Futures Perspective
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From HO to ULSD:

The NYMEX division of the CME Group has announced that as a transition from heating oil to trading ultra low sulfur diesel fuel (ULSD) there will be no heating oil contracts listed beyond the April 2013 contract, with a last trading day of March 29, 2013. We hope this informational report will help you to understand and plan for this transition.

Why is the change being made?
The change in the futures trade is a reflection of ways that the physical market for mid-weight distillate fuels has evolved. The current New York Harbor heating oil contract allows sulfur content of up to 2,000 ppm for example, but New York City is mandating the use of ultra low sulfur fuel for new instillations, with a maximum of 15 ppm allowable. This matches the specification for ultra-low sulfur diesel (ULSD). We also note that diesel fuel consumption has increased its share of the market, with ULSD accounting for almost 82% of 2010 US total refinery distillate output. ULSD has become the US standard product, and NYMEX is changing its futures contracts to stay in step.

What will the change mean?
For those who use the futures market for hedging, the change from heating oil to ULSD will mean a shift in the basis – the spread between the cash price of the specific physical product being hedged in the location it is being stored or delivered and the futures contract used to hedge. High sulfur heating oil that traded in close correlation with the US harbor heating oil futures contract will likely trade at a discount to the new ULSD contract. On-road ULSD diesel fuel which has typically traded at a premium to the heating oil futures will likely trade closer to level. Jet fuel, keeping its relative value, would trade at a reduced premium over the new contract. Everyone who has used the heating oil futures contract as their hedging vehicle of choice would still be able to use the new ULSD contract just the same, just with some adjustment in the basis risk compared with before. For those hedging fuel in locations far from the New York Harbor market, the change in the basis may not even be particularly noticeable, given the variability in cash market values now.

For those using the markets as an investment or trading vehicle, the switch to trading USLD will likely be relatively seamless, mostly a matter of learning a new ticker symbol.

How will the transition work?

The transition from heating oil to ULSD will run very much like the migration from the unleaded gasoline contract to RBOB (reformulated blendstock for oxygenate blending). The two contracts will be available for trading side by side, but no new contracts will be listed in the contract being discontinued. As the heating oil contract runs out of months to trade, volume and open interest will gradually shift into the new ULSD listing. In the case of heating oil, the last contract listed is for April 2013 delivery, with the last trading day of March 29, 2013. In other words, the current heating oil contract will still be available to hedge the 2012-13 heating season, but heating oil distributors looking to hedge future winters will need to use the ULSD contract.

Although each market has distinct characteristics, when the transition from unleaded gasoline to RBOB took place, the last contract listed was for January 2007, with trade ending in December 2006. In terms of open interest, the unleaded contract became the smaller market and the new RBOB contract became the larger in late August. In terms of trading volume, the crossover between the two contracts occurred in mid September, when RBOB turnover overtook the volume of trade in unleaded. This experience suggests that we should look for a similar transition 3-4 months before the last of the heating oil trade. By December 2012 or so, more of the trading volume and open interest will be likely reside in ULSD.

As one more key element, we should be on the alert for how ETF or index fund managers opt to handle the transition. We've already seen one statement from Barclays Capital, for example, that they plan to use the heating oil futures prices only through the March 2013 contract, presumably to sidestep any risk of unrepresentative pricing that could occur in the final April trade. We would not be surprised to see some index funds opt to use ULSD from the start of 2013 when they make their asset allocations.

How Citi will help

Once we begin seeing some ULSD trade, we'll begin featuring regular updates on heating oil and ULSD volumes and open interest as a regular part of our *PM Energy News & Views* reporting, so that you'll always know where the liquidity is during this important transition over the coming year.

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