

## The Price Of Oil Market Transparency

*Over the last few months, PIW has presented a variety of views about the current high level of oil prices. Continuing that series, David Hufton, Managing Director of PVM Oil Associates Ltd. in London, provides the following assessment of the influence of futures markets on underlying oil prices. PVM is a leading international crude oil, refined products, OTC and futures brokerage firm that has been in business for the last 35 years.*

The big question everyone in the industry is asking is why crude prices remain so high in the face of overwhelming evidence of oversupply. Opec, Chinese oil demand growth, Iraq and a myriad of real or feared supply disruptions have all been fingered at various times. In reality, the major new factor adding a new layer of demand is the growth from a new generation of nontrade speculators attracted by geopolitical tensions and facilitated by futures exchanges.

If futures exchanges did not exist oil prices would be a lot lower. Without them there is nowhere for the speculators to place their oil bets, except, of course the limited and far less flexible equity markets. Futures prices reflect the supply and demand for speculative barrels and as speculative volumes increase they bear less and less relevance to the supply and demand for physical oil. This leads to the inevitable conclusion that futures are not necessarily a safe place for physical hedgers.

The absolute price of physical oil, luckily for producers, is currently determined by a differential to futures prices. If the demand for futures is robust, physicals benefit, although the differential may stretch. The CEOs of ICE and Nymex may claim that their exchanges have brought transparency and regulatory integrity to the oil markets but it is at the expense of volatility and higher prices. Exchanges are here to stay, but while the benefits are widely touted, the costs receive far less attention.

### ***Futures Magnify Real Demand Growth***

Although oil producers and oil companies were originally disdainful of the growth of futures exchanges they should now be embracing them as the facilitator of high price levels, and huge cash flows. For oil producing nations, futures exchanges have helped them to achieve levels of political influence they could only have dreamt of in times past. Futures markets in oil have unleashed forces of supply and demand that dwarf the physical growth of oil demand from China, India and the undeveloped world in general. They have enabled this real demand growth to be harnessed and magnified many times over.

Oil consumers and governments, assured that transparency and liquidity was what they needed, have been misled. They were sold one side of the story and seduced by the argument that transparency is "good" and that the opaqueness of the OTC oil markets hid all manner of evils. Oil prices are higher than they would otherwise be without the development of these markets. Consumers can only hope that the speculative forces will, in due course, similarly exaggerate supply and take prices much lower than they would otherwise be.

Of course futures markets are not floating on hot air alone. There is enough going on in terms of physical supply

and demand uncertainties, tightness and geopolitical tensions to encourage and pump up speculative futures demand. When it is possible to invest in paper oil without the consequences of physical delivery, speculators can react to intifadas, Nigerian militancy, Venezuelan threats, nuclear showdowns, hurricanes, refinery incidents etc. with only price issues to consider. Futures markets have been around a long time but their influence has exploded in an era of poor equity returns, low interest rates and a flow of funds desperately looking for new outlets. Futures Industry Association data shows that Nymex moved into sixth place (from seventh) in terms of volume traded on global exchanges in 2005. Nymex volumes climbed 25% over the previous year. ICE trade advanced 18% last year, moving to 14th place (from 15th).

### ***Futures Not Without Cost***

The point is not that the growth of futures markets' is a step backward for the oil industry. Quite the contrary. For their participants they have increased access, liquidity, provided an improved paper trail and are more easily regulated. They have opened up a new outlet for savings for those previously unable to benefit from participation in the oil markets. They have not come cost free, however. Given the universal acceptance that increased speculation has been a key price driver, it is a tribute to the futures industry PR machine that they have escaped criticism as facilitators of the new addiction to oil gambling.

The concern for those worried about high oil prices and volatility must be that there is a lot more futures oil demand to come with billions more of funds expected to flow into the energy sector in the coming months. The new funds have a particular appetite for electronic markets and ICE has successfully answered that call. ICE Brent volumes have doubled since it went electronic and its WTI contract is already averaging a daily volume of 66,000 lots in the first two months of trading.

Nymex plans to run open outcry and electronic in parallel in second quarter. It is talking to the behemoth Chicago Mercantile Exchange (with total trading volumes five times bigger than the Nymex) about moving its energy contracts onto CME's electronic platform Globex. The deal would not only secure technology for Nymex, but avoid the entry of a third futures exchange into the market. More and bigger casinos in which to play will facilitate the growth in virtual oil demand. It is a good reason to be bullish towards futures oil prices and fear a growing discontinuity with physical supply/demand and pricing.