Streetwise Professor

Was "Oil Leak" the Culprit in Crude Market's Steep Drop?

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The regulatory and trading world is all up in arms over the big price drops September 17 in West Texas Intermediate and Brent crude oil prices, along with gasoline and heating oil futures.

Was it caused by a "fat finger?" A runaway algorithm? Round up the usual suspects!

I say none of the above, especially in light of a September 18 Financial Times report that Saudi Arabia is going to increase oil output.

The price pattern was not typical of a liquidity event, such as arises from a trading or algo error. In such an event, the price usually retraces quickly to its pre-error level. That is, price impacts are almost purely transitory if it is understood that the order was an error, or simply a demand for liquidity.

Indeed, a paper written in 2009 by Bahattin Bayuksahin, Michael Haigh and Jeffrey Harris documents that prices of trades subsequently identified by the exchange as errors reverse well before the official announcement – meaning, the market participants figure it out on their own.

In the oil market's tumble earlier this week, the price fell dramatically then only partially recovered. Thus, there was a persistent/permanent component to the price move. This combination of temporary and persistent price impacts means that market participants viewed that there was some likelihood that the order or orders was or were submitted by somebody with private information.

(The fact that the move occurred on all major energy markets simultaneously supports that view, although with algorithmic trading one cannot be as confident — one can be more confident it wasn't four or five fat human fingers).

Put that together with the Saudi announcement (into which they were probably dragooned by a threat from the International Energy Agency and the administration to tap the Strategic Petroleum Reserve) **and the most likely explanation is that the announcement was leaked, or that the individual or individuals behind the decision decided to act on the information.**

And they did make money, because prices traded off more after the story was released publicly.

Therefore, in my opinion this was the result of an "oil leak" — somebody spilled the news of the Saudi decision, and that triggered a big trade that pushed down prices.

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