THE DAWN OF A NEW ORDER IN COMMODITY TRADING – ACT III

FIVE MEGATRENDS THAT WILL ALTER THE INDUSTRY

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Since 2011, oil prices have traded in a narrow band of around $100 per barrel in spite of a series of disruptions that in another era would have triggered significant price spikes. In Libya, rebels took over the government of the fifth-largest holder of proved oil reserves in the world. An anti-government uprising in Syria shut off more than one-twentieth of global oil production. South Sudan lost one-third of its oil production to fighting that damaged its oil wells.

Commodity markets are repeatedly shrugging off shocks for a simple reason: The world is oversupplied with everything from crude oil to coal to natural gas, everywhere from the United States to China to Siberia.

But it would be a mistake to be lulled into a false sense of security. Behind this benign excess, the commodity trading environment is changing radically, introducing new challenges and opportunities for traders, industrial companies, and consumers worldwide. In our view, these new trends could potentially spark market disruptions, higher levels of commodity price volatility, and fundamentally alter the way commodity trading markets work in the future.

As we predicted in “The Dawn of a New Order in Commodity Trading” acts I and II, which appeared in the *Oliver Wyman Risk Journal* in 2012 and 2013, respectively, commodity traders, which traditionally leased or borrowed their assets, continue to invest in assets ranging from coal mines to storage terminals to gasoline retail chains.

Recently, traders have been increasingly trying to secure “structural shorts,” the industry term for long-term supply contracts. Given that there is a glut in almost every type of commodity and the fact that they have built out extensive portfolios to capture a wide range of options, traders need to lock down stable sources of demand around which supply positions can be structured and optimized.

Historically, traders could achieve this by simply entering long-term sales contracts for a commodity. But in the current competitive environment, they must organize financing for asset investments, take equity stakes in their counterparties, or provide some form of expertise in areas such as financial risk management or technical blending to convince customers to enter into such deals.

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Take the example of independent trader Vitol. Since 2011, Vitol has paid billions of dollars to buy multiple assets from Shell, ranging from 870 service stations and a refinery in Australia to 1,185 retail stations and 900,000 cubic meters of storage in Africa. Vitol went so far as to agree to invest in and switch a power plant from fuel oil to liquefied petroleum gas for the US Virgin Islands' Water and Power Authority in order to secure LPG orders for seven years.

As commodity markets continue to shift, five new trends are accelerating, which will change the face of the commodity trading industry. These megatrends will either unlock new avenues for growth for trading firms or become a potential cause for their undoing.

Predicting how each of these developments will play out depends on the reactions from market participants, policymakers, and rating agencies. In this article, we examine three of the most likely potential scenarios from across a wide spectrum of possibilities. In our view, every company that produces, consumes, or trades commodities should carefully review its strategies against these three potential courses of events.

But before moving on to describe those three scenarios, let's first examine the five trends that are rewriting the rules.

FIVE MEGATRENDS

TREND 1
COMMODITY MARKETS MATURE

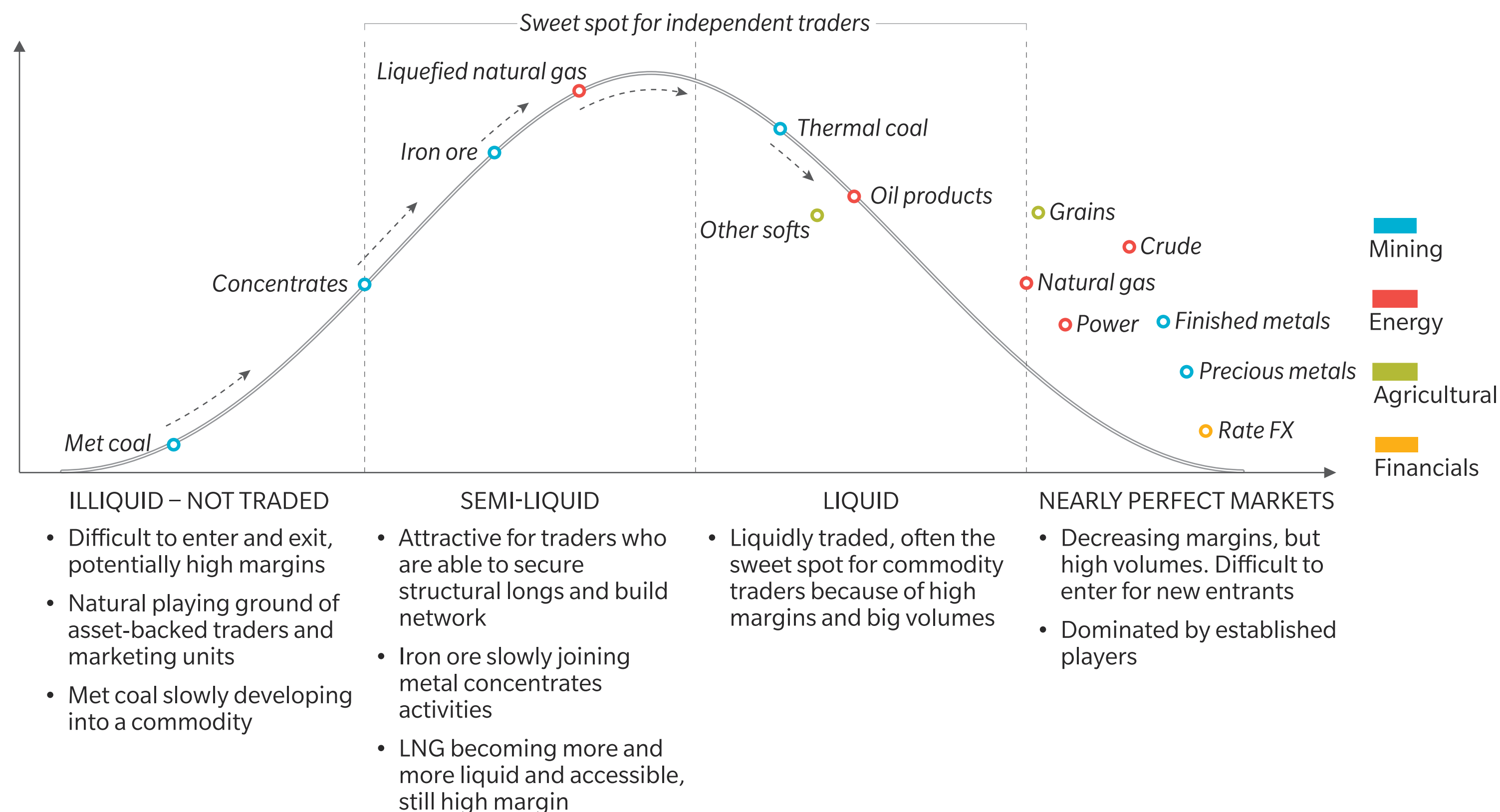
Traditionally, independent commodity traders earned their greatest profits from supplying commodities that could not be accessed easily on open markets. But now, many of these commodities are traded on markets that are transparent and liquid. (See Exhibit 1.)

As a result, traders can no longer act simply as intermediaries without the risk of losing market share. Transparent markets are shrinking their margins. As recently as five years ago, traders earned margins of $3 to $5 per ton using long-term fixed price arrangements to supply thermal coal. Now that thermal coal has become a much more widely traded commodity with transparent price benchmarks and indexed pricing, we estimate those margins have shrunk by 40 percent on average, to as little as $1 to $3 per ton.

EXHIBIT 1: TRADING MARKETS MATURE

SOME COMMODITIES TRADED MOST PROFITABLY BY INDEPENDENT TRADERS ARE MOVING OUT OF THE "SWEET SPOT"

TRADING ATTRACTIVENESS (MARGIN AND VOLUME CONSIDERATIONS)



Source: Oliver Wyman analysis

TREND 2
BANKS EXIT COMMODITY TRADING

Since United States President Barack Obama signed the Dodd–Frank Act into federal law in 2010 and European Basel III/CRD IV regulations placed restrictions on banks' proprietary trading, nine of the world's 10 largest Western banks that have been active in physical commodity trading have made moves either to withdraw from commodity trading completely, or to curtail their activities drastically. Ten other smaller banks have exited as well.

The impact of these moves on market liquidity has varied, depending on the commodity. Exchange-traded derivative markets for widely traded commodities such as oil remain robust because the remaining participants picked up the business left behind by those players who have departed. A few commodity trading teams also relocated from banks to hedge funds and other trading houses.

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But hedges are scarce in niche markets, especially for longer-term trades. We believe hedges will be in short supply in more markets going forward, which could lead to rising hedging costs for producers and consumers. Ultimately, consumers will bear the brunt of these higher costs.

TREND 3
NEW MARKET STRUCTURES ARE FORGED

The commodity trading market is a three-tiered structure made up of producers, commodity traders (including intermediaries such as banks), and consumers. Today, the balance between producers, traders, and consumers differs considerably across commodity classes. Metals and minerals markets are dominated by a few large players, while the markets for oil, power, and gas are fragmented with many participants.

In the next several years, we predict the structure of all commodity markets will become more homogeneous. Players will enter those markets where they can create significant value from their existing positions and exit those where global scale is increasingly important.

This new structure is already manifesting itself in a number of markets. Large commodity producers, such as oil majors and national oil companies, are increasingly establishing trading activities so that they can monetize their upstream production and gain greater control over their value chains. By contrast, smaller power producers are reducing their trading activities and leaving trading to larger players.

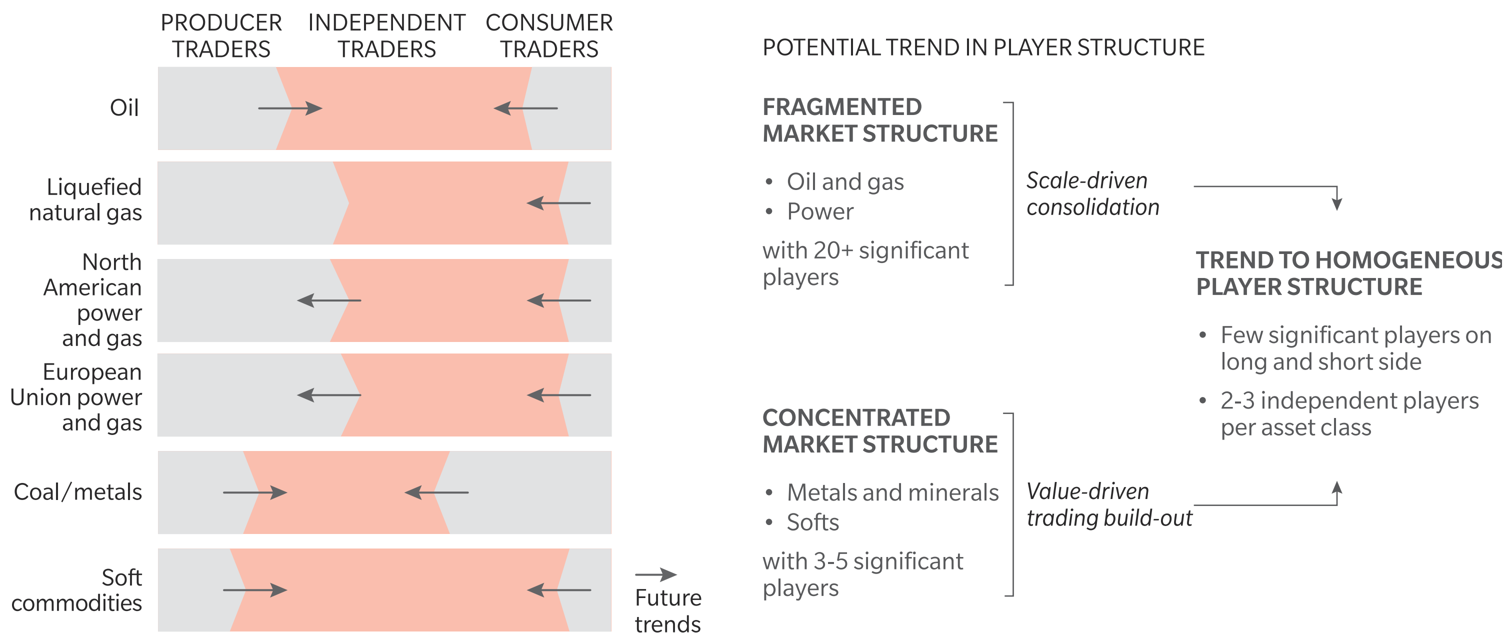
Major soft commodity consumers, too, that have critical mass in one or more commodities, are becoming more active traders. More Chinese companies are building up trading businesses that can source foodstuffs from a broader network of suppliers, instead of buying farmland in foreign countries. Global packaged consumer goods companies are following the lead of competitors with substantial trading businesses, such as Unilever and chemical giant BASF.

But independent trading players and smaller producers, which make up the market's middle tier, continue to be under pressure. In fact, we predict that soon only two to three will remain, due to an increasingly cutthroat environment. Fewer traders that specialize in a single commodity class will prevail. (See Exhibit 2.)

EXHIBIT 2: HOMOGENIZATION OF MARKET PLAYER STRUCTURE

MARKET STRUCTURES ACROSS COMMODITIES WILL FURTHER HARMONIZE, LEADING TO A THREE-TIER MODEL

MARKET PLAYER STRUCTURE WILL BE MORE HOMOGENEOUS IN FUTURE, ON THE BACK OF SCALE REQUIREMENTS AND VALUE-DRIVEN TRADING BUILD-OUT



Source: Oliver Wyman analysis

TREND 4
PRICE SPIKES RESULT FROM CHANGING METRICS

Since independent traders require more long-term capital to acquire assets, they are issuing more bonds and attracting greater attention from rating agencies. These agencies, in turn, are evaluating the independent traders' activities based on the expected returns from their total capital employed – instead of just their returns on equity.

Commodity price spikes will likely become more common in reaction to this basic shift in how potential returns from trades are evaluated. By taking the increasing amount of debt associated with trades into account, rating agencies are driving up the cost of traders' capital. These higher costs harm the margins of some of the industry's more traditional trading strategies, which have been critical to smoothing out demand and supply imbalances.

As a result, independent traders have significantly less incentive to make volumes of inventory readily available to resolve supply disruptions. If their capital costs rise by seven percentage points, we estimate the gross margins for trades associated with holding inventory could be cut by 50 percent or more on average. The gross margins on complex, structured trades, such as fixed-price supply agreements, could be reduced even more.(See Exhibit 3.)

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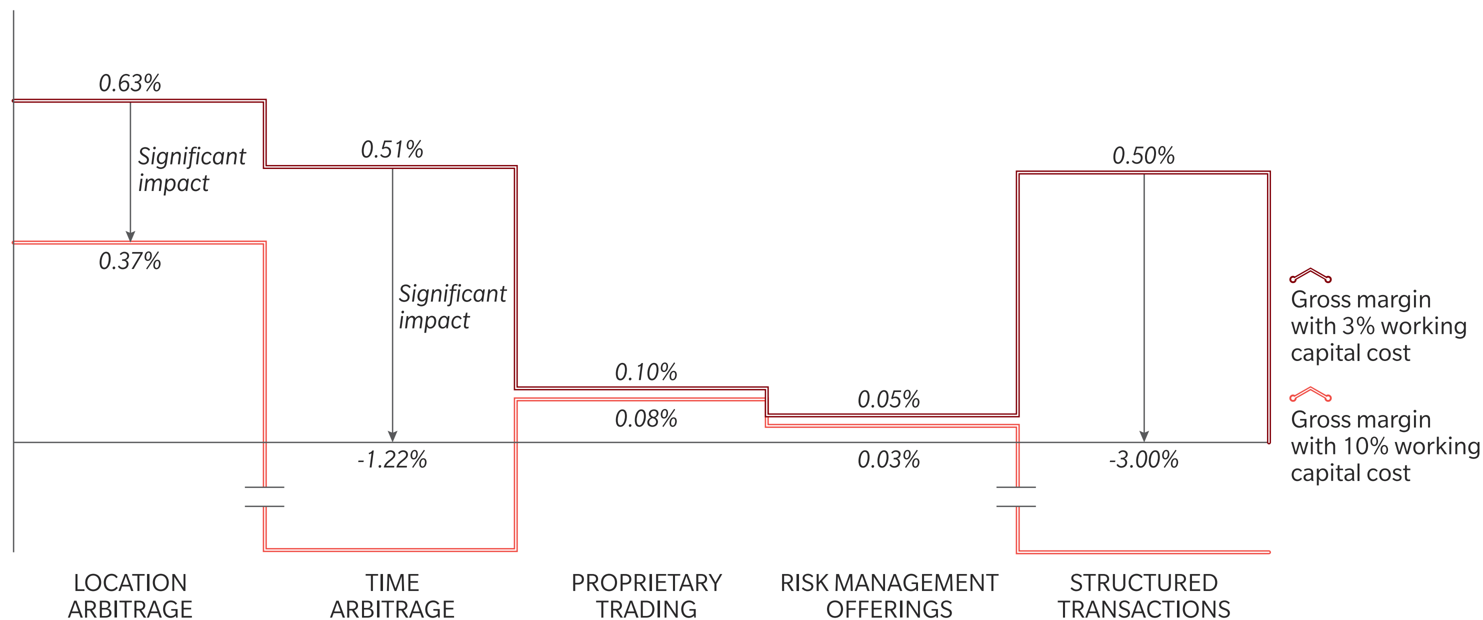
EXHIBIT 3: TRADING MARKETS MATURE

STANDARD TRADING PLAYS WILL BECOME SIGNIFICANTLY LESS ATTRACTIVE
IF TRADERS ARE CHARGED MORE FOR THE COST OF THEIR WORKING CAPITAL

IMPACT OF A CHANGE IN WORKING CAPITAL COST ACROSS STANDARD DEAL TYPES



Source: Oliver Wyman analysis

TREND 5
LOW COMMODITY PRICE VOLATILITY CAUSES SUPPLY DISRUPTIONS

The volatility of energy commodities has dropped to a historic low and is now about 50 percent below its long-term average. (See Exhibit 4.) An overabundance of supply is shredding traders' margins, forcing them into riskier, more capital intensive, and complex deals. Traders are also abandoning some markets or reducing their activities, resulting in less available liquidity. Consequently, there is a higher probability of severe supply disruptions that could cause price spikes if supply or demand suddenly shifts.

EXHIBIT 4: VOLATILITY IS CURRENTLY AT HISTORIC LOWS

AVERAGE ROLLING 60 DAYS IMPLIED VOLATILITY FOR KEY ENERGY FUTURES*
(% YEARLY STANDARD DEVIATION)

Source: Reuters, Oliver Wyman analysis
*Average includes: Brent, WTI, ICE Gasoil, RBOB, ULSD, NatGas HH, Nat Gas NBP

THREE KEY MARKET SCENARIOS

Although the reasons for change and rising risks in the commodity trading landscape are clear, their consequences are complicated, and the paths forward for companies defy simple solutions. Nonetheless, we have identified three illustrative scenarios that outline possible developments. Movement from one scenario to another can occur depending on regulatory or market reactions to these occurrences. (See Exhibit 5.)

SCENARIO 1
TRADING IS NOT WHAT IT USED TO BE

If the present levels of low commodity price volatility continue and present regulations and accounting rules remain in place, there is a significant risk that players currently active in the markets and that are filling the void left by the banks will also eventually have to reduce their activities. The overall profitability from trading will be minimal. Independent commodity traders, consumers, and producers will easily be able to find more promising and higher-returning uses for their capital.

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EXHIBIT 5: THREE KEY MARKET SCENARIOS

Scenario		Description
"TRADING IS NOT WHAT IT USED TO BE" Trading activity Today	**Banks' exiting the commodity trading space** **Homogenization of market structure**	• Banks leaving the market, no substitution, limited activity of independents, producer, and consumer traders • Alternative usages for capital preferred • Prolonged period of low volatility
"BACK TO NORMAL" Trading activity Today	**Pressure on independent trader model** **Regulatory changes (Dodd-Frank, BASEL III, IFRS...)**	• Substitution of the banks' activities through producer/consumer traders • Alternative providers established for risk management offerings and market liquidity • Increase to an average level of market volatility
"THE RETURN OF THE BANKS" Trading activity Today	**Commodity market dynamics and oversupplied markets** **Maturing across commodity classes**	• Change in regulation (potential for 3-4 year horizon) and/or engagement of emerging markets banks (BRIC, Singapore, Middle East) • Banks in commodities trading supported by consumer/producer traders • Increased market volatility

Source: Oliver Wyman analysis

The availability of hedging products and spot volumes will be limited. Market disruptions will have a greater impact on prices and supply chains. Intermediaries and their instruments, such as hedges and inventory, will be unavailable, making it difficult for traders to smooth out imbalances in the same way that they have traditionally.

Although we believe this is the least likely of our three scenarios, it is also the one that market players most need to guard against. Should it develop, there will be significant disruptions in global trade that will harm both industrial consumers of commodities and private households.

But a different scenario could materialize if these trends are mitigated by new developments. A better balance between supply and demand could be achieved if rating agencies treat marketable inventory and short-term debt differently. Market volatility could also return to its long-term historic average.

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SCENARIO 2
BACK TO NORMAL

The combination of commodity price volatility returning to a long-term average and a different treatment of marketable inventory by rating agencies will make commodity trading markets more attractive. In response, commodity producers, consumers, and new investors will become more active, replacing banks that have exited from commodity trading.

Established physical players will build up banklike risk management and product structuring offerings. This will enable them to offer risk management solutions to their clients and act as market makers. The result could be a well-functioning market, which is very similar to today's, with different players providing the cushion for short-term market disruptions and longer-term risk management solutions.

Participants who believe in this scenario have a strong incentive to build up product structuring and risk management capabilities now in order to be prepared, positioning themselves as the go-to players. Companies that cannot determine which of the two scenarios is more likely to occur should build the core set of capabilities and then be prepared to scale them depending on market developments.

However, it is also possible that the trading sector will grow in the future. If that happens, banks might return to the arena.

SCENARIO 3
THE RETURN OF THE BANKS

When American and European lawmakers placed restrictions on banks that encouraged them to exit from the commodity trading business, their goal was to avoid another Great Recession by stabilizing banks and the financial system overall. They also aimed to discourage speculative trading that could drive up consumer prices.

However, there is a risk that their efforts could have the opposite effect. We believe commodity prices will soon be more vulnerable to sudden disruptions than they have been over the past decade, and will remain so for the foreseeable future.

50%
The percentage that the volatility of energy commodities has dropped below its long-term average

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As a result, when there are disruptions, markets will experience more "spikes," which will have a greater impact on the real economy and consumers over the next several years.

Regulations may need to be revised to permit banks to re-enter the commodity trading business to provide market liquidity and a risk management offering to industrial corporations in the Western developed markets. Banks in less-regulated emerging markets (such as Asia or the Middle East) that are not subject to these restrictions will likely become major players in their own right. They will support the trading operations of commodity producers and consumers, starting with local trading firms.

We believe that this scenario will potentially materialize over time as a consequence of Scenario 2. Companies that position themselves well for the first two scenarios will benefit. If banks re-enter commodity trading, companies that have stepped in to provide the services traditionally provided for by banks will have a strong market position by then and may consider expanding further through joint ventures or other forms of cooperation with banks.

GAINING CONTROL OF RADICAL CHANGE

Radically shifting business landscapes can stymie capable companies when they don't understand what is happening around them and why. But managers who take the time to grasp potential paradigm shifts have been known to turn the changes into opportunities for growth.

The trends and scenarios that we have presented in this article are not only relevant for the firms currently engaged in commodity trading. Every company that makes use of commodities, whether as a raw material or in processed form, will feel their impact. Consumers may also confront periods of increasingly volatile prices for gasoline, power, and other commodities.

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Consequently, understanding these developments and preparing for their potential ramifications can assist a wide variety of companies to gain a competitive advantage and to grow their margins more than their more passive competitors. At a minimum, we recommend that every company that trades, consumes, or produces commodities should evaluate its current capabilities and strategic position in light of the trends and scenarios described.

Management teams should ask themselves three critical questions:

1. What is the scenario, or series of scenarios, that I believe is most likely?
2. What capabilities am I missing to be one of the players who thrives in this scenario?
3. Do I want to invest in building these capabilities in order to strategically position myself for this potential development?

The companies that openly and critically engage in this debate will be the future market leaders. They will be prepared to seize the opportunities created by new developments. Others may be caught by surprise when a situation suddenly transforms the commodity markets as they have come to know them.

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