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## Speculators versus Investors

The debate over position limits in the commodities markets, and the role of speculators in the price-discovery process, has been raging for over a year now. Commodity market participants facing tough new regulations are invoking the famous medical dictum, *Primum Non Nocere*, “First, do no harm”. They warn that under the law of unintended consequences, restricting speculative activity, and the liquidity it provides, could make the markets more volatile and less efficient. Politicians, on the other hand, are much more inclined to follow another medical dictum, *Primum Succurrere*, “First, hasten to help”—despite the potential adverse consequences of the remedy.

In this paper we will present our arguments and clearly demonstrate why we believe that investors' desire to hold commodity exposure has an adverse effect on the price discovery process, whereas short-term speculators continue to play the stabilising and liquidity-creating role suggested by traditional economic theory. We shall then suggest possible amendments to regulation. These should distinguish between the useful activity of short-term speculators, who tend to assist price-discovery, and the potentially disruptive influence of long-only financial investors, who tend to destabilise commodity markets.

### 1- Some Background on the Commodity Markets

The Commodities Futures Trading Commission (CFTC) has two main mandates:

- To promote market integrity, and
- To assist market participants in the price-discovery process.

These are the basic purposes that any modern market serves. But, in recent years, concerns have been raised that the price-discovery process in the commodity markets was failing.

Now undeniably, commodities are a very different beast than currencies, equities, or bonds. Commodities are consumables that require supply-chain management for timely delivery. In agriculture, supply is a function of yields on planted acreage (which can be affected by weather, plague, etc.), plus inventories. In energy, supply is a function of installed capacity and geopolitics, etc... The price discovery function of commodity markets is thus to assign a value on the immediate marginal and nearby demand, and estimate where the economics lie for future capacity expansion. Spare supply is not something that naturally occurs in other markets, while supply chain infrastructure is non-existent in equities, bonds or currencies.

Let us focus on oil (for it is the market which attracted the most attention from policymakers when prices spiked to US\$150/bbl). The large oil producers typically do not hedge their future production—they are, for the most part, price takers. OPEC members, who supply 45% of the world's needs, do not hedge production, nor, under the cartel's rules, are they allowed to participate in the derivatives market. Of the remaining 55% of producers, most are sovereigns who also do not hedge, and their production is already assigned to consumers. So only about 10% of commercial suppliers participate in the energy derivatives market—equivalent to 8 million barrels a day. These commercial players in energy futures markets include some of the super-majors, some of the small independent producers and a few small sovereigns. And this supply forms the underlying of the marginal barrel price.

In the mid-1990s, most of the trade focused on the first three-months of the forward curve.

Now the first three months represent only about 25% of outstanding contracts—in other words, producers are stuck tying up more working capital.

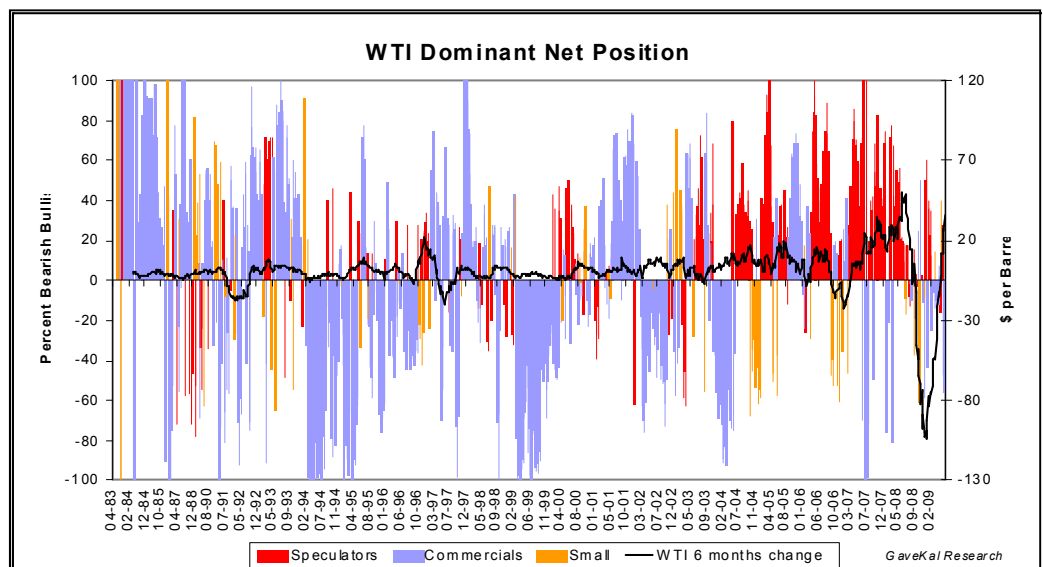
Up until 2004, commercial players were the dominant price-setters in WTI futures.

Back in the mid 1990s, when I began trading in energy derivatives markets, 80% of all futures open interest was concentrated in the first three months, and the remaining 20% in the rest of the forward curve. The OTC swaps market used to cover an average of 42 days of supply; i.e., that of secondary stock (refined stock) needs. Interestingly, the total futures open interest was equivalent to one full day of world demand. That was the natural state of price discovery according to the fundamentals of supply and demand. So the commercials, both suppliers and consumers, were responsible for ensuring that secondary stocks were hedged and their total futures activity amounted to setting the price on a day-to-day basis for exactly one day of world demand.

Today, the first three months of futures open interest represent only about 25% of total outstanding and the OTC markets cover over 300 days of total demand (or 25 billion barrels). This is a strange thing because if anything, supply-chain management is much more efficient today than it was ten years ago, ensuring that oil majors do not have to tie-up so much working capital on useless inventories. Compared to the norm of a decade ago, and despite solid improvements in supply chain management, today's trading activity is overdone by seven times. Given that the world today does not consume seven times more than it did ten years ago, and given that super-majors produce as much, the remainder of the trading volume must be accounted for by other parties who do not have any need for physical oil.

## 2- Do Speculators Have a Case to Answer?

Below is a chart that I would update every week back in my active trading days. It is a breakdown, by category, of the CFTC report on open interest in the WTI futures market. Let us first explain that for every buyer there is a seller, so the net position regardless of volumes is always zero once we net everyone out. But what is interesting is which category, in any given week, has the greatest net position, whether net long or short. That category is deemed to be the dominant price setter for that week. As a refinement we also calculated their percentage of bulls vs bears. Up to the end of 2004 the commercials category was the dominant price setter throughout the past twenty years. Speculators had a few occasions to shine but only briefly.



The commercials net position almost always tended to be the opposite of the price change. They would sell into a price increase and buy into a price decrease, i.e., they were natural hedgers and liquidity providers. Since 2005, the picture has completely changed with speculators dominating the price-setting mechanism — especially on the long side, with speculators having only been found ‘net short and dominant’ a mere three weeks over the past four years but ‘long and dominant’ for 138 weeks (or 162 if we include the small speculators).

If non-commercial activity becomes trend-setting in the oil markets, then we reach a point when the oil producers' fire-power is exhausted .

Some may argue that speculators are as adept at figuring out what the fair oil price is as commercials, if not better.

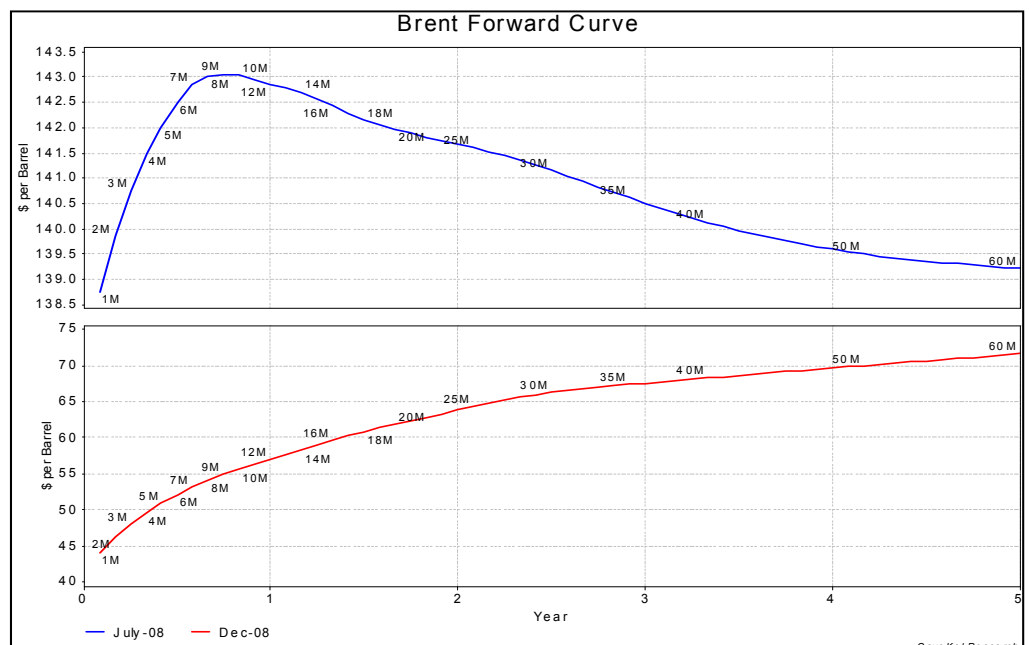
But the fact is, that the physical oil market is not big enough to support the number of investors interested in this market.

Does that matter? It does not if the dominant position of non-commercials is purely that of arbitrageur. But if non-commercial activity becomes trend-setting, then we reach a point when commercial fire-power is exhausted and arbitrageurs can no longer compete with volumes.

Let us explain. Since prices are made at the margin, a small difference between net longs and net shorts is all that is needed to swing prices higher or lower. Thus the net position in any category is bound to be fairly close to zero with respect to the total open interest. For example of the 3 to 4 billion barrels of open interest before 2005, the prompt headline price was made by an average surplus or deficit amounting to 244,000 barrels a day only, with a maximum of 900,000 barrels a day. This is highly consistent with the physical operations of the oil markets. So it is no surprise to find that the commercials systematically had a higher net open interest than the speculators, and as such dominated the price-setting process. But since 2005 this has changed dramatically. Speculators' net average and maximum positions became much higher than that of commercials—by 2.9 million barrels and 7.8 million barrels respectively—while the net commercial barely changed at all. Summing it up, we can clearly say that since 2005 speculators have dominated the price setting mechanism in the crude oil market 70% of the time, while prior to 2005 commercials were setting the price 73% of the time.

Some may argue that speculators are as adept at figuring out what the fair oil price is as commercials, if not better. Perhaps. But the argument we are presenting really rests on two key issues:

- **That the commodity markets are there to set the day-to-day price that reflects fundamental supply demand balances.** The crude oil market is bound historically by a minimum of 11,000 barrels and a maximum of 1 million barrels a day. So commercials have neither the desire, nor need, to exceed these volumes. But speculators have and are now outweighing the market by between 2.9 and 7.8 million barrels above that of commercial activity throughout the curve. These barrels have nothing to do with supply-demand balances but simply reflect speculation activity.
- **That the forward curve acts as a price signal to expand future capacity.** If 80% of all open interest were concentrated in the first three futures month (again equal to secondary inventories), and the price was set by commercials, it ensues that the forward curve was a reflection of the discounted future marginal cost of production. Further out, the curve ought to be extremely stable. But now that 75% of all derivatives activity is concentrated beyond this (that is, beyond secondary inventories), the future curve is less stable.



It is hard to argue that what the fair price may be five years down the line is the best way to derive today's delivery fair price.

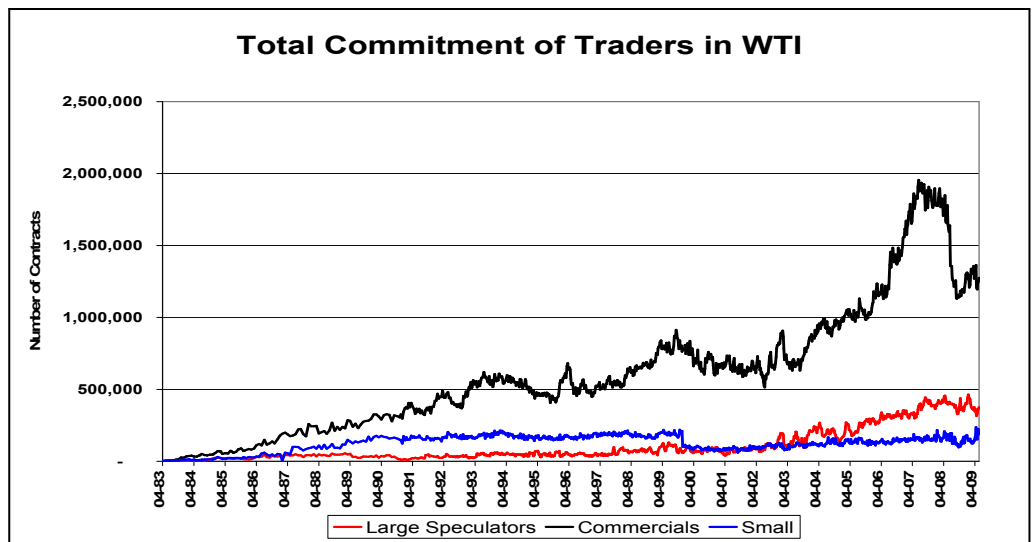
Clearly the exponential growth in long-only energy investment products had a big impact on oil prices.

Long-only investors add to the buy side in the futures markets, without every taking delivery of a physical barrel.

The overwhelming story of crude oil derivatives trading is that its function has radically changed from price discovery, according to immediate supply demand balances and secondary inventories, to the distant future marginal cost of production as perceived by non-commercials. In our view, this a complete reversal of the market's function. This may very well be a fair use of price-discovery, but it is hard to argue that what the fair price may be five years down the line is the best way to derive today's delivery fair price. And if commodity markets ought to be pricing distant fair value, then they are doing an extremely lousy job with the market being unable to decide whether the price ought to be 50% higher or 75% lower than a year ago, or anything in-between!

### 3- Do Commercials Have a Case to Answer?

As our readers may remember, the unsurprising reaction of US policymakers to rising oil prices was to drag the CEOs of Exxon, Conoco-Phillips and other oil companies in front of Congress for a good old-fashioned tongue-lashing. So are commercials really to blame? From our analysis above, we have found that commercials' behaviour has remained consistent through time and in accordance with their need. Yet if speculators' activity in the commodity markets has increased exponentially (4 times over since 2001), so did that of commercials in absolute terms.



Part of the rise in commercials' open-interest can be associated with a greater desire to hedge forward consumption at a time of rising prices. But lest we forget, consumer hedging is relatively tiny and in normal times represents only 20% of the consumer's total needs. That is because consumers have a limited amount of cash available for hedging, and prices can always go down. The dramatic increase in OTC derivatives, from an average of 3.3bn barrels in the decade prior to 2005 to 21bn barrels at the end of last year cannot thus be solely accounted by a desire to hedge consumption further on two counts, a) the increasing cost of hedging and b) extending duration from less than a quarter forward to over three-quarters.

So the most likely explanation is that the tremendous increase in OTC derivatives for commodities is leaking into the futures market and showing up into the commercials category. New instruments such as commodity indexing, ETCs and ETFs have grown exponentially in recent years, mainly as long-only instruments, and have created a new demand for futures. What indexation does is to add to the buy side of paper barrels, without ever owning or having to take delivery of the physical barrel. This is precisely how a price disconnect might have occurred, which dramatically changed the face of the commodity markets.

The desire to own paper barrels is equivalent to hoarding in many ways because, as long as accumulation occurs, it constantly raises the floor price. Indeed, while

If financial hedgers were not classified the same as physical hedgers, we would have a better sense of the role that non-commercials had on price.

Speculators have historically been good for commodity markets—but but long-only investors are not speculators in the traditional price-stabilising and liquidity-creating sense.

the pool of sellers has not increased (at least not by the same magnitude), the market loses its balance and bubble-like patterns can develop.

Sadly, the physical market price for the commodity gets affected since it is benchmarked to the futures price and the physical commodity price can become divorced from its underlying supply-demand balances pretty quickly.

Which takes us back to the definition of commercials. Is a commercial entity one that is considered a natural hedger of the underlying commodity, or a natural hedger, full stop? The two are not the same. Physical players hedge the underlying, but financial intermediaries hedge their financial exposure to the market, including their exposure to clients' OTC orders on the futures markets. And while financials leverage their entire portfolio, consumers have only limited need for hedging, usually the spot part of their uncertain consumption.

Let us assume that a \$100bn pension fund decides to have 2% of its capital exposed to crude oil markets. The pension fund has absolutely no desire to receive delivery of physical oil. Nevertheless, our fund may buy futures, or options, or swaps that are financially settled. With its \$2bn allocation and with a \$7,763 initial deposit margin, the fund can buy the equivalent of 257,000 futures contracts. That's the equivalent of one new consumer desiring to buy 257 million barrels above that of the world's natural consumption, without ever being interested in relinquishing its position. Things could be done differently if the fund does not want to suffer undue downside loss. In that case, \$2bn is allocated to buying at-the-money call options. So let's say that it buys in the distant future at a cost of \$12 a call. With \$2bn that's 166.6 million barrels of oil.

Once bought from the investment bank the fund can forget about it; its loss is capped at 2% of its total funds. On the other hand, the investment bank cannot forget about it since it now has an exposure to the oil market by being short. The ATM call forces it to immediately buy 50% of the volumes as futures to be delta neutral, i.e., hedged, resulting in an extra demand for paper barrels of 83,333 futures contracts that will have to be managed on a day-to-day basis. Meanwhile, as other financial institutions desire an exposure to commodities, the floor price is underpinned higher.

#### 4- Sifting the Grain From the Chaff

Over the past year, the 'evil speculator' (is there any other kind?) has been widely blamed in the general media for short-selling equities and for running-up the price of commodities. Undeniably, making an honest living out of speculation is harder than it was! As much as a speculator can be long commodities, another can be short, and ditto in equities. More importantly, with hindsight, the decision to ban short-selling was a disaster: it prevented any short-term rallies (when short-sellers cash out their gains) and killed a lot of arbitrage strategies (convertible arbitrageurs comes to mind).

Given this experience, policymakers should be very careful in any attempt at limiting speculation activity in commodities. New restrictions on speculators could have the unwanted effect of not only draining liquidity from the market, but also limiting the speed, and depth, of downward price adjustments (assuming that this is what policymakers are seeking)—the law of unintended consequences at work.

In the commodity markets, speculators have historically played a critical part in the price-discovery process by providing both liquidity, and arbitrage. In a sense, the old speculators were specialists who had the guts and wherewithal to correct price anomalies relatively fast. Thus, any regulation that specifically creates a large disadvantage for speculators will damage the ability of the markets to reach their true equilibrium.

For now the CFTC is taking the right approach in its proposal to create a fourth reporting category that would in effect return the commercial category to that of

**Imposing ad-hoc trading limits on speculators should only be considered after we know more, not before.**

**A better solution is to bring investor into the physical market. Investors desiring an exposure to commodities would receive ownership of the underlying from a physical owner.**

hedgers of the physical market, and put hedgers of the financials into a separate category. This will go a long way to understanding further the impact that non-physical players have on price, if any, and whether their activity adds value, is neutral or detrimental. Imposing ad-hoc trading limits on speculators should only be considered after we know more; not before.

In our view, the greater problem has been the creation of indexation products for the commodity markets. This is a serious problem that needs to be carefully examined. Indeed, if the overwhelming amounts of such instruments are purely long side (in terms of trading volumes) then de-facto, this creates an artificial pool of demand that has no natural seller to counter-weight. So while indexing is not wrong per-se, such indexing should perhaps have to be carried at full cost, i.e., zero leverage. In our view, the reason Gold ETFs only grew at a tiny fraction of other instruments is because buyers pay for the full price of ownership of the physical gold. For other ETFs and i commodities indices, buyers pay for the full amount but never take delivery of the physical, while the instrument is backed by futures for the purpose of following their price—such futures are leveraged 10 times over. In our view, indexation and ETFs should be private transactions that do not feed into the futures markets.

That may run counter to the whole argument of bringing the OTC market onto cleared exchanges, but it is not. While we definitely need greater transparency and reporting of OTC activity, we also need to clearly understand the major fact that the futures market are, to a greater extent, at the receiving end of the financial hedging requirement of OTC exposure. Commodity Indexation and Exchange Traded Commodities (or Funds) are OTC transactions that are hedged 100% with futures. But the transaction that these instruments bring to the regulated commodity markets add absolutely no value to the price discovery, other than to tell us that more investors are seeking price gains in commodities (which their very investment activity will bring as a self-fulfilling prophecy).

Investors in indices, ETCs and ETFs are not speculators in the sense that true speculators perform two key valuable functions: 1) they add liquidity both on the long and short side of the market, and 2) many of those are specialists who can arbitrage fundamental price mismatch. Investors do not perform any of that; all they do is to inflate the amount of paper barrels on the long side without adding paper barrels on the short side, thereby creating irrevocable imbalances.

It thus becomes necessary to divorce indexers from the futures markets to ensure the survival of the function of commodity exchanges—that of efficient and fair price discovery. But in order to avoid driving such investment “underground”, as is widely claimed, the creation and segregation of various classes of market participants must be enforced with strictly different rules. Since OTC exposure will always be hedged with futures it follows that margin requirement for investment products that put 100% upfront outlay in their investment cannot be hedged with a leveraged position. Take the case of a commodity index. The investor will buy at full cost the price of the index. The index provider will then use that income to purchase, one for one, futures contract but only with a 10% deposit margin, the rest of the money will likely sit in bonds, earning interest to the provider. To make matters worse the whole exercise is conducted tax-exempt, as it is deemed to be a natural hedge.

The solution is thus to bring investors into the physical market. Investors desiring an exposure to a commodity would receive ownership of the underlying from a physical owner. The easiest example is that of gold where investors in the gold ETF receive physical delivery in vaults. That gold can then be lent. For other commodities the old owner could keep the management of a commodity on behalf of the new owner, and the profit or loss will accrue to the investor. For example, with a market in contango there is a great need for working capital to buy and store oil against future delivery and capture the spread. The role of

**If we get creative, there are a number of ways to decrease the “long-only effect” of energy investors.**

**One way would be to increase margin requirements for those investors piling in on one side of the curve (physical hedgers are generally more neutral so would be less affected).**

investors is to provide that working capital, which can then be freed by the physical players to do their own investment. Thus investors would be back to their old role, and the physical market would benefit from their activity. Rather than receiving a fixed interest like debt, the investor could receive multiples of that, and this time from a pure physical commodity angle. To ensure that no hoarding takes place, physical players would declare their “owned on behalf of investors” activity, the play would lose its tax-exempt status, but in a creative way to ensure that it is beneficial to all. It could remain tax-exempt for a period of one month with tax gains escalating if the commodity is stored more than one year (unless it is strategic reserves)?

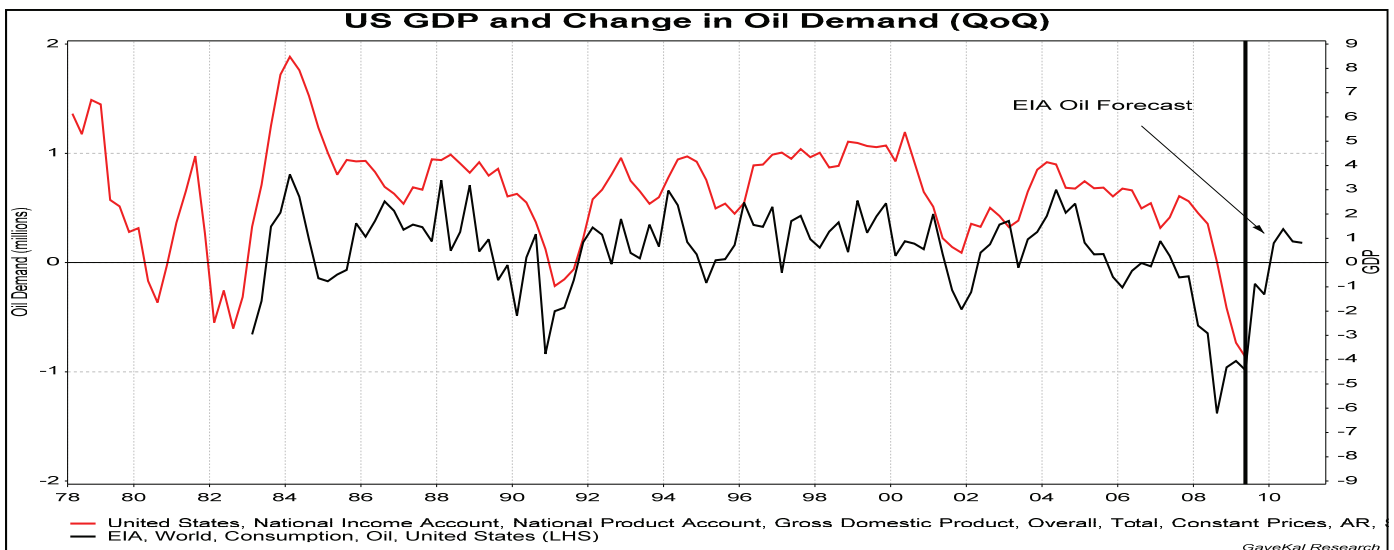
The treatment of savvier long-short players is more complex. To our great surprise, margin requirements on futures during the last bull run in 2008 only increased in the same proportion as the futures price, i.e., the margin stuck to about 10% of the underlying price. Margin rules could be a creative way to manage the various conflicts of interest. For example, non-commercials could be forced to increase their margin deposit according to the size they carry so as to constantly tighten the potential of any one-way building position. This is an important concept for the following reasons:

- 1) Natural hedgers by definition are more or less neutral in their position, and if they aren't they measure their exposure in volumes, not in dollars. Their exposure is the opportunity cost of future volumes loss, i.e., they own the volumes but may have to take a loss on those.
- 2) Non-commercials can and do build substantial positions and their exposure is measured in dollar losses. The more in profit they are, the more they can leverage, further aggravating market imbalances. One way to rectify such imbalances is to bring non-commercials closer to the natural behaviour of commercials without losing liquidity. A blanket position-limit policy seems blunt and inadequate.

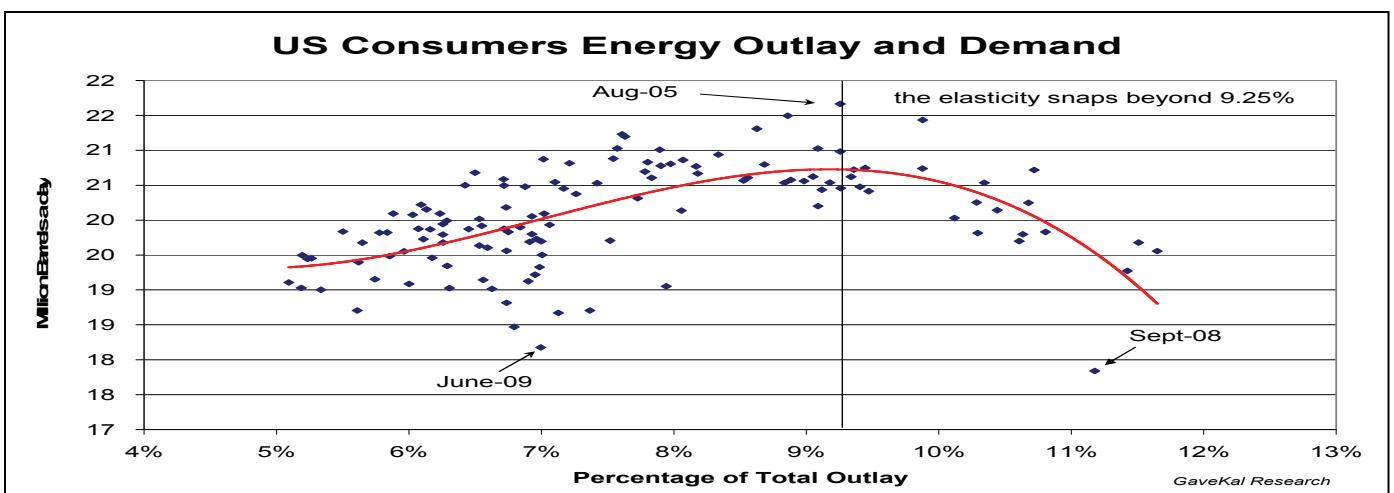
Whatever the CFTC comes up with, it will have to tread a fine line— as we saw earlier, it does not take much volume for price to swing one way or the other. What is clear is that since the absolute net position of non-commercials became larger than that of commercials, the market changed radically. Restoring balance without harming the market dynamics will not be easy. In our view there is a place for everyone in commodities—but if physical players continue to be marginalised, then the market will not work for anyone in the end.

## Can the Recovery Afford Higher Oil Price?

The financial crisis brought an unprecedented collapse in global industrial production—thus the recovery is being launched from a very low base, with potentially huge expansions on the cards. Oil prices, on the other hand, remain at a relatively high base. As the world’s industrial complexes begin refiring, will oil prices rapidly rise? And if so, can economies absorb them—or will oil prices damage the recovery process?



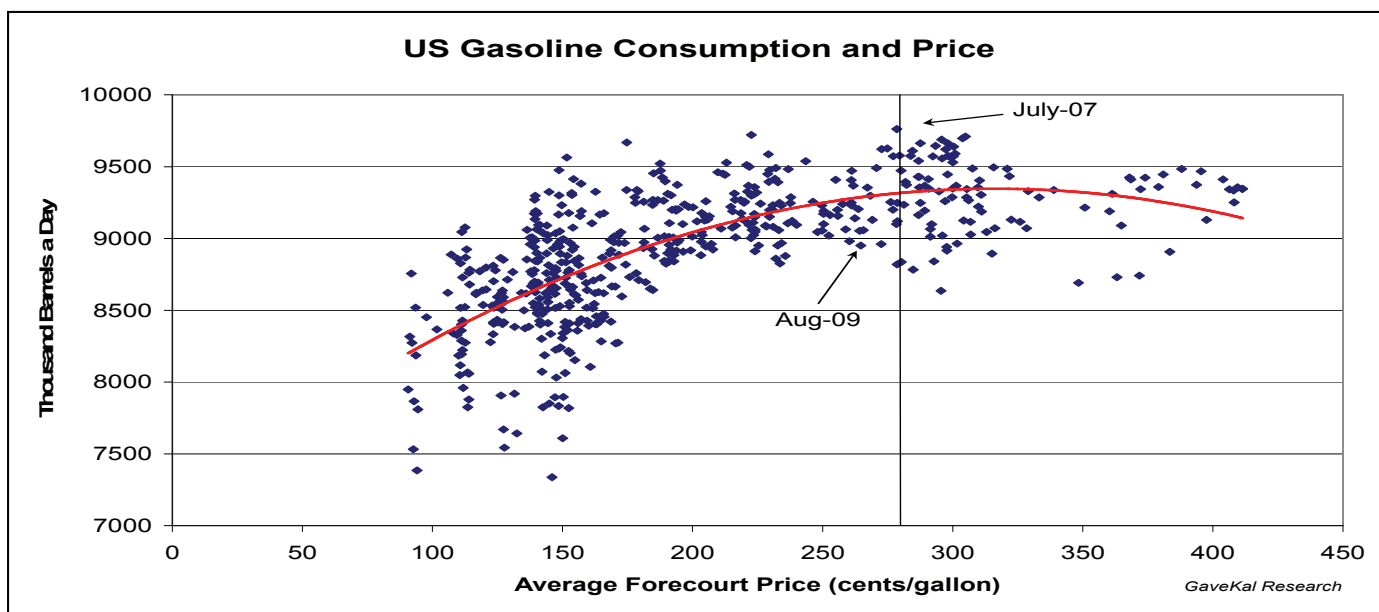
The EIA forecasts that by 2010, US demand will have increased by 1.68mn barrels a day from current levels. But what matters is where those extra barrels will be consumed. A breakdown by the American Petroleum Institute (API) shows that 70% of total oil consumption in the US is used in transportation, and of this we can safely estimate that at least 50% is for private motorists. Thus we need to ask—if oil prices begin rising on increased industrial demand, will demand then fall as motorists are forced by higher prices to drive less? As the chart below shows, the price elasticity of total demand in the US is a function of energy outlay as a proportion of total outlay. Whenever that ratio goes over 9.25%, US consumers cut their energy spending—and that cut can be substantial. In August 2005 the US reached an all-time consumption high of 21.66Mbd, breaching the 9.25% outlay threshold. In Sept-08—when the outlay increased to 11.2%—consumption was reined in dramatically, to 17.83Mbd. Our last data point, June-09, shows that demand has barely changed; it stands at 18.17Mbd despite the sharp drop in the outlay ratio to 6.9%. This would indicate that oil prices could go a lot higher (before hitting the 9.25% threshold). So, to get a better estimate of future upward pressure on oil prices, let us break down consumption by sectors....



## 1—Transport

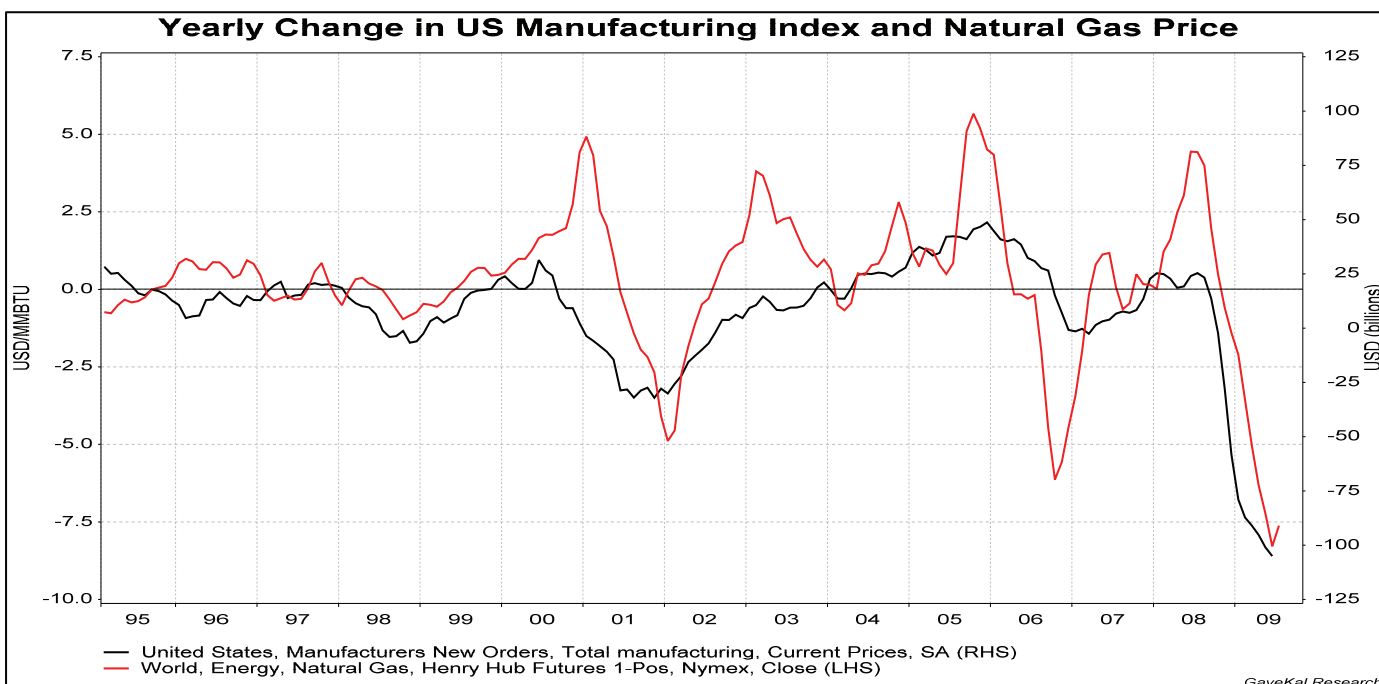
If we plot the average price of gasoline at the pump against demand, we see a drop-off in demand once the price goes beyond \$2.78/gallon (July-07). The average gas price in the US reached \$2.67/gallon as of last week—yet demand was -800,000 barrels below what it had been at the past when gas prices were at similar price levels.

In the summer of 2006, motorists were able to put up with \$3/gallon gas, but that was when the US economy was still growing at 3% p.a. In light of the current growth situation, combined with a gasoline price which is already dangerously close to our \$2.78/gallon threshold, it is hard to imagine private motorists' willingness to expand their consumption. Again transport forms 70% of US oil demand—and what is true for motorists is also even more true for commercial transport (trucks, rail, maritime and air).



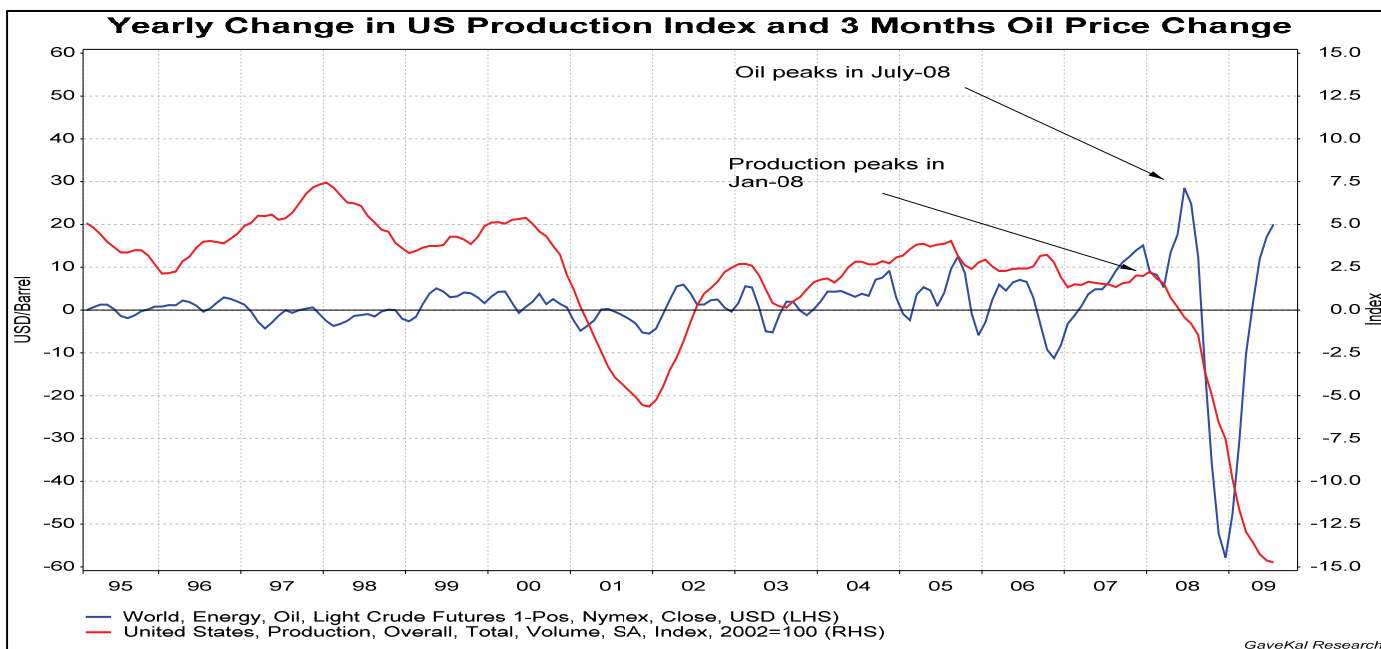
## 2—Commercial

Many light-industry and commercial activities (other than those related to transport) are not directly supportive of WTI prices. This is because these industries are mainly dependent on electricity and natural gas. Unlike oil, the price of natgas has not bounced back following last year's price collapse. In like-for-like energy terms, the natgas 6 month strip stands at the equivalent of \$35/bbl. This should come as a boon to those that can buy wholesale, yet electricity prices are already higher than they were last year despite lower natural gas prices. This shows that the natural gas price is a much better reflection of its supply and demand dynamics in the US (and not, like WTI, a reflection of international demand).



### 3—Industries

The outlook for large industries dependent on oil is not particularly bright. The US production index is just about bottoming now, but oil prices have already had a sharp bounce. If oil prices continue to rise, this will be very bearish for production expansion.



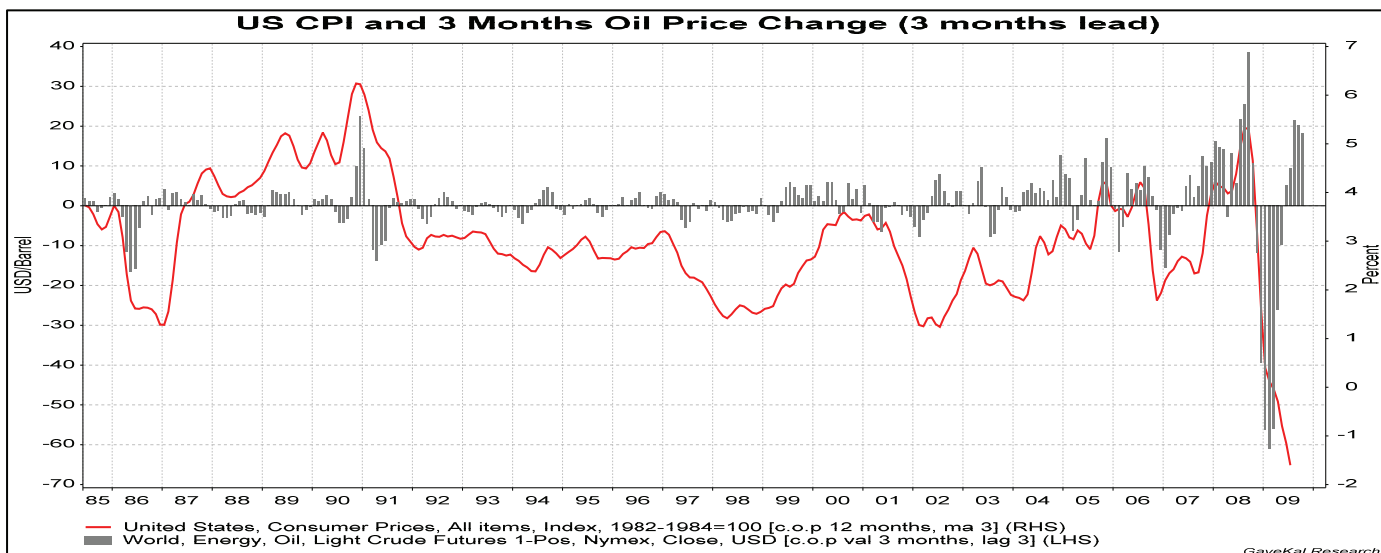
### 4—Conclusions

The first conclusion we can draw is that higher energy prices are ultimately deflationary! At least for growth...

The second conclusion is more of a question—and that question is whether oil futures have already priced in the recovery, or whether every new sign of recovery will push more bulls into the energy markets? If it is the latter, then production green shoots could quickly shrivel. This may partly explain why the CFTC is looking at ways to lock some financial players out of the energy markets (see [Speculators vs Investors](#)).

As to transportation consumption, there is the risk that prices will rise once “the lag effect” discussed earlier takes hold. The energy outlay of consumers is low today due to a mixture of high disposable real income (from negative CPI and cheap money), and low demand for energy. With the energy outlay-to-total outlay at just 6.9%—well below the 9.25% ratio at which consumers usually balk—there is still room for more upward pressure on prices.

The wild card is OPEC’s reaction—or more specifically, the production quotas set by Saudi Arabia, which holds the largest spare capacity in the world today (about 4.5Mbd). We tend to believe that Saudi Arabia’s interest is better served by cooling-off oil prices and keeping the recovery going—rather than expanding its short-term economic rent. We see \$85/bbl as the barrier at which Saudi’s begin to really ramp up supply—although we should not take anything for granted.



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## How the Accumulation of Futures Buying Can Permanently Affect Price—An Explanation

After last week's publication of [Speculators versus Investors](#), we received a number of questions about the affects of futures markets on energy prices. The usual question goes something like this: *"If for every buyer there is a seller, when I have to sell my futures length I do it to someone who wants the physical oil. So the act of buying futures cannot permanently affect the spot price because there is a buyer for physical on the other side. If there was no buyer then the price would go down"*. We will try to clear this up in the space below and we also have a [forum discussion](#) on this and related questions.

1. First of all, we have to remove the idea of someone wanting the physical oil. Futures are purely financial transactions—no physical oil changes hands. One cannot sell an expiring futures contract to someone who wants to take delivery of the actual product—physical transactions take place in a separate market. That physical market is however benchmarked to the futures market because commercial hedgers use futures to hedge; moreover, toward expiry, they may exchange their futures for physicals (a process known as EFP) and enter the dated market for physical, where they will have 15 days to trade physical before contract expiry (the Brent dated market). The volume of EFP activity is tiny, and because of this, market rules dictate that three days before futures expiry, no one can own more than a net 3,000 futures contracts (3mn barrels). This is to avoid market squeezes and allows spot and futures to converge price wise. Against that, the average open interest on the prompt futures is in the order of 350,000 contracts (350mn barrels) for a single exchange. The dated market will finally settle around the actual physical production out of the North Sea (Brent), and physical players will battle it out over the surplus or deficit that they have, or are likely to have, in any 5 to 10 day period. Historically, this surplus or deficit has ranged from as low as 13,000 to as high as 1mn physical barrels. Thus, the entire futures market transaction in the nearby contract leads into the dated market where the discovery of the fair price will be a function of a surplus or deficit. That is the essence of pricing the marginal barrel against which many producers around the world will benchmark their crude.
2. The process of rolling length forward is a zero-sum volume transaction. The original volume of futures bought has not disappeared—it has simply been rolled forward. But as more long-only investors enter the futures market, their activity constantly adds to the volume on the long side. True, for every buyer there is a seller—but **once the extra volume on the demand side exceeds that of the natural hedgers desire to sell forward, then upward price pressure ensues**. Speculators as we explained are there to add liquidity. More often than not they are specialists who will make their money on small price differences. For example, a specialist may be very happy to provide liquidity in a rising market by selling futures—not as a result of a trend-following strategy, but to take advantage of small windows of opportunity for spread arbitrage, etc. But as more and more investors enter the long side, the ability of specialists to provide liquidity diminishes. Thus long-only investors do not add liquidity to the market—on the contrary they create liquidity traps. This is because it is not the absolute volume rise that matters, but rather whether there is a fair balance between buyers and sellers. This was precisely what we used to have when commodity markets were mainly operated by commercials that are natural hedgers, where indeed for every seller of physical oil there was a buyer of physical oil, implying that trading volumes were a reflection of physical supply/demand balances rather than trend following. Liquidity was further enhanced by the activity of speculators and specialists that were as happy to be long as short. Trends in those days were short in duration (maximum 3 months), since it would not take that long for physical rebalancing, and as a result the price change was not great.

The above may read like a long and difficult answer so for a shorter answer, please consider the following:

There are on average 150mn barrels of long futures to settle every month in a single exchange. Against that the physical market cannot exchange more than the entire North Sea production (2.5mn barrels a day, or 75mn barrels a month), and in fact only exchanges a fraction of that. This implies that for every futures contract there clearly is not a physical buyer. This would not be a problem if the vast majority of these futures transactions were hedges since they would balance out, and the price change would be a fair reflection of supply/demand balances. **But it does matter if a growing proportion of the futures volume is not for commercial hedging purposes, because then the volume becomes skewed toward a price trend and the expectation of a greater price trend, thereby creating liquidity traps and ultimately bubble-like behavior.**