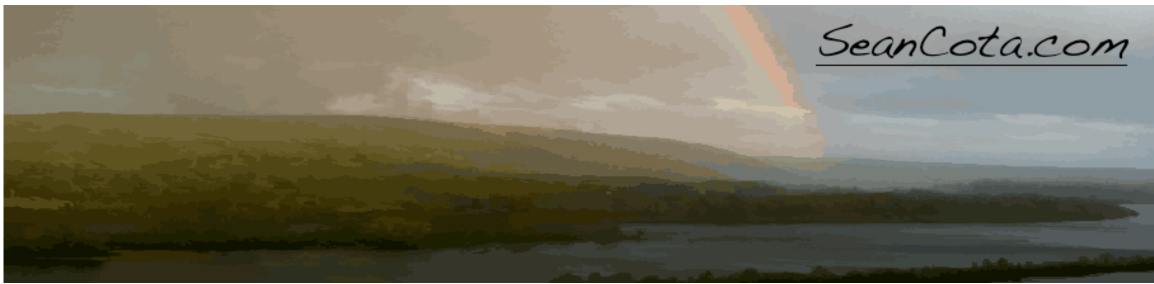

What Happened to Energy Commodity Markets in the Last Decade?

Sean Cota's commentary on how commodity markets have changed in the last decade.

As you may know I have been working on financial reform in commodities since 2004. During that period a lot of things about the trading world has been revealed about how the world for petroleum marketers has changed. For petroleum marketers, the traditional model of supply and demand fundamentals no longer exists in the products we buy and sell.

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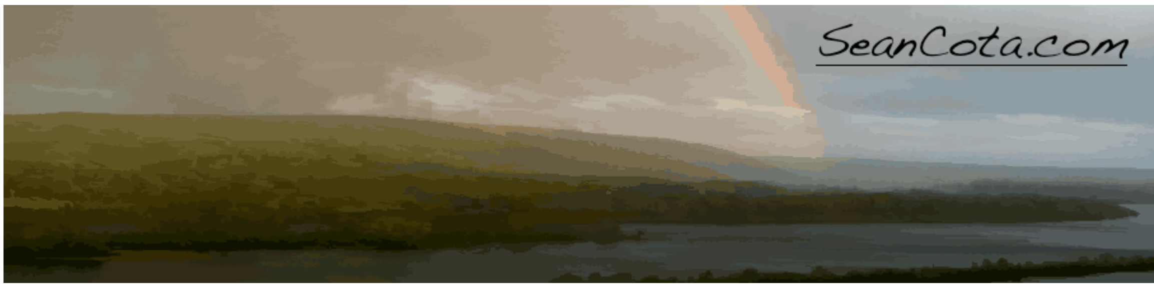
Supply and demand

Classical market economics told us that prices are based on supply and demand. If the supply of particular commodity went down and the demand remained constant, prices went up. If demand went up with supply static, again prices would rise. If demand went down, supply increased, and prices would decline significantly. You get the picture. But that was before the investment banking community securitized the commodity markets in the same way they securitized housing mortgages and other financial instruments.



The securitization of the commodity markets

This securitization, enabled by the Commodity Futures Modernization Act of 2000 which first lead to the Enron excesses, began to ramp up in 2004. Over time supply and demand mattered less and less as to what the price of a particular commodity was. Today we find that these markets are opaque, Dark Markets. Most energy trading is no longer on the New York Mercantile Exchange (NYMEX). Traditional regulated exchanges were very transparent in pricing and clearing. The price bids and offers were seen by the entire market. In addition, the exchange clearing functions (for which most of the margin is based), guaranteed the trade.

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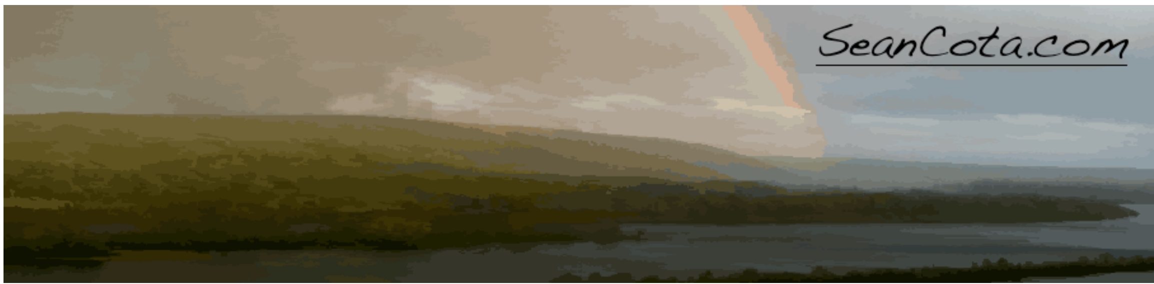
The dark world of Dark Markets

Today, NYMEX only represents only about 20% of the total market. The rest of trading in energy is in the form of swaps. Swaps are often over the counter contracts where an investment bank or hedging company who deals with an investment bank, is basically making a bet that the prices will be in a certain range. They can either

do that with futures contracts meaning that they will deliver a certain volume of product at certain time in the future at a certain price with a certain differential for a particular point of delivery. In most cases these swaps are identical to futures contracts, with the



exception that they are a Laissez-faire market. These swap trades are now mainly in the unregulated Dark Markets, where it is impossible to know who is buying at what volumes and to what extent.

If we went back to the old world of oil trading on the NYMEX composition of trading was a mixture of speculators and commercial players where 1/4 to 1/3 consisted of speculators with the balance being commercial players. The majority of the trading were commercial players hedging in the future. Those hedgers could be refineries or crude oil producers selling product or retailers purchasing product or refiners purchasing crude oil. Today, paper contracts with traders who have no commercial interest in delivery make up between 70 and 90 percent of the volume depending on how you measure it. They are not hedging commodity or commercial risk. They are just betting on the price.

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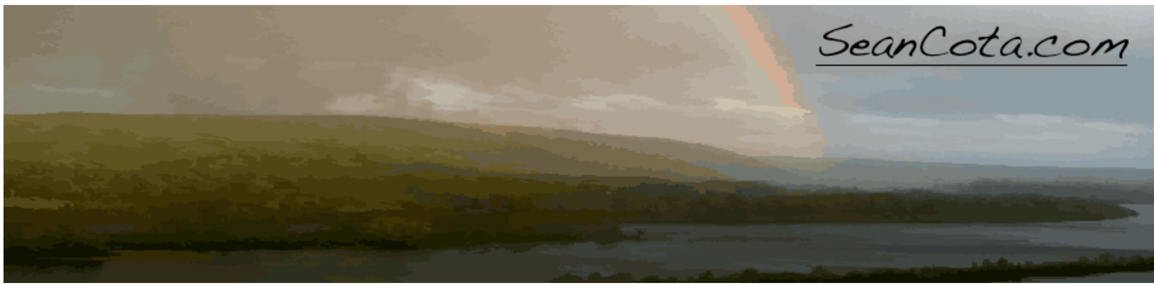
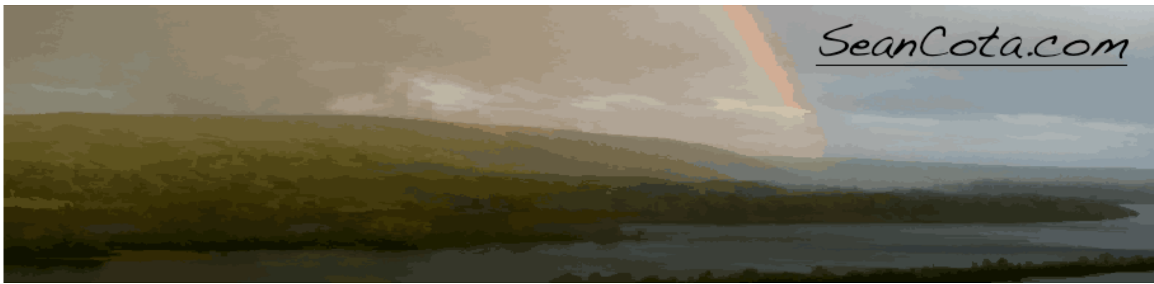
Technology changes but not human behavior

At the turn of the 19th century when France and England where at war, Lloyds of London would insure ships and cargo. If the ship was sunk, the ship owner would be reimbursed or if the cargo was lost the cargo shipper would be reimbursed. Lloyds at the time was a form of trading desk where anyone with cash could place bets on the insurance. Many of the parties betting on the risk had no “insurable



interest." Today this would be calle d a Naked Credit Default Swap. What they found is that those who bet the ship would sink would tell the French navy where the ship was and the French Navy would sink the ship and the speculative betting party would then be reimbursed. That activity was finally banned but today it exists in much of the trading that occurs in these markets. Today this is legal in most trading. These parties either know what is going on in the Dark Market or have a sufficient volume that make up overwhelming proportions of the trading. Today

it is these trades that influence the prices to a large degree. Because they have no insurable interest meaning that they are not a producer or seller their bet is based upon moving money and it doesn't matter what occurs to the underlying commodity for the commercial players. Their only desire is to profit on the trade. Because they can influence the change in price, they have no incentive for stable pricing. Their incentive is for volatile pricing where they can control the price, direction and exit at an advantage to the traditional trader or hedger. Their volume and



trading style forced the price of the commodity up. When these large players feel the price has reached a critical point then they will first short the price of the commodity contract and then they will sell their existing contracts into the market, forcing the market into a rapid decline. Where as the average commercial player that is insuring an interest is merely going along for the ride without influencing how or when this occurs.

Dodd–Frank Wall Street Reform and Consumer Protection Act of July 2010. Light or continued darkness?

In the aftermath of the near complete financial collapse of 2007-2008, the Dodd–Frank Wall Street Reform and Consumer Protection Act of July 2010 was a rational attempt to bring back transparency and systemic risk protection back to the highly leveraged, highly risky, opaque dark market trading world.

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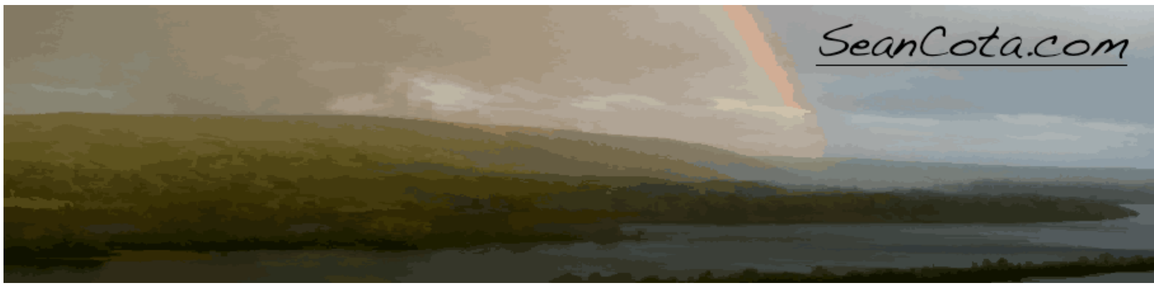
I'm proud to stay that bill that the retail petroleum industry along with hundreds of partnering organizations had significant influence, particularly in the commodity arena. Despite Dodd-Frank becoming law nearly two years ago, only 10 to 20% of it has been implemented. Dodd-Frank did a series of things in the context of oil trading under Title 7 which were significant. One of the items was to take the Dark



Market of swaps and have them be reported in a transparent manner. Swaps are just another variation of a futures contract. So when you hear the word swap think of futures trading because in reality they are mostly just that. Dodd-Frank would require price discovery in these swaps. If you are part of the investment banking community who has market controlling influence in this Dark Market of swaps, you do not want transparency. It is no surprise now that we are in the administrative role making process of Dodd-Frank, these investment banks who control these OTC derivatives, are fighting how much should be transparent, and if so when. Transparency works against traders who are selling a contract that in a visible market, customers wouldn't buy. The CFTC's original position on transparent reporting was that it should be live so the public can see the trades at the same time as the regulator. That has now been throttled back to short time

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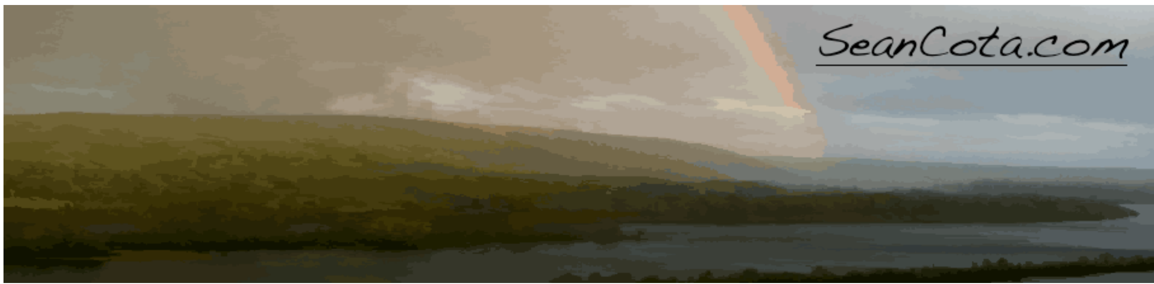
duration but still gives an advantage to the high frequency traders. HFT, High Frequecy Trading and future flash crashes in commodities will be a topic for a future newsletter.

Clearing is life insurance

Another issue that Dodd-Frank addressed which was significant for the commodities world is that it required a clearing of trades. Clearing is important



and is what has occurred over the last century on NYMEX. An example of this would be a retail oil company buys a contract on the NYMEX, the physical counterparty would be a refinery. The NYMEX Exchange functions as the middleman. The exchange records what that price is so that there is transparency in the pricing. The clearing function of the exchange guarantees that if either company goes out of business the exchange will guarantee the trade. Without this, everyone is in bankruptcy court for years. In the current world if your oil hedge was with Lehman Brothers you would still be in bankruptcy court trying to recover your investment today. Clearing is very important but it is not free. If someone is going to provide life insurance for you they aren't going to do it for free. The clearing function charges show up in the margin required on those trades. Traders whose interests are short term (even by the millisecond) want to avoid these margin requirements so they use OTC and less regulated markets like Inter Continental Exchange (ICE). Ironically ICE is a U.S. company based in Atlanta, Georgia, but is regulated in most trades by a London UK laissez-faire regulator. Clearing gets you paid promptly and keeps you out of bankruptcy. Additionally, the mere fact that higher margins are required will deleverage markets. A 1% OTC margin to a 5% NYMEX would reduce oil trades by 5 times. When traders have to put up more money they don't

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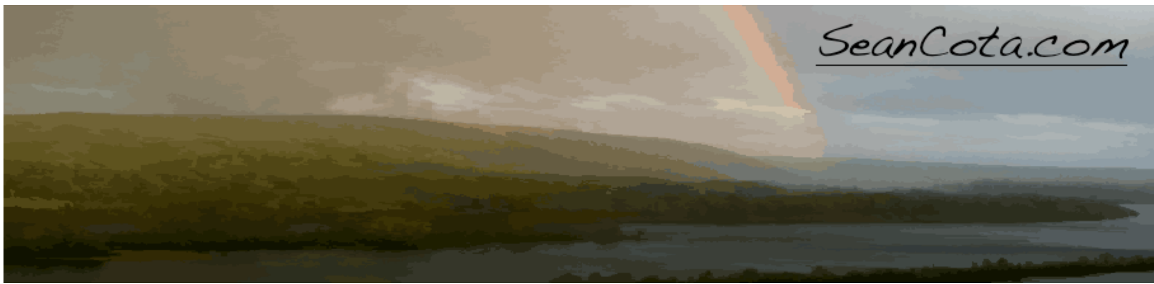

go to their bank and write a check, they sell positions in order to cover the margin, and that forces markets down.

A speed limit only for Aston Martin's, Bugatti's, and their peers.

The last area of interest to commercial parties in commodity market reform that I will discuss is position limits. However, these limits when they go into effect are really not limits at all. The rule is that there will be two pools of limits. One for the cash settled market where there is never the intent to take delivery. The limit in this cash settled market is defined that one trader cannot own more than 100% of the deliverable market. The other pool is for the traditional DCM NYMEX type of market. In this market, traders can demand physical delivery. As with the cash settled market, in this market, again a single trader cannot own more than 100% of the

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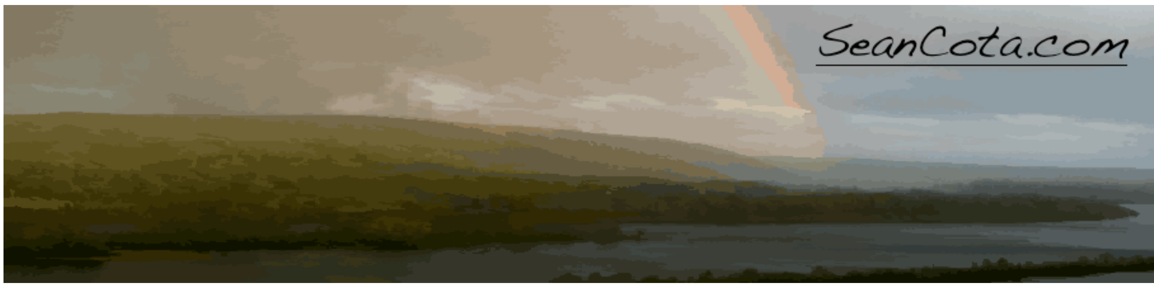
deliverable. Combined, one trader can own 200% of the deliverable market. The financial community wanted limits many times higher. But I ask you, what is the price impact, in any market, if you allow one single person to own 200% of all that is available? So these limits, although they will to some degree deleveraging these markets, really are not limits at all.

Effective Date of Rules, maybe someday...



Most of these rules covering the 80% of the market that is unregulated will come into effect after the election, at the earliest. The Securities Industry and Financial Markets Association (SIFMA) and the International Swaps and Derivatives Association (ISDA) challenged these new rules in December. If they are successful with an injunction to prevent implementation, the new rules will not be implemented for years.

Knowing what you don't know

The world that the commercial petroleum company, and industrial consumer, or the public, is still an unregulated dark market world. The traditional hedger will only have a glimpse of this dark world through the cloudy window where we see the NYMEX trades. Prices in this brave new world of commodity trading reflect what we don't see, and about the huge increases and decreases in money flows as they move throught these markets.

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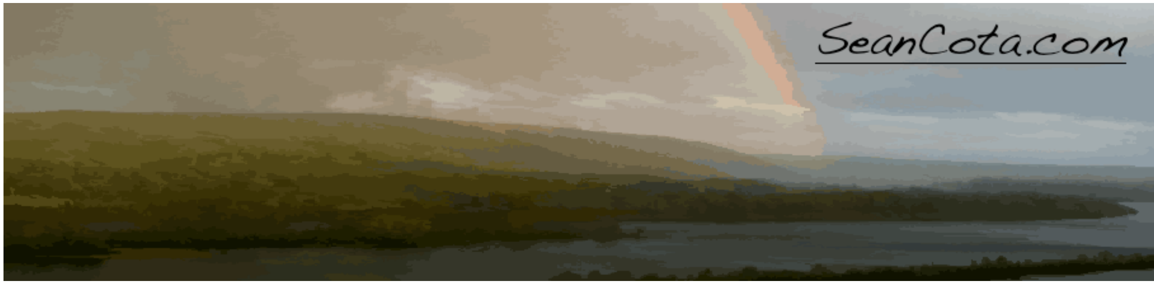
This is the world of oil in which we all live day to day. The supply and demand numbers do not matter to a great extent for the purposes of determining price. The supply and demand numbers really only matter for the timing of technical trading, and that's it. Knowing that these markets work this way, gives you the knowledge of how to trade and how to participate in trading when your hedge turns out to



be controlled by a rigged game.

...And sometimes the best play is not to play. -Sean Cota

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