



Capping Oil Prices

Over the past four years, fuel prices have been increasing. This rise has caused stress to individuals and various other fuel dependents. To ease this burden, people began driving less, car pooling, selling/trading in SUVs, and limiting fuel consumption to an absolute minimum.

As the overall demand for fuel decreased, the supply increased. This low demand and high supply effect should have lowered the price of fuel; however, the cost continued to rise. In fact, in just one year, the cost of crude oil doubled from \$69/barrel to about \$150/barrel.

On July 17, 2008, fuel prices reached an all-time high at \$4.11/gallon. A future filled with reasonable gas prices seemed doubtful. The public made obvious sacrifices and lowered fuel demand, but their efforts had no positive effect. In a country that strongly depends on fuel, it seemed that every advantage was being taken of American society.

Surprisingly, the \$4/gallon gas hike didn't last long, and by August 2008, prices were back around \$3/gallon. From August to September 2008, the prices fluctuated in the \$3/gallon range, but once October came, the prices appeared to be lowering.

Fuel prices dropped from an average of \$4.11/gallon in July to an average of \$2.92/gallon in October. And throughout November, prices continued to drop—\$2.75, \$2.50, \$2.22, \$2.10, \$1.99! People hadn't seen fuel prices this low since early 2005! But the decline didn't stop there. In December 2008, fuel prices continued to drop and reached an average price of \$1.64/gallon.

How did this happen? Prices like \$1.64/gallon hadn't been seen since 2003. How could fuel cost in 2009 be the same as in 2003?

On January 11, the television news magazine *60 Minutes* aired an interesting segment, aimed at answering those unexplained questions, titled "Did Speculation Fuel Oil Price

Swings?" I have excerpted some particularly interesting pieces of that report below. For the complete transcript, or to view the video segment go to: <http://www.cbsnews.com/stories/2009/01/08/60minutes/main4707770.shtml>

To understand fuel prices, one must first understand crude oil trading. For many years, crude oil has been bought and sold on 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 in the future.

It was created so that farmers could gauge what their unharvested crops would be worth months in advance, so that factories could lock in the best price for raw materials, and airlines could manage their fuel costs, but more than a year ago, the markets started behaving erratically. When oil doubled to \$147/barrel, Dan Gilligan, President of Petroleum Marketers Association (PMCA), set out to make sure the Commodities Futures Market was an honest market.

Gilligan represents over 8,000 retail and wholesaler suppliers ranging from home heating to gas stations owners.

Gilligan's suppliers were being blamed for gouging prices, but they were also paying high product amounts. Gilligan explained that the problem was in the commodities markets.

"Approximately 60 to 70 percent of the oil contracts in the futures markets are now held by speculative entities. Not by companies that need oil, not by the airlines, not by the oil companies. But by investors that are looking to make

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money from their speculative positions," Gilligan explained.

Gilligan went on to say. "All they do is buy the paper, and hope that they can sell it for more than they paid for it. Before they have to take delivery."

"They're trying to make money on the market for oil?" Steve Kroft (60 Minutes reporter) asked.

"Absolutely," Gilligan replied. "On the volatility that exists in the market. They make it going up and down."

Hedge fund manager, Michael Masters, tracks 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.

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, Wall Street trading desks were following right behind them, putting money - 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."

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.

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.

"Did China and India suddenly have gigantic needs for new oil products in a single day? No. 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.

Masters believes the investor demand for commodities, and oil futures in particular, was created on Wall Street by hedge funds and the big Wall Street investment banks like Morgan Stanley, Goldman Sachs, Barclays, and J.P. Morgan, who made billions investing hundreds of billions of dollars



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of their clients' money. Masters says if the markets working properly, price of oil should've been decreasing. The only thing that makes sense is that investor demand increased.

"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," Masters said.

For the most part, Dan Gilligan agrees with Masters. Kroft went on to ask Gilligan, "Are you saying that companies like Goldman Sachs and Morgan Stanley and Barclays have as much to do with the price of oil going up as Exxon? Or...Shell?"

"The oil bubble began to deflate early last fall when Congress threatened new regulations and federal agencies announced they were beginning major investigations."

"Yes," Gilligan said. "I tease people sometimes that, you know, people say, 'Well, who's the largest oil company in America?' And they'll always say, 'Well, Exxon Mobil or Chevron, or BP.' But I'll say, 'No. Morgan Stanley.'"

It's impossible to tell exactly who was buying and selling all those oil contracts because 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.

Who was responsible for deregulating the oil future market?" Kroft asked Michael Greenberger. "You'd have to say Enron," he replied. "This was something they desperately wanted, and they got."

"When Enron failed, we learned that Enron, and its conspirators who used their trading engine, were able to drive the price of electricity up, some say, by as much as 300% on the West Coast," he added.

"Is the same thing going on right now in the oil business?" Kroft asked.

"Every Enron trader, who knew how to do these manipulations, became the most valuable employee on Wall Street," Greenberger said.



The Energy Information Administration webpage provides some basics on crude oil <http://www.eia.doe.gov/kids/energyfacts/sources/non-renewable/oil.html#Howused>

Oil was formed from the remains of animals and plants that lived millions of years ago in a marine (water) environment before the dinosaurs. Over the years, the remains were covered by layers of mud. Heat and pressure from these layers helped the remains turn into what today we call crude oil.

Crude oil is...usually found in underground areas called reservoirs. Scientists and engineers explore a chosen area by studying rock samples from the earth... if the site seems promising, drilling begins.

After crude oil is extracted, it is sent to a refinery...where different parts of the crude oil are separated into useable petroleum products...A 42-U.S. gallon barrel of crude oil provides slightly more than 44 gallons of petroleum products. This processing gain is similar to what happens to popcorn, it gets bigger after it is popped.

One barrel of crude oil, when refined, produces about 20 gallons of finished motor gasoline, and 7 gallons of diesel, as well as other petroleum products. Most of the petroleum products are used to produce energy... Other products made from petroleum include: ink, crayons, bubble gum, dishwashing liquids, deodorant, eyeglasses, records, tires, ammonia, and heart valves.

But those valuable employees may now be looking for work. The oil bubble began to deflate early last fall when Congress threatened new regulations and federal agencies announced they were beginning major investigations. It finally popped with the bankruptcy of Lehman Brothers and the near collapse of AIG, who were both heavily invested in the oil markets. With hedge funds and investment houses facing margin calls, the speculators headed for the exits.

"From July 15th until the end of November, roughly \$70 billion came out of commodities futures from these index funds," Masters explained. "In fact, gasoline demand went down by roughly five percent over that same period of time. Yet the price of crude oil dropped more than \$100 a barrel. It dropped 75 percent."

Asked how he explains that, Masters said, "By looking at investors, that's the only way you can explain it."

When dealing with the economy or politics or any other debatable subject matter, it seems like everyone has their own opinion. Type "Why have gas prices dropped" into any Internet search engine and prepare to read theory after theory

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after theory—each providing an answer to that broad question. And here's the tricky part—who's right and who's wrong? Here are three things to do: stay involved, research and most importantly, listen. Don't settle on that first news story or explanation from "John" at work.

Over the past few years, the American public has united and managed to drastically reduce their fuel intake. The message was clear, "These gas prices are ridiculous." And although it took some time and sacrifice, that message finally seemed to have gotten delivered. **-OC**

Sources:

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