The reason behind high oil prices

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Synopsis
It's not supply crisis that explains the sharp spike in oil prices. It's unregulated commodities markets and greed. **Gainers & Losers** | **Rising food prices** | **Day in Pics**

By: Ed Wallace

"One of the things I think is very important to realize is that the growth in the world oil consumption is not that strong." -David Kelly, chief market strategist, J P Morgan Funds; The Washington Post, May 4, 2008

"...There is substantial evidence that the large amount of speculation in the current market has significantly increased [oil] prices." -US Senate Staff Report, The Role of Market Speculation in Rising Oil and Gas Prices, June 27, 2006

On May 13, the price of a barrel of oil briefly hit a record of $126.98 on the New York Mercantile Exchange The reason was ostensibly that Iran was cutting oil production. But there is no gas shortage. So why are prices still going up?

In late April the American Association of Petroleum Geologists held its annual invitation-only conference in Dallas for, as my source put it, "the bigwigs" of the energy industry. During this meeting, influential and knowledgeable CEOs reached the consensus that "oil prices will likely soon drop dramatically and the long-term price increases will be in natural gas." Of course, despite the pedigrees of those in attendance, their forming a consensus on the direction of energy prices does not mean that it's written in stone or is even going to happen. The group is clearly bullish on

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The energy executives' prediction about the future price for crude oil had sound backing. Just a few days earlier, Lehman Brothers (LEH) investment bank had said that this current oil pricing boom was quickly coming to an end. Michael Waldron, the bank's chief oil strategist, was quoted in Britain's Daily Telegraph on Apr. 24 as saying: "[Oil supply] is outpacing demand growth." Waldron added, "Inventories have been building since the beginning of the year. The Saudi Khursaniya field has just opened, with 500,000 barrels a day of production, and the new Khurais field will start next year with a further 1.2 million b/d [barrels a day]."

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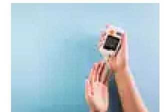
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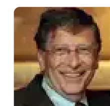
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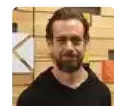
Jack Dorsey
Entrepreneur

No lines at the pump

Waldron's assertion rang true. In the US alone, stockpiles of oil climbed by 11.9 million barrels in the month preceding the Energy Information Agency's (EIA) May 7 inventory report; they were up by nearly 33 million barrels since January 1. At the same time, MasterCard's (MA) May 7 gasoline report showed that gas demand has fallen by 5.8%, while the government suggested that gasoline consumption might have fallen by slightly over 6%.

We do know that refineries in the U.S. again cut back their utilization to 85%. That's down from 89% a year ago, in a season when production is normally 95%, only because they're trying to draw down gasoline inventories to bid gasoline prices up. Yet despite the reduced refinery runs, the EIA said, the US managed to put another 800,000 barrels of gasoline in stock. The American Petroleum Institute put the gas gain at 1.4 million barrels. The point is that neither organization is in disagreement that gasoline was added into our active stocks; it's just a question of exactly how much.

Only the day before, the EIA had released its monthly Short Term Energy Outlook report, concluding that US oil demand is expected to decline by 190,000 b/d in 2008. Chinese consumption is expected to rise this year by only 400,000 b/d-hardly the "surging oil demand" usually blamed on China in the media. Last year China imported 3.2 million barrels per day, and its estimated usage was around 7 million b/d total. The US, by contrast, consumes around 20.7 million b/d.

The May 8 report from Oil Movements, a British company that tracks oil shipments worldwide, shows that oil in transit on the high seas is quite strong; almost every category of shipment is running higher than it was a year ago. The one exception was oil shipments to the West during the previous 30 days. Even there, on page three of that report, comes the cryptic line, "In the West, a big share of any [oil] stock building done this year has happened offshore, out of sight." Oil Movements' Roy Mason qualified that line: "Oil in temporary floating storage offshore is hard to pin down, and we don't have useful info on that. Whenever this happens it generates market noise-and we don't hear any!"

Still, the consensus of the American Association of Petroleum Engineers and the energy executives may be right: No supply crisis justifies the way the world's oil is being priced today.

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the fact that few other oil analysts agreed with that position, "$200 a barrel!" was the major news story on oil for the next two days. Arjun Murti, Goldman Sachs' energy strategist, predictably laid the blame on "blistering" demand from China and the Middle East, combined with his belief that the Middle East is nearing its maximum ability to produce more oil. While the outside chance exists that Murti is right, his prediction certainly isn't backed up by the EIA's Short-Term Energy Outlook, or by Lehman Brothers' report from 10 days earlier. As for the Middle East being tapped out on oil production, there might be one more thing to consider.

On May 2, the Friday before this prediction made news, Bloomberg had reported that Iran is again storing its heavy crude on tankers in the Persian Gulf because the country has run out of onshore storage tanks while awaiting buyers. Further, Saudi Arabia has extended discounts on its sour crudes to $7.45 for Arabian Heavy. Doesn't sound like there's any real supply problem with that grade of crude, does it?

It is an understatement to say that over the last five years the media have rained reports predicting an impending energy Armageddon. But those reports have tended not to disclose their sources-which often were individuals heavily invested in the oil futures market.

For example, Goldman Sachs was one of the founding partners of online commodities and futures marketplace Intercontinental Exchange (ICE). And ICE has been a primary focus of recent congressional investigations; it was named both in the Senate's Permanent Subcommittee on Investigations' June 27, 2006, Staff Report and in the House Committee on Energy & Commerce's hearing last December. Those investigations looked into the unregulated trading in energy futures, and both concluded that energy prices' climb to stratospheric heights has been driven by the billions of dollars' worth of oil and natural gas futures contracts being placed on the ICE-which is not regulated by the Commodities Futures Trading Commission.

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Deceptive practices

In case you've forgotten, it was only 2001 when BusinessWeekreported that some Wall Street firms were hard-selling to the public stocks that their companies were quietly divesting-and/or pushing questionable stocks for companies in which their affiliated banks had a financial interest. In a nutshell, some individuals with a specific vested interest in a certain financial outcome used the media to enrich themselves and their companies, leaving the public investor holding the bag.

Once that deception was uncovered (after the stock market collapsed), and after the congressional hearings in 2001 proved beyond any doubt that these things had happened, the national media swore that they would never again be taken in by this type of corporate deceit. Then came 2004 and oil.

As the second quote at the beginning of this column makes clear, the Senate pointed out in its 2006 report that oil reserves (not including the Strategic Petroleum Reserve) were at a 20-year high during the time that report was

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oversupply problem in fall of 2006.

Then, as now, that certainly isn't what we were being told. Instead we were being bombarded daily in the media and analysts' reports with justifications for the high price of oil: The "terrorism premium" on each barrel of oil, the rising demand of China and India, troubles in the Nigerian oil patch, oil pipelines' being blown up in Iraq, wider war in the Middle East, T. Boone Pickens' warnings that the world was on the cusp of Peak Oil, "surging demand" for gasoline in

reserves. It is not maximum production.) However, the Senate took a dim view of those excuses, particularly the ones about Peak Oil or diminished capacity for oil production: "There's a few hedge fund managers out there who are masters at knowing how to exploit the peak [oil] theories and hot buttons of supply and demand, and by making bold predictions of shocking price advancements to come, they only add more fuel to the bullish fire in a sort of self-fulfilling prophecy." (The Role of Market Speculation in Rising Oil and Gas Prices, US Senate, June 27, 2006).

Yes, this line suggests that persons invested in the oil futures market are purposely driving even more money into oil to raise the prices even higher, even though the market's actual supply and demand in no way justifies their claims. On a side note, Enron is named frequently in both investigations as exemplifying this type of energy market manipulation.

And, although both the Senate and the House have already investigated why oil is selling for more than supply and demand dictate, on May 12 we found out that the House Energy & Commerce Committee will look at this issue once again this month and into June.

Let's give Congress a little direction.

Covering their losses?

Commodities have often been the refuge for investors who have lost money on equities or fixed-income investments. Moreover, the commodities rush today is not limited to oil; now we also have runaway food and feed prices. Could it be that all the financial losses on subprime mortgages, plus the anticipation that the option ARM mortgages about to reset could be an even bigger problem, combined with the huge losses in securities last year, are why investment money today is flooding into often unregulated commodities, where the demand pricing of the final goods is inelastic?

Consider this: You may not buy gasoline or even eat today, but by next Monday you'll probably have to do both, no matter what it costs. Basically, besides enabling the Fed to bail out Wall Street and our banks again, every time you gas up or eat you may be paying investors to cover other financial losses. We know that investors can't control their losses on mortgages, securities, or bad loans. But, demonstrably, if not restrained they can drive up the price of goods that we can't get out of buying. Odds are, that's what's really been going on.

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