Don't Kill the *Oil Speculators*

Because if that happens, energy prices will skyrocket. How commodity transactions promote price stability.

BY PHILIP K. VERLEGER, JR.

Last July, Britain's Prime Minister Gordon Brown and France's President Nicolas Sarkozy called for a global program to stabilize oil prices, stating that "volatility damages both consumers and producers." To address the issue, they demanded that international security regulators tighten rules and supervision to "reduce damaging speculation." They also called on the world's producers and consumers to cooperate on reducing price swings. Bluntly, they advocated strong government intervention into energy market operations.

Six months later, prices did stabilize. Remarkably, oil and natural gas prices remained steady during a two-month period of record cold weather that spanned much of the globe. Energy prices did not rise during the cold spell for the first time since controls were removed from markets more than thirty years ago. The absence of excitement in energy markets occurred even as the frigid temperatures caused air and rail travel (including the technically advanced Euro Star) to grind to a halt, prices of perishables such as orange juice and strawberries to surge, and governments in some countries to warn residents to stay inside.

Not surprisingly, the absence of energy price movements received little mention in the press. There was no story. Instead, the

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media rushed to cover disasters such as the catastrophe in Haiti. Articles about placid markets did not appear and why would they? After all, what paper would run a headline that read "Man Does Not Bite Dog"?

There is, however, a very important underlying tale. The market stability sought by Prime Minister Brown and President Sarkozy in July, achieved against all odds in December 2009 and January 2010, occurred because government officials were focused on other issues. To repeat, energy prices were steady during the extremely cold weather because energy policymakers were concentrating on different issues, principally the climate negotiations in Copenhagen. No doubt, energy prices would have increased had these policy officials been aware and involved during the cold snap.

Prices remained stable in December 2009 and January 2010 for two reasons: energy commodity markets have finally matured and financial institutions have encouraged a large number of passive investors to allocate a portion of portfolios to commodities. Credit for the absence of a price surge should go to the financial engineers and financial institutions that had the foresight to integrate energy markets and investors. This is an area of activity that offers major consumer benefits. As Wall Street undergoes a storm of criticism, the institutions and individuals there who helped create this innovation deserve kudos for the achievement as well as the gratitude of consumers.

The December/January success occurred because the world entered this winter with extraordinarily high levels of heating oil and natural gas inventories. As economists have long acknowledged, plentiful stocks provide a natural buffer to unexpected increases in commodity demand. This winter, global heating oil stocks were 20 to 30 percent above levels observed in prior years. Natural gas inventories were also much higher.

Market forces, not government intervention, created the abundant inventories that buffered markets in 2009/2010.

The JPMorgan Example

The "cash-and-carry" transaction credited to JPMorgan is a well-known practice. Agricultural firms have engaged in such activity for more than one hundred years. In 2009, JPMorgan and many other firms acquired oil in this manner, often earning risk-free returns exceeding 50 percent.

(Note that another firm, Morgan Stanley, apparently did a number of these deals. The shipping consulting firm of Poten & Partners reports that Morgan Stanley ranked ninth among the world's largest charterers of ships with 117 vessels under contract. In comparison BP, fifth on the list, chartered 217 ships and Chevron, tenth on the list, chartered 110 ships.)

Consumers across the globe benefitted from this entrepreneurialism because prices did not rise when the weather turned cold. Instead, the supplies held on tankers moved to the market.

—P. Verleger

The "extra" stocks were sold to meet the unanticipated demand created by the cold weather. Thus, spot heating oil prices barely budged. In contrast, spot prices jumped almost 70 percent during frigid weather in January 2000. That price increase was attributed to low stocks in subsequent analyses done by the U.S. Department of Energy. DOE also blamed low inventories for the 50 percent price increase during a December 1989 cold snap.

Market forces, not government intervention, created the abundant inventories that buffered markets in 2009/2010. Between 2005 and 2009, investors, encouraged by academics such as Gary Gorton at Yale and K. Geert Rouwenhorst at the University of Pennsylvania, poured billions into commodity futures in an effort to diversify portfolios. Their purchases of energy futures contracts lifted futures prices of commodities such as oil relative to current or cash prices. Commercial players in the markets responded to the rise in futures prices by buying and storing physical volumes of commodities such as natural gas and oil while selling futures contracts to the investors. World inventory levels rose through these serendipitous interactions, not because

Gordon Brown

Nicolas Sarkozy

Not Paying Attention

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some government official commanded companies to add oil to stocks.

JPMorgan Chase & Co. was one of the firms that bolstered inventories. Last June, Bloomberg reported that the company hired a brand new supertanker to store two million barrels of heating oil. According to the article, the bank could buy the oil for $553 per ton and sell it for delivery three months hence for $580. This transaction may actually have occurred a few weeks earlier and if so, the bank could have acquired the oil for $400 per ton and sold it for delivery in January 2010 for $500.

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Consumers across the globe benefitted from this entrepreneurialism because prices did not rise when the weather turned cold. Instead, the supplies held on tankers moved to the market. As one trader told the industry publication *Platts*, "It's now or never." As this sequence of events unfolded, the world's commercial sector demonstrated that energy prices could be held steady if politicians and regulators allowed commodity markets to function as they had for over a century. Far from promoting price volatility as Prime Minister Brown and President Sarkozy suggested, commodity transactions are a force for price stability.

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Unfortunately, though, the price stability experienced in 2009/2010 may be a unique episode in economic history. New regulations proposed by the U.S. Commodity Futures Trading Commission, as well as the impending Congressional financial reform, threaten to tie the hands of those operating in commodity markets. The CFTC rules will limit investor activity, possibly preventing investors from accumulating the contracts required to support stock levels that help dampen price swings. In addition, President Obama's proposed bank regulation would likely keep JPMorgan from engaging in the cash-and-carry transactions described by Bloomberg.

If the regulatory clampdown proceeds, consumers will have to rely on governments again, not markets, to stabilize markets. Under the circumstances, I suggest consumers buy plenty of blankets. Prices could double the next time it gets cold because the government intervention proposed by Brown and Sarkozy will not provide the needed supplies of heating fuel. ◆