Crude oil cover-up

Liberalization of trading in commodities markets has allowed speculators to distort market fundamentals, argues chapter three of the New Normal eBook

JOHN RICHARDSON PERTH, AUSTRALIA

The chaotic and confusing direction of oil prices continues to befuddle chemicals companies the world over as they wrestle with the perennial problem of making accurate forecasts.

It was the famous economist John Kenneth Galbraith who commented: "The only function of economic forecasting is to make astrology look respectable."

But we argue in the third chapter of our free eBook *Boom, gloom and the New Normal – how Western baby boomers are changing global chemical demand patterns, again* that oil forecasts are arguably even more likely to be wrong than just about any other type of forecast.

The reason is that those assessing its direction make the mistake of thinking that what matters most is supply and demand.

Financial and physical traders in the vital black liquid have instead now become the price setters, thanks to regulatory changes.

OIL-MARKET LIBERALIZATION

The most important change occurred on December 15, 2000. This was when US President Clinton signed the Commodity Futures Modernization Act (CFMA) into law.

The act designated that certain over-the-counter contracts were outside the jurisdiction of the Commodity Futures Trading Commission (CFTC), meaning that financial players were able to bypass the speculative limits set by exchanges.

This was thanks to successful lobbying by the now bankrupt Enron.

The CFMA also excludes swap transactions, allowing institutional investors to take larger positions on actual exchanges than would have been the case if they still had to stick to limits on speculative positions.

The groundbreaking legislation also made it more difficult in general for the CFTC to regulate the New York Mercantile Exchange, according to a research paper published by the James A. Baker III Institute for Public Policy at Rice University in Houston, Texas, US. The paper was written by Kenneth B. Medlock and Amy Myers Jaffe.

The authors suggest that because the International Commodity Exchange in London is outside the jurisdiction of the CFTC, this has further added to financial-sector influence; this is termed the "London loophole."

Non-commercial traders were able to increase their market presence by 15-fold from 1995 to August 2009, the authors add.

Open interest held by these non-commercials in early 2005 was 20% of activity on all the futures markets. Just before the great 2008 crash it had risen to more than 55%.

"And more importantly, open interest by

the non-commercial players moved from a lagging to a leading indicator of price by 2006," the study continues.

THE ONE-WAY BET

Global surplus crude production capacity fell from 5.54m bbl/day in 2002 to 1m bbl/day in 2005. This resulted in the oil price doubling to around $50/bbl, say those who believe that supply and demand fundamentals drive the market.

Surplus capacity, however, then increased in 2006–2007 as prices rose towards historic highs, damaging their case.

Another claim was made during this period to justify the surging cost of crude. There was a lack of refinery capacity able to handle heavy grades of oil – those containing high amounts of sulfur.

This added to the premium for lighter crudes that the refineries could handle. This, in effect, reduced total supply because heavier grades could not be processed by many of the refineries. Oil prices then tumbled in 2009 as surplus crude capacity increased from 1.49m bbl/day to 4.33m bbl/day. All well and good you might argue – a sign that the oil market was once again functioning correctly. But 2010 saw surplus capacity increasing even further to more than 5m bbl/day and yet prices increased – because something else was happening.

That year also saw the start-up of a record amount of "full-conversion" refinery capacity able to handle heavy grades of crude, adding to the length in the overall market. There now follows an explanation about why the market behaved in this way.

"The easiest way to check the underlying health of the oil market since early 2009 has been to go to the east coast of Singapore and enjoy a seafood meal," says a senior executive with a global petroleum and chemicals logistics provider.

> **"Open interest by the non-commercial players moved from a lagging to a leading indicator of price by 2006"**
>
> **RESEARCH PAPER**
> James A. Baker Institute

He is referring to the number of very-large crude carriers (VLCCs) moored outside the Singapore harbor. The higher the number of vessels in-view from the open-air seafood restaurants, the wider the contango. When onshore storage for crude has become full, the VLCCs have been the remaining option.

Putting crude and refinery products, such as gasoline and diesel, into storage became a no-brainer for physical traders from late 2008 to early 2009 onwards (note that the financial, or non-commercial, players trade only in paper contracts as they never want to take physical delivery).

> **"The easiest way to check the underlying health of the oil market... has been to go to the east coast of Singapore and enjoy a seafood meal"**
>
> **SENIOR EXECUTIVE**
> Global petroleum and chemicals logistics provider

This was the result of the "one-way bet" – confidence that there would be no change in US Federal Reserve (Fed) policy for a length of time relevant to the markets.

Since late 2008, the Fed had been printing money in an attempt to achieve a lasting recovery in the US economy.

The purpose had been to avoid deflation, and even to inflate high levels of debt away, while the extra money in circulation stimulated overall economic activity. In August 2010 the Fed signalled it was planning QE2 – a second round of quantitative easing.

A wide range of commodity prices, including crude, rallied as a result of greater confidence in the Fed maintaining high levels of liquidity and record-low interest rates. This was followed by the formal launch of QE2.

Record low interest rates had already made it cheap for participants in the oil market to borrow money to either put physical crude and crude products in storage, or trade in paper contracts. Ironically, the fall in real demand for oil and gasoline had reduced the cost of putting all of these commodities into storage. Ship owners took delivery of brand-new VLCCs just as the 2008 crisis occurred. The owners were unable to occupy these vessels by supplying real demand as demand collapsed.

The only option was to therefore rent out storage space to the speculators at low rates. The result was a historically low total cost of carry – interest rates plus storage charges.

Now QE2 has come to an end it will be fascinating to observe whether this one-way bet will continue. However, recent disappointing US unemployment statistics point to the Fed keeping interest rates at historic lows for a some time. Could there also be a QE3?

UNDERSTANDING CHINA

On the other hand, it will be interesting to see whether oil-market bulls will continue to hold sway now that China's economy appears to be weakening.

The financial world, flush with QE2 cash, justified the post-2008 surge in prices on booming emerging market demand, and in particular Chinese, as we also discuss in chapter three. But we argue that even when GDP growth in China was expanding at a rapid rate, oil consumption did not always follow the same upward trajectory.

INVESTING IN REFINING CAPACITY

China invested heavily in new refinery capacity in 2009–2010 to supply booming domestic gasoline and diesel demand, just as fuels affordability became an issue for many motorists due to subsidies being unwound.

This led to China becoming a substantial exporter of gasoline, indicating that a significant amount of crude was being imported to be re-exported as gasoline.

It is possible you will strongly disagree with the arguments we put forward in chapter three. If so, we want to hear from you.

The idea behind the chapter, and the book as a whole, is to stimulate this kind of debate in an effort to prevent another "Black Swan" moment – an event of complete surprise and with major consequences.

But did the events of late 2008 really represent a Black Swan moment or should we have realized that oil prices would not be trading at $200/bbl by end-2011, as one investment bank had forecast? A little skepticism can go some way towards better planning. ■

MEET THE AUTHORS

Chapter three of *Boom, gloom and the New Normal – how Western baby boomers are changing global chemical demand patterns, again* is now available on free download at **icis.com/NewNormaleBook**.

It is co-authored by Paul Hodges, chairman of International eChem, who writes the ICIS Chemicals and the Economy blog, and John Richardson, director, ICIS training Asia, who writes the Asian Chemical Connections blog.

ICIS and International eChem have launched a training course aimed at helping companies become winners in the New Normal. Visit **icis.com/NewNormalSeminars**