CONTENTS

DEDICATION v
ABOUT THE CONTRIBUTORS xvii

Chapter 1

Introduction to Energy Financial Risk Management 1
Introduction 1
Energy is an Immature Financial Market 3
The Market Drivers of Energy Trading 3
Organization of this Book 5

Chapter 2

Energy Futures Today 7
Introduction 7
Futures: Where’s the Risk? 8
Risk Premiums 10
The New Market Fundamentals 11
The Future of Energy Futures 14
Notes 16

Chapter 3

Overview of the Over-the-Counter Energy Derivatives Market 17
Introduction 17
Overview of Energy Markets 18
OTC Trading 20
OTC Instruments 22
The Convergence of OTC and Futures 24
Futures Contracts Settlement on Expiry 24
Settlement of Swaps Contracts on Expiry 25
Where Have OTC Trading and Clearing Platform Progression Left the Market? 28
A Short History of Energy Trading  28
Conclusions  30
Note  30

Chapter 4

Energy Derivatives Structures  31
Risk and Risk Management Themes  31
Market Risk Exposure  33
Basic Derivatives Instruments  35
Derivatives Packages  42
Structuring and Derivatives Structures  46
Reference  50

Chapter 5

The Nordic Electricity Markets  51
Introduction  51
The Nordic Electricity Market  51
History and Development of the Nordic Electricity Market  55
Nord Pool Spot: The Physical Day-Ahead Market  56
Determination of Day-Ahead Market Clearing Prices  56
Area Prices and Market Characteristics  57
Settlement  59
The Electricity Derivatives Market: Nord Pool Financial Market  60
Counterparty Risk  62
The Emissions Market: Nord Pool Carbon Dioxide Allowance Market  63
Conclusions  65

Chapter 6

Market Risk Measurement and Management for Energy Firms  67
Introduction  67
Measure of Market Risk  68
Estimating Measures of Market Risk with a Mean-Reverting Jump-Diffusion Process  71
Modeling Spreads  74
Stress Tests and Scenario Analysis  77
Organizational and Qualitative Aspects of Risk Management  78
References 79
Notes 79

Chapter 7

Best Practices in Credit Risk Management for Energy and Commodity Derivatives 81
Introduction 81
Internal Risk Ratings: Obtaining and Analyzing Credit-Related Information from Counterparties 82
How Bad Can It Get? Potential Future Exposure 83
Counterparty Credit Risk Charges 88
Credit Loss Distributions 88
Economic Capital and Credit Risk 89
Conclusions 93
References 93

Chapter 8

Introduction to Natural Gas Trading 95
What Is Natural Gas? 95
Consumption Commodity 96
Pipeline Grid 96
Supply and Demand 97
Financial Market 98
The Physical Market Meets the Financial 101
Characteristics of Natural Gas Risk 104
How the US Gas Industry Developed 106
Where Are We Going? 108

Chapter 9

Structured Transactions in Natural Gas 111
Introduction 111
Natural Gas Storage 112
Valuation Techniques 112
Optimization Overview 121
Swing Options 124
Asian Options 127
Chapter 10

**Liquidity Risk Measurement and Management for Energy Firms** 133

Introduction 133

Components of a Liquidity Risk Framework 133

Infrastructure 140

Conclusions 143

References 143

Chapter 11

**Value of Technical Analysis in Energy Markets** 145

Introduction 145

What Is Technical Analysis? 146

The Principles of Technical Analysis 147

Trendlines 148

Trendline and Breakout 150

Other Types of Charts 152

End of Trend Signal 155

Fibonacci Retracement Levels 157

Chart Reading 159

Mathematical Indicators 159

Interpretation 162

Conclusions 164

Reference 165

Chapter 12

**Risk Management in Energy-Focused Commodity Futures Investing** 167

Introduction 167

Risk Is the Flipside of Return 167

The Most Important Element of an Investment Process 168

Product Design Issues 168
The Valuation of Options 259
Electricity Option Basic Structures 261
Commonly Observed OTC Electricity Option Products 262
Potential Portfolio Applications 265
Conclusions 268
Notes 268

Chapter 18
The New Weather Risk Market Hedging and Trading Strategies 269
Why Is Weather Important? 269
Developing a Weather Strategy: How to Identify and Quantify the Risk 271
Developing a Weather Strategy 276
Conclusions 281
Further Information 282
Notes 282

Chapter 19
Outlook for Asian Energy Markets 283
Introduction 283
Asia's Risk Profile 284
Different Market Evolution 284
The Market Drivers of Energy Trading 285
Market Development 285
The Asia-Pacific Region in the Global Supply Scheme 286
Other Fundamental Changes Under Way in Asian Oil Markets 288
Changes in Oil Suppliers 289
Tanker Market Developments 289
Asian Market Characteristics 290
Challenges to Change 291
Conclusions 293

Chapter 20
Green Trading: Environmental Financial Markets and Energy Trading 295
Introduction 295
Market Developments Now Under Way 297
Where is Green Trading Today? 299
The New Investment Model for the Green Space 301
Climate Change as an Investment Opportunity 303
Cleantech Investment Indexes 304
Get to Know Your Risks 304
Why Environment Is Rising as Both a Corporate Financial Issue and
Investment Opportunity 305

Chapter 21

Lessons Learned from the US Experience in Trading Sulfur Dioxide Allowances 307
Introduction 307
Summary of SO2 Allowance Trading 308
Experience to Date 311
Lessons Learned 317
References 324

Chapter 22

The Complexities of Trading Regional Emission Markets 327
Introduction 327
Houston/Galveston Mass Emissions Cap and Trade (MECT) Program 330
San Joaquin Valley Emission Reduction Credit Trading Program 333
Notes 336

Chapter 23

Climate Risks and Electric Utilities 337
Introduction 337
States Taking the Lead in the USA 340
Focus on Electric Power Companies 341
IGCC Holds Promise 348
Outlook for US Carbon Regime 352
References 353
Notes 353
### Chapter 24

**Green, White, and Red Certificates Trading in Italy** 355

- Introduction 355
- Green Trading 356
- White Trading 358
- Red Trading 360
- Conclusions 362
- Note 362

### Chapter 25

**Carbon Trading: A New Commodity Is Born** 363

- Introduction 363
- The Genesis of Carbon 364
- The Policy Framework 366
- The Kyoto Protocol 367
- Flexibility Mechanisms 369
- The EU Emissions Trading Scheme 375
- Drivers of Carbon Pricing in the EU ETS 377
- Future Uncertainties in European Gas and Power Affecting Carbon Pricing 383
- Emergence of Multiple Carbon Product Markets in the Short Term 384
- Will the EU ETS Set the Global Price for Carbon? 384
- Impact on the European Power Sector 387
- Concluding Remarks: Post-2012 Scenario 390

### Chapter 26

**Entrance of Energy and Environmental Hedge Funds** 393

- Introduction 393
- Energy Hedge Funds 394
- Why Enter Energy Now? 396
- Oil Trading Market Opportunities 399
- Structural Changes in Commodity Trading 399
- Waiting for Mean Price Reversion 400
- What Is a Hedge Fund? 402
Chapter 27
Forward-Looking Energy and Environmental Trading Market Developments 413
Introduction 413
Energy Hedge Funds 417
Nature of Risk-Taking Is Changing 418
Other Market Changes 419
The Future in Energy and Environmental Trading Will Be Different 420
Conclusions 420

GLOSSARY 423
INDEX 451