CME Group, owner of the NYMEX, today reported (a formal announcement is scheduled in two weeks) a plan to institute a new 15 ppm (0.0015%) sulfur content maximum for its Heating Oil (HO) contract starting with the May 2013 delivery month (the current contract has a 2,000 ppm maximum). The company will seek authorization from the CFTC for the specification change. After the change is authorized, CME plans to list HO contracts for months past April 2013.

As background, the CME in January 2011 listed the LH contract (15 ppm sulfur diesel) alongside the HO contract, but it has failed to attract any trading volume. For now, the CME is saying it will keep both the HO and LH contracts available for trading…even though both contracts are for the same delivered product in New York Harbor!

It might have been expected that, given time, the ULSD contract would attract equal if not greater liquidity than the HO contract, but more than a year later it remains still virtually untraded, attracting minimal market attention. Somewhat surprisingly, even the fund/speculative community has not been interested enough to generate a forward market even for a commodity as basic as ULSD, constituting a far larger proportion of the nation's distillate consumption than traditional high sulfur Heating Oil.

The problem has been that without a viable forward contract, prospective buyers and sellers of distillates beyond April 2013 have had no convenient ability to hedge.

So what has changed today?

On one hand, the discussion of when HO will die and volume transfers to LH has become a moot point. We suspect that traders (most of who are speculators) won't bother trying to jump off the horse they've ridden for years and keep their trading volume in the HO contract instead of switching to LH. Given the fact that speculative trading is the CME's breadwinner, it wouldn't be surprising to see LH go away entirely and be de-listed sometime down the road.

On the other hand, hedgers of the traditional high-sulfur heating oil will still need to deal with a change in historical basis patterns between the "futures market" and local cash market pricing. Given the historical 4-6 cent price premium for ULSD versus HS #2 (desulfurization costs) in the NY Harbor cash market, we expect that prices for high sulfur product at the racks will appear even closer to the NYMEX HO value. Generally speaking, weaker basis patterns are possible (assuming no change to supply/demand fundamentals). For some racks, the chance even exists to see negative basis levels versus NYMEX HO.

As a reason for the apparent decision, the CME cites customer requests and the lack of liquidity in the ULSD contract, as well as the general move toward lower sulfur heating fuels in the Northeast, exemplified by NY State's pending switch to 15 ppm effective this July. What is not clear is why continuing the Heating Oil contract beyond April 2013 but with the same reduced sulfur specs as applied to the ULSD contract will make a significant difference. Anything that helps increase or speed up the liquidity that is bound to come eventually as the end of the existing HO gets closer, whatever the new contract is called, is positive, but it is difficult to see how essentially a name change will help.

In either case, that part of the hedging community involved with the continuing supply of higher sulfur heating oil outside New York State will need to come to grips with the basis risk between the post Aril 2013 ULS grade and the traditional max 2,000 ppm product which largely makes up heating fuel requirements in the rest of the Northeast. Although this has run historically in the 4-6 cent range that reflects desulfurization cost, it can vary widely depending on supply and demand factors affecting either grade at any given time. This will certainly add to the uncertainty of generating a forward market for the higher sulfur product.

Stay tuned.