

Energy Trade Status Report

IMMATURE BUT GROWING

BY PETER C. FUSARO

ENERGY COMMODITY TRADING continues to attract risk capital wanting exposure to the energy complex and portfolio diversification. Today, we are in the fourth year of higher sustained energy prices with oil hitting all time highs of over \$90 per barrel in October 2007.

We have entered a new realm of energy trading with higher highs imminent as the world continues to gobble up fossil fuels. This continuous trend and high price volatility has brought more hedge funds into energy commodity trading. Today, our Energy Hedge Fund Center tracks over 200 energy commodity trading hedge funds. Despite the high profile blow-ups of Amaranth and Motherrock, we continue to see new energy commodity hedge funds launched each month.

But hedge funds are small compared to the continued market entrée of investment banks. They have a larger capital base than hedge funds and are more established in the energy business through both trading and project finance. What the big banks are up to is unprecedented. They are active in both the financial and physical energy business globally and are hiring traders in New York, Houston, London and Singapore and eyeing Dubai and other locales.

The convergence of the physical and financial markets and the loss of trading floors are moving the complex into an era of more price volatility. Since the banks need access to information flow that previously was available on the commodity trading floors, they are gaining that access to market information and de facto price discovery by ownership of oil and gas pipelines, storage facilities, power stations, renewable energy production and the like particularly in illiquid markets.

Today, we size energy trading at over \$3 trillion in notional value and that may be an understatement as I have seen one analyst say that the over-the-counter markets for oil may be 18 to 20 times larger than NYMEX. That is substantially less than the over \$200 trillion forex trading, \$35 trillion credit derivatives market, and a total derivatives complex of over \$450 trillion. Energy trading is now in a more rapid market maturation process fueled by higher sustained energy prices, more price volatility and globalization. These changes create a market opportunity of perhaps \$20 to \$40 trillion over the next 15 years as

commodities typically trade six to twenty times the physical. The reason for this is that oil is a fungible global commodity.

The impacts on consumers are higher energy prices to come, despite claims by politicians and regulators that they can do something to bring prices down through regulation. The world consumes more electricity and transportation fuels each year. Cheap energy is gone forever. Environmental restraints in the form of carbon costs are going to add another layer of higher energy prices particularly for electricity consumers. I foresee a further 40 to 50 percent rise in electricity prices as new generation, transmission and distribution equipment is deployed. It will need to be amortized. Anyone who believes that energy will be cheaper in the future needs to remember that energy today is still cheap compared to the 1970s.

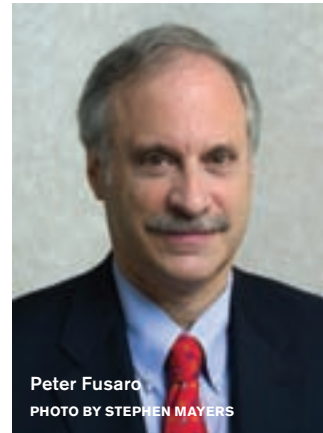
The financial energy markets are about to unleash a wave of unprecedented innovation in new technology that is more energy efficient, more environmentally benign and more costly. Energy market acceleration in this new energy trading world occurs where commoditization of weather and the environment are joining oil, gas, power and coal as part of an enlarged cross commodity trading complex. Large corporations are going to have to learn to manage price risk proactively because with these higher prices come more price volatility as we enter the real-time energy trading world. Please remember that traders trade volatility not just price.

The free ride of cheap energy prices and lower price volatility during the 1990s has been supplanted by the new energy market dynamics. Risk is now more pervasive in a multiplicity of dimensions and includes market, weather, climate, regulatory and geopolitical factors, to name a few. These must all be managed.

Who are the winners in this new energy world? Oil, gas and coal producers, renewable developers, clean technology entrepreneurs, hedge funds, brokers, banks, software companies and electric utilities – but not consumers. They take it on the chin in higher energy prices and will need to look at new technologies for load aggregation, demand response, energy efficiency and other costly services to obtain any benefits.

It's clear sailing ahead for the development of this new energy trading and risk management world. Cyberspace has made this go global and go faster. Markets today are not for amateurs but for the professionals who can manage risks in many flavors and varieties. I continue to say, "Energy is a risky business!" ☺

Peter C. Fusaro is chairman of Global Change Associates and co-founder of the Energy Hedge Fund Center.



Peter Fusaro
PHOTO BY STEPHEN MAYERS

NewsFlash

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