

## **First Do No Harm**

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This annual meeting of the Futures Industry Association should be celebrating the recent success of energy markets. After more than 30 years, these markets finally performed as promised during a period of unusually high consumption caused by abnormally cold weather in December 2009 and January 2010. For the first time in three decades, a rapid price increase (spike) did not accompany Mother Nature's unruliness. For the first time in years, airlines only had to deal with scheduling problems related to bad weather rather than that and an adverse impact on fuel costs. For the first time in more than 30 years, consumers did not see heating fuel prices surge. Only the refining industry, which traditionally sees much higher margins during times of severe cold, lost out.

The winter of 2009 and 2010 represents a triumph for free markets and a great victory for those of us who have written for years that efficient liquid markets bring great benefits to consumers. I estimate that markets saved consumers between \$20 and \$40 billion dollars this season. These savings are invaluable given the nation's current economic situation.

The success of energy markets over the past several months should also assuage worries regarding the proposed cap-and-trade program for emissions credits. The successful operation of energy markets in December and January demonstrates that prices for emissions credits will not rise uncontrollably when demand surges if all economic agents are allowed to buy and sell credits freely and buy and sell futures on emissions credits freely. The message is markets work and work very well if they are allowed to function with sophisticated oversight that only steps in to prevent manipulation or the accumulation of market power.

However, I regret to say that, given present trends, a celebration of the market's success here would likely be unique. New regulations from the Commodity Futures Trading Commission guarantee that consumers will never again experience stable prices during a serious cold spell. These rules ensure that financially strapped airlines will once again face higher jet fuel prices in conjunction with operational problems caused by cold weather. The rules will again make certain that refiners earn good profits. In addition, they could raise raw material costs.

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I also regret to say that proposals to limit the emissions permit trading in the draft cap-and-trade legislation in Congress will probably guarantee very large price increases for such permits. Markets will not be allowed to function. Instead, Congress now seems to believe that creating a “strategic reserve of emissions credits” will protect consumers better than the market would. This approach is being taken despite 30 years of experience with a failed petroleum reserve program, one that has exacerbated price increases and decreases.

Here I begin by describing the heating fuel market’s great success. I then show how the CFTC’s proposed position limits, had they been in effect, would have frustrated the market’s triumph. I then note that an emissions trading program based on how the heating oil market operated before the CFTC mandated changes would guarantee stable emissions permit prices. Finally, I conclude by observing that the CFTC regulations will adversely affect U.S. energy markets going forward.

### **The Market’s Great Success**

Episodes of unusually cold weather have historically coincided with unanticipated increases in energy demand for obvious reasons. Eastern North America has experienced four such episodes in the last 30 years: the winters of 1983/84, 1989/90, 1999/2000, and 2009/2010. On each occasion energy use surged. The severe cold that occurred at the end of December 2009 and beginning of January 2010 was particularly remarkable because it was global rather than isolated to North America. Even the vaunted Eurostar trains from London to Brussels and Paris were stopped.

The first three of these incidents were accompanied by substantial increases in energy prices. Articles published in *The Boston Globe*, *The New York Times*, *The Washington Post*, and other papers chronicled the economic difficulties suffered by consumers due to the price rise. The electronic news media also had a field day covering the price spike and the economic cost of the cold weather.

In 2010, however, it was difficult to find an article on price increases. The reason was quite simple. Just as newspapers do not carry stories about a man **who did not bite a dog**, the news media does not write stories on energy when prices remain steady.

Energy prices did not rise this winter. In contrast, in the 1999/2000 episode heating oil prices climbed more than 70 percent and natural gas prices in the Northeast went up as much as 170 percent. Following the price increases, President Clinton’s Secretary of Energy explained that his department was caught napping.

The Department of Energy’s statistical arm, the Energy Information Administration, subsequently issued a detailed study of the 1999/2000 price increase. The authors explained that the cold spell occurred when oil and natural gas inventories were low by historical standards. In New York and other northeastern states, natural gas consumers that could switch to heating oil, such as power generators, were ordered to do so. The demand for heating oil from these consumers added to the increased demand

from regular oil users just when inventories were low and supplies tight. Prices almost doubled. It was a near-perfect economic storm that generated great profits for oil refiners for a few weeks.

The 2009-2010 episode was different. The world entered the winter with abnormally high oil and natural gas inventories. In the United States, these stocks were at record levels. Thus, there was plenty of gas to meet demand from interruptible gas users and plenty of oil to meet demand from oil consumers. Suppliers were more than happy to sell at the prevailing price. As one trader told Platts, “It is now or never.”

As students of commodity markets know well, prices do not rise when inventories are high, even if stocks are drawn rapidly. Anyone who has traded wheat, corn, or copper will cite the work of Holbert Working on the supply of storage as they warn new traders to avoid speculating on price spikes when stockpiles are abundant.

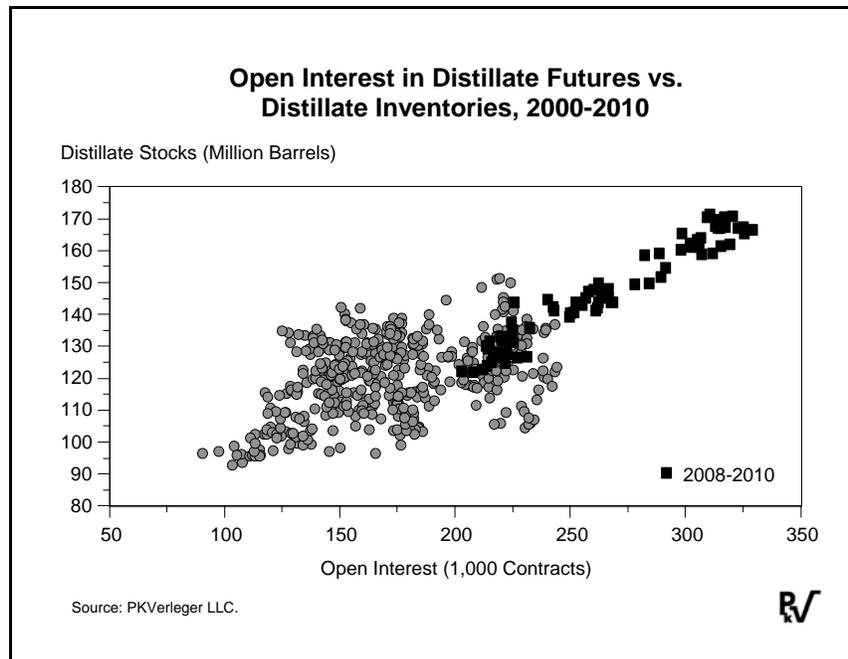
The price stability that occurred in 2010 did not happen by accident. Inventories were high because investors had purchased thousands of heating oil futures contracts as part of their effort to diversify portfolios. One observer has described these investors as the “massive passive.” Some view the presence of passive investors as a negative development because they believe such investors have a “non-economic impact.” In other words, passive investors have made markets a little like the proverbial “roach hotel” where the investors, like the insects, check in but never check out.

This conclusion is wrong because the “massive passive” concept neglects the bilateral nature of futures transactions. As I hope everyone in this room understands, futures are bilateral transactions, meaning that for every long there is a short. Thus the purchases by passive investors are offset by sales from other market participants. At times, the new shorts may come from speculators who are betting that prices will fall. However under most circumstances the shorts are traders who buy oil, put it in tanks, and sell futures to lock in profits. I suppose these traders should be described as the “massive actives.”

Last July, Bloomberg described such a transaction undertaken by JPMorgan. According to Bloomberg, the firm bought two million barrels of heating oil, chartered a new VLCC that had never been used, filled the VLCC with the heating oil, and parked the ship in the Mediterranean. Based on market conditions at the time, I calculated that JPMorgan earned a risk-free return in excess of 50 percent after accounting for all costs. The company could achieve this profit because the massive passive bought futures.

A review of industry data shows that world oil inventories grew at record rates over 2009. U.S. natural gas inventories also approached unprecedented numbers. The stock accumulation occurred thanks to the massive passive. Stocks would have been much lower—and price increases this winter much larger—had attacks on markets by those such as Michael Masters been successful.

Evidence of the linkage between the growth of the massive passive and inventories can be found in the figure below. This graph compares the rise in heating oil inventories in the United States with the rise in open interest. Distillate inventories are graphed on the vertical or y axis and open interest in the distillate futures contract on the x axis. For emphasis, the observations for 2008 to 2010 are indicated by the square black markers. All of these observations are to the right of the graph and associated with the highest levels of inventories and the greatest amount of open interest. You do not have to be an econometrician to see that the massive passive promoted stock building.



The success of heating fuel markets this year should be cited by proponents of emissions cap-and-trade programs. These markets demonstrated that they can deliver price stability to consumers if they are allowed to function with close oversight, such as that provided by the Financial Services Authority in the UK, but no undue intervention.

### Proposed Position Limits

Unfortunately, the success experienced this last winter may not be repeated. As everyone in this audience recognizes, the CFTC wants to impose position limits on swap dealers who trade energy products. As you no doubt also know, the CFTC has proposed to limit each swap dealer to a maximum position of 10,100 heating oil contracts. This rule will take effect this spring.

In an open meeting on the proposed position limits rule on January 14, the CFTC commissioners and the public were told that the proposed limits would have very little impact on traders. Specifically, they heard that a total of “three unique traders in crude oil” would have been affected over a period of two years had the rules been in effect. This statement suggests that these regulations are essentially innocuous.

The presentation failed to convey the complete story, however. A table included in it showed that 19 unique owners of gasoline futures and 16 unique owners of heating oil would have been affected by the rules at one time or another. But the table does not show what the CFTC's new weekly database on positions of traders in energy contracts reveals: that the maximum number of swap dealers in the gasoline contract over the two-year period covered by the new database just happens to be 19. It also does not show that the maximum number of swap dealers in the heating oil contract was 20, meaning that the new regulations would have affected 85 percent of firms doing swaps in heating oil during that time.

This absence of transparency on the part of an agency supposedly bent on improving market transparency is shocking to say the least. Indeed, one must ask why the CFTC is so determined to impose restrictions on the heating oil market following its great success. A cynic might suggest the Commission is concerned about low refinery profits.

Consumers (homeowners as well as airlines and truckers) may not be as exposed in the future as they were in the past because other markets are available. Oil is traded in a number of centers, including Rotterdam and Singapore. Futures on Rotterdam oil are traded in conjunction with this market, and trading there will expand as the U.S. futures market shrinks. Derivatives trading is already growing around offshore markets outside the CFTC's jurisdiction. Traders can and have moved transactions to them.

The existence of alternative markets is good news. One can expect global distillate inventories to remain high going forward, despite position constraints imposed in the United States. However, the shift in attention to other markets may cause the inventory accumulation promoted by passive investment to be held in locations far from the United States. U.S. consumers will become more vulnerable to market disruptions going forward in this case. One need only recall that prices almost doubled in 2005 following Hurricanes Katrina and Rita and remained high until emergency stocks from Europe arrived. These stocks were released through the International Energy Agency's sharing program. The cost to gasoline consumers amounted to \$0.30 per gallon for two months. During that period, these buyers paid \$7 billion more for gasoline than they might have if supplies been available in the United States.

The CFTC may have inadvertently exposed U.S. consumers to a repeat of the 2005 episode. In some future winter, prices here may shoot higher due to low domestic inventories. Consumers may again have to wait for ships from Europe or Asia to arrive to moderate market tightness. The absence of U.S. inventories could cost buyers another \$20 billion the next time extremely cold weather hits.

The absence of position limits in other markets may also permit a viable cap-and-trade system for emissions credits to develop if free trade in the actual permits is permitted and if holders of the permits can effectively hedge them. As with heating oil, a foreign market will provide an effective means for hedging and investing, but it will not

be as effective as an unfettered U.S. market. Firms operating in the United States will be put at further disadvantage vis-à-vis their competitors.

### **The Hippocratic Principle**

The title of this talk, “First Do No Harm,” is based on the Hippocratic Oath. From the time of Hippocrates in ancient Greece, medical students have been counseled to prescribe health regimens that “never do harm to anyone.”

Economic policymakers do not follow this principle. Indeed, legislative proposals and regulations often seem designed to do as much damage as possible. Humans would now be extinct had doctors followed the approach taken by such officials.

The CFTC has clearly failed to observe the principle espoused by Hippocrates with its proposed rules for energy traders. Congress has ignored it as well in setting rules for emissions trading in the energy legislation now being considered.

Tragically, great harm to the American economy will result from these unenlightened actions. A great opportunity has been squandered.