The Economics of Commodity Trading Firms

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Fundamental Facts About CTFs

• CTFs transform physical commodities
• CTFs buy and sell commodities, so are focused on margins (price differentials) not on flat price levels
• Physical business, with profitability driven by volumes and margins
• Extensive users of derivatives but as hedgers of flat price risk
• Main exposure is to basis risk
Commodity Transformations

• CTFs perform commodity transformations at all levels of the value chain

• Transformation in space (transportation)

• Transformation in time (storage)

• Transformation in form (processing)

• Different firms focus on different transformations and different commodities: substantial diversity among firms
Trading

• Spreads and pricing relationships, not flat prices, are the essence of physical commodity trading
• Trading and managing the risk of such price exposures requires an understanding of the value chain
• CTFs specialize in understanding the value chain and enhancing value by identifying physical “arbitrages” and managing the associated risks
Commodity Trading Firms: Agents of Transformation

- Commodity trading firms specialize in making transformations in space, time, and form.
- As such, they are focused on price relationships (spreads) rather than flat prices.
- Flat prices matter primarily to the extent that they affect (a) volumes/margins, and (b) financing constraints.
Flat Prices & Volumes/Margins

• Relationships between flat prices and volumes/margins depends on whether supply or demand shocks are driving flat prices
• High prices due to high demand: good for margins and volumes
• High prices due to low supply: bad for margins and volumes
• Margins/volumes *much* more stable over the cycle than prices
Paper Trading by CTFs

• CTFs are extensive users of listed and OTC derivatives, but primarily as hedgers
• Use derivatives to exchange flat price risk for basis (spread) risk
• Typically major sellers of futures/swaps to hedge their inventory holdings
• Speculative trading focuses on spread trades, rather than directional trades
Asset Ownership By Commodity Trading Firms

• Commodity trading firms can transform commodities without owning assets (charter a ship; rent storage space)

• Commodity trading firms quite diverse in their asset ownership patterns

• Asset light firms

• Asset heavy firms
Trends in Asset Ownership

• Widely believed that commodity trading firms becoming more asset heavy
• In reality, considerable diversity in trends across commodity trading firms
Why Own Assets?

• Common to say asset ownership provides optionality, but you can have optionality without ownership (shipping is a great example, or offtake agreements)

• Asset ownership can mitigate “transactions costs”, notably costs associated with “holdups”

• Holdups can occur when an asset is specialized and there are few available substitutes
Example: Storage Facilities

- Efficient utilization of storage rapid response to supply and demand shocks
- The owner of a storage facility can attempt to extract concessions from a firm using the facility by threatening to delay access to the stored commodity (look at aluminum, cocoa)
- “Temporal specificity”
- The storer can avoid this problem by owning the asset
Logistics Assets

• Similar considerations pertain for other “midstream” assets, like terminals: rapid access to asset on an unpredictable basis necessary to execute arbitrage transactions

• Many midstream assets are also large scale, site specific, with few close substitutes, and users often move volumes sufficient to utilize a large fraction of capacity
Upstream Assets

• Some ownership of upstream assets by commodity traders (e.g., palm oil plantations)

• In some cases, transactions costs considerations seem to explain this: in the case of palm oil, desirable to locate processing plants on plantations, so holdups are avoided by having the same firm own both

• In other cases, notably mines, this seems less clear
Downstream Assets

• Considerable integration recently into downstream assets (e.g., fuel marketing)
• Transactions costs considerations seem important here:
• Flipside of disintegration by oil majors
• The development of robust spot markets for fuel means that majors don’t need to own downstream assets to market their products
The Ownership of Commodity Traders

• Diversity here as well: some firms private, others public
• Trade off: better incentives under private ownership, but it limits ability to raise capital and limits ability of owners to diversify
• Relationship between asset intensity and ownership
• Uses of hybrid financing strategies to finesse trade off (perpetual debt; selling equity in asset-heavy subsidiaries)
Do Commodity Trading Firms Pose Systemic Risks?

• Post-crisis, it has been asserted that commodity trading firms pose systemic risk like banks do
• “Too big to fail”
• Commodity trading firms very different from banks, and hence do not pose even remotely similar systemic risks
Why Commodity Traders Aren’t Systemically Risky

• Not really that big
• Balance sheets not “fragile” (no maturity transformation)
• Don’t supply credit like banks do: mainly conduits of credit from banks to customers/suppliers
• Little concentration
• Assets redeployable
• Less vulnerability to major economic downturns
Why Commodity Traders Aren’t Systemically Risky (con’t)

• Historically, large disruptions to logistics networks have not had systemic effects (e.g., Japanese tsunami)

• Failures of commodity firms have not had systemic spillover effects: indeed, entire sectors (e.g., US merchant energy in 2002-2003) have suffered financial distress without major effects on the broader economy