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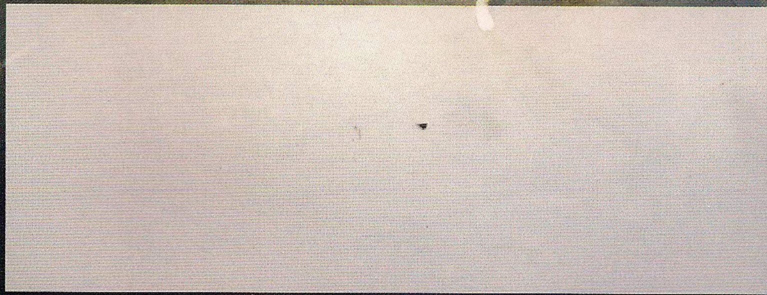

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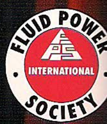

Stranger Than Fiction: The Truth About OIL PRICES

A couple of months ago, we talked about the fluctuating world price of oil and how it affects prices at the pump. In that column we talked mostly about supply and demand and mentioned how oil is traded as a commodity. Well, there is a lot more to that story. A whole lot more.

CBS-TV's program *60 Minutes* has been a reliable and informative show for decades, giving in-depth reports on a variety of topics. In a segment aired in January 2009, CBS correspondent Steve Kroft showed that commodity traders--and not oil supply or market demand--were responsible for sharp climbs in fuel prices. The broadcast was revealing and surprising.

Over a one-year period, the price of oil went from $69 per barrel to nearly $150 and then in just three months collapsed with the stock market. Kroft reports, "Many people believe it was a speculative bubble, not unlike the one that caused the housing crisis, and that it had more to do with traders and speculators on Wall Street than with oil company executives or sheiks in Saudi Arabia."

Kroft explains, "To understand what happened to the price of oil, you first have to understand the way it's traded. For years it has been bought and sold on something called the Commodities Futures Market. At the New York Mercantile Exchange, it's traded alongside cotton and coffee, copper and steel by brokers who buy and sell contracts to deliver those goods at a certain price at some date in the future."

Dan Gilligan is the president of the Petroleum Marketers Association who represents more than 8,000 retail and wholesale suppliers, everyone from home heating oil companies to gas station owners. When *60 Minutes* talked to him last summer, Mr. Gilligan said his members were getting blamed for gouging the public, even though their costs had also gone through the roof. He told Kroft the problem was in the commodities markets, which had been invaded by a new breed of investor.

Gilligan said these investors don't actually take delivery of the oil. "All they do is buy the paper and hope that they can sell it for more than they paid for it. The volatility is being driven by the huge amounts of money and the huge amounts of leverage that is going into these markets."

About the same time, hedge fund manager Michael Masters reached the same conclusion. His expertise is in tracking the flow of investments into and out of financial markets, and he noticed huge amounts of money leaving stocks for commodities and oil futures, most of it going into index funds, betting the price of oil was going to go up.

When *60 Minutes* asked who was buying this "paper oil," Masters told Kroft, "The California pension fund. Harvard Endowment. Lots of large institutional investors. And, by the way, other investors, hedge funds, and Wall Street trading desks were following right behind them. Sovereign wealth funds were putting money in the futures markets, as well. So you had all these investors putting money in the futures markets. And that was driving the price up." Twenty-seven barrels of crude were being traded for every one barrel of oil consumed.

In a five-year period, Masters said the amount of money institutional investors, hedge funds, and the big Wall Street banks had placed in the commodities markets went from $13 billion to $300 billion. Last year, 27 barrels of crude were being traded every day on the New York Mercantile Exchange for every one barrel of oil that was actually being consumed in the United States.

CBS News points out, "A recent report out of MIT, analyzing world oil production and consumption, also concluded that the basic fundamentals of supply and demand could not have been responsible for last year's run-up in oil prices. And Michael Masters says the U.S. Department of Energy's own statistics show that if the markets had been working properly, the price of oil should have been going down, not up.

As an example, the price of oil jumped $25 in a single day. That day was Sept. 22. Michael Greenberger, a former director of trading for the U.S. Commodity Futures Trading Commission, the federal agency that oversees oil futures, says there were no supply disruptions that could have justified such a big increase.

"Everybody agrees supply-demand could not drive the price up $25, which was a record increase in the price of oil. The price of oil went from somewhere in the 60s to $147 in less than a year. And we were being told, on that run-up, 'It's supply-demand, supply-demand, supply-demand,'" Greenberger said.

"From quarter four of '07 until the second quarter of '08 the EIA, the Energy Information Administration, said that worldwide supply went up and worldwide demand went down. So you have supply going up and demand going down, which generally means the price is going down," Masters told Kroft. "So you had the largest price increase in history during a time when actual demand was going down and actual supply was going up during the same period. However, the only thing that makes sense that lifted the price was investor demand."

Is there price manipulation by these huge investors? The Petroleum Marketers Association President Dan Gilligan told Kroft, "I can't say. And the reason I can't say is because nobody knows. Our federal regulators don't have access to the data. They don't know who holds what positions…federal law doesn't give them the jurisdiction to find out."

Kroft adds, "Most of the trading is now conducted in secret, with no public scrutiny or government oversight. Over time, the big Wall Street banks were allowed to buy and sell as many oil contracts as they wanted for their clients, circumventing regulations intended to limit speculation. And in 2000, Congress effectively deregulated the futures market, granting exemptions for complicated derivative investments called oil swaps, as well as electronic trading on private exchanges."

There is more to this story, and for a complete transcript of the *60 Minutes* Program, visit our website (www.askthefuelexpert.com).

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