ANALYSIS-Wall Street's commodities trading under fire, rivals creep in

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By Jeanine Prezioso

NEW YORK, July 24 (Reuters) - Just as Wall Street's commodity titans face intensifying pressure over their trading operations, nimble rivals are stepping up efforts to chip away at their bedrock business of financing the world's raw materials industry.

Minutes before senators in Washington began questioning why the biggest U.S. banks were straying so deeply into the murky world of commodities, privately owned merchant trading group Freepoint Commodities announced on Tuesday it had completed its first deal to finance oil and gas output.

The Volumetric Production Payment, a once-popular type of structured deal created by Enron and eagerly adopted by Wall Street, was a timely illustration of how merchants are pushing deeper into traditional banking territory while regulators threaten to make it harder for behemoths like JP Morgan and Goldman Sachs to compete in physical markets.

While the merchants, many like Freepoint now backed by private equity and staffed by former bank traders, are unlikely to be able to match the funding rates that the banks provide, the deal served as a reminder of why banks are so determined to maintain the oil traders, power schedulers and metals brokers that allow them to combine deep market insight with low-cost capital.

"The size and complexity of this transaction demonstrate the ability of Freepoint's platform to deliver customized financing solutions to the upstream oil and gas sector," according to Freepoint's head of structured finance Brian Cumming, who worked for Deutsche Bank until last year.

The Senate Banking Committee questioned experts and lawyers about whether commercial banks should control oil pipelines, power plants and metals warehouses, and be able to use such infrastructure to trade commodities.

The hearing came just days after the Federal Reserve shocked the industry by saying it was reviewing a landmark 2003 decision that first allowed commercial banks to trade raw materials.

For banks already coping with new regulations barring proprietary trading and raising capital requirements, the political focus on commodities is an unwelcome reminder that competitors like Freepoint and its Stamford, Connecticut neighbor Castleton Commodities are waiting in the wings.

"We have seen private equity get into the space," said Elizabeth McGinley, a partner in the tax practice at law firm Bracewell & Giuliani in New York, adding that it used to be largely banks who did VPPs.

PHYSICAL TRADE

Banks have long argued that they can offer clients better and cheaper services if they are able to buy or supply the same raw materials that their customers use or produce.

Allowing commercial banks to trade in spot raw material markets "likely would benefit customers" as banks could deal in a "wider variety" of markets and products, the Federal Reserve said in a letter to Citigroup in 2003, when it granted the bank permission to trade in physical markets.

It would also allow the banks to "improve their understanding of commodity derivatives markets and the profitability of their existing" businesses.

Freepoint's VPP deal, which gives the buyer access to physical supplies without the risk entailed in producing the oil or gas, will allow it to purchase a set amount of oil and gas from private producer Elm Ridge Exploration Co LLC, with the volumes to be delivered over an 11-year period.

The production will come from a pool of nearly 1,000 wells in the San Juan producing basin in New Mexico and Colorado. Elm Ridge produced and sold some 2.7 billion cubic feet of gas this year through May, according to data from the Colorado Oil and Gas Conservation Commission.

Enron had pioneered the deals because "not only did they look at it as a financing tool they realized they could make money on the production," said Jeff Munoz, a partner in the oil and gas mergers & acquisitions practice at law firm Latham & Watkins in Houston.

VPP deals gained notoriety in recent years after banks including Goldman Sachs, Deutsche Bank and Barclays put up billions of dollars to fund the expansion of oil and gas production of companies like Chesapeake Energy .

TRADER SHOCK

Since the financial crisis, rivals have been predicting banks' retreat from the commodities markets, a high-margin business increasingly seen as non-core for many. A number of banks have cut back significantly and some have exited. Total commodity revenue for the 10 top banks fell to around $6 billion last year, one-third of its peak in 2008 and 2009.

Started in 2011 by former RBS Sempra Commodities executives, Freepoint has been built largely on a bet that retreating banks would leave behind business for merchants. Last month Freepoint closed a financing for a coal company. In March it completed the purchase of natural gas wells from a Canadian company.

It has been in hiring mode, most recently looking to add originators in oil, to market the production of smaller oil companies, according to a commodity industry recruiter who did not want to be identified because of ties to the industry. Freepoint officials were not immediately available to comment.

Private equity firm Riverstone Holdings LLC is also said to be growing a $1 billion commodities business led by Deutsche Bank former head of commodities David Silbert.

But the opportunity to take financing business away from Wall Street appeared to expand significantly over the past few weeks, with growing public awareness and political pressure over multibillion-dollar commodity businesses long out of the public eye.

The Fed's surprise statement last Friday offered the hope of an even wider opening, if it decides to row back the decade-old decision that commercial banks can trade raw materials.

"I was completely shocked by that," said one senior executive with a trading merchant. "We've anticipated and expected their business to come under pressure around the Dodd-Frank regulations, swap dealer rules, maybe even ownership of hard assets like power plants. Those things we expected."

The Fed review "takes it to a whole other level."

COME ON OVER TO THE UNREGULATED SIDE

Both the physical and financial commodity trading business is falling into the hands of unregulated commodities trading merchants, the likes of Glencore , Vitol [VITOLV.UL], Mercuria and Trafigura [TRAFGF.UL], all based in Switzerland, who have their fingers on every point of the commodity value chain.

Those trading houses are largely unregulated and unfettered by government restrictions that have all but sunk commodities businesses at banks that took decades to build.

"They are driving the people who know the space very well within the banking community out of the industry and out of the regulated environment and they are really holding out a carrot and saying, 'Come over to the deregulated side,' because there won't be the same scrutiny of their activities," said one executive at an Australian bank.

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