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Hedge Funds, Speculation and Energy Prices

By Gary M. Vasey, Ph.D.
Vice President, Trading & Risk Management Services

Over recent months, there has been much discussion around energy price volatility and the presence of speculators a.k.a. hedge funds. Some of this discussion has naturally resulted in a rush to judgment and, in some instances, calls for investigation. Much of the furor has been caused by both the general background of rising commodity prices, but specifically by Natural Gas prices, and the impact on Natural Gas price by an inaccurate EIA storage report. In Congress, members have asked the FERC, CFTC and NYMEX for investigations of trading by hedge funds after receiving complaints from energy companies and consumers that hedge fund trading was distorting the market.

The incorrect EIA monthly storage report, which was issued on Nov. 24 saw prices on the NYMEX rise more than $1 per MMBtu by end of the trading day as a result of a clerical error that resulted from a major storage operator submitting incorrect data. This event accentuated the focus on speculators in energy commodity markets more sharply. But were speculators really to blame?

Why Blame Hedge Funds?

While there are many who might gain some benefit in placing the blame on speculation for price volatility or perhaps more truthfully, increasing energy commodity prices, we believe that there is little or no evidence that speculation by hedge funds is the primary factor at work. Energy industry figures faced with consumer distaste for higher prices and others who might wish to veil the lack of investment in energy infrastructure and lack of an energy policy that recognizes that fact, are among the most likely to attempt to place

the blame on speculation. OPEC too has consistently sought to point to speculation as the primary reason behind recent oil price volatility.

Speculators Good for Markets?

Our research shows that this view is most likely false. At the time that the EIA released its inaccurate report, hedge funds were net short according to the CFTC Commitments of Traders report (non-commercial positions), indicating that the funds were actually betting on a decrease in natural gas prices. Indeed, movement in the market at the time was more likely to be the result of the end users trading activities.

In our recently released hedge fund report, we showed that oil price volatility and rising energy prices were more likely to be a result of a tightening of the supply demand dynamic caused by a variety of factors including:

- Surprising levels of demand from Asia and North America particularly
- Lack of investment in exploration and production and more limited potential for OPEC swing production
- Disruption and/or threat of disruption of supply in a number of significant producing regions of the world
- A terrorism premium.

In North America, natural gas supply dynamics have also tightened over recent years as generators switched to natural gas-fired generation.

We also found that speculators in the form of hedge funds primarily utilize “black box”" models often unrelated to the underlying dynamics of the market. In fact, the black box models used often look at the emerging price curve in and of itself to predict buy and sell points. The hedge funds identify and follow trends making bets on the trend. In this sense, they may *accentuate* a trend but they do not create that trend. For us, hedge fund speculation may have a minor role in volatility through accentuation but this is a small price to pay for the considerable benefits that speculators and their money bring to energy commodity markets. Apparently, others agree with our analysis. Tom Mathews of Kinder Morgan recently published an article citing various academic research that showed an inverse relationship between outstanding futures contracts on the NYMEX and spot market volatility[1]. Further, he demonstrates this convincingly using CFTC Commitment of Traders data saying that “when non-commercial positions were less than 40 percent of the overall market, price volatility is on average 20 percent higher than markets where non-commercial activity exceeds 40 percent.”

Summary

We believe that the benefits of the speculative hedge fund activity far outweigh any negatives providing the market with a broader set of market information and price formation while also ensuring greater market liquidity for hedgers and potentially, improved counterparty credit exposures. Mathews makes an even stronger defense of speculation saying that "those entities that complain about price volatility, regardless of

the commodity market, need to encourage more trading activity rather than denounce it," arguing that more participation in the futures market, irrespective of source, presents a better picture of supply and demand and more efficient capital allocation. We agree.

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