Energy hedge funds **enter**

Peter Fusaro and Dr Gary Vasey, following up on the article contributed by Nedia Miller in *Pipeline 44*, discuss the substantial potential significance of the hedge funds on energy markets.

Energy hedge funds have entered energy trading markets and are preparing to be fully involved in global energy trading. Their activity is changing the energy trading markets structurally as they bring increased risk capital and better credit to the sector. The new energy trading equation rests on risk taking, trading acumen, deep financial pockets and credit worthiness. Added to this new risk equation are the multinational oil companies and investment banks. This new trading triangle is bringing a more financially-based approach to the global energy-trading complex.

Hedge funds in energy

Today's energy-trading markets only trade $2 trillion on a notional basis, compared to a $4 trillion physical energy market, according to Global Change Associates' estimates. Typically, commodities markets trade 6-20 times the underlying physical market. The hedge fund activities are accelerating the market maturation process so that energy trading should reach $10 trillion by 2010. In contrast, today's foreign exchange and government securities markets, the world's largest financial markets, trade around $190 trillion in notional value.

The hedge funds world is secretive and largely unregulated so it is difficult to assess its impact on energy markets and energy prices. However, our research for *Hedge Funds Enter the Energy Trading Space,* suggests that this could be the beginning of a sea change in energy-trading markets. More hedge funds, fuelled by pension fund and other institutional monies looking for greater returns on investment, are being created to target oil markets in the US, Canada, Europe and Asia. We also know of a new commodity index developed specifically for energy hedge funds, to be launched shortly, that will be a catalyst for more hedge fund trading. Currently, the Goldman Sachs Commodity Index, which is comprised of 72 per cent energy contracts, probably trades at least $20 billion.

The energy complex fits the hedge funds' financial focus because of its sustained price volatility. The total impact of the funds' energy trading activity

centre stage

does not appear in the US Commodities Futures Trading Commission data and many hedge funds trade through banks so it is difficult to disaggregate trading data sufficiently. However, the funds are bringing in new trading liquidity and risk capital which is significant and many more funds are being formed which will bring more liquidity to energy markets.

All this new "risk capital" will probably increase price volatility in the oil, gas and coal markets and many traditional hydrocarbon futures traders are grumbling about this new volatility. They will have to adapt to the new energy market reality, characterised by more price volatility in intra-day energy trading, which will require a different kind of trading acumen. We expect that electricity and gas utilities, increasingly, will become marginalised in this new era of deep-pockets energy traders and that they will mostly abandon energy trading in the US as Wall Street analysts consider such activities a negative on their equity prices. Dynamics in the new energy market will be influenced by multinational oil companies, investment banks and energy hedge funds. This new trading dynamic will require acumen, credit worthiness and risk taking at an unprecedented level.

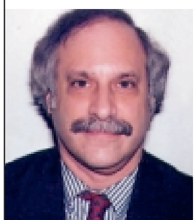
The hedge funds, destined to remain, are now expanding their operations as they move beyond the North American oil, gas and coal markets into renewables, oil and gas reserves, and carbon trading. The funds also have access to substantial numbers of energy traders who lost their jobs after the collapse of Enron and other energy trading ventures.

The old claims of Nymex floor traders, that the funds are "in" and the funds are "out", echoed by many energy journalists, have passed. The new trading credo will be adapt or die. We see this as a structural change in energy trading that is just beginning as many more energy funds are being formed in New York, London, Chicago, Houston, Zurich, Singapore and Shanghai. The year 2005 promises to see a breakthrough in global energy markets fund trading due to energy market fundamentals.

Energy markets dynamics

Ironically, there is now a sustained bull market in oil, gas and coal markets not seen since the 1973/74 oil embargo which, then, mainly affected oil markets. Greater volatility in oil prices is also causing an unexpected rise in the emissions-trading market with sulphur dioxide allowances in the US reaching $655 per ton as a consequence of oil and coal usage, prices and volatility. The much discussed multi-commodity market is finally emerging as funds invest in, *inter alia,* oil, gas, power, coal, emissions, renewables, weather, distressed assets, oil and gas reserves and energy equities.

The market fundamentals suggest increasing supply tightness in oil and gas production and refining capacity coupled with robust demand in 2005. Energy markets could see record volatility. The reason is a sustained lack of investment by Opec over the last 20 years in production capacity and reluctance by the oil majors to invest after being hurt by previous price collapses. Unlike a few independent companies, whose activities, nevertheless, will not make an impression on demand, they are not increasing drilling activities and will enjoy some great quarterly returns, and higher stock prices, as prices continue to appreciate. They will make money by maintaining



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business as usual. Many securities analysts have been slow to grasp the repercussions of this lack of new investment.

Again, led by the US and China, oil demand this year could repeat the pattern in 2004. Supply tightness, not shortage, is what observers are missing while they hide behind the weekly American Petroleum Institute or Department of Energy inventory statistics as explanations of what is now occurring in oil and gas markets on the NYMEX.

We shall probably be in a sustained bull market for energy for many more years. Ironically, there has been no "conservation effect" reflecting these record-breaking higher energy prices although some dampening of demand seems to be occurring now in Europe. The US economy, in contrast, seems to absorb the price increases without much economic pain. Because this energy crisis could well persist, the hedge funds have arrived with impeccable timing and they may well remain "at the table" for up to five years as high energy prices and greater price volatility create greater trading arbitrage opportunities in energy commodities, energy equities, distressed assets and emissions markets.

Characteristics and impact of the funds

The funds follow trends but they are also primarily financial traders. Consequently, many utilise "black box" models, tools and methods to detect trends on which they will bet. Secondarily, the funds follow one another into "hot" markets and early indications are that most of the funds taking bets on energy commodities are producing sensational returns for their investors. More and more funds will come into energy in search of similar returns, especially as hedge fund performance in their more traditional markets has been lacklustre recently. Consequently, they have already exacerbated price movements for oil, gas and coal presently and for the foreseeable future.

While markets have been in a sustained upward run, the funds have largely followed that trend with impressive results. However, a small number of funds have bet against the market and lost. The issue for the energy business is whether the lack of energy knowledge and understanding of the underlying physical aspects of the business will result in another market meltdown by the funds. This is a difficult question but, because there are so many individual funds involved in the market, with assets ranging from $1 million to over $10 billion, it is unlikely that the implosion of any single fund would have a significant impact on the market. Indeed, because about one in eight funds fail before starting their second year, this must be anticipated. Already, one major fund has failed, albeit for reasons not related to the energy market, and some others have experienced losses shorting the market but these events have had no effect on funds in the sector or the greater energy trading markets.

The deeper our research, the more evidence we have found of involvement in the energy complex by hedge funds. They have recently been publicised by becoming significant shareholders in energy corporations such as British Energy and Aquila. Hedge funds are among the largest providers of debt financing to what remains of the industry's energy merchant sector and have also been involved in acquiring those groups' valuable assets. Investment banks, and possibly hedge funds themselves, have been buying oil reserves and oil production capacity while taking positions in futures markets several years out. This must mean that they see a continuing trend of higher sustainable energy prices and they are creating alternative opportunities to go long in these markets.

Summary

We believe that there are many more funds being set up around the world to take advantage of continuous price volatility driven by supply tightness and higher-than-expected demand. Traditional energy utility companies are either abandoning trading or are retreating to the margins. However, many of the funds do not understand energy and lack relevant fundamental knowledge. Although they have sophisticated tools and models, there is a very real danger that this lack of specific energy knowledge could result in a further market fall-out at some stage in the near future.

The difference between the energy markets and other financial futures and derivatives is the physical factors which influence energy prices. These include weather, geopolitics, supply/demand, terrorism, supply logistics, transportation, events, and, now, the funds themselves. The multiplicity of factors bothers many energy analysts and commentators who want a simple answer to a very complex problem with many variables. Ultimately, energy is attractive because of its volatility and pricing and the hedge funds have found a new home to park their money and make their profits. Become used to the new equation of more uncertainty and risk!

Global Change Associates have launched a new Energy Hedge Fund Center at **www.energyhedgefunds.com**

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