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A Few Speculators Dominate Vast Market for Oil Trading

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Regulators had long classified a private Swiss energy conglomerate called Vitol as a trader that primarily helped industrial firms that needed oil to run their businesses.

But when the Commodity Futures Trading Commission examined Vitol's books last month, it found that the firm was in fact more of a speculator, holding oil contracts as a profit-making investment rather than a means of lining up the actual delivery of fuel. Even more surprising to the commodities markets was the massive size of Vitol's portfolio -- at one point in July, the firm held 11 percent of all the oil contracts on the regulated New York Mercantile Exchange.

The discovery revealed how an individual financial player had gained enormous sway over the oil market without the knowledge of regulators. Other CFTC data showed that a significant amount of trading activity was concentrated in the hands of just a few speculators.

The CFTC, which learned about the nature of Vitol's activities only after making an unusual request for data from the firm, now reports that financial firms speculating for their clients or for themselves account for about 81 percent of the oil contracts on NYMEX, a far bigger share than had previously been stated by the agency. That figure may rise in coming weeks as the CFTC checks the status of other big traders.

Some lawmakers have blamed these firms for the volatility of oil prices, including the tremendous run-up that peaked earlier in the summer.

"It is now evident that speculators in the energy futures markets play a much larger role than previously thought, and it is now even harder to accept the agency's laughable assertion that excessive speculation has not contributed to rising energy prices," said Rep. John D. Dingell (D-Mich.). He added that it was "difficult to comprehend how the CFTC would allow a trader" to acquire such a large oil inventory "and not scrutinize this position any sooner."

The CFTC, which refrains from naming specific traders in its reports, did not publicly identify Vitol.

The agency's report showed only the size of the holdings of an unnamed trader. Vitol's identity as that trader was confirmed by two industry sources with direct knowledge of the matter.

CFTC documents show Vitol was one of the most active traders of oil on NYMEX as prices reached record levels. By June 6, for instance, Vitol had acquired a huge holding in oil contracts, betting prices would rise. The contracts were equal to 57.7 million barrels of oil -- about three times the amount the United States consumes daily. That day, the price of oil spiked \$11 to settle at \$138.54. Oil prices eventually peaked at \$147.27 a barrel on July 11 before falling back to settle at \$114.98 yesterday.

The documents do not say how much Vitol put down to acquire this position, but under NYMEX rules, the down payment could have been as little as \$1 billion, with the company borrowing the rest.

The biggest players on the commodity exchanges often operate as "swap dealers" who primarily invest on behalf of hedge funds, wealthy individuals and pension funds, allowing these investors to enjoy returns without having to buy an actual contract for oil or other goods. Some dealers also manage commodity trading for commercial firms.

To build up the vast holdings this practice entails, some swap dealers have maneuvered behind the scenes, exploiting their political influence and gaps in oversight to gain exemptions from regulatory limits and permission to set up new, unregulated markets. Many big traders are active not only on NYMEX but also on private and overseas markets beyond the CFTC's purview. These openings have given the firms nearly unfettered access to the trading of vital goods, including oil, cotton and corn.

Using swap dealers as middlemen, investment funds have poured into the commodity markets, raising their holdings to \$260 billion this year from \$13 billion in 2003. During that same period, the price of crude oil rose unabated every year.

CFTC data show that at the end of July, just four swap dealers held one-third of all NYMEX oil contracts that bet prices would increase. Dealers make trades that forecast prices will either rise or fall. Energy analysts say these data are evidence of the concentration of power in the markets.

CFTC leaders have argued that speculators are not influencing commodities' prices. If any new information arises during the agency's examination of swap dealer activity, officials said they would report it to Congress.

"To date, the CFTC has found that supply and demand fundamentals offer the best explanation for the systematic rise in oil prices," CFTC spokesman R. David Gary said, reading a statement that had been crafted by agency officials. "Regardless of their classification . . . the CFTC's market surveillance group scrutinizes daily the positions of all large traders, both commercial and non-commercial, to guard against market manipulation."

Victoria Dix, a spokeswoman for Vitol, declined to answer questions. The firm, through Dix, released a statement that stated only that it had not been contacted by the CFTC about the

reclassification of its business and that its trading status remained unchanged. CFTC officials said they do not typically contact firms that are reclassified.

On its Web site, the firm says it has \$100 billion a year in revenue and describes its thriving global energy-trading business.

For most of the past century, regulators put limits on financial actors to prevent them from dominating commodity exchanges, which were much smaller than the bond or stock markets. Only commercial operations, such as farms, airlines, manufacturers and the middlemen that handle their trading activities, were allowed to buy nearly unlimited quantities. The goal was to allow these businesses to minimize the effect of price swings.

The first major change to this regulatory framework occurred in 1991, when Goldman Sachs, through a subsidiary called J. Aron, argued that it should be granted the same exemption given to commercial traders because its business of buying commodities on behalf of investors was similar to the middlemen who broker commodity transactions for commercial firms.

The CFTC granted this request. More exemptions soon followed, including one to the Houston-based energy trader Enron.

"When the CFTC granted the 1991 hedging exemption to J. Aron (a division of Goldman Sachs), it signaled a major shift that has since allowed investors to accumulate enormous positions for purely speculative purposes," said Rep. Bart Stupak (D-Mich.) Now, he added, "legitimate businesses that hedge and take physical delivery of oil are being trampled by the speculators who are in the market purely to make profit."

A second turning point came when Congress passed the Commodity Futures Modernization Act of 2000. The law formally allowed investors to trade energy commodities on private electronic platforms outside the purview of regulators. Critics have called this piece of legislation the "Enron loophole," saying Enron played a role in crafting it.

In the months after the act was passed, private electronic trading platforms sprang up across the country, challenging the dominance of NYMEX.

"Investment banks had been frustrated with the established exchange because they really were never able to get control of it," said Michael Greenberger, a law professor at the University of Maryland and a former staff member at the CFTC.

The most successful of the private platforms was InterContinental Exchange, or ICE, founded by Goldman Sachs, Morgan Stanley and a few other big brokerages in 2000. ICE soon opened a trading platform in London, allowing its founders to trade vast quantities of U.S. oil overseas without being subject to regulation.

The exemptions for swap dealers and the development of overseas markets allowed big brokerages to open the door for more hedge funds, pensions and big investors to move into commodities.

In the coming years, commodity investments by funds could grow to \$1 trillion, veteran hedge fund manager Michael Masters said in testimony before the Senate earlier this year. In an interview, he said this trend could raise commodity prices for everyone in the coming years and "have catastrophic economic effects on millions of already stressed U.S. consumers."

Meanwhile, commodities have been good business for big Wall Street brokerages. Its commodity trades helped keep Goldman Sachs profitable during the credit crisis, said Richard Bove, a banking analyst at Ladenburg Thalmann.

"Business is lousy right now," Bowie said of Goldman Sachs. "Commodities and currencies are clearly the strongest business they have right now."

In the coming months, swap dealers expect to have yet another venue for oil speculation. The CFTC has stated it would not stand in the way of trading in U.S. oil contracts overseas in Dubai. Goldman Sachs and Vitol are among the major investors in this new exchange.