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PERSPECTIVES

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Oil Goes Negative. How?

It arrived too late in the month to be an April Fool's joke, and was here and gone in under a day, leaving most wondering if that really just happened, did the price of a barrel of crude oil really fall below zero? The answer is incredibly simple, it did, and it didn't.

Oil is a commodity, it has an inherent value in that it can be stripped into constituents, jet fuel, gasoline, plastics – a myriad of uses exist for oil. It also has value as a financial instrument, and traders are betting on the future price of oil all day and every day. Oil trades in a price per barrel, and you can place a wager on its value next month, and the next month, and onwards out for several years. What fell below zero in April was not the economic value of the barrel of oil, but what fell below zero was a financial contract in the trading pits of New York and London. And these are very different things.

When filling up your car, you may not think of how many times that fuel had changed hands before it ultimately became yours to burn. A refiner will have turned it into gasoline, the station will have held it for a while, and you were the ultimate consumer. Producing oil can be a costly venture, so locking in prices can be important, as this is the first step in that journey from ground to consumer. A producer wants to deliver a barrel in July, a refinery seeks to receive a barrel in July, they can work together in July, or they can purchase a contract to have oil delivered. Buyers and sellers can contract each other to do this, but the most efficient way to buy July oil – and a way to guarantee delivery – is to trade on the exchange.

The mechanics of April's oil price plunge were relatively simple, but quite esoteric. The quoted price that fell to nearly minus forty dollars a barrel was for May delivery, and the issue here was entirely structural. If you currently own a May contract, someone will deliver oil to you. You, in turn, need somewhere to store it, and storage became the price driver for the May contract, as there was nowhere to put the oil, at any price. The immediate economic value of a barrel of oil became overwhelmed by the simple question of where would you put the oil once you took delivery? In non-oil terms, owning a car is a genuine convenience, nobody is ever happy when they pay for parking, but the act of paying for parking does not mean the vehicle is suddenly worth less than nothing.

Throughout the dramatic plunge in the price of oil, it maintained all of its manufacturing uses, refineries were refining, drivers were driving, and polymers were spun. The economic value of oil remained relatively intact; the financial harm was limited to several exchange traded funds, hedge funds, and retail investors who were betting heavily on the value of oil appreciating, never expecting that the price and value of oil could dislocate so quickly and starkly. The phenomenon was short-lived; once the exaggerated forced selling was over, the value of the nearest-term oil contract rebounded to the high teens.

Futures contracts are inherently volatile, they require very little upfront investment and attract conventional users and speculators alike. Pricing in those markets relates to the real world economy but is not a guarantee of what is happening. Option prices can go negative, as we now know. Negative prices for commodities are an impossibility, though they make for interesting headlines. In the worst case, a barrel of oil is worth at least the barrel, as, outside of the futures markets, there will always be a real value to any commodity asset.

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