

# product

## PROFILE

### ICE's Gasoil Contract

By Tom Doggett

Over the last five years, volume in the gasoil futures traded at ICE Futures Europe has grown nearly five-fold. The contract now ranks as the most actively traded refined petroleum future in the world, with volume more than double the heating oil futures contract traded in New York.

The gasoil contract has been around since 1981, when it was launched at the International Petroleum Exchange, the predecessor of ICE Futures Europe. It was not until the last few years, however, that the contract has really taken off.

Gasoil futures volume rose from 10.97 million contracts in 2005 to 52.32 million contracts in 2010. The contract is now the second most actively traded contract at ICE Futures Europe. In addition, open interest has risen from approximately 200,000 on average in 2005 to more than 610,000 on average in 2010, a clear sign that market depth has increased significantly over the last five years.

The dramatic increase in volume reflects the fact that the ICE gasoil futures contract has become the leading European benchmark for the so-called "middle distillates" such as diesel fuel, heating oil and jet fuel. These petroleum products account for about 40% of the product refined from a barrel of crude oil and are heavily traded in the physical market.

The gasoil contract also has benefitted from the increased availability of clearing for OTC derivatives based on the price of gasoil. ICE Clear Europe offers clearing for several dozen types of gasoil swaps, many of which are linked to the large and growing flow of refined petroleum products between Europe and Asia.

#### Hedging Mechanism

The ICE gasoil future contract requires physical delivery at expiration. The lot size of the contract is 100 metric tons of gasoil,

which is equal to 745 barrels of fuel. The delivery locations for the gasoil are the European ports of Amsterdam, Rotterdam and Antwerp.

Although some market participants say that an increasing share of the volume is driven by high-frequency trading, ICE statistics show that commercial users still dominate the market. ICE estimates that commercial users account for about 60% of the trading volume in gasoil futures, with swap dealers and hedge funds accounting for 24%.

The contract can be traded out to 36 consecutive months and then quarterly out to 48 months and then half-yearly out to 60 months. As of early September, 58% of the contract's open interest was in the first four trading months, with the other 42% in the outer months.

Gasoil is essentially the same thing as heating oil, which is widely used in Northern Europe to heat homes and offices, and diesel, which is the main transportation fuel in Europe. The ICE contract therefore is widely used as a benchmark for European demand for heating oil and diesel. The gasoil contract also serves as the basis for over-the-counter trading in gasoil swaps as well as spreads against other refined products such as jet fuel and U.S. heating oil. Consequently, the volatility in these spreads contributes to the increased trading of gasoil futures.

A major driver in the trading of the gasoil futures contract is the large underlying market in physical cargoes. There are about 200,000 barrels a day of distillate product heading to Europe every day. There are also cargoes from Europe going to Latin America and West Africa. Russian diesel and heating oil is also sent to Europe, along with Middle East and Far East diesel flowing into Europe to help meet transportation demand.

"The ICE Gasoil futures contract is well placed to meet the demand for price discovery and hedging at the natural hub of trade in

middle distillates," said Mike Davis, director of market development for ICE Futures Europe.

#### Libya and Japan

This year trading volume is up 11% over last year due to disruptions to both supply and demand. Unrest in the Middle East disrupted the flow of crude oil to European refineries, and the damage to Japan's electric power producers caused a jump in demand for diesel fuel. Airlines, refiners, utilities and other commercial entities turned to the contract to help protect their business from price swings and lock in future supply.

At the start of the year, Europe was expected to receive about 85% of Libya's 1.5 million barrels per day in oil exports for processing into diesel fuel and other petroleum products. Libya's crude contains relatively low sulfur levels, making it especially valuable for European refiners meeting the demand for clean fuel. However, those shipments were shut off this past spring by a popular uprising against Muammar Gaddafi.

Also in the spring, the earthquake in Japan and the subsequent tsunami knocked out the Fukushima nuclear power plant and other electric generating facilities. The country's demand for diesel increased as it imported more of the fuel to run power plants, portable generators and heavy equipment during its recovery and rebuilding.

"A lot of people started to realize the only way this country was going to get any power was by burning diesel," said Richard Robins, a senior distillate broker at Tullett Prebon in London.

Prices for crude oil and other petroleum products were already volatile because of uncertainty over the strength of the global economy and related energy demand. The loss of Libya's oil and Japan's higher diesel consumption made matters worse. "There's a limited amount of light sweet crude," said Davis.

## Asian Flow

In recent years, a number of new refineries have been built in countries like India, South Korea, China and Singapore. This has resulted in more trading of the ICE gasoil contract by market participants involved in operating these refineries or shipping their output to other parts of the world.

Refineries often use derivatives to hedge the price differential between crude oil and refined products. For example, there is an active trade in swaps based on the “crack spread” between gasoil and various grades of crude.

“A lot of Asian refineries have come on stream and they’ve decided it’s time they started hedging their production,” said Robins.

There is also an active trade in swaps based on the difference between the ICE gasoil benchmark and prices for gasoil in Singapore, a major hub for energy trading in Asia. While there are futures exchanges in Asia that list petroleum product contracts, they are still building momentum and do not yet have the international activity that is seen on ICE and the New York Mercantile Exchange.

“Middle distillate moves globally, and Europe as a key importer tends to act as a conduit for the major swings in trade,” said Lawrence Eagles, global head of oil research at J.P. Morgan. “As such there is a natural gravitation in terms of futures volumes to the liquid ICE contract, which is seen as more representative than some of the Asian contracts.”

Another factor is the dislocation of WTI crude oil prices from the physical market for crude oil. Brent futures traded at ICE are seen as more indicative of the global market, and that has pushed more companies with an international exposure to petroleum prices to use ICE’s contracts. “Liquidity in both crude and product contracts on the

same exchange tends to enhance liquidity overall,” said Eagles.

## Increased Transparency

Still another factor is the change in the U.S. regulatory environment. According to Michael Corley, president of Mercatus Energy Advisors, a Houston-based energy trading and risk management firm, companies that want to hedge or speculate on petroleum prices are worried about position limits and other regulations that will be implemented by the Commodity Futures Trading Commission, and in some cases they are taking their business to ICE Futures Europe.

“If you have thousands of contracts outstanding, it’s not in your best interests to wait until the 11th hour to get out of them at the NYMEX and basically enter into similar positions on ICE,” said Corley. “You are better served by transitioning those positions over time than by trying to rush in as the U.S. rules are implemented.”

ICE recently began issuing weekly reports on Brent and gasoil modeled on the CFTC’s commitments of traders reports. The reports, which were launched in June, provide aggregate information on outstanding positions in futures and options as well as a breakdown into four categories of market participant: producers, swap dealers, managed money, and “other reportables.” The reports also provide information about the concentration of positions among the largest traders.

For example, the Sept. 6 report shows that producers were holding 45.4% of the long open interest and 76.4% of the short open interest for gasoil futures and options combined. Swap dealers were holding 25.3% of the long open interest, 3.7% of the short open interest, and 10.4% of the open interest

in spread positions. The report also showed that 233 firms were active in the market that week, and that the top eight firms were holding more than 40% of the open interest.

## Change in Contract Specs

To make sure the gasoil contract meets the future needs of market participants, ICE in September introduced a new version of the contract to reflect cleaner fuel standards that have been adopted in Europe. The exchange believes other countries, particularly China, will adopt similar standards to reduce their greenhouse gas emissions and fight global warming.

“The world is moving to low sulfur diesel and it’s gaining quite significant momentum,” said Eagles.

The new contract is based on gasoil with 10 parts-per-million levels of sulfur, versus 1,000 parts-per-million for the existing contract. The contracts will trade side by side beginning with the January 2012 delivery month through January 2015. The low-sulfur contract will be the sole version available for trading from the February 2015 delivery month onwards.

The exchange also introduced 13 related over-the-counter low sulfur gasoil swaps that will be cleared by ICE.

As sulfur levels are lowered globally for both diesel fuel and heating oil, ICE’s Davis said the market may end up with a “dual fuel” that can be used for both running cars and warming homes. “The alignment of the new contract with the boilerplate distillate grade will ensure the long-term usefulness of the contract as both a trading tool and a hedging tool,” he said.

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**Tom Doggett** has been a journalist in Washington, D.C. for over two decades. Most recently he covered energy policy for Reuters.

**Table 1: Surge in Popularity**

ICE Gasoil Futures Volume and Open Interest

	2005	2006	2007	2008	2009	2010
<b>Volume</b>	10,971,719	18,289,877	24,509,884	28,805,192	36,039,074	52,296,582
<b>Open Interest</b>	216,721	320,817	273,479	418,094	547,076	618,982

Source: ICE Futures Europe