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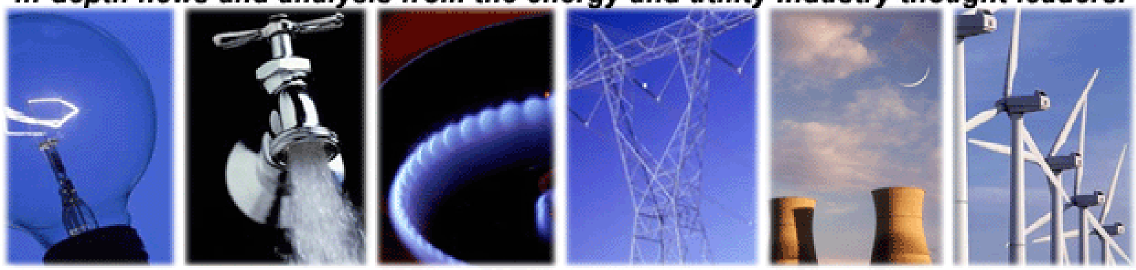

Gary M. Vasey

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Hedge Funds, Attracted By Energy Commodity Price Volatility, Set to Enter Energy Trading

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

For many in the energy industry, trading has become a dirty word inferring a speculative approach to make money in energy markets. In fact, many would point to the failure of the mega-merchant model as evidence that speculative energy trading has no real future. However, according to Peter Fusaro, Chairman of Global Change Associates, speculative energy trading has a strong future but, it will not be the traditional utilities and energy merchants that will create and maturate that market.

Re-emergence of Speculative Trading?

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 at all impacted by the Enron collapse and, as a result of geopolitical issues, the relative weakness of the US$, and other supply/demand factors, these higher prices are sustainable with increased price volatilities set to be the norm. The future for North American natural gas is similar as supply and production declines have also resulted in higher sustainable prices and increased price volatilities. Meanwhile, robust demand for coal is also apparent with over 90 new coal plants in line for construction in the US as the attraction of natural gas as a generation fuel recedes. Electric power is also seeing unprecedented price volatility.

It is a combination of this price volatility and available trading talent that Fusaro sees as creating the opportunity for hedge funds. With over 90 hedge funds already playing or set to play, in energy commodities, these funds are primed to bring more risk capital to bear in 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 merchants. While new hedge funds are being created specifically for the energy trading opportunity, existing larger hedge funds are also planning to enter energy markets.

What is a Hedge Fund?

Hedge Funds are un-regulated private investment funds that seek to profit from nontraditional opportunities using alternative investment strategies. As a result of their expertise in other markets, hedge funds are attracted by the volatility in energy markets and see a speculative trading opportunity.

“Energy is a $2 trillion commodity market and a $4 trillion physical market today,” says Fusaro. “Commodities usually trade 6 to 20 times the physical market and so energy is a long way from market maturation.” Fusaro sees energy markets as just getting started and only in global crude oil markets is the ratio between physical and commodity trading approaching that common in other commodity markets. Given this, Fusaro sees energy trading being dominated by more sophisticated and well capitalized financial players such as hedge funds and investment banks, as well as by multinational energy companies with a global footprint, while electric utilities are more marginalized to niche 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. Fusaro sees this new breed of energy traders as having interest in crude, natural gas, coal and green energy markets but thinks that the highly regional nature of electric power markets will be unattractive for hedge funds and investment banks. Evidence of their influence has been the 55 percent growth in open interest on Nymex crude, heating oil and gasoline contracts over last year and the more violent and volatile intraday trading moving during recent months.

What Impact Will This Have on Existing Markets?

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. The impact on traditional energy commodity 'trading' firms will be to increase volatility and counterparty credit risk while increasing risk management sophistication. Should Fusaro be correct, it also suggests that traditional energy companies from producers to Local Distribution Companies will indeed become more marginalized players in the physical markets primarily but it also ought to increase the availability of hedging opportunities as well.

The emergence of more speculative trading business models by more sophisticated trading entities will also create new opportunities for software vendors. While the

software market has tended to favor vendors with more physical-oriented trading and transaction management solutions, hedge funds and investment banks will require an altogether new breed of more sophisticated trading and risk management systems that may result in a second wave of new entrants from more traditional financial markets.

Summary

The emergence of hedge funds and investment banks as energy traders suggests that commodity trading is about to rebound. Meanwhile, the current ratio between physical trading and commodity trading across all energy commodities when compared with other markets shows that there is considerable room for growth of energy commodity trading. Indeed this is evidenced in the more mature crude oil markets, where only 0.1 percent future contracts result in actual physically delivery.

The speculative trading model may well re-emerge in the hands of much more sophisticated, well-capitalized players including hedge funds and investment banks. UtiliPoint research seems to confirm Peter Fusaro's work at Global Change Associates showing that existing hedge funds are attracted by the volatility in oil, natural gas and coal markets and they are hiring seasoned energy traders that had formerly worked for the likes of Enron and Dynegy. There is also evidence to show that new hedge funds are being created specifically to trade in energy markets.

Note: *Some of the material used to write this IssueAlert was obtained through attendance at Global Change Associate's July 14th Webinar, "Today's New Energy Trading Markets: The Accleration of Financial Energy Trading by Hedge Funds & Banks" delivered by Mr. Peter Fusaro, Chairman, Global Change Associates.*

UtiliPoint International and Global Change Associates are partnering to create a multi-client study on the Hedge Funds entry in to energy trading markets. Further information on the proposed study may be obtained from either Dr. Gary M. Vasey at 281 681 8020 or email gvasey@utilipoint.com or Mr. Peter Fusaro at 212-316-0223 or email peterfusaro@global-change.com