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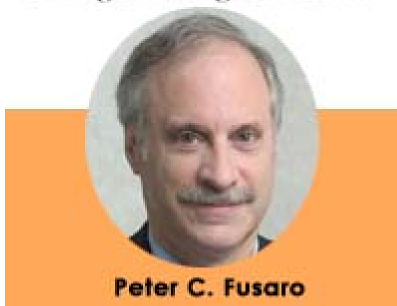

September 20, 2005

Turbulent Markets Ahead: Why the Energy & Environmental Crisis Will Continue For Many Years

By Peter C. Fusaro, Chairman, Global Change Associates

The realization that energy problems will not be fixed by the recently passed energy bill will take time for the “inside the beltway” crowd in D.C. to admit. But the energy markets don't lie. It has taken Wall Street about a year to finally accept that we no longer have mean reversion in oil prices. Or, as a trader in London quipped to me this summer, “The lows get higher.” The reality is very different than the illusion. When the paradigm actually breaks, not shifts, people just run scared. They deny what is obviously in front of them and pretend it's not there.

My thinking is quite simple: Markets don't lie, especially the energy market. The recent run up in crude, gasoline, heating oil and natural gas are harbingers of the future. The energy industry being too shell shocked from price crashes in the 1986 and 1998 frankly doesn't even believe it. So, it coughs back the profits to investors in dividend boosts and stock buy backs. The new energy hedge fund phenomena has also been slammed recently as several very big funds lost $100 to $150 million apiece on natural gas prices. They thought natural gas would tank in the historical “shoulder period” of the fall when gas usage drops. They were dead wrong due to the “event risk” of Hurricane Katrina.

Earlier this summer, the big Wall Street houses and some other hedge funds lost many more hundreds of millions on gasoline/heating oil spreads. They could not imagine that heating oil would go higher than gasoline in June. It just never happened before. The fact that demand was there did not matter. The plain fact is “this time it's different.”

The markets are not following traditional seasonality. They are following too many factors to quantify in multi-factor models. Black box trading ignores “common sense.” As one very experienced energy technical trader (one who uses charts) told me a decade ago “Sometimes he goes with his gut." He has traded over 10 billion barrels of oil on the NYMEX and is still in the game.

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The point is that the forward price curve is an indication of forward oil and gas prices. The markets don't play favorites, don't lie and can't be squeezed although many attempts have been made. So, what's going on out there in energy commodity land? Well, it's supply/demand fundamentals and complemented by weather risk as well as other risk factors. But how long will this bull market play last? Two more years? The nonsense of $161 oil heard in some quarters is just that—nonsense. We are in not in the twilight of oil since the cost base has risen and money will drive further production from more high-priced sources globally. But higher prices will also bring at some juncture a "desired" conservation effect. That has not happened to any great degree yet, except anecdotally in the press. But in two years we will have more than ample supply.

Then something very interesting happens: The environment establishes itself as the next disruptive actor in energy commodity markets. Environment overlays the energy value chain. The traders are lining up now as green hedge funds magically appeared at the end of last year. They bring liquidity to markets once again. This change in a new emerging market also brings added complexity to markets since environmental financial markets are really hybrid markets depending on government sanction and markets. Their convergence with capital markets is just beginning. They truly are a second wave that will hit energy trading and the global energy industry way beyond carbon trading. Rising and more stringent environmental standards will cause supply disruptions, price spikes, and more uncertainty than ever before. There will be greater cross commodity arbitrage opportunities than ever before. The arbitrage will be between oil and gas, coal and emissions, coal and gas, weather and emissions, renewables and efficiency and on and on. This is a new dimension of energy trading where environment is the new unquantified risk factor among many factors. As one D.C. law firm recently stated "Pollution will Reshape U.S. Markets." That is an understatement.

The new financial markets of energy and environment will knock out whatever equilibrium people expected to return. The models and templates of the past and the mean reversion expected is gone forever. Green now rises as a disruptive force in markets. The ride is not only bumpy but more risky. Knowledge and experience in energy commodity markets will be one factor in creating the markets, but green project finance in renewable energy, gasification technology and the like will now escalate (especially with the new energy bill) to create more credit and allowance trading. Ethanol trading will create an entire submarket as will biofuels. As carbon trading accelerates from only 50 million tons today to billions of tons in 2008, the markets will need speedier thinking. Environment is the disruptive factor. And "green will be good" as in both money and environment. The trading opportunity will continue through the end of the decade as the new converging factors of energy, environment and capital markets increasingly come to the forefront. The future will never be the same!

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