

Crude Contango: Oil markets dance to the beat of global traders

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“The traders have preserved a remarkable level of anonymity despite such a crucial role in the daily supply of energy and food.”

—Javier Blas¹

As global oil markets continue their downward slide, we are reminded of the slump in oil prices that preceded the global financial crisis of 2008. As oil plummeted from over \$140 a barrel to under \$40 and the world economy teetered on the brink of collapse, some commodities traders saw an opportunity to make huge profits by simply buying the cheap oil and storing it until prices recovered.² The strategy proved so profitable that five firms—Vitol, Glencore, Trafigura, Mercuria and Gunvor—now control enough oil each day to supply the U.S., China and Japan.³

Vitol, the world’s largest independent oil trader with over \$300 billion in revenues and 200 ships at sea at any one time, handles over 5 million barrels of crude oil and oil products each day.⁴ Glencore, a major producer and marketer of more than 90 commodities with a global network of more than 90 offices in over 50 countries, boasts on their website, “We handle the physical supply of around 3% of the world’s daily oil consumption.”⁵ Trafigura, the world’s third-largest oil trader, transacts business involving about 2.5 million barrels of oil a day⁶ through its offices in 36 countries on six continents.⁷ Mercuria, also one of the largest oil traders, has a global network of 38 trading offices in 27 countries and 40 million barrels of storage worldwide.⁸ Only founded in 2004, Mercuria recently acquired the commodities business of J.P. Morgan Chase.⁹ Gunvor, another top oil trader, handles over 1 million barrels of oil daily and claims access to over 10 million barrels of storage capacity. In addition, the firm owns two refineries and maintains its own in-house intelligence capabilities.¹⁰

How big are these oil traders? When Russian oil giant Rosneft wanted to acquire TNK-BP back in May 2013, chairman Igor Sechin turned to Ian Taylor and Ivan Glasenberg, the chief executives of Vitol and Glencore for a \$10 billion loan, which was collateralized by future supplies of oil.¹¹ The deal, one of the largest in the history of the industry, not only made Rosneft the largest oil producer in the world with a capacity of 200 million barrels per day along with 28 billion barrels of oil reserves,¹² but also illustrates how these obscure, sometimes unlisted and almost unknown oil traders pack a potent financial punch.

Although it sounds like a dance, contango is a term used by commodities traders to refer to market conditions where futures contract prices for a given commodity exceed anticipated future spot prices.¹³ The current crude oil market is said to be “in contango” since projected spot prices are running lower than the futures contract prices. For example, crude oil for January 2016 delivery is quoted at about \$56 per bbl. while projected spot prices are around \$50. The opposite of contango is backwardation, which occurs when futures contract prices are lower than anticipated future spot prices and is considered a normal condition for commodities markets.

When current crude oil spot prices dip below contract prices for future delivery, traders buy oil at current spot prices and look for some place to store it, in storage tanks and even in oil tankers.

Oil storage became extremely profitable during the global financial crisis of 2008 and 2009 with many investment firms—including Wall Street giants Morgan Stanley, Goldman Sachs and Citicorp—earning substantial profits by storing crude oil.¹⁴

One such place for storing crude is Cushing, Oklahoma in the central western U.S., an oil town with a population of 8,500 and massive oil storage tank farms covering 23 sq. kilometers (9 sq. miles). While its oil wells ran dry in the 1940s, Cushing became the global crossroads for crude when the New York Mercantile Exchange selected the town as the designated delivery point in futures contracts for light, sweet crude oil, the grade preferred by refiners for making gasoline.¹⁵

Up to ten percent of U.S. crude oil stocks are stored at Cushing, whose inventory levels are watched carefully by the oil traders for clues as to what is happening on world oil markets. Back in July 2008 when oil was \$143 a bbl. at the peak of the global financial crisis,¹⁶ Cushing had about 15 million barrels of oil in storage. By the time oil prices dropped to almost \$30 a bbl. in December some 30 million barrels—double the amount just six months earlier—were in storage at Cushing,¹⁷ illustrating how traders amassed oil in hopes of higher future prices.

By the end of July 2014, Cushing inventories had dropped to below 18 million barrels with spot prices over \$100 a barrel. By January 2015, oil had dipped below \$50 a barrel and Cushing was once again storing over 30 million barrels for speculators hoping for higher prices. The inverse relationship between crude oil spot prices and inventories at Cushing, while not in strict lock step, can at least be seen from these figures.

With worldwide demand for crude oil down, oil tankers are idled and thus become attractive as storage facilities. Shell Oil itself has rented two tankers while oil traders Trafigura and Vitol have followed suit renting crude oil tankers for twelve-month periods for storage. Vitol, the world's largest energy trader, has leased the TI Oceania Ultra Large Crude Carrier, one of the largest supertankers in the world with a three million barrel capacity. So far, only about 15 million barrels of storage capacity has been rented. In comparison, in 2009 when oil markets were in contango, traders then had over 100 million barrels in storage in tankers. With so-called Very Large Crude Carrier (VLCC) tankers commanding less than \$40,000 per day rents,¹⁸ a quick calculation shows that for a 3 million barrel capacity tanker, the added cost for storage is less than \$5 per barrel.

There has been much discussion over the issue of whether oil traders pose a “systemic risk” to the financial system, that is, whether these firms pose risks to the world's financial system analogous to banks, and therefore should be subject to regulation. According to former Federal Reserve chairman Ben Bernanke, “Systemic risks are developments that threaten the stability of the financial system as a whole and consequently the broader economy, not just that of one or two institutions.” While Trafigura downplays the potential threat, an examination of the widespread influence exercised by these firms over global energy distribution should be enough to convince most anyone that regulatory oversight is desperately needed.¹⁹

These oil trading behemoths, along with their partners in crime, namely Royal Dutch Shell, BP and Statoil, have already been accused by traders on the New York Mercantile Exchange of collusion to fix the Brent crude oil price benchmarks, which is used in about two-thirds of all

international oil transactions and, of course, would influence profits on oil futures contracts.²⁰ The accusations were of sufficient gravity to prompt investigations by the European Commission, the Japanese Fair Trade Commission, the Korean Fair Trade Commission, the U.S. Commodity Futures Trading Commission, and U.S. Federal Trade Commission, but to date nothing substantial has occurred except that the U.S. Federal Trade Commission called off its inquiry last October,²¹ which should come as no surprise.

One oil trader, Halis Bektas, has admitted that the manipulation of oil price benchmarks is quite easy since the traders are not required to report their transactions. If a trader has a contract to buy a hundred thousand barrels of oil pegged at the Brent crude oil benchmark price, he can sell a small amount of his oil assets, say one thousand barrels, at a price lower than the current benchmark and report that transaction. The reporting services will use the lower price of the sale in recalculating their benchmark price, resulting in a lower Brent benchmark and thus a lower purchase price for the hundred thousand barrels. The reverse of this process could be used to obtain an increased benchmark price for higher profits on a sale.²²

While it is true that commodity traders can provide a useful role in distributing scarce resources and alleviating shortages, the industry has become heavily financialized, thus shifting the focus from a human endeavor benefiting the masses to maximizing profits for the select few. Unfortunately, oil trading has become the domain of unscrupulous hedge fund managers, blood-sucking leaches like Andrew J. Hall, who in 2009 earned \$100 million from Citigroup, which received U.S. government bailout money²³ as millions of his fellow citizens lost their homes.

Endnotes

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