It’s Not the Hedge Funds or Money Managers; It’s the Hedgers

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Oil markets passed a milestone last month when producers sold (and presumably hedged) more than one billion barrels of oil using the InterContinental Exchange’s Brent contract. Today, producers have sold Brent forward at almost double the rate of WTI. Figure 1 shows the jump in the “merchant short” (interpreted here as producer hedging) using the Brent contract versus hedging in the WTI contract.

As Figure 1 illustrates, merchant hedging in Brent roughly equaled hedging in WTI until October 2012. Since then, the WTI merchant short position has remained flat while Brent has surged. (Note that I combined the CME and ICE WTI merchant short positions for this comparison.)

Surprisingly, the rise in forward selling on ICE by merchants seems not to have affected the forward price curve. In fact, the curve today is essentially the same as at the end of October 2012, as Figure 2 shows.

The changes in open interest in Brent and WTI deserve attention because they may have significant market implications. Table 1 conveys the shift. This graph shows total and merchant open interest in Brent and WTI from the end of October 2012 through Friday, August 16, 2013. The calculations reveal some very interesting details regarding the market situation.

> Merchant shorts account for more than half the open interest in Brent but only fifteen percent for WTI.

Merchant longs account for roughly one third of the open interest in Brent but only one fifth of the open interest in WTI.

The long positions of "other" traders has increased by three hundred twenty-nine thousand contracts in Brent but only two hundred thirty-seven thousand contracts in WTI.

The long position of merchants in WTI has increased one hundred forty-four thousand contracts while the Brent merchant long contract has risen only twenty-seven thousand contracts.

The short open interest position of "others" in Brent has increased only eleven thousand contracts from October to August but four hundred twenty-eight thousand contracts in WTI.

The dichotomy in the change in the short position of "others" between Brent and WTI stands out. It may be explained by the fluctuation in the spread between WTI and Brent. WTI traded at a $30 per barrel discount to Brent at the end of October 2012. Friday, the spread was $4.50.

The increase in the short position for WTI may be explained by traders taking positions in expectation of Brent/WTI spread widening. Time will tell if they are correct.

The data make it clear, though, that the Brent contract today seems to be a far more significant commercial instrument than the WTI contract. This finding is surprising because some observers have concluded that the fracking boom had led to greater use of the WTI contract. *Financial Times*' Ajay Makan, for example, has written that the hedging activity of shale producers has driven forward crude prices down.[1] This is correct. However, Commodity Futures Trading Commission data do not confirm his observation that hedging has increased.

The absence of increase in the WTI merchant short position suggests shale producers in North Dakota and Texas are hedging less than some think.

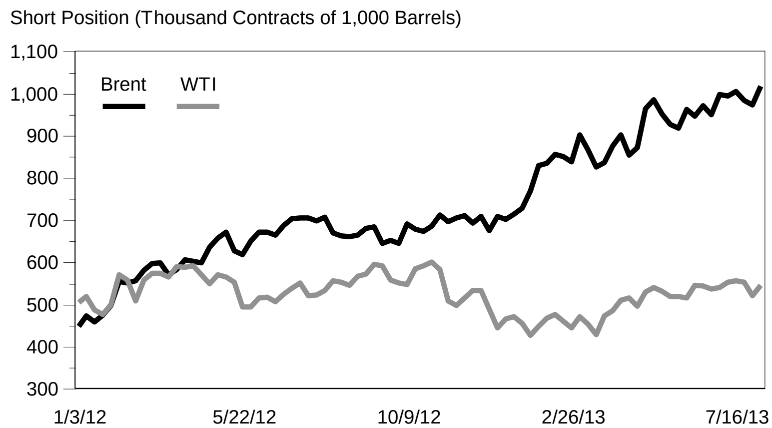
One should also note the merchant long position in WTI. In a recent issue of *Notes at the Margin*, I suggested that East Coast refiners may have protected themselves by taking long positions in WTI and short positions in Brent. The trade would have allowed them to capture the large WTI spread and protect against the eventuality of Brent and WTI prices converging. The data suggest that refiners did this. In this one instance, WTI seems to be playing an important commercial role.

For those involved in the markets, the emergence of a very large merchant short position in Brent should probably be the greatest concern. The traders who are short (and the evidence suggests one should not net the positions because the individuals who are short are different from the individuals who are long) presumably hold their positions to offset some type of physical or financial transaction. These traders will be unlikely to liquidate their positions when prices fall. As a result, those who are long Brent futures will find themselves bidding with a relatively limited number of shorts who want to close their positions. In fact, there are three "other" longs for every two "other" shorts. The imbalance could lead to a large decline in the Brent contract if the global supply situation eases.

[1] See "US Shale Revolution Triggers Oil Derivatives Upheaval," *Financial Times*, July 30, 2013 [http://goo.gl/f0HLL6].

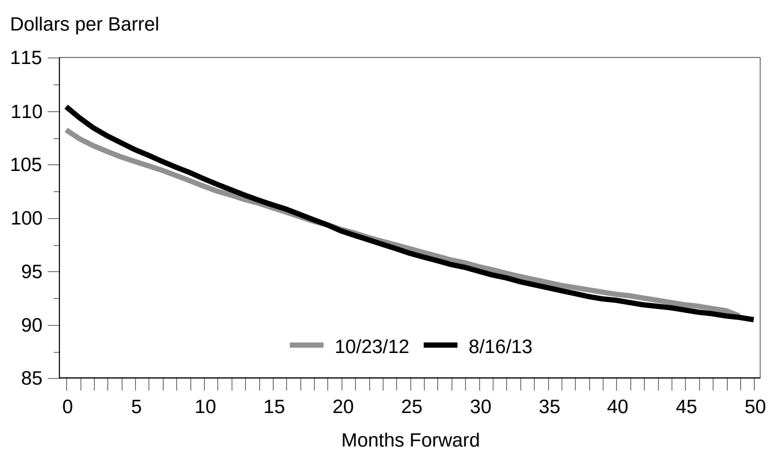
Figures and Table

Figure 1
Merchant Short Positions in Brent and WTI, 2012-2013



Note: WTI position combines CME and ICE contracts.
Source: ICE; CME.

Figure 2
Brent Forward Price Curve on 10/23/2013 and 8/16/2013



Source: PKVerleger LLC.

Table 1. Open Interest in Brent and WTI on August 16, 2013, and October 23, 2012 (Contracts)

	Brent 10/23/12	Brent 8/16/13	WTI 10/23/12	WTI 8/16/13
Total	1,543,506	1,899,618	3,166,813	3,548,027
Merchant Long	596,012	623,044	600,057	744,086
Merchant Short	672,800	1,017,720	591,990	545,362
Merchant Long as % of Open Interest	38.6	32.8	18.9	21.0
Merchant Short as % of Open Interest	43.6	53.6	18.7	15.4
Increase in Open Interest		356,112		381,214
Increase in Merchant Long		27,032		144,029
Increase in Merchant Short		344,920		(46,628)
Implied Long Position of Others	947,494	1,276,574	2,566,756	2,803,941
Implied Short Position of Others	870,706	881,898	2,574,823	3,002,665
Increase in Long Position of Others		329,080		237,185
Increase in Short Position of Others		11,192		427,842

Source: ICE; CME; PKVerleger LLC.