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Black Gold: A Series On Oil

Speculation and the Price of Oil ~ *Patrick Brown*

Since the oil monopoly of the 'seven sisters' was broken in the seventies, the price of crude oil has been set by trading in futures on markets in New York, London, and Singapore. As I write this, the price of oil for September 2005 delivery has topped $66US a barrel (42 US gallons) and is continuing to rise.

Each day brings a significant price change, mostly up. This affects trading in currencies and all other investments. The actual prices of petroleum products affect the economies of nations, corporations, and individuals around the world, and particularly in the US, which uses a quarter of the world's oil.

How can the price of such a basic commodity display such volatility? The answer, as dryly expressed by the US International Energy Agency, may be that 'trends warranted by supply-demand factors have been significantly amplified by speculative factors.'

The Price We See

The daily oil price reported on TV and in the newspaper is the price per barrel established today for a type of crude oil known as 'West Texas Intermediate (WTI)' for delivery at Cushing, Oklahoma (where pipelines meet) anytime next month. It is set by 'open outcry' on the trading floor of the New York Mercantile Exchange (NYMEX).

Price increases work their way through the system as the oil is delivered, refined, and sold at your local gas station. Although today's price is for next month's oil, brokers, refiners, distributors, and retailers each attempt to raise prices on the current shipment to pay for the next shipment. This explains the near instantaneous translation of increases in the price of next month's crude at Cushing to the price of gasoline today at the pump. (A $1US increase in crude seems to translate to about a 1¢CAN increase in gasoline in Vancouver.)

Prices in Perspective

Many experts have tried to guess at the effect of speculation on the price of oil; current estimates range up to $20/barrel. It's hard to tell. So the price could go down.

But crude prices over $60 clearly make the oil business, all the way from exploration to retailing, even more profitable. Governments that own national oil companies gain enormously; OPEC's target price of $22–$28 has been left far behind (along with any US hopes that increased OPEC production might restrain the price).

But the oil used has to be replaced, and more must be found. The historical cost of the oil now being sold ranges from as low as $2 up to over $30, depending on how recently it was developed and the technology involved. Some estimates put the cost of replacing the oil being consumed at over $35/barrel.

So higher prices mean more 'unconventional' oil sources will be profitable: besides the incredibly costly oil sands, there will be ever deeper and more exotic drilling, new kinds of secondary recovery, exploration and drilling in remote and exotic locations, deepwater drilling, and so on. If these significantly increase

Commentary

The significant influence of speculative traders on the world price of oil, the key energy commodity, raises vital issues of both economic and social justice. The traders have, in effect, bought themselves the ability to tax the world, through manipulating the market. Their interest is in prices that are volatile in the short term, rising in the longer term, or preferably both.

They do not trade in the commodity itself, but in a complex set of financial surrogates, so the extent of their trading is not limited by the shortage which they seek to exploit. The price variations that result from this extra activity have destroyed the validity of price signals and corrupted the prime function of the market.

So the fundamental morality of the 'free market' concept has been turned on its head. The resultant distortions in the economies of nations, corporations, and individuals far outweigh the profits made by the speculators, massive though they may be. Additional profits from the exaggerated prices are made by oil companies and governments, who are thus unlikely to interfere.

One would like to assume that this behaviour carries within it the seeds of its own demise. At the moment, however, it would appear to have a greater potential to create social and economic inequalities, and destroy ethical markets along with unethical ones.

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supply, they will not bring down the price of oil; they just might give it momentary pause on its way up.

By way of justification, it has been pointed out that, adjusted for inflation, oil prices are not yet as high as experienced in the early eighties, when the near $40 price peak could be translated as over $80 now. But that was before NYMEX started trading crude oil futures in 1983. It was expected to bring transparency and liquidity (not a pun) to the international crude oil market. But then we didn't have this toxic mix of too much money and too little oil playing in the oil market. Now we do.

NYMEX

The NYMEX trading floor is the scene of the most trading action in oil futures. NYMEX trades futures for delivery up to 84 months ahead. These are normally expressed in whole contracts of 1,000 barrels, but potential buyers can choose from a dazzling menu of derivatives, including options, half contracts, and combinations of bets of all sorts. Many of these derivatives are offered by traders who anchor their offerings by their own trading on the NYMEX floor. And NYMEX is a privately held profit-making corporation which does everything it can to encourage as much trading as possible.

The NYMEX futures prices lead the market prices of Brent crude (London) and Dubai crude (Singapore); although they set the reference prices, these three markets process only about one third of world oil transactions. Most of the private trading outside these markets takes place at prices referenced to these market prices. But much of the world's oil moves entirely within the big multinational integrated oil companies (Exxon-Mobil, Chevron-Texaco, etc.); their internal pricing may well depend on other factors, such as tax avoidance.

Hedging

Oil futures have customarily been traded by companies and consumers in the oil business to reduce their price risk in times of price volatility; this is a perfectly legitimate business activity (known as hedging), and the ultimate holder of the futures contract expects his oil to appear at Cushing (or wherever) on the appointed date. (BC Ferries hedges in diesel to stabilize fuel costs.)

As an additional hedging facility, NYMEX also allows contract holders to settle in cash rather than oil. This also has a legitimate function. But it makes it possible to trade in oil futures with no intention of ever selling or buying any actual crude.

'Non-Commercial Traders'

Some major traders are not in the oil business at all, and trade completely in cash. NYMEX calls these traders 'non-commercial', and insists that they make up only 30% of those registered to trade. However, they include major financial houses such as Morgan Stanley, Goldman Sachs, Merrill Lynch, Lehman Bros., Citigroup, HSBC, BNP Paribas, Deutsche Bank, etc. They trade for very large pension and hedge funds, and on their own behalf.

No public figures are available on how much of NYMEX's activity is carried out by these 'non-commercial' traders. But trading of this kind has have doubled over the past ten years. It is clear that current trading levels in crude oil futures—as many as 373,000 contracts in one day in April, and 'open interest' (contracts offered but not closed) of up to 850,000 contracts at a time—far and away exceed any concept of the hedging needs of the actual crude market.

The non-commercial traders on the NYMEX may now trade more oil contracts in cash than the oil business trades in oil. (Remember, each contract is supposed to represent 1,000 barrels and the US uses (only) 20 million barrels a day.)

The One-Way Bet, with Leverage

For the big financial houses and their pension and hedge funds, trading oil futures is now the best game in town. The US stock market offers little potential; bonds are going nowhere; real estate is too small potatoes for hedge funds; and the foreign exchange market is too much work for too little return.

And it's looking like a one-way bet for these big speculators. After all, everybody knows that the world demand for oil is already within one or two million barrels a day of the supply. There is not much of a surplus or cushion. And China, now the world's second-biggest oil consumer, and India are both seeing rapid increases in consumption. World oil inventories are mostly held by the major oil companies who can be depended on not to upset the market; the US government's Strategic Oil Reserve is estimated at 700 million barrels in August, enough to bridge a short-term shortage only.

Many things could happen which could trigger a million-barrel a day shortage in supply. They are recited in the media every day: refinery fires in the US, hurricanes in the Gulf of Mexico, shenanigans with Yukos Oil in Russia, arguments with Iran over nuclear power, the death of King Fahd in Saudi Arabia, pipeline bombings in Iraq.

These fears and rumours are gleefully repeated by the experts as excuses for the rising price of oil. A 'risk premium,' they say. Goldman Sachs (not a disinterested party) predicts oil will go to $105/barrel.

And so the speculative traders have tremendous leverage over the NYMEX market, which in turn has tremendous leverage over the prices at which world oil is actually traded. The effect of this is that of a large and amoral tail wagging the world's most substantial economic dog. ✐

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