Crude Oil Price: Shortage or Speculation?

By Byron A. Ellis-May 24, 2008

All major oil companies use traders to ensure a regular supply of crude oil to their refineries. The trader's role is to purchase crude oil in advance. Traders also resell crude oil purchased at a low price for a profit.

Since traders purchase crude oil in advance, often several months elapse between purchase and delivery dates. The trader benefits from crude oil price increases between the period of purchase and delivery. For example, if the trader promises to pay $125.00 per barrel for future delivery, say a month from today and at the time of delivery the price is $130.00; the trader's profit is $5.00 per barrel. Conversely, if at the time of delivery the price fell to $120.00, the traders lost is $5.00 per barrel.

However, to protect against the risk of a price drop, a financial mechanism called covering exist. Short covering is the act of closing an open short position. Traders cover their shorts whenever they speculate that security will rise.

When the price trend is upwards, it is profitable for crude oil traders to continuously bid up prices. Furthermore, once the upward price trend has been established, reversing it in a war environment is difficult. The invasion of Iraq creates a continuous potential risk of supply disruptions. Traders use the potential for supply disruptions to add a risk premium to crude oil purchases.

It is this risk premium, induced by the war and the resulting profit that it creates, that causes oil prices to increase. Leon Hess, whose oil company made over $200 million by trading in crude oil futures during the Persian Gulf crisis said that if the New York Mercantile Exchange (NYMEX) was not in operation there would be ample crude oil at reasonable prices all over the world. In essence, traders would not be able to trade on potential supply disruptions.

NYMEX provides markets for the trading and clearing of crude oil, gasoline, heating oil, natural gas, propane, electricity, uranium, coal, and other commodities. According to NYMEX futures prices are not price predictions, but rather a consensus of where prices appear to be heading. Thus, NYMEX does not pretend, as the executives from the refining industry do, that futures pricing is based on the laws of supply and demand.

NYMEX notes that hedgers and speculators, also called investors, have divergent goals. Hedgers tend to use futures to help stabilize revenues or the cost of business operations. Speculators, on the other hand, seek to profit from market movements.

Some traders concentrate on fundamentals, they look at supply disruptions, such as rebels ceasing refineries or rumors of the US invading Iran or Venezuela and increases or decreases in demand, to predict potential price movements. Others focus on technical reasons, using computers to plot trends. For instance, after the Iraq invasion the trend in crude oil prices and trading volumes have been upward. Therefore, both fundamentalist and technical traders see a pattern of continuous price increases and have handsomely profited from the upward price trend.

Data from the leading electronic energy marketplace, the Intercontinental Exchange (ICE), confirms that crude oil trading volume (Brent), Figure 1, increased significantly after the invasion of Iraq (March 19, 2003). The higher trading volume is an indication that the

Middle East destabilization is profitable to crude oil traders.

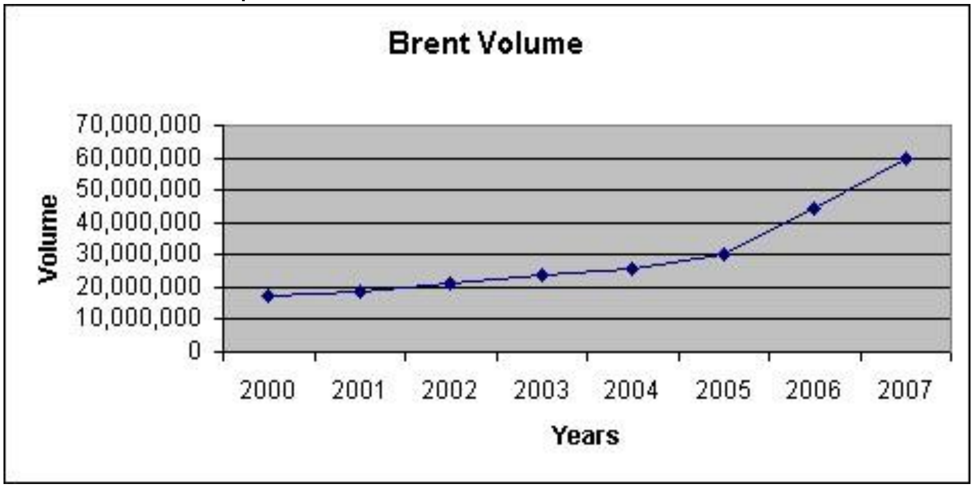

Figure 1- Brent Trading Volume (ICE Futures European Volume)

On May 22, 2008, Bloomberg blamed Wall Street for the rise in crude oil price rising to $135 a barrel. They noted that traders bought crude to cover wrong-way bets that prices would decline. Thus, it is the existing NYMEX process that allows speculators to play with the US and the world's economy. And, Congress continues to allow speculators and energy executives to claim that price movements are due to the laws of supply and demand.

Enron in the process of manipulating the electric market also claimed that price increases were due to the laws of supply and demand. And, Congress then, as now, was incapable of deciphering their lies. With crude oil gouging, however, the economic stakes are far higher to the nation and the world.

Congress must understand that the household budgets of hard-working Americans are limited and as transportation outlays crowd out other expenditures, there is a breaking point that is bound to significantly disrupt US and world commerce.

Therefore, the US can no longer tolerate crude oil industry traders, whether independent or representing the refiners to siphon off the hard-earned income of American workers.

They are two ways to prevent, and possibly even reverse, the rise in crude oil prices. The first is to stop the Iraq war and begin a meaningful dialog with perceived regional adversaries. The second is to heed Leon Hess' advice, if not fully, it may be heeded partially by suspending futures trading under circumstances of regional instability.