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Did Speculation Fuel Oil Price Swings?

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(CBS) About the only economic break most Americans have gotten in the last six months has been the drastic drop in the price of oil, which has fallen even more precipitously than it rose. In a year's time, a commodity that was theoretically priced according to supply and demand doubled from $69 a barrel to nearly $150, and then, in a period of just three months, crashed along with the stock market.

So what happened? It's a complicated question, and there are lots of theories. But as **correspondent Steve Kroft** reports, many people believe it was a speculative bubble, not unlike the one that caused the housing crisis, and that it had more to do with traders and speculators on Wall Street than with oil company executives or sheiks in Saudi Arabia.

To understand what happened to the price of oil, you first have to understand the way it's traded. For years it has been bought and sold on something called 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 at some date 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 those markets started to behave erratically. And when oil doubled to more than $147 a barrel, no one was more suspicious than Dan Gilligan.

As the president of the Petroleum Marketers Association, he represents more than 8,000 retail and wholesale suppliers, everyone from home heating oil companies to gas station owners.

When ***60 Minutes*** talked to him last summer, his members were getting blamed for gouging the public, even though their costs had also gone through the roof. He told Kroft the problem was in the commodities markets, which had been invaded by a new breed of investor.

"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 money from their speculative positions," Gilligan explained.

Gilligan said these investors don't actually take delivery of the oil. "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?" Kroft asked.

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

He says his members in the home heating oil business, like Sean Cota of Bellows Falls, Vt., were the first to notice the effects a few years ago when prices seemed to disconnect from the basic fundamentals of supply and demand. Cota says there was plenty of product at the supply terminals, but the prices kept going up and up.

"We've had three price changes during the day where we pick up products, actually don't know what we paid for it and we'll go out and we'll sell that to the retail customer guessing at what the price was," Cota remembered. "The volatility is being driven by the huge amounts of money and the huge amounts of leverage that is going in to these markets."

About the same time, hedge fund manager Michael Masters reached the same conclusion. Masters' expertise is in tracking 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. Last year, 27 barrels of crude were being traded every day on the New York Mercantile Exchange for every one barrel of oil that was actually being consumed in the United

States.

"We talked to the largest physical trader of crude oil. And they told us that compared to the size of the investment inflows - and remember, this is the largest physical crude oil trader in the United States - they said that we are basically a flea on an elephant, that that's how big these flows were," Masters remembered.

Yet when Congress began holding hearings last summer and asked Wall Street banker Lawrence Eagles of J.P. Morgan what role excessive speculation played in rising oil prices, the answer was little to none. "We believe that high energy prices are fundamentally a result of supply and demand," he said in his testimony.

As it turns out, not even J.P. Morgan's chief global investment officer agreed with him. The same that day Eagles testified, an e-mail went out to clients saying "an enormous amount of speculation" ran up the price" and "140 dollars in July was ridiculous."

If anyone had any doubts, they were dispelled a few days after that hearing when the price of oil jumped $25 in a single day. That day was Sept. 22.

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.

A recent report out of MIT, analyzing world oil production and consumption, also concluded that the basic fundamentals of supply and demand could not have been responsible for last year's run-up in oil prices. And Michael Masters says the U.S. Department of Energy's own statistics show that if the markets had been working properly, the price of oil should have been going down, not up.

"From quarter four of '07 until the second quarter of '08 the EIA, the Energy Information Administration, said that supply went up, worldwide supply went up. And worldwide demand went down. So you have supply going up and demand going down, which generally means the price is going down," Masters told Kroft.

"And this was the period of the spike," Kroft noted.

"This was the period of the spike," Masters agreed. "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 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 of their clients' money.

"The investment banks facilitated it," Masters said. "You know, they found folks to write papers espousing the benefits of investing in commodities. And then they promoted commodities as a, quote/unquote, 'asset class.' Like, you could invest in commodities just like you could in stocks or bonds or anything else, like they were suitable for long-term investment."

Dan Gilligan of the Petroleum Marketers Association agreed.

"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?" Kroft asked.

"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.'"

Morgan Stanley isn't an oil company in the traditional sense of the word - it doesn't own or control oil wells or refineries, or gas stations. But according to documents filed with the Securities and Exchange Commission, Morgan Stanley is a significant player in the wholesale market through various entities controlled by the corporation.

It not only buys and sells the physical product through subsidiaries and companies that it controls, Morgan Stanley has the capacity to store and hold 20 million barrels. For example, some storage tanks in New Haven, Conn. hold Morgan Stanley heating oil bound for homes in New England, where it controls nearly 15 percent of the market.

The Wall Street bank Goldman Sachs also has huge stakes in companies that own a refinery in Coffeyville, Kan., and control 43,000 miles of pipeline and more than 150 storage terminals.

And analysts at both investment banks contributed to the oil frenzy that drove prices to record highs: Goldman's top oil analyst predicted last March that the price of a barrel was going to $200; Morgan Stanley predicted $150 a barrel.

Both companies declined ***60 Minutes'*** requests for an interview, but maintain that their oil businesses are completely separate from their trading activities, and that neither influence the independent opinions of their analysts. There is no evidence that either company has done anything illegal.

Asked if there is price manipulation going on, Dan Gilligan told Kroft, "I can't say. And the reason I can't say it, is because nobody knows. Our federal regulators don't have access to the data. They don't know who holds what positions."

"Why don't they know?" Kroft asked.

"Because federal law doesn't give them the jurisdiction to find out," Gilligan said.

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. And in 2000, Congress effectively deregulated the futures market, granting exemptions for complicated derivative investments called oil swaps, as well as electronic trading on private exchanges.

"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."

Greenberger, who wanted more regulation while he was at the Commodity Futures Trading Commission, not less, says it all happened when Enron was the seventh largest corporation in the United States. "This was when Enron was riding high. And what Enron wanted, Enron got."

Asked why they wanted a deregulated market in oil futures, Greenberger said, "Because they wanted to establish their own little energy futures exchange through computerized trading. They knew that if they could get this trading engine established without the controls that had been placed on speculators, they would have the ability to drive the price of energy products in any way they wanted to take it."

"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 percent 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.

But some of them 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."

The regulatory lapses in the commodities market that many believe fomented the rampant speculation in oil have still not been addressed, although the incoming Obama administration has promised to do so.

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