The Battle of the Sour Futures Contracts

Bassam Fattouh

The Intercontinental Exchange (ICE) and the New York Mercantile Exchange (NYMEX) with its partner the Dubai Mercantile Exchange (DME) have been fiercely competing to create a viable and liquid sour oil futures contract that could serve as a pricing benchmark and as a mechanism for improved risk management. In part, this fierce competition reflects a battle between two very different approaches to oil trading and pricing. While ICE's Middle East sour crude futures contract (launched on 21 May) is a purely financial instrument settled in cash against a Platts Dubai assessment, DME's Oman futures contract (launched on 1 June) allows settlement against physical delivery of Oman crude oil. In the first month of trading, DME announced that a total of 4000 Oman futures contracts would be going for physical delivery in August. This is equivalent to 4 million barrels comprising a little less than 18 percent of Oman's monthly crude oil production.

Since inception, both competitors have engaged in a propaganda battle, each emphasising the superiority of its futures contract. DME's main emphasis has been on physical deliverability which according to DME CEO Gary King 'provides true price convergence between the cash and physical markets'. Ahmad Sharaf, the Chairman of the DME, argues that the 'high number of contracts going for physical delivery in August certainly confirms the market's need for a physically delivered rather than a financially settled crude oil futures contract.' ICE's main emphasis has been on its electronic trading platform and its growing popularity with market makers, financial institutions, hedge funds and physical traders. The opening paragraphs of the document outlining the ICE Middle East Sour Crude Oil Futures contract's specifications emphasise that the contract 'not only brings the benefits of electronic trading to Middle East sour crude oil but also brings together the world's three most significant oil benchmarks on a single Exchange. This in itself offers a number of benefits to participants, including reductions in collateral requirements through the offsetting of margins.'

In this ongoing battle, both parties found a fleeting sense of achievement in the first month or so of trading. To begin with, both contracts have shown a relatively strong start compared to previous failed attempts to launch a new sour contract. It seems that each market has attracted its own flock: DME's Oman contract is probably traded more by oil companies and physical traders while ICE's Middle East Sour contract is traded more by financial players. Vitol SA, one of the world's biggest independent oil traders, has provided support for the DME's Oman crude oil futures contract, considering it superior to the old pricing method based on Dubai which has been suffering from continual decline in physical liquidity. On the other hand, financial institutions have been more inclined to use the ICE's future contract as these are not interested in physical delivery and are more familiar with trading of the ICE cash-settled instrument which is similar to the already-existing Dubai swaps instruments.

Both ICE and DME have been providing incentives to 'market makers' on the condition that they trade a certain volume. According to a Platts article on 5 July, DME is offering up to $5 per traded lot to market makers who trade at least 600 lots a day for 15 consecutive days. Allegedly, this is in addition to a big stipend. It is said that ICE has five and DME twenty market makers. Although many firms and traders (about 250 in all) have entered the ICE market since the inception of the contract on 21 May, the average number of trades per trading entity has been exceedingly small. The same situation obtained in DME.

DME faces a specific challenge. It has been long realised that for the DME's futures contract to have any realistic chance of success, it required that Oman abandon its official pricing system. Having both an official selling price (OSP) and futures market-related price undermines the market function as price discoverer. Thus, Oman's strong backing for the DME contract and the Sultanate's decision to shift from a retroactive pricing system to a forward pricing system based on the DME contract represents the crossing of an important milestone. The OSP for Oman crude for the month of June has been calculated as the arithmetic average of the daily settlement prices over the month of June for delivery in August. The Government of Dubai also announced that it will cease pricing its export crude oil sales off its current mechanism and instead will utilise DME futures prices giving additional boost to the contract.

These limited achievements however have been eclipsed by low and more importantly declining liquidity. Figure 1 shows the volume of DME Oman futures contracts between June and July. After peaking at 4085 contracts on 5 June, trading volumes have been going down at an alarming rate. For the month of June, average volume per trading day stood at 1885 contracts. In the first eleven trading days of July, average trading declined to around 800 contracts per trading day (this is not counting the zero trade on 4 July). The ICE Middle East sour futures contract has not been doing much better. After reaching a peak of 6177 contracts on 29 May, the volume has been in decline with some secondary peaks. In the month of June only 42,209 Middle East sour crude oil futures contracts were traded i.e. around 2000 contracts per trading day.

The futures market plays two important roles: price discovery and hedging/speculation or what is termed as risk management. In order to efficiently perform these functions, liquidity remains the key factor. Physical deliverability, which the DME tends to emphasise, is less important. To put it differently, deliverability is a necessary but not a sufficient condition for the success of the DME Oman futures contract. In fact, in some instances, physical deliverability can reduce the chances of the success of a futures contract if market participants have doubts about the likely performance of the delivery mechanism. In other instances, physical bottlenecks around the delivery point can create some serious dislocations. In the context of the DME Oman futures contract, some companies have raised concerns about the logistical

problems in delivering Oman crude especially that there is asymmetry between buyers and sellers. While the latter may sell small amounts, the buyer can only take physical delivery if he holds an open position of 200,000 barrels. The DME is however confident that it would be able to deal with such logistical problems. Indeed, there is no reason to believe why physical delivery against the August futures contract would encounter any problems. This is especially true given that Shell would be delivering the bulk of the 4 million barrels while Vitol would be taking most of the delivery (Argus Petroleum, 9 July 2007). For these two parties, it is business as usual.

In the future, the battle between the two exchanges will be over which of the contract gains sufficient liquidity. If low liquidity persists, then the two functions of price discovery and risk management will be undermined and both contracts would cease to be attractive for market participants. Thus, the main question is: where would the liquidity that is vital for the success of any of the contracts come from? In principle, liquidity could come from producers, physical traders, and financial institutions. How does each of these parties view the current contracts?

Gulf oil producers do not generally hedge their oil production and this is unlikely to change in the near future. For oil exporters, the interest in a sour futures contract would be only for pricing purposes. Low liquidity however is likely to discourage the already very cautious Gulf oil exporters from setting their crude price against the DME or ICE futures contracts. So far, none of the big Gulf producers such as Saudi Arabia, Kuwait, and Iran have shown any interest in these new contracts. Instead, these producers have adopted a wait-and-see approach. For instance, Saudi Aramco's Marketing vice-president Ibrahim Mishari has been quoted saying that Saudi Arabia is 'watching this [the DME Oman futures contract] and probably will be the last one to join it'. The survival of the contracts would depend to a large extent on Middle East producers. If they do not switch to DME or ICE settlement prices, then it is pointless to rely on either of the futures contracts for pricing oil cargoes.

Asian interest is crucial in the long term as the Asia-Pacific region is the main importer of the Middle East sour crude oil. To Asian traders, this contract could serve both as a risk management tool and as a tool for price discovery. However, Asian traders who were the main target for this contract have also shown little enthusiasm. As Petroleum Argus (9 July 2007) notes, most of the trading of the DME Oman contract has been taking place during US and London time reflecting Asian traders' lack of enthusiasm in the DME contract. It is clear that like oil exporters, Asian traders have also adopted the wait-and-see approach. As one Singapore-based trader puts it, 'There is not enough volume. We need to see the coming months.'

As to the financial players, these contracts may open new opportunities for trading and risk management. But again, without sufficient liquidity, speculators and hedgers will not be attracted to the market. Both exchanges have been trying to boost liquidity through the use of market makers. But so far this has not met any success.

Given that the main parties are adopting the wait-and-see approach, it is difficult to see where the needed liquidity to support these contracts would come from. If there is no surge in liquidity very soon, a vicious circle will set in. In the same way that liquidity attracts further liquidity, illiquidity can result in more illiquidity. Although it is too early to make a firm prediction about the future of these contracts, it is likely that both contracts are falling in this vicious circle. If this were the case the difficult question would be: how can this circle be broken? It seems that at this stage, the battle is not between ICE and DME, each engaged against one another to eliminate the competitor. It is rather a battle conducted in parallel in which both parties are seeking to attract higher liquidity. This is a very difficult battle to win and it is possible that it would end with two losers and the demise of yet another two sour crude futures contracts.

Figure 1: DME Contract Volume