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Blaming Oil Speculators: A Costly Diversion from Real Solutions to Rising Oil Prices

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The price of oil, having soared to an all-time high in July 2008 before plummeting by nearly 75 percent, is rising again and is likely to climb ever higher as the economy recovers.

Of course, rational solutions, such as unlocking America's restricted oil potential, appear to be off the table for the Obama Administration and the current Congress.

Partially filling the policy void is a convenient scapegoat: oil speculators. A recent statement by Commodities Futures Trading Commission Chairman Gary Gensler and several pending anti-speculation bills in Congress suggest yet another tired debate on whether to crack down on such activities. However, oil speculation is not the long-term cause of high or volatile oil prices, and ill-advised market restrictions may well prove counterproductive and a diversion from more sensible responses like increasing supplies.

Oil Speculation: At Best a Marginal and Temporary Cause of High Energy Prices. To some, there is something unseemly about making money by betting on future outcomes. When we do this in the office pool, well, that's acceptable. And when we do this by buying a share of stock, a corporate bond, or a mutual fund, then we tell ourselves that it's investing, not speculating. But in truth, if you are taking on risk in the hopes of getting a higher return, then you have joined the ranks of speculators.

Speculators are rewarded for accepting risk if they prove right, and they lose money if they get it wrong. When oil prices began to rise in 2008, some speculators bet that prices would rise further, and they made a bundle. Others bet that prices would rise less or fall, and they lost a bundle when prices jumped up rather than down. The same process took place when prices collapsed, with some speculators making money and others losing their shirts.

So speculators operate on both sides of a market when prices are expected to go up and when they are expected to go down. They buy what they do not need from someone wanting to lock in a sales price, or they sell what they do not have by contracting with someone wanting to lock in a purchase price.

Speculators are often easy targets because they seem to make money without working for it, and sometimes they make a lot of money. But professional speculators typically succeed by their wits, the sum total of their research, training, and experience, not luck. In so doing, they perform a vital role in financial markets: Speculators accept risk that somebody else does not want.

For example, airlines have enormous demand for fuel, but they do not want to bear the risk of higher oil prices. At the right price, the speculator will take that risk. So the speculator contracts with the airline

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to deliver an amount of oil (or jet fuel) at a certain place and time and for a fixed price. The speculator, of course, does not have the oil. Rather, at the appointed time, the speculator buys the oil on the spot market for delivery. If the spot price is then below the price contracted with the airline, the speculator makes money. If not, the speculator loses. Either way, the airline's future oil price is locked in today.

Without the speculator on the other side of the transaction, the airline cannot hedge its risk. This is the first important lesson about speculators: For every contract, there are two parties—in this case, one party with risk it does not want and one party willing to accept the risk at a price.

Suppose the airline does not hedge against a rise in the price of oil. The airline has become the speculator, at risk of facing higher oil prices than its competitors.

Speculators play a vital role in financial markets, facilitating the price discovery process and improving the efficiency of financial markets. Businesses of all kinds, and therefore their customers and owners, benefit from the willingness of speculators to take on risk for a price.

Under most circumstances, speculators move the market toward the "right" price. On occasion, speculative activity seems to contribute to a distorting of prices, especially when bubbles appear as occurred in the dot-com bubble at the end of the last decade, the real estate bubble, and last summer in the oil price bubble. These asset price bubbles are troubling for many reasons and are the subject of intense study and scrutiny. But bubbles are relatively temporary, short-term phenomena.

Increased Domestic Production: A Sensible Response to Oil Price Concerns. Oil speculation is, at most, a short-term contributor to price swings. Long-term solutions to energy affordability lie elsewhere.

The anti-speculation fervor, if carried to fruition, could diminish the effectiveness and competitiveness of America's financial markets to the detriment of all concerned. Even more worrisome, it could divert attention away from better means to address oil price increases, namely increased domestic production.

Indeed, Washington's responses to price spikes have long suffered from such red herrings. In the past, the favorite culprit of price increases has been the major oil companies. The political response has included congressional hearings featuring oil company CEOs being harangued before the television cameras, endless Federal Trade Commission investigations into industry "price gouging" that invariably came up empty,[1] and a number of anti-gouging bills.[2]

However, at the height of $4 gas, the public was shouting "drill, baby, drill" not "regulate, baby, regulate," and they were on to something. According to government estimates, 19 billion barrels of oil lie beneath restricted offshore areas[3]—the equivalent of over 30 years of current oil imports from Saudi Arabia. And such initial estimates often prove to be low.

Last year, President Bush and Congress repealed the restrictions on oil leasing in 85 percent of America's territorial waters that had been off limits: the Atlantic and Pacific coasts and the eastern Gulf of Mexico. The Department of the Interior is now handling the process of actually leasing these new areas to energy companies. Unfortunately, the Obama Administration has done a 180 on the issue and has thus far delayed any new leasing. It has also revoked some onshore leases. Similarly, Congress has intro-

1. See Federal Trade Commission, "Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases," Spring 2006, at *http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf* (August 24, 2009).
2. For example, anti-price gouging legislation was included in the 2007 Energy Independence and Security Act, and a Federal Trade Commission rule pursuant to this statute was recently promulgated. This rule prohibits market manipulation in wholesale petroleum markets—for example, attempts to distort prices by misstating planned pricing or output decisions or false reporting of data. See Federal Trade Commission, "New FTC Rule Prohibits Petroleum Market Manipulation," August 6, 2009, at *http://www.ftc.gov/opa/2009/08/mmr.shtm* (August 26, 2009).
3. U.S. Department of the Interior, "Report to Congress: Comprehensive Inventory of U.S. OCS Oil and Natural Gas Resources," February 2006, p. xii, at *http://www.mms.gov/PDFs/2005EPAct/InventoryRTC.pdf* (August 26, 2009).

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duced a number of measures to further reduce oil production via additional regulations or higher taxes and fees.

Instead of clamping down on domestic oil supplies, bills like the American Energy Innovation Act (H.R. 2828), the No Cost Stimulus Act (S. 570 and H.R. 1431) and the American Energy Act (H.R. 2846) seek to increase supplies. These bills expand and expedite offshore leasing and open up promising onshore sites such as Alaska's Arctic National Wildlife Refuge, a small portion of which is believed to sit atop 10 billion barrels of oil.

Real Solutions Are Needed. At best oil speculation has a marginal and temporary impact on prices. Targeting oil speculators for high and volatile prices, much like targeting oil companies, is a political response that is likely to do more long-term harm than good by undermining the vital role speculators play in financial markets.

On the other hand, unlocking America's untapped oil potential is a truly useful step towards affordable energy. Increased domestic production would have a noticeable impact on supplies and prices and is well worth doing, especially now that the latest drilling technologies have greatly minimized the risk of oil spills and other environmental damage. This pro-energy approach would clearly help rather than hurt, something that cannot be said of anti-speculation legislation.

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