The Rise of Financial Energy Trading Markets: Enter the Hedge Funds

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Energy trading is no longer the domain of just any energy company; energy trading has entered the world of big-time, big-stakes trading.

IT HAS TAKEN OVER TWO YEARS FOR THE financial train wreck of Enron and merchant energy trading to get back on track and for the trading market to be rebuilt. The dire warnings that the industry would be in turmoil for many years were overly exaggerated, but the predictions that Humpty Dumpty would be put back together again also were dead wrong. We did not see the globalization of electric utilities that many had thought would happen. We have seen German, Japanese, and other foreign utilities retreat from American power markets. Instead, we have seen the Wall Street power companies rise as they bought distressed assets and began to trade those assets through various asset optimization strategies. We have seen the resurfacing of the financial institution/utility joint venture through the CSFB/TXU version and now Merrill Lynch's purchase of the Entergy/Koch venture. We have more recently seen the entrance of financial hedge funds focusing on the energy industry for a variety of reasons.

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What has occurred is the merger of big money and big energy. This is no longer a game for small companies, including electric and gas utility companies. This is investment banking, asset-backed trading, pure commodity trading, and—most important—that of financial balance sheets that assume "capital at risk." Our recent study, called "Hedge Funds Entering the Energy Trading Space," has revealed that there are more than 200 hedge funds focused on energy trading. This includes pure energy commodity trading on NYMEX or over-the-counter markets, commodity/energy equity plays, distressed asset plays, and various other financial plays.

Why Now and Why Energy?

Today there are more than 7,000 hedge funds with at least $800 billion at work. That is double the number there were in 1999, and that number is rising as pension funds look for greater returns and diversification of financial risk. The flat or sideways trading of global equity markets for the past year is not showing the rates of return that investors have become accustomed to—that is, double digits. The energy complex is volatile. The energy complex is capital intensive. The energy industry is just plain interesting. You can't put down the paper these days without seeing every angle of the energy complex under intense scrutiny.

Our current financial energy markets are the culmination of 26 years of energy trading. We are still only trading on a notional basis $2 trillion of paper energy compared to $4 trillion of the physical business. We have a long growth trajectory. We now are seeing a sustained bull market for oil and gas that is moving into the power business globally. This will continue for several years due to supply constraints and robust demand. We are seeing a resurgence of interest in coal trading, and its impacts on electricity fuel supply can not be understated. We are even seeing more esoteric plays in green trading with carbon and renewable energy trading funds in formation.

The energy industry is attracting the interest of hedge funds and investment banks in increasing numbers. Though energy commodity markets have become characterized by increasing prices and price volatilities, the general business environment in a post-Enron world is also spurring previously unseen interest in energy equities and energy industry assets. While oil markets continue to boom as a result of geopolitical issues, the relative weakness of the U.S. dollar, and other supply/demand factors, other energy commodities have followed suit. North American natural gas supply and production declines have resulted in higher sustainable prices and increased price volatility. Meanwhile, robust demand for coal is also apparent as generators eye the higher costs of generating electric power using natural gas as a fuel. Electric power is also seeing renewed trading interest due to its price volatility and the inability to store it.

The combination of price volatility and available energy trading talent from among the jobless—created through the collapse of Enron and exits from the trading business by many other energy companies and utilities—has created an opportunity for hedge funds. More than 200 hedge funds already play or are set to play in energy commodities markets, and they are primed to bring more risk capital to bear in those markets. Evidence of their trading activities is already speculated to account for the much higher crude oil prices seen in recent months, and some analysts suggest that hedge fund activity may account for up to $8 per barrel of total price. Additional evidence of their influence has been the 55% growth in open interest on NYMEX crude, heating oil, and gasoline contracts over past year and the more violent and volatile intraday trading moving during recent months. What happened in oil has spread to gas, power, and coal.

Hedge funds bring increased sophistication, liquidity, and the risk culture and trading acumen to bear on energy commodities markets. Seeking new opportunities to obtain greater returns, hedge funds see energy markets as providing that opportunity. Likewise, the investment banks have a risk trading culture, deep pockets, and access to both physical and financial traders. Even the energy companies with surviving trading arms are now partnering with investment banks to sustain and improve trading operations while obtaining access to increased expertise, more sophisticated tools, and risk capital. Moreover, we have the multinational oil and gas companies with the balance sheets to put their capital at risk. It is no accident that BP is the No. 1 gas trader and in the top five in power trading; BP has the balance sheet and supply to play in this new financial market.

What's Up?

The next three to five years will see the accelerated financialization of global energy trading markets. We will see investment banks eventually sell back their generation assets to utilities as the supply surpluses are burned off. (Incidentally, the same circumstances will prevail in Europe.) We will see the emergence of a global climate change regime that directly brings new financial risks to the utility patch. The multicommodity market that has been talked about, with its multiplicity of risks, has finally arrived. We will see more hedging of fuels such as oil, oil products, gas, and coal. We will hedge environmental risks such as carbon and other greenhouse gases that will take their place along with today's SO_X and NO_X markets. We will hedge financial renewable energy. We will hedge negawatts as demand response regimes come into maturity and show a financial benefit of energy efficiency linked to carbon reductions.

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But most importantly, we will see markets that work and a more sophisticated and financially savvy form of energy risk management emanating from New York, where it all started.

Hold on folks, it's going to continue to be a bumpy ride! ■