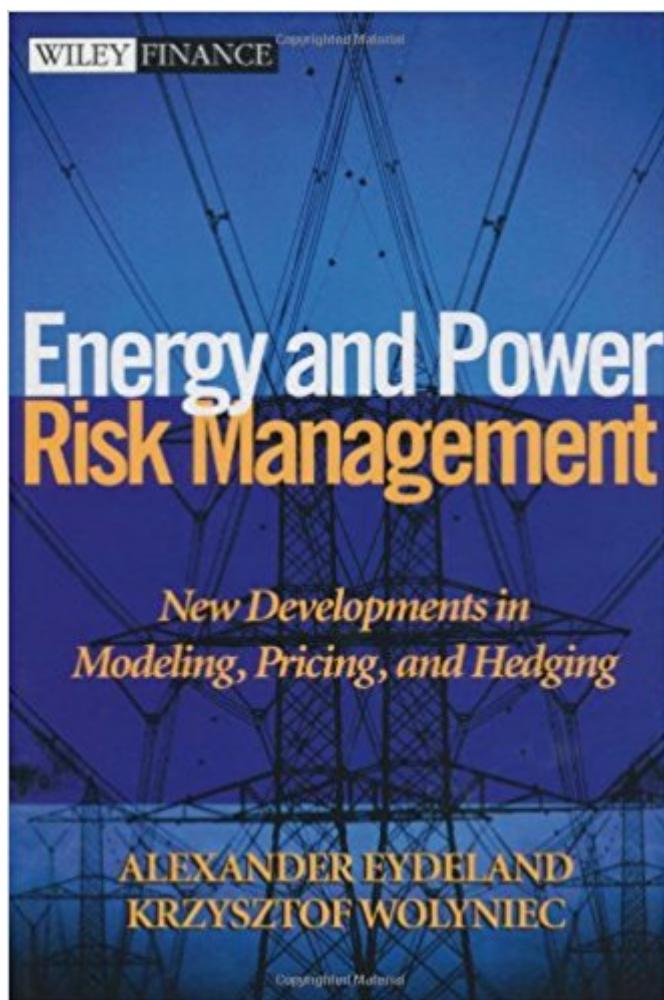


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Energy And Power Risk Management: New Developments In Modeling, Pricing, And Hedging



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The management of risk in the context of energy or weather is quite different than in other contexts, due to the peculiarities of the data that occurs in energy prices. The high volatility of energy prices can range, as the authors of this book point out, between 50-100% for gas, to 100-500% for electricity. No doubt this kind of volatility, and other properties such as correlations and mean reversion, entails that some different mathematical strategies for modeling energy derivatives be devised. The authors give a good tour of some of these strategies, and anyone interested in energy

derivatives will gain a lot of insight into their modeling when reading this book. Due to space constraints, only chapters 5 and 7, which this reviewer considered the most important of the book, will be reviewed here. In chapter 5 the author presents techniques for energy modeling that go beyond the use of the convenience yield by using forward pricing techniques. The goal is to describe the dynamics of future contract prices that takes into account the correlations with other futures, and not on the price evolution of a single contract. Thus it is the 'forward curve' that is relevant for obtaining a useable model for derivative cash flow. The HJM model is presented as one of these, with changes in the forward curve over a particular time interval represented as a linear combination of random perturbations. For energy markets, each perturbation is specified by a deterministic shape function multiplied by a Gaussian factor. The unobservability of the factors determining the forward curve evolution makes the use of historical data mandatory if the parameters are to be estimated. But lack of sufficient historical data and its nonstationarity complicate this estimation.

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