# How does oil speculation raise gas prices?

by Josh Clark

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The next time you drive to the gas station, only to find prices are still sky high compared to just a few years ago, take notice of the rows of foreclosed houses you'll pass along the way. They may seem like two parts of a spell of economic bad luck, but high gas prices and home foreclosures are actually very much interrelated. Before most people were even aware there was an economic crisis, investment managers abandoned failing mortgage-backed securities and looked for other lucrative investments. What they settled on was oil futures.

An **oil future** is simply a contract between a buyer and seller, where the buyer agrees to purchase a certain amount of a commodity -- in this case oil -- at a fixed price [source: CFTC]. Futures offer a way for a purchaser to bet on whether a commodity will increase in price down the road. Once locked into a contract, a futures buyer would receive a barrel of oil for the price dictated in the future contract, even if the market price was higher when the barrel was actually delivered.

As in all cases, Wall Street heard the word "bet" and flocked to futures, taking the market to strange new places on the fringe of legality. In the 19th and early 20th centuries it bet on grain. In the 21st century it was oil. Despite U.S. petroleum reserves being at an eight-year high, the price of oil rose dramatically beginning in 2006. While demand rose, supply kept pace. Yet, prices still skyrocketed. This means that the laws of supply and demand no longer applied in the oil markets. Instead, an artificial market developed.

Artificial markets are volatile; they're difficult to predict and can turn on a dime. As a result of the artificial oil market, the average price per barrel of crude oil increased from $31.61 in July 2004 to $137.11 in July 2008 [source: DOE]. The average cost for a gallon of regular unleaded gas in the United States grew from $1.93 to $4.09 over the same period [source: DOE].

So what happened?

## Oil Speculation Basics

As oil prices (and, by extension gas prices) suddenly soared, the world was caught off guard. Competing theories seeking to explain the sudden rise emerged. Perhaps the world had finally hit **peak oil** -- the point where oil production inevitably begins to decline due to the finite amount of oil on the planet. That argument was undermined by the amount of oil left in reserve; supply still exceeded demand. Others pointed to geopolitics. Unstable nations or countries hostile to the West like Nigeria and Venezuela are depended on to supply much of the world's oil. Perhaps it was instability that was causing volatility in the markets. Michigan Sen. Carl Levin pointed out during a hearing on energy, "Without doubt, much of our oil comes from unstable parts of the world. But that is nothing new; it's been that way for decades" [source: Levin].

The more Congress and market watchers looked into the rise in oil prices, the more it looked like oil speculation was responsible.

Everything that can be bought or sold has what 18th-century political economist Adam Smith called a **natural price**. This price is the sum total of the values of everything that came together to create the product or service. Raw materials, labor, distribution -- all of these add to the natural price of a product.

Any amount that the seller of a good or service can get above this natural price is profit.

What speculators do is bet on what price a commodity will reach by a future date, through instruments called **derivatives**. Unlike an investment in an actual commodity (such as a barrel of oil), a derivative's value is based on the value of a commodity (for example, a bet on whether a barrel of oil will increase or decrease in price). Speculators have no hand in the sale of the commodity they're betting on; they're not the buyer or the seller.

By betting on the price outcome with only a single futures contract, a speculator has no effect on a market. It's simply a bet. But a speculator with the capital to purchase a sizeable number of futures derivatives at one price can actually sway the market. As energy researcher F. William Engdahl put it, "[s]peculators trade on rumor, not fact" [source: Engdahl]. A speculator purchasing vast futures at higher than the current market price can cause oil producers to horde their commodity in the hopes they'll be able to sell it later on at the future price. This drives prices up in reality -- both future and present prices -- due to the decreased amount of oil currently available on the market.

Investment firms that can influence the oil futures market stand to make a lot; oil companies that both produce the commodity and drive prices up of their product up through oil futures derivatives stand to make even more. Investigations into the unregulated oil futures exchanges turned up major financial institutions like Goldman Sachs and Citigroup. But it also revealed energy producers like Vitol, a Swiss company that owned 11 percent of the oil futures contracts on the New York Mercantile Exchange alone [source: Washington Post].

As a result of speculation among these and other major players, an estimated 60 percent of the price of oil per barrel was added; a $100 barrel of oil, in reality, should cost $40 [source: Engdahl]. And despite having an agency created to prevent just such speculative price inflation, by the time oil prices skyrocketed, the government had made a paper tiger out of it.

Commodity Futures Trading Commission

In the United States, oil futures come in three major forms: contracts on crude oil, gasoline and heating oil. All three of these commodities are essential for the nation to operate and thrive. Unfortunately, the Commodity Futures Trading Commission (CFTC) was unable to do anything to stop manipulation of the market for the energy on which we're painfully dependent.

The CFTC was established by Congress in 1974 specifically to prevent speculation from artificially inflating the price of commodities. Over time, its powers were slowly stripped. The scope of the CFTC's power to regulate is limited to trading within the formal setting of the New York Mercantile Exchange (NYMEX). Traders on this exchange must file daily reports on exchanges so the commission can keep an eye on speculation. But speculators were able to make an end run around the CFTC's regulatory power, thanks to help from oil giant Enron.

The year 2000 was a bad one for consumers as far as oil goes. Prices remained low (less than $30 a barrel), but mechanisms were set in motion that would raise prices and vastly increase oil company profits. That year, Congress (under lobby by Enron and other oil companies) removed the regulatory powers of the CFTC over American oil futures traded over the counter (OTC) [source: Levin]. Enron had created specialized software that allowed futures to be traded OTC -- exchanges outside of the formal exchange markets. The software and what came to be known as the **Enron loophole** for OTC trading allowed futures exchanges without government oversight.

Also in 2000, a consortium of oil companies and financial institutions created the **Intercontinental Exchange** (ICE) in London to trade European oil futures, although the group was headquartered in Atlanta. Since the exchange was in Europe, the CFTC's reach didn't extend to it.

The CFTC gave up more regulatory power in early 2006 when it allowed the Intercontinental Exchange to install terminals in the United States [source: Engdahl]. Up to that point, only OTC speculators could trade outside of CFTC oversight. But once the commission allowed U.S. futures to be traded on ICE, rather than only on NYMEX, the CFTC lost its ability to regulate even formal exchanges. Once traded on ICE, an American futures derivative fell out of the jurisdiction of the CFTC. The convergence of the Enron loophole and the establishment of ICE meant the CFTC could no longer accurately police speculators who sought to drive up energy prices through futures speculation.

Whether it was speculators that drove up the cost of gas and oil is still debated. A July 2008 report by the International Energy Agency concluded that speculation had little to do with price increases [source: CNN Money]. But a report issued the following September contradicted the IEA report, pointing to correlations between the influx of money in oil futures markets and the rising cost of oil. The price of oil doubled, tripled and eventually quadrupled in step with the increase from $13 billion to $260 billion in the market from 2003 to 2008 [source: U.S. Senate].

In response to calls for better regulation of oil futures, Congress introduced the Consumer-First Energy Act in May 2008. The bill would have extended CFTC oversight to foreign markets, but the act died on the Senate floor the following June. After the bill was defeated, the argument over oil speculation changed focus. No longer was the debate over what caused oil prices to rise beginning in 2006, but how long the United States would allow speculation to continue.

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