Viewpoint

The Emergence Of Financial Players In Energy Trading

Speculative energy trading has a strong future but it will not be the traditional utilities and energy merchants that will underpin the market. While much of the energy industry has returned to the relative safety of trading around assets and marketing activities, energy markets have become characterized across all energy commodities by increasing prices and price volatilities. Oil markets are booming and were not impacted by the collapse of **Enron** and, as a result of geopolitical issues, the relative weakness of the U.S. dollar and other supply/demand factors, higher prices are sustainable with increased price volatilities set to be the norm.

The future for North American natural gas is similar because supply and production declines have also resulted in higher sustainable prices and increased price volatilities. Robust coal demand has brought price volatility to that market as well. Indeed, more than 90 new coal plants are in line for construction in the U.S. as the attractiveness of natural gas as a fuel source declines.

Electric power continues to exhibit tremendous price volatility. These factors are driving a charge by hedge funds into the energy business.

Hedge funds are being drawn to these markets by a combination of heightened price volatility and the availability of experienced trading talent. With more than 100 hedge funds already playing or set to play in commodities, these funds are primed to bring more risk capital to bear in the energy markets. They also bring sophistication, liquidity, the risk culture and trading acumen to bear on energy markets and have access to readily available experienced trading resources that were let go by the mega energy merchants.

While new hedge funds are being created specifically to exploit energy trading opportunities, larger hedge funds are also entering or planning to enter energy markets. Complementing them are investment banks with superior trading talent, strong balance sheets and a global footprint.

Energy is a $2 trillion financial market and a $4 trillion physical market. While financially-settled derivatives usually trade six-to-20 times the physical market, energy is a long way from market maturation. Thus, energy markets are ripe for further commoditization. Only in the global crude oil markets does the ration between physical and financial trading approach the level that is common in other commodity markets.

The new breed of energy traders is interested in crude oil, natural gas, coal and green energy markets. But the highly regional nature of the global power market, combined with unmanageably high price volatility, continues to make electricity an unattractive sector for hedge funds and investment banks, although they are now dabbling in these markets.

Evidence of financial players' influence is the 55% growth in open interest on Nymex crude, heating oil and gasoline contracts over the last year and the more violent and volatile intra-day trading swings during recent months. In effect, the pricing of oil has become dominated by the futures prices on Nymex, and hedge funds are now a permanent feature of the market.

The emergence of hedge funds as energy commodity traders suggests that energy trading will re-emerge, bringing increased liquidity, more sophisticated financial instruments and risk management approaches/strategies after two difficult years. The impact on traditional energy trading commodity trading firms will be to increase volatility and counterparty credit risk while increasing risk management sophistication. It also suggests traditional energy companies, from producers to local distribution companies, will become more marginalized, especially in the physical market. But it also ought to increase the availability of hedging opportunities as the markets become more liquid. There is considerable room for growth of energy commodity trading across the complex.

The new speculative energy trading market is a two-tiered market in which existing hedge funds are attracted by the volatility of oil, natural gas and coal prices and new hedge funds are being created specifically to trade in energy markets. They are bringing added price volatility, unpredictability and employ size as a major trading tool beyond the short-term. The added liquidity in oil futures is a harbinger of things to come as energy markets become more volatile and increasingly dominated by financial players.

This week's Viewpoint was written by ***Peter Fusaro****, ceo of* ***Global Change Associates****, and* ***Gary Vasey****, v.p.-trading & risk management at* ***UtiliPoint International****. They are writing a study on the "Hedge Funds' Entry Into Energy Trading Markets". For more information, call Peter Fusaro at 212 316 0223.*