



Oil: the Market is the Manipulation

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This is a guest post by Chris Cook. Chris is Former Director of the International Petroleum Exchange, and is now a Strategic Market Consultant and commentator.

Clearly manipulation has been going on in the global market in oil – there's nothing new about that – it's what intermediaries who transact for profit do and have always done. Indeed, some market wags say that trading could be defined as “acceptable market manipulation”. But until the last few years what consenting adults were doing among themselves in the oil market didn't really affect the man in the street.

But things have changed. We have now reached the culmination of a process of financialisation of the oil market to a degree where the market has become entirely sociopathic. It now operates to the detriment of consumers and producers alike and for the benefit of the intermediaries who control the market.

How did we get here? Who's doing it? How are they doing it? And what can be done about it?

A Brief History

For a good many years a few major oil companies – the Seven Sisters – more or less tied up the oil market in long term contracts and there was little trading. They simply refined what they produced.

Through the Seventies and Eighties, after oil producer nations asserted themselves, trading in cargoes of physical oil and products began, and independent traders sprang up alongside the trading arms of some of the oil majors.

When I joined the International Petroleum Exchange as Head of Compliance and Market Regulation in 1990, the growing market in oil derivative contracts (futures and options contracts the purpose of which is to manage oil price risk) took off dramatically with the first Gulf War, and the IPE never looked back.

During my time at IPE major investment banks were completing a transformation into “Wall Street Refiners” who provided liquidity to the end user producers of oil and consumers of oil products who use derivative markets to “hedge” the risk that prices may fall, or rise, respectively. Indeed, I unwittingly facilitated their emergence by introducing new trading tools such as “Exchange of Futures for Swaps”, “Volatility Trades” and “Settlement Trades” which became hugely successful.

When I left IPE in 1996 the pieces on the present day oil market chessboard were pretty much set, and the game was commencing. It was already clear that the trend towards screen trading was unstoppable, despite the wishful thinking of the traders on IPE's open outcry trading floor. Moreover, market participation of investors through funds was already visible in embryonic form.

A Partnership made in Heaven?

There are probably few more influential people than Peter Sutherland. An Irishman with a high level legal and political background, he became a non-executive director of BP as early as 1990, and after a brief but successful period to 1995 as head of the World Trade Organisation he has been on the BP board ever since, from 1997 as chairman. He has also chaired Goldman Sachs International since 1995.

Lord Browne of Madingley was a career BP man who ascended to the top in 1995 and eventually fell from grace in May 2007 shortly before he was due to retire. He was on the Board of Goldman Sachs from May 1999 until May 2007.

BP have always been natural traders. Unlike Exxon, who are vertically integrated and produce & refine oil and distribute products, BP sell the oil they produce on the market, and buy the oil they refine. In the years since 1995, BP has made phenomenal profits by trading oil, and oil derivatives.

So have Goldman Sachs. You don't rise to the top in Goldman Sachs unless you are responsible for making a great deal of money: and their energy trading operations have made immense amounts.

The key player in Goldman Sachs is the current CEO Lloyd Blankfein, who rose to the top through Goldman's commodity trading arm J Aron, and indeed he started his career at J Aron before Goldman Sachs bought J Aron over 25 years ago. With his colleague Gary Cohn, Blankfein oversaw the key energy trading portfolio.

It appears clear that BP and Goldman Sachs have been working collaboratively – at least at a strategic level - for maybe 15 years now. Their trading strategy has evolved over time as the global market has developed and become ever more financialised. Moreover, they have been well placed to steer the development of the key global energy market trading platform, and the legal and regulatory framework within which it operates.

The ICE Forms

The founder entrepreneur behind the Intercontinental Exchange (ICE) is Jeffrey Sprecher - the current CEO - who saw early the potential of screen trading for energy. He acquired the US-based Continental Power Exchange in 1997 as awareness of the Internet began to spread, and everyone grabbed for market platform territory, with Enron Online leading the way.

But my understanding is that the Continental Power Exchange would in all likelihood have gone the way of most Internet start ups had Gary Cohn of Goldman Sachs and John Shapiro of Morgan Stanley not had dinner and agreed to set up an exchange. Their two firms put up the initial capital, and their stroke of genius was to offer to the other founder members - BP, Deutsche Bank, Shell, Soc Gen and Total - an inspired deal. In exchange for providing liquidity these traders would receive equity in the exchange, alongside Sprecher's Continental Power Exchange, which was the other founder.

At a stroke ICE was created and had transcended the Liquidity/Neutrality paradox of the Internet: if a platform is neutral, then it's not liquid: and if it's liquid, it's not neutral. By 2001 things were really cooking; other trader/shareholders had joined ICE (having had to buy in); but the key was to actually reach the thousands of participants out there who were the actual “end users” of the market.

An approach to acquire NYMEX was rejected, since NYMEX membership was dominated by independent “locals” who were and are in competition with the investment banks as financial intermediaries. However, in July 2001 ICE acquired for a pittance the International Petroleum Exchange – which was set up and owned by brokers - having made the IPE an offer they couldn't refuse ie “....accept this offer, or we take our business elsewhere”.

Since then, the ICE has extended beyond energy into other markets, but its core business remains energy.

The Brent Complex

The “Brent Complex” is aptly named, being an increasingly baroque collection of contracts relating to North Sea crude oil, originally based upon the Shell “Brent” quality crude oil contract which originated in the 1980s. It now consists of physical and forward BFOE (the Brent, Forties, Oseberg and Ekofisk fields) contracts in North Sea crude oil; and the key ICE Europe BFOE futures contract which is not a deliverable contract and is purely a financial bet based upon the price in the BFOE forward market.

There is also a whole plethora of other “OTC” contracts involving not only BFOE, but also a huge transatlantic “arbitrage” market between the BFOE contract and the US West Texas Intermediate contract originated by NYMEX, but cloned by ICE Europe.

North Sea crude oil production has been in secular decline for many years, and even though the North Sea crude oil benchmark contract was extended from the Brent quality to become BFOE, there are still only about 70 cargoes, each of 600,000 barrels, of North Sea oil which come out of the North Sea each month, worth at current prices about \$2.5 billion. It is the price – as reported by Platts – of these cargoes which is the benchmark for global oil prices either directly (about 60%) or indirectly (through BFOE/WTI arbitrage) for most of the rest.

So it will be seen that traders of the scale of the ICE core membership wouldn't really have to put much money at risk by their standards in order to move or support the global market price via the BFOE market. Indeed the evolution of the Brent market has been a response to declining production and the fact that traders could not resist manipulating the market by buying up contracts and “squeezing” those who had sold oil they did not have. The fewer cargoes produced, the easier the underlying market is to manipulate.

But note that all of this action was going on among consenting adults, and was pretty much a zero sum game, which explains why the UK regulators responsible for it essentially ignored it, with a “light touch” regime.

Market Strategy

If you are an end user, then market volatility is your enemy – indeed, that is why end users began to use derivatives in the first place. But if you are a middleman, then volatility is your friend, and the only bad news is no news. Likewise, good access to market data is essential to end

users – whereas privileged or “asymmetric” access to market data is beneficial for intermediaries.

The temptation is therefore always there for intermediaries to create artificial volatility through “hyping” or even creating news, and to move the market around. Whether or not BP and Goldman Sachs trading arm J Aron were involved in such collaborative behaviour during the late 90s is an interesting point, since they were uniquely well placed, but if they did, they wouldn't have been the only ones.

Certainly by 2000 manipulation of settlement prices – for the purpose of making profits “off exchange” - was rife on the IPE to the extent that the opportunity for profit to which it gave rise was affectionately known by IPE locals as “Grab a Grand”. When I discovered it by chance, and blew the whistle on it, my allegations were buried by the UK's Treasury, FSA and IPE between them, and so was I, personally and professionally.

Meanwhile, in 1999, Goldman Sachs managed to convince the US regulators, the CFTC, that they were entitled to the same regulatory “hedge” exemptions as those market participants who were genuinely hedging their physical requirements. This, combined with the collapse of Enron in December 2001, cleared the way for the complete takeover of the global energy marketplace which has followed in trading on (and off) the ICE platform, and prepared the ground for making money out of the growing constituency of financial investors.

Financial Investors

Through the 1990s two new breeds of financial investors in the energy markets began to evolve. Firstly, the inaptly named hedge funds, which recruited, or were set up by, some of the top energy traders, who preferred to make money for themselves rather than their employer oil firms or investment banks. These traders began to take large bets in the oil and energy markets, using investors' money as risk capital, using both on and off exchange contracts, and as much “leverage” as they could command, either through derivatives, borrowing, or both.

This was good business for the “prime brokers” who acted as counter-parties to hedge funds and benefited both from commission and fee income, but also from privileged knowledge of order flow, superior knowledge of the physical market, and “front running” of customers wherever possible.

The lion's share of this prime brokerage business went to the ICE founders, Goldman Sachs and Morgan Stanley, who took different approaches to their necessary relationship with the physical market. Morgan Stanley acquired energy market infrastructure, particularly storage, whereas Goldman appear to have relied more upon their close relationship with BP. In the years from around 2002 until the Credit Crunch neutered the hedge funds, BP, Goldman and other prime brokers prospered mightily.

The advent of the Goldman Sachs Commodity Index (GSCI) fund in 1995 was one of the earliest examples of a fund investing in commodities for the long term as a “hedge against inflation”. To do so the fund ran increasingly significant positions in all commodity markets, but weighted towards energy. These positions were held over time, and had to be “rolled over” from month to month in the futures markets either directly, or through the intermediation of J Aron. This resulted in the phenomenon of what John Dizard [documented as](#) “Date Rape” and which I had observed – and pointed out to the FSA - several years earlier.

In the last few years, and particularly in the aftermath of the Credit Crunch, a massive wave of money has washed into a new breed of Exchange Traded Funds (ETFs) some of which exist solely to invest in commodity markets (ETCs). By mid 2008 it was estimated that some \$260 billion of

such money was invested in the energy markets. Compare that to the value of the oil actually coming out of the North Sea each month, at maybe \$4 to \$5 billion at most.

No one is in any doubt that this tidal wave of fund money caused a Bubble in oil prices culminating in a “spike” to \$147.00 per barrel on 11 July 2008. But there appears to be a complete misconception – particularly in the US - as to **how** this Bubble occurred, and **who** was responsible. There is no consensus, and many conflicting theories, as to **why** it occurred and also why the oil price appears to be held at levels apparently unjustified by supply and demand.

How and Who

In Summer 2000 I was interviewed in London by a couple of staffers who were researching the Brent market on behalf of Senator Levin's Sub-Committee on Investigations, but the Senate then passed to the GOP in that year's election and a Minority Report was the result. This political attention to the Brent market pre-dated the assimilation of the global energy market by ICE, and almost the entire influx of speculative investor money into the market.

Current political attention is almost entirely focused on US futures markets, such as NYMEX and ICE, and a supposed “London Loophole” relating to trading on ICE Europe of WTI in particular. There is indeed a London Loophole, but it isn't where the politicians are looking.

The key point to understand is that for a deliverable futures contract like NYMEX's WTI, the futures price converges on the physical price, and not the other way around. What matters in terms of manipulation is the exercise of control over physical oil in tank or in transit, in order to be in position for delivery in accordance with exchange rules.

For six years I oversaw the trading and delivery cycle of the IPE's deliverable Gas Oil contract and can categorically say that neither IPE nor the London Clearing House saw any reason to even consider position limits other than in the month of delivery itself. Even were the Clearing members to be negligent or mad, IPE took care to ensure that any of their clients who still had contracts open were in a position to make or take delivery in accordance with the rules. I knew that all of the action in what was occasionally Europe's biggest game of “chicken” was taking place in the physical market between the consenting adults whom I had on my speed dial.

I have no doubt that the manipulation of global energy prices which is taking place does so not on exchanges, but in trading within the Brent Complex where the key transactions take place on the telephone or – in a modern twist – in the instant messaging chat-rooms to which most of the negotiations have migrated.

Some of the resulting contracts are registered and cleared by ICE Europe and elsewhere, but most remain open bilaterally between seller and buyer. So most of the huge volume of transactions which take place in ICE Europe and NYMEX are in fact “hedges” of the risks taken on by financial intermediaries in these opaque off-exchange transactions. The futures markets are the tail, not the dog: the problem is that the tail can be seen, but the dog is invisible.

BP and Goldman Sachs are, as ever, the best placed, since Goldman has acquired strategic pipeline and other assets in the US which give them an information advantage over other players in the US oil and gas world. BP for their part may have disposed of their North Sea oil interests but they made sure they kept ownership of pipeline and other infrastructure.

I surmise therefore, that the rest of the financial intermediaries who have been queuing up to join the party, dance profitably to BP and Goldman's tune, and carry out similar transactions as

counter-parties to producers and funds based upon the same market logic.

Which brings us to *why* the market is doing what it is doing. What actually is the logic?

Yield and Profit

At this point I must give a risk disclosure statement. What follows is purely speculation, and based in part upon some unconventional thinking I have come across, and find attractive.

From the perspective of a producer high prices are desirable, and they are hardly likely to complain about market prices being manipulated upwards.

Now the conventional assumption is that the ruling factor for producers in market decision-making is the marginal cost of production ie the cost of producing an additional barrel of oil, or tonne of iron ore. But if that were the case, why did all the commodity markets spike at the same time, and indeed, why are they doing so again at the moment, when there have been no obvious cost changes in any of them?

Clearly some other factors are at work here.

Firstly, the profit motive, and secondly, the price of money over time, or “yield curve”.

Unlike for investors, the cost of storage for producers is virtually zero. Because they are in business to maximise profits they will therefore tend to keep their oil in the ground if it is more profitable over time to do so than to sell it and hold the proceeds in financial assets.

As Shalom Hamou [puts it](#):

Financial decisions are always about choices:

The shape of the yield curve is paramount in any financial decision, rather than long-term assets.

Miners and drillers who contrary to the bankers have no vested interest in buying long-term assets, prefer short-term assets to long term assets when the yield-curve is inverted.

If you consider the minerals as short-term assets, you come to the conclusion that confronted with an inverted yield curve, would prefer to hold minerals in the ground, their most profitable short-term assets. It creates a rise in the price of minerals which comforts them in their behaviour.

Hence, miners would keep a higher proportion of their minerals in the ground where storage is infinite and almost free to them (for a miner, the best short-term asset is minerals in the ground, so selling them in order to buy short-term financial assets is simply not relevant), rather than sell them and invest the proceeds in long-term assets. Because of their self-restraint on output, hence on supply, they generate as the commodity price rises, which is compounded with the increase in their unrealized revenues.

That behaviour need not be conscious but is probably the result of the propagation of

arbitrages through the different financial markets, among them the cash and derivative markets on fixed income securities and the cash and futures markets for minerals.

His point is, as I read him, that it is the shape of the yield curve which tends to drive commodity prices. And of course it is the “propagation of arbitrages” which is the business of the BPs and Goldmans of this world.

Whether and to what extent the yield curve has affected commodity pricing are interesting questions beyond my experience and competence, but the argument is an interesting one.

Returning to market manipulation, market observers with long memories will recall that a cartel of tin producers was able for years to hold the tin price at an artificially high level by buying in production into a pool. Eventually, however, the high price stimulated so much new production that the cartel was unable to support the price and the market collapsed overnight from \$800 per tonne to \$400 per tonne.

More recently, Sumitomo's copper trader Yasuo Hamanaka was able to manipulate the copper market for some 10 years with the complicity of several investment banks and brokers who took part in a programme of lending and borrowing copper through forward sales on the London Metal Exchange. Mike Riess's brilliant presentation in 2003 is a fascinating study of [modern market manipulation](#).

It appears to me that what has been occurring in the oil market may have been that – through the intermediation of the likes of J Aron in the Brent complex – long term funds have been lending money to producers – effectively interest-free - and in return the producers have been lending oil to the funds. This works well for as long as funds flow into the market, or do not withdraw in quantity, but once funds withdraw money from the market, there is a sudden collapse in price.

A combination of market hype, the opacity of the Brent Complex and the relatively small scale of trading of the benchmark BFOE crude oil contract enabled the long run up in prices, and several observers believe that the dramatic spike to \$147.00 per barrel was the specific outcome of the collapse of SemGroup which that company's management subsequently blamed mainly on Goldman Sachs.

To quote Riess:

Before the '80's, there were just us traders. Rogue traders arrived on the scene with the large institutional participants, both private and public. Today's companies and government marketing boards are large enough for senior management to distance itself from controversy, including market manipulation.

In a competitive, amoral environment, middle managers in these mega-organizations have the authority to hijack an institution's reputation and the financial clout to manipulate the market—and they do. As long as they succeed, they enjoy promotions and perks and, sometimes, the fruits of embezzlement. If the manipulation unravels, the company denies any knowledge and hangs the rogue out to dry. We've seen this over and over again, most recently with D'Avila and Codelco, Hamanaka and Sumitomo, Leeson and Barings and Tsuda and Daiwa Bank.

The manipulation in the oil market is taking place at a different “meta” level to the Leasons and Hamanakas. The Goldman Sachs and J P Morgan Chase's of this world do not break rules: if rules are inconvenient to their purpose they have them changed.

The Market **is** the Manipulation.

What is to be Done?

The dysfunctional nature and inherent instability of today's market is a combination of the profit motive of trading intermediaries, and the “deficit-based” nature of money created as interest-bearing credit.

I believe that the solution lies in the evolution of a new – dis-intermediated – market architecture and a simple but radical approach to the financialisation of oil and energy through what I call “unitisation”. This is the simple expedient of the creation and issue by producers of Units redeemable in energy, whether carbon-based or otherwise.

The evolution to such an architecture will in my view be a consequence of the direct instantaneous connections of the Internet. But that emergence is another story.



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