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The energy trading markets have suffered declines alongside most other financial markets. Some parts of the market are starting to see recovery. However this recovery could be hampered by possible large-scale regulatory reform. **Denise Bedell-Bleeker** writes

All eyes on the regulators

The energy trading markets, like many other commodities markets, have seen a general deleveraging over the course of the financial crisis. A number of traders have had to scale back the volume of trades they make so that their position fits a downsized balance sheet, and many are adjusting their business to the new reality. This has created a dislocation in the market that is still being felt.

In July, volumes on the *Chicago Mercantile Exchange (CME)* were down 25 per cent over the same period last year. On the *New York Mercantile Exchange (Nymex)* – home of energy trading for the CME – volumes in July

were down 9 per cent on the previous year. Volumes averaged 1.7m contracts overall and 983,000 contracts per day for energy futures and options, some 6 per cent down on last July.

In Europe, it is a similar picture, with a slump in trading volumes at the *European Energy Exchange (EEX)* in the first half of this year, thanks to a decline in the volume of power derivatives traded by financial institutions. Both spot and forward trading volumes for power decreased in the first half of 2009 – spot volumes fell by 6 per cent over the first half of last year and derivatives fell 11 per cent. Reduced physical delivery is a key contributing factor in the decline.

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Natural gas trading on the EEX saw an increase in spot trading but still fell short of goals. Forwards fell 14 per cent in the first half versus last year.

Regulatory reforms affecting the market

The big question on most energy market participants' minds now is what the markets will look like once regulators are finished with them. Over the past weeks, the US Commodity Futures Trading Commission (CFTC) in the US, the market regulator, has held hearings to determine the best action, and a number of potential courses have been set forth for discussion. The possibility of big change has sent a ripple of fear through the markets and many are waiting on tenterhooks to see what comes out of the hearings. The UK also held an informal meeting in August with large energy companies and other market stakeholders to assess whether UK regulatory reform is necessary.

Michael Cosgrove, managing director of commodities and energy brokerage North America at GFI Group, says that



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some of the changes that have been discussed could have severe consequences: “There is a cry to clear all OTC transaction via regulated exchanges. That is politically unachievable. It cannot pass because there are too many

companies that would be so grossly adversely affected by such regulation that the sheer weight of employees that vote in each election will make it impossible for any government to pass such regulations.”

One sector that could be severely impacted by such regulation is companies that operate globally and rely on their banks to hedge their currency risk without having to post traditional collateral to their banks for those swaps. It is simply not feasible to clear the thousands of unique swaps through an approved exchange and the only solution would be to package all those hedging needs into a small subset of approved, standardised swap contracts. That would mean less precise hedging at greater cost and creates basis risk between actual risk and the available hedge. It also introduces cost volatility for the company trying to hedge its exposures, and makes the company less attractive to investors who are unhappy with volatility in earnings. In addition, the company has to come up with collateral acceptable

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to the clearing house to margin these trades.

Cosgrove adds: “The big problem that every company that does OTC swaps with banks would run into is putting up cash in a difficult time. It would mean deploying more cash to hedge less perfectly than before – leaving less money to invest in core businesses.”

Cosgrove believes that most large companies that use derivatives will oppose clearing of all OTC swaps. He notes: “I suspect that Congress and the Senate will push for clearing of OTC instruments between wholesale dealers but nothing beyond that. To push for clearing all OTC transactions is political suicide.”

Another big regulatory discussion centres around the CFTC’s proposal to put position limits on energy traders in order to curb excessive speculation, such as that which led to the asset bubble and oil price run-up last year. However, whether this was down to excessive speculation is debatable, and in fact is counter to the CFTC’s position

last year. In a report issued by the CFTC in 2008, the agency presented evidence debunking the suggestion that the oil price run-up was due to speculation. Some would even argue that speculation is essential in order to provide market liquidity.

In addition, the CFTC is re-examining position limit exemption rules for traders that are hedging actual commodity deliverables. If they were removed, this would place constraints on traders looking at commodities for purely financial reasons. By limiting purely financial participation, it could have a serious impact on the natural gas markets, in which low prices are now being driven by smaller independent drillers that are reliant on debt financing. These companies, and the banks that finance them, need a liquid futures market to offload commodity price risk.

The agency is also looking at possible position limits for commodity index funds. If commodity tracking funds are curbed, this creates regulatory arbitrage risk – the risk that traders will simply move their business to other exchanges.

The result would be falls in energy futures demand, and thus forward oil prices.

The goal of position limits is to reduce the possibility that any one trader or group of traders could unduly influence prices by cornering the market for a particular commodity. But this is already covered under rules on market manipulation. Perhaps more resources put into fraud and anti-manipulation enforcement would have a greater effect.

A number of market participants have voiced their concerns and proposed alternatives to the harsh regulatory changes suggested by the CFTC. They say that should position limits be necessary, they should be handled at the regulatory level, rather than by exchanges as they are now, and they should be set by entity – not by a particular exchange. As one broker says: “It is not sensible to have certain limits on one exchange and others on other exchanges. It makes more sense to have them at the trader level and as their obligation to comply.”

He adds: “From what we saw during the meetings, we expect there will be position limits. We think the position

REC Market Starting to Improve

On the flipside of energy trading, the emissions markets are of growing interest to banks and investment houses worldwide. Global carbon offset markets saw volumes of more than \$60bn traded in 2008. Volumes have dropped off a great deal in 2009 but some recovery is under way, say market participants. As governments worldwide look at further curtailing emissions and developing their renewable energy programmes, the mandatory market, at least, will continue to grow.

The carbon offset market has both voluntary offsets and mandatory offsets. Europe has the European Union Allowance (EUA) and Certified Emissions Reduction (CER) certificates while the US operates Renewable Energy Credits (RECs) under the Regional Greenhouse Gas Initiative. However, both Europe and the US saw a drop in the trade of these late last year and early this year.

Spot trading on the European Energy Exchange (EEX) grew an astonishing 300 per cent in the first half of 2009 over the same period last year. However, futures volumes plummeted by 45 per cent over the same period. Elsewhere in Europe, the European Climate Exchange (ECX) saw an increase in volumes in June, but overall trading on the ECX, EEX, Nord Pool, BlueNext and

the Green Exchange fell by about 12 per cent – from 558.6m tonnes to 489.6m tonnes – between May and June this year.

It is a similar story in the US. Nicole Fabri, president, Clear Energy Brokerage and Consulting, says: “Liquidity started drying up in the REC markets as early as April 2008 and by October or November there was virtually nothing trading. Liquidity and volumes continued to be very low through the end of 2008, and started picking up a bit in the first quarter.”

Fabri adds: “It is understandable that in a recession, you’d see a decrease in liquidity in the voluntary market for RECs. However, liquidity and prices dropped in the compliance markets as well.” There were several factors at work in this, including the compliance markets for RECs experiencing quite a bit of secondary trading – speculative trading beyond what was required for compliance.

Fabri explains: “Beginning with the fall of Bear Stearns, many traders at dozens of banks, hedge funds, energy companies and a slew of other trading companies, simply lost their jobs. So the buoying effect that secondary trading can have on a commodities evaporated, and what was left was the natural buyers and sellers transacting at a much lower level of liquidity.”

The picture was further clouded as a result of the credit crunch itself as market participants moved more to spot trading and shorter-term contracts to reduce counterparty risk. Point Carbon, the carbon market research company, said in a recent market review: “Settlement within the next few days appears more reliable than settlement that could be a year or more into the future.”

In addition, the global economic crisis has decreased global production and therefore emissions – thereby reducing the need for carbon offsets. This has led to something of a sell-off of unnecessary compliance credits, which is likely to continue until either the surplus is taken up or the economy improves.

In the US, the situation could change if the American Clean Energy and Security Act of 2009 (ACESA) takes effect. One market participant says: “This is potentially a major regulatory event for the renewable energy market. Whether it significantly increases trading in the REC market will depend on the pricing of Fed RECs – which will be affected to some extent by regulatory provisions on banking and other issues that tend to balloon supply – and on demands set by regulators. If demand is quite significant, it will go a long way to supporting robust prices for Fed RECs.” Fed RECs are also being eyed by renewables developers interested in new projects.

David Finnegan, partner at Mayer Brown, the law firm, explains how regulation would work for carbon trading markets under the ACESA: “The Federal Energy Regulatory Commission (FERC) would have the responsibility of issuing regulations within 18 months of the ACESA’s enactment that govern markets for the new emissions allowances, offset credits and federal renewable energy credits.” He explains that new regulation would cover market oversight, fraud, market manipulation, excess speculation, pricing fluctuation management and so on. ACESA would also give the CFTC authority to regulate carbon and energy derivatives transactions – or futures trading.

In the meantime, things have begun picking up in the renewable energy credit markets. In Europe, trading volumes on the ECX saw a big rise in June, with 463,149 contracts traded – the third highest month for the ECX. Average daily volume rose 57 per cent over the same period last year.

In the US, the market slowdown has also started to turn around. Fabri notes: “In January or February, we saw more deals going through and counterparties that were dormant for several months started to wake up a little bit. We are definitely seeing the upswing now.”

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limits are necessary and desirable but for specifically delivered contracts, not financially settled contracts. We think position limits for financially settled contracts would present very adverse outcomes and are very bad idea.”

On June 5 and June 12 Nymex and the CME announced that they were imposing hard position limits on energy natural gas swaps. This has had a negative effect on natural gas trading in North America and a number of traders are choosing for now simply to minimise their trading position. If regulators set hard position limits at levels that the CME has set, it will make these markets far less hospitable for large speculators, which will exacerbate volatility.

Of great concern to many traders is the fact that these limits mean they cannot hold their position until convergence with the physical market – that is, until delivery of the commodity. One broker says: “But this is what they do

and what they know – what they trade on. If they are allowed to trade and hold their positions until the final settlement price, they have a good view on that. Those are bid week days, the days when the final price is determined. The limits announced by Nymex are having a significant negative effect by taking this away from traders.”

As far as CFTC position limits go, there is little real evidence that large-scale speculation caused the commodity price bubble. The strongest argument that proponents of limits use is that it is common sense. But market changing decisions should be backed by evidence of causality. The broker adds: “It is easier to blame speculators than to deal with what is actually happening, and that is a bit disturbing.” ■

See Carbon positive, Page 38