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Market Facts

Commodity Speculators And U.S. Refining Margins

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We received a question:

"If speculators are driving the commodity market, why is it that distillate/heating oil crack spreads are so wide and gasoline crack spreads are so narrow, especially given that long only index funds hold more gasoline than heating oil?"

Let's answer a question with a question: Are speculators driving the commodities markets? Even if we assumed the entire open interest of the NYMEX refined products contracts to be long speculators of all classifications versus short hedgers of all classifications, a wildly incorrect assumption given the wide use of long heating oil futures by diesel and jet fuel hedgers, we find the gasoline and heating oil contracts represent 22.52% and 36.21% of actual demand, respectively. Physical deliveries of these contracts vary, but a 5% of open interest delivered estimate is generous.

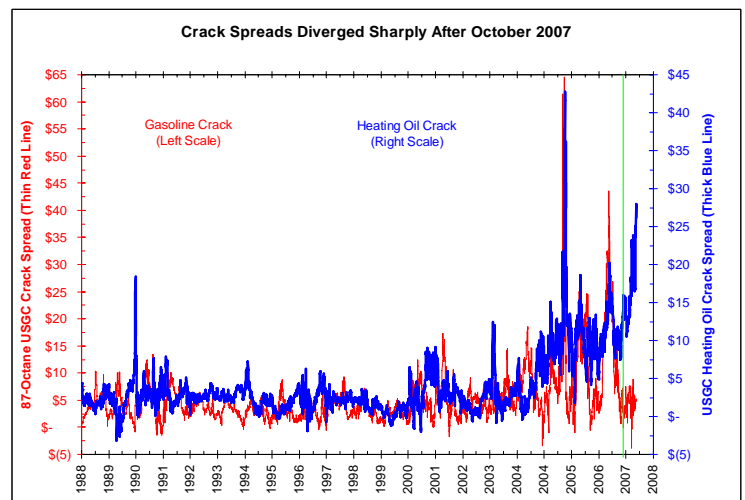
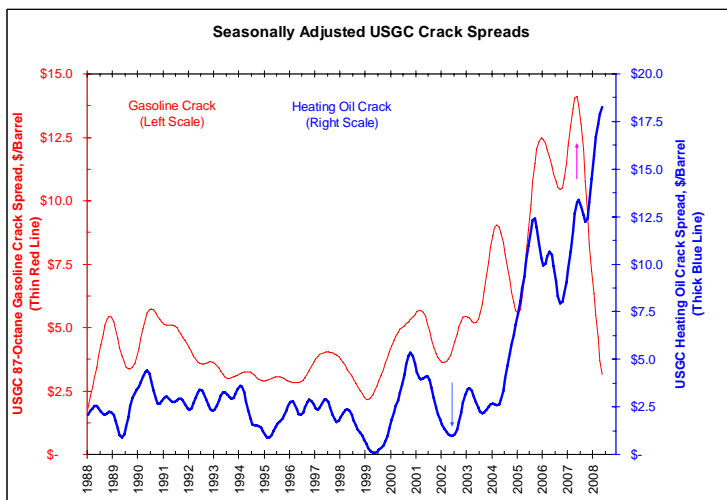
Second, seasonally adjusted crack spreads for heating oil at the U.S. Gulf Coast (thick blue line) have been rising since June 2002 (blue arrow). This preceded the widespread adoption of long-only commodity index funds.

Third, seasonally adjusted crack spreads for 87-octane gasoline at the U.S. Gulf Coast (thin red line) peaked in May 2007 (magenta arrow). Even as gasoline prices rose more than 50%, refining margins narrowed.

As the crack spread trends were underway before the major surge in petroleum prices, it would be disingenuous to claim long-only commodity index funds caused them.

The trends imply, of course, refiners have been unable to pass on higher crude oil costs to their gasoline customers while they have been able to pass them on to distillate fuel buyers. Most gasoline is sold to individuals; most distillates are sold to commercial and industrial customers.

The raw data for the gasoline and heating oil crack spreads (thin red and thick blue lines, respectively) are displayed in the right-hand chart. Their paths diverged after October 2007 (green vertical line), which is consistent with the concept refiners have been unable to pass on their higher crude oil costs to their gasoline customers.



Conclusion

While the role of long-only commodity index funds is important, we should not overstate it by thinking a few

thousand contracts can change the economics of a global industry.

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