Energy Market Volatility Fuelling Growth in Financial Investment

Increased price volatility has prompted a significant growth in financial trading in EU power and gas markets. Market participants consider that this influx of new investment is providing much-needed liquidity and has been the major driver behind the rapid growth in CO_2 trading. With more transparency and wider market liberalisation the expansion in financial trading is set to continue. These are some of the main conclusions of Moffatt Associates' latest European Energy Trends Survey.

Setting the Scene

Financial trading in the EU energy markets has become increasingly popular in recent months as energy prices have risen sharply. As competitive markets continue to develop in many European countries, and the original pools evolve into OTC bilateral trades and organised energy exchanges, new secondary or derivative markets are being established to manage financial risk associated with price volatility. Advances in IT have also managed to transform the speed of handling energy trading transactions, which has also helped to attract the financial markets into this area.

The phenomenon of financial trading in energy commodities initially took off in the United States, where hedge funds in particular began to take an interest in the energy markets. Energy markets have become attractive to financial investors for a number of reasons, including the need to diversify financial risk and the lack of attractive returns in other areas.

According to Lionel Greene, Manager, Structured Derivatives Trading at EDF Trading, "Financial investors are attracted to the EU energy markets as a means of satisfying the holy grail of diversification. Ever since Harry Markovitz came up with his modern portfolio theory, investors have been trying to use it to get their free lunch."

Hedge funds, banks and other alternative investors all regard energy as an attractive commodity to trade. The availability of cheap assets from a series of mergers and acquisitions in Europe which can be leveraged, or the opportunity to invest in future energy commodity prices, have both encouraged interest in financial trading in the energy market.

Daniel Pyc, Head of Trading at Diapason Commodities Management, believes that current growth in the financial trading markets is mainly coming from hedge funds, although there are many more actors, including index trackers like Diapason, who are active in the market.

Increasing Price Volatility

More actors means more volatility, and this volatility has heightened financial interest in energy markets. Indeed, most of our expert panel in this quarter's APX bulletin believe that it is volatility that has been driving the energy markets.

Fuelled by pension funds and institutional investors, the oil industry is attractive to hedge funds because the current price volatility provides generous returns for their investors. However, these investments are not without risk.

The impact of hedge funds on energy trading has been to increase liquidity and to facilitate the development of more sophisticated financial instruments and strategies for risk management. New hedge funds are even being set up specifically to trade in energy markets.

Role of Investment Banks

Banks are often involved on behalf of hedge funds, rather than acting for traditional funds such as pensions. It is these players, rather than the traditional utilities, which are driving financial trading forward at present.

The increased availability of experienced energy traders in the market following the collapse of Enron and the withdrawal from trading of a number of energy companies has also helped to stimulate interest from hedge funds seeking to capitalise on price volatility. Indeed, some of the newly created hedge funds focusing on energy have been set up by those who lost their jobs when Enron imploded a few years ago. However, there are some signs that future shortages of experienced energy traders could act to inhibit financial energy trading in the short term.

Product Focus

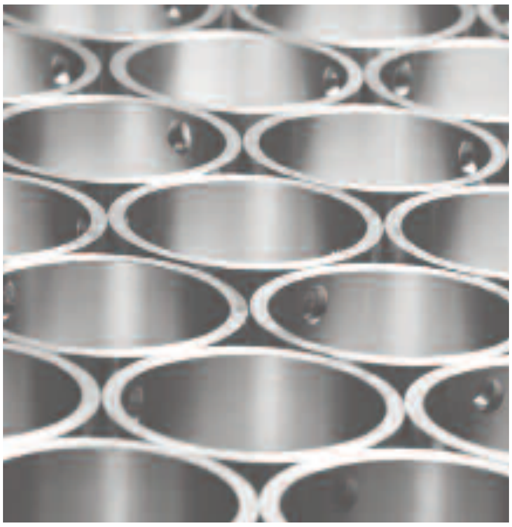
Our panel of experts were generally agreed that the most attractive energy markets for financial trading at present were UK gas, followed by German power and Nord Pool, because of the relatively high liquidity in these markets. However, the recent fall in gas prices could result in a decline in interest in the longer-term.

The bull market for oil and gas has been moving towards power, as electricity demand continues to rise and supply constraints grow. After a fall in liquidity in 2005, European power trading grew strongly in 2006, with German power in particular continuing to attract substantial interest from financial traders. The fact that electricity cannot be stored adds to the trading interest. The Nord Pool power market is also attracting interest, not only from local Scandinavian funds but also from US-based commodity trading funds. ▶

However, the wild swings in natural gas prices in autumn 2006 caused problems for some hedge funds, which found themselves over-exposed to energy, and this experience could lead to hedge funds reducing their involvement in financial trading in the short term. In September 2006, for example, the hedge fund manager Amaranth Advisors suffered disastrous losses after its trades in the US natural gas markets went seriously wrong, and the group was forced to sell its energy trades to Citadel and JP Morgan to prevent forced liquidation.

As well as gas, oil and power, financial interest in coal trading is growing, as high gas prices stimulate renewed interest in the use of coal for power generation, despite continuing environmental concerns. There is also increasing interest in all forms of trading in green energy, including carbon and renewables. The potential in this area is huge, given the growing interest in clean energy.

Financial market interest in CO_2 trading is also continuing to expand. In particular, Phase Two compliance trading will start with the finalisation of the NAPs over the next few weeks and months, and a combination of these events could lead to a huge amount of trading on the CO_2 market this year.



2008 will mark the start of international emissions trading under the Kyoto Protocol, and this again should encourage a greater level of trading in carbon. At present, most of the trades in CO_2 are being carried out by the banks, with utilities so far not as active. As utilities gain more experience, however, this could change.

Role of Energy Exchanges

Many also believe the involvement of the exchanges in trading energy commodities is also important, if financial trading is to be encouraged. Strong exchanges such as APX Group, the EEX and Nord Pool have a key role to play in stimulating the market and helping to provide more liquidity. These could also provide more stability compared to the over-the-counter markets.

The question of whether financial trading has contributed towards the recent rise in energy prices received a mixed response from our expert panel. While some participants believed that it had played its part in the rise, others were more sceptical.

As to what can be done to encourage the growth in financial trading, our panel of experts were largely agreed that more liquidity and transparency are crucial if trading is to continue to grow in the energy markets. Conversely, a lack of liquidity and transparency is regarded as one of the main reasons why trading may be constrained in the future. Some of our panel also believed that regulatory uncertainty could inhibit trading in the future.

Lionel Greene of EDF Trading believes that one factor that could encourage growth would be customer education. "The more awareness there is of the potential, the greater the incentive to act. Other factors would be transparency: the more information is published, using the Nord Pool or the UK power market as an example, the less the fear of the unknown, and transmission mechanisms. The easier it is to move power and gas in between the different grids, the greater the liquidity and the more trading takes place."

Other market participants believe that there are no real obstacles to growth in financial trading in the markets at the moment. Daniel Pyc of Diapason, for example, believes that there are no particular obstacles to financial trading in energy at present, since people largely now have the information they need in order to trade.

Financial Trading Here to Stay

Looking to the future, it seems likely that with energy prices still relatively high and volatility continuing to be a feature of the markets, the growth that there has been in financial trading in the energy markets will continue. There will be more hedging of fuel such as gas, coal and oil, and also of environmental risks, mainly carbon but also other greenhouse gases.

With financial investors taking a much closer interest in the energy markets, new, more sophisticated risk management products will continue to emerge, and utilities will gradually become more active in this area, particularly in relation to environmental risk. Energy users, who have so far not been active players in the market, may also decide that the rewards of involvement in energy trading outweigh the potential risks.

What is clear is that financial interest in energy markets is here to stay.

MOFFATT ASSOCIATES
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