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EQUITY RESEARCH

INDUSTRY UPDATE

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ENERGY/Oil & Gas

Curbing Oil Speculation. Time for Change.

SUMMARY

The unprecedented 150% surge in crude oil prices between January 2007 and July 2008 was, in our opinion, more a result of excessive speculation than due to strong market fundamentals. It is worth noting that oil demand during this period declined in most regions of the world, except where oil prices are subsidized. ***Government inaction and lack of regulation have contributed to what amounted to the fleecing of America by speculators, who created the oil bubble.*** Despite the 36% decline from the July record, oil prices are still 41% above a year ago and remain inflated as even the Russian invasion of Georgia, the 10-day disruption of oil flow from Azerbaijan due to the Turkish pipeline explosion and the two recent hurricanes have failed to stem the slide. ***The oil bubble is deflated, not burst.***

KEY POINTS

- **Self Regulation.** It usually does not work, especially when huge sums of money are involved as in the case of oil exchanges, which have become global gambling halls. In our opinion, government regulators are either unable or unwilling to hold the speculators accountable for their actions. ***If self regulation worked, we wouldn't need the IRS to collect taxes or traffic cops and speeding penalties to enforce speed limits.***

- **Oil Speculators.** They are financial players that use oil futures to hedge against interest rates, currency, inflation, and market indices. They facilitate trading among commercial hedgers, but exacerbate price movements and create volatility that often disconnects prices from market fundamentals. ***Speculators make bets on perception of events they often help create to manipulate prices.***

- **Government Inaction.** The CFTC (U.S. Commodity Futures Trading Commission) continues to minimize the role of speculators in the oil markets, and maintains that prices reflect fundamentals. It has underestimated speculators' share of oil futures and cannot explain why prices rose despite weaker demand and declined despite tightening supply. The ***CFTC cannot fix a problem it denies exists.***

- **Market Manipulation.** It is our view that financial players, led by the largest investment banks, who are also the largest oil traders, have created the oil bubble by hyping demand growth and supply concerns. But supply seems to have outpaced demand as growth faded due to the global economic slowdown. ***The financial markets' meltdown could significantly reduce speculation.***

- **OPEC Role.** OPEC has been an unwilling participant in the fleecing of America at the hands of financial speculators, which was overlooked by government regulators. A year ago OPEC declared that oil prices were driven by speculations, and should not exceed $55/b, which was $10/b higher than the $45/b target set in 2006. ***We don't expect OPEC to defend oil prices above $60/b.***

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Following is the text of my testimony before the Subcommittee on Energy of the Senate Committee on Energy and Natural Resources. The hearing was held on Tuesday, September 16, 2008, at 2:30 p.m. in room 366 of the Dirksen Senate Office Building in Washington, D.C.

The purpose of the hearing is to receive testimony on recent analyses of the role of speculative investment in energy markets.

Good afternoon.

I am here today to share my personal views on the impact of speculation on the oil markets. ***I believe the energy markets in recent years have been driven more by speculation than by industry fundamentals of supply and demand.*** Oil prices peaked in July at more than $148/b, despite softening demand, to more than double their levels a year earlier. Since then, oil prices declined by more than 36% despite supply disruptions. Speculation has disconnected oil prices from market fundamentals.

As a managing director of oil & gas research at Oppenheimer & Co. Inc., I closely follow the energy markets for the sole purpose of advising investors in energy stocks. I do not trade energy future contracts or manage investments that could gain from lower energy prices. I have no vested interests in declining energy prices, and in fact, the energy stocks that I own for many years would decline further with lower oil prices.

I testified on the impact of speculation on oil prices on December 11, 2007, before the Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs and the Subcommittee on Energy of the Committee on Energy and Natural Resources. Oil prices then averaged $90.02/b, up 47% from $61.22/b a year earlier. When I testified before the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, oil prices closed at $132.57/b, or double the $66.27/b a year earlier. Although oil prices are down 36% from their peak in July, and down 1% for the year, they are still 43% above the year-ago level.

Even after the recent decline, I believe that oil prices are still inflated and their current levels do not reflect market fundamentals. The price decline was a result of selling of oil future contracts by financial players on fears of slowing oil demand due to the weak global economy and the meltdown in the financial markets. The fact that the decline in crude oil prices has continued despite the Russian invasion of Georgia, the 10-day disruption of oil production from Azerbaijan due to the pipeline explosion of the Turkish pipeline, and the recent hurricanes in the Gulf of Mexico, proves that oil prices are inflated and that they are disconnected from supply and demand fundamentals.

Many people believe that the recent drop in oil prices was a result of pending legislation allowing more drilling in the U.S. Although we should pursue all options, including opening federal land to exploration, this is unlikely to have any meaningful impact on our dependence on foreign oil for years. I believe energy conservation and increased use of alternative energy sources, including renewable energy, is a much better strategy and should be a top priority in any future energy legislation. However, I think the investigations by the Senate and the House have contributed to the recent decline in oil prices by exposing the role speculators played in creating the oil price bubble.

I have been an energy analyst for more than 22 years, and spent six years before that working for a major oil company. I follow 22 energy companies including the majors, the integrated, the independent refiners and the domestic oil and gas producers. I communicate regularly with the companies I cover, and none of them either publicly, or privately, indicated they expected oil prices to reach, let alone exceed, $100/b. Some even ridiculed $60/b oil and declared it to be unsustainable.

Only a year ago several OPEC ministers said that the surge in oil prices was not due to lack of supply, but due to excessive speculation and a weak dollar. OPEC repeatedly said that the "fair" price for oil is around $55/b. Our Energy Secretary last October agreed with OPEC that speculations, not market fundamentals, were the cause of the run-up in oil prices. That was before he reversed his opinion last June, and agreed with the Treasury Secretary that oil prices reflected supply and demand fundamentals, not excessive speculation.

Three years ago, after hurricane Katrina, I had two long discussions with the secretary general of OPEC, Dr. Adnan Shehab-Eldin, Ph.D, who was also the head of OPEC Economic Analysis for the past 14 years. He expressed deep reservations about the surge in oil prices to $62/b because of its potential negative impact on global economic growth, energy demand, and potential energy conservation and switching to renewable sources. He believed that OPEC prefers to see oil prices closer to $45/b, not $65/b. The unprecedented surge in oil prices was, in my opinion, more due to excessive speculation rather than increased global demand, a weak dollar, or supply concerns.

Self-regulated markets don't work, especially when there are huge sums of money to be made. There are always people who will try to beat the system in markets that are tightly regulated by the government, let alone self regulated. I liken self-regulated markets to trying to enforce the speed limit without traffic cops or speeding penalties, or collecting taxes without filing with the IRS. The self-regulated markets are like private clubs making up their own rules. They will fight change, but should not be given that option. Government agencies should not defend the right of a few to make huge profits at public expense.

Speculation is not illegal, but excessive speculation could result in serious economic dislocation. Investors speculate when they buy or sell stocks and financial players speculate when they buy or sell future oil contracts. Speculators provide the needed liquidity to facilitate trading transactions between commercial hedgers who end up taking physical delivery of the commodity. But, since financial speculators have no intention of taking physical delivery, they usually roll over their hedge positions. They generate huge profit if prices move in line with their bets, up or down. Excessive speculations, however, tend to magnify and exacerbate price movements and create volatility that could disconnect prices from market fundamentals as has been the case in recent years.

Oil is unlike any other commodity where prices are usually based on supply and demand. That is because the oil markets are not free markets since more than half of the world supply is now controlled by OPEC and Russia, while demand is impacted by government taxes and subsidies. Sharply higher oil prices reduced demand in most countries, except where prices are subsidized, like in China, India, and in oil exporting and developing countries. High oil prices limited access to new energy resources as they strengthened the hand of national oil companies, while significantly increasing government take, including royalties, taxes, fees, and tariffs. High oil prices remove the incentive for oil exporting countries to grant new concessions to international oil companies. That explains why high oil prices did not result in increased supply and did not fully impact demand.

I believe the government must regulate the oil markets, and limit, not eliminate financial speculation, which is needed to facilitate trading transaction by commercial hedgers. The CFTC should raise the margin requirement, set trading limits, require transparency, prevent conflict of interests, and limit trading to government regulated exchanges in compliance with U.S. rules.

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