

THE ODD HISTORY OF THE PETROLEUM FUTURES MARKETS

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Energy futures now dominate the commodity futures markets in terms of the total value of contracts, but the oldest, heating oil, is less than four decades old. Commodity futures markets have been around for a couple of centuries because they are an efficient mechanism for transferring price change risk to speculators and thus protecting both producers and consumers.

In the spring, farmers need to decide what crops to grow in their fields – corn, wheat, soybeans, etc. If they base their decision solely on the current price, they may get a nasty surprise at harvest time if there is big price decline. Commodity futures markets give the farmers the ability to protect themselves from at least part of a big drop in prices by agreeing to sell some or all of the crop at harvest at a guaranteed price to speculators. The futures price is often less than the current cash price, but still can guarantee the farmer a profit if his costs are low enough. Speculators take the other side of the transaction by guessing that any change in price will be less than what they have to pay the farmer for the product.

The economic advantages of shifting risk from producers (farmers) to speculators is sufficiently powerful to also be applied to most non-agricultural commodities, such as metals. The New York Mercantile Exchange (NYMEX), now part of the CME Group, is the world's largest energy markets commodity exchange. As of the end of 2016, it stopped the last of the open-outcry trading and moved totally to electronic trading. (Film makers will mourn the loss of trading floors covered with frantic, shouting people.)

NYMEX was formed in 1872 to trade butter and cheese, but over the years added other commodities, acquired other small exchanges, and in 1882, renamed itself the New York Mercantile Exchange. By the early 1970s, the major commodities NYMEX traded were Maine potatoes, platinum, palladium and miscellaneous others. It was during this period that I became directly acquainted with NYMEX when a close

friend and mentor, Alan Abrahams, became its chief economist and was part of a team to modernize the Exchange and find new commodities to trade. At that time, NYMEX was still located in an old building in lower Manhattan that it had occupied since 1885. It finally moved to a new building in the World Trade Center in 1977. Back then, all trades were done by open-outcry on the trading floor, and price changes were recorded by boys using large blackboards with chalk on a walkway above the trading floor (even primitive then by the standards of the day).

In 1975, Congress created the Commodity Futures Trading Commission (CFTC) to regulate commodities futures and the exchanges. By that time, I had finished graduate school at Columbia University in New York and had moved to Washington. NYMEX had no Washington presence at that time but was suddenly being required to submit all sorts of reports to the new CFTC, including justification studies for each of the commodities they traded. This was an absurd requirement, because if there was no economic justification for futures trading in a commodity, there would be no trading. NYMEX then hired me to prepare the studies and do other miscellaneous tasks for them in Washington that were now being required (the start of their Washington office).

In May 1976, Jack Simplot, the biggest potato producer in the country (and the developer of freeze-dried potatoes during WWII), as a result of a failed attempted price squeeze, engaged in default of a huge number of potato contracts on the NYMEX. It was a major financial scandal at the time and almost killed the Exchange. The members and management of the Exchange were understandably desperate to find new commodities to trade to replace the now dead potato contract.

As I recall, several of the board members of the Exchange also owned rent-controlled apartment buildings in New York City. One of their major costs was heating oil for their buildings. Under the rent control regulations at the time, apartment building owners could only be reimbursed for increases in their heating fuel costs after they had been incurred and paid, which was often many months. The suggestion was made that NYMEX start a heating oil contract. (At that time, there were no contracts on organized futures exchanges in petroleum or petroleum products.) A heating oil contract was developed with a North Sea delivery point (Rotterdam) where the international oil price was set at that time by traders each day. Much to the disappointment of the people at NYMEX, there was little trading in the contract. I was asked to go to London and Rotterdam to interview oil traders to find out why they had no apparent interest in the NYMEX heating oil contract. In short, what I found was they had a long-established old-boy network for determining prices among themselves, which they found both convenient and profitable.

Fortunately, the leaders of NYMEX were not willing to give up after receiving my discouraging report. They changed the delivery point in the contract to New York Harbor and engaged in a marketing campaign directed at all of those who might find it potentially useful and economically beneficial. The new contract started trading in 1978 and by 1979 had become a success. Over time, the success of the heating oil contract led NYMEX to add crude oil, gasoline, natural gas, propane, coal, uranium and electricity. Subsequently, NYMEX acquired and merged with other major exchanges, such as COMEX, which had major markets in aluminum, copper, gold, and silver.

In 2006, NYMEX underwent an IPO and was listed on the New York Stock Exchange, and other parts were sold to the Chicago Mercantile Exchange (CME), which is the world's largest and most diverse derivatives marketplace, handling three billion contracts.

How ironic, that the trillions of dollars of trading now done in the various oil futures products had their beginning in an economic need to mitigate part of the costs of New York City's apartment rental price controls by enabling landlords to protect themselves from changes in the price of heating oil for their buildings.

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