speculators" and "profiteers," the public's attention is drawn away from the real issue—a sustained lack of investment in energy industry infrastructure. Yes, it's true that hedge funds and investment banks seek to make a profit in the energy industry. In fact, this influx of cash is a good thing for liquidity and for the energy companies that need access to capital. Yes, it is true that speculation tends to magnify an existing trend somewhat by helping to accentuate that trend but no, speculation is not the underlying reason for rising energy prices. It is clearly market fundamentals of supply and demand and an aging energy infrastructure that is the basis for the trend.

However, it's nearly Christmas. Something old is now new again—i.e. energy. The world's largest business is about to get a tremendous shot of steroids. Expect greater price volatility and higher prices. Each low is now viewed by the smart money as a buying opportunity. You Ain't Seen Nothing Yet!

Happy Holidays!

Note: UtiliPoint ® International and Global Change Associates will be repeating their online seminar on Energy Hedge Funds on Jan. 18, 2005—see http://www.pgsenergy.com/online/f201.html for more information and to reserve your place.

For up to the minute news and articles on hedge funds in energy, visit the Energy Hedge Fund Center at www.energyhedgefunds.com

[1] *FusaroFocus* newsletter is available at www.energymediagroup.com.