

# WebMemo



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## Oil Speculators Help Consumers at the Gas Pump

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Markets can operate efficiently even when people don't understand how they work. On the other hand, policymakers can do untold damage when they don't understand how markets work. A case in point is the current misguided Senate proposal to regulate petroleum futures markets.

A 2006 study by the Senate's Permanent Subcommittee on Investigations (SPSI) is used by those claiming a causal link from futures market speculation to higher petroleum prices.<sup>1</sup> However, evidence since publication unequivocally disproves that finding—using the SPSI's own logic.

**How Speculation Can Raise Prices.** The only way that oil futures markets can affect price at the pump is by changing the amount of gasoline delivered to gas stations. This can happen, but it requires a specific chain of events.

Take agricultural markets. Farmers will not sell corn from their silos for \$4/bushel today if the price for delivery next year is \$8/bushel, because they will make more profit by waiting and selling it at the higher price, even with storage and carrying costs. Therefore, the high futures price can cause less corn to be supplied today as farmers stock up in anticipation of next year's higher price.

Because many farmers will take advantage of this opportunity, today's price rises. At the same time, next year's price goes down because more corn has been stored for use at that time. The only difference in price will be the storage and carrying cost.

It is possible, though, that a bubble will emerge: Speculation on futures markets can hold too much

corn off the market and raise price to an unsustainable level. However, the speculative bubble will pop when the silos can hold no more corn or when farmers start to unload their inventories. At that point the price of all the corn—both on the spot market and in the silos—plummets, and speculators lose their shirts.

**The SPSI Guessed Wrong.** One characteristic of a speculative bubble is the simultaneous increase in price and increase in inventories. This supports the theory that a speculative bubble is increasing today's price, but without rising inventories, there can be no link between higher futures prices and an impact on the current supply and current price. This is true for corn, wheat, and anything traded on futures markets, and it is true for petroleum as well.

In fact, the SPSI report makes dozens of references to this critical link between higher prices and growing inventories. Indeed, it is the primary evidence presented to support their finding of a speculative bubble.

But the SPSI misunderstood what was happening. This critical link between higher prices and higher inventories is also evidence of something else

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entirely: futures markets and speculators effectively anticipating tighter markets and rearranging consumption patterns to soften the blow on consumers. The price response when inventories are sold tells the story.

If, after a period of simultaneously rising prices and inventories, the inventories are reduced and the price holds steady or rises, then there was no speculative bubble after all. This pattern would instead be confirmation that futures markets *anticipated* higher prices but didn't *cause* higher prices. That is, in aggregate, traders on the futures markets correctly anticipated deteriorating supply and demand conditions, saved petroleum for the worse times, and provided additional barrels when they were most needed.

This is, in fact, exactly what we have seen. At the publication of the SPSI report, American petroleum inventories were at a record high of 347.5 million barrels while price was at \$70 per barrel (not including the Strategic Petroleum Reserve). By the summer of 2008, these inventories had dropped below 300 million barrels while prices made their most dramatic rise in history. As the SPSI report made clear, speculation in futures markets cannot cause price increases when inventories are drawn down.

Having not seen the drawdown of inventories, the SPSI was itself only speculating as to the cause of the higher prices in 2006. It bet on a specula-

tive bubble. We now know it was a harbinger of a tighter market.

Far from supporting a claim of speculator-caused petroleum price increases in 2008, the logic of the SPSI report combined with more recent evidence makes clear that futures markets built up oil supplies for the correctly anticipated rainy day. The over 50 million barrels that were, in effect, transferred from several years ago to this year saved the economy \$3.5 billion.

On top of this, futures markets and speculators have other critical functions, such as providing liquidity and reducing risk for both consumers and producers.

**More Oil, Not More Regulation.** Based on a gross misunderstanding of how futures markets work and what they do, current proposals to hobble futures markets with additional regulation will harm both consumers and producers of petroleum and petroleum products. A better solution is to increase access to new energy sources. If new sources of oil are allowed to be used, futures markets and speculators will lower the future cost of oil, which will translate into lower fuel prices at the pump.

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1. Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate, "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," June 27, 2006, at <http://levin.senate.gov/newsroom/supporting/2006/PSI.gasandoilspec.062606.pdf> (July 22, 2008).