



The Use of Derivatives in Energy Trading

Adapted from:

Fundamentals of Upstream Petroleum Agreements by C.P.Thorpe 2008

"Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." Warren Buffet, the "Sage of Omaha", 2002

In the 1980s, when I was last heavily involved in crude oil sale agreements, selling crude was a fairly simple matter. It was mainly the province of the producers who were selling real barrels, and getting the best price was a question of market awareness and timing.

The problem was that the spot price of oil is highly volatile, and always has been since the first well at Spindletop in 1901 flooded the US oil market and caused the first oil price crash.

A solution to this problem arrived in the last twenty years with the rise of derivatives, which have entirely transformed energy trading.

Derivatives are used in all commodity and financial markets, not just oil, and they involve the trading not of physical commodities but future rights to buy and sell those commodities.

For the sellers and buyers of crude oil, derivatives allowed traders to smooth out the peaks and troughs of the spot market and to hedge their exposure to it by locking in price and quantity for future deliveries of crude.

Derivatives also enable speculation on the future price of oil, and even to make money from a falling oil price. This possibility attracted new types of traders and businesses like banks, who did not have real oil to sell nor any intention of taking delivery of a cargo of crude.

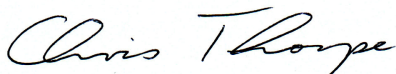
Their interest was to make a profit by correctly reading and exploiting the future direction of the oil market.

For traders and speculators alike, profiting from derivatives is dependent on correctly forecasting future price movements. An incorrect forecast can be expensive.

In 2006 the Amaranth hedge fund in the United States collapsed after suffering a loss of \$6.3 billion on gas futures contracts, as a result of an incorrect prediction of gas prices.

These increasingly sophisticated financial instruments have transformed crude oil trading. But all this activity is a zero sum game. One person may make a dollar, but this necessarily means that another person has lost a dollar.

Derivatives certainly have their uses, but taken over all no value is added. The value is added by those who get the oil and gas from the ground and transport, refine and distribute it, just as it always was.



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