The Oil Drum
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CFTC Report on High Oil Prices - "Speculation My A$$"

Posted by Nate Hagens on July 23, 2008 - 12:00pm
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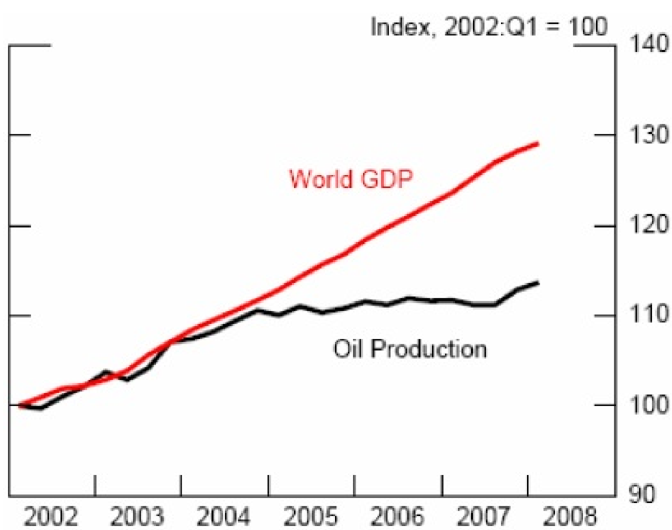
Tags: cftc, commodities, george soros, michael masters, oil prices, original, speculation [list all tags]

With a pending Senate vote on the "Stop Excessive Energy Speculation Act", it seems that we (not the TOD 'we', but the collective society 'we') continue the ongoing witch hunt to pinpoint any 'explanation' for our high oil and gas prices that is not related to finite geologic flow limits or Malthusian themes (i.e. benign). Greedy oil companies, dastardly OPEC plots, and off-limits drilling of the Arctic National Wildlife Reserve and Outer Continental Shelf are among the reasons oft floated in the conventional media for why oil has risen in price over 10 fold in the last decade. Yesterday, a report from a credible institution was released detailing why at least one of the high oil price bogeymen, *'the speculators'*, are not to blame. In this report, the Commodity Futures Trading Commission (CFTC), threw cold water on the recent rhetoric in Congressional testimonies and television commentary that high oil prices are primarily caused by investment speculators.



Excerpt from Figure 1 from CFTC Interim Report on Crude Oil - Click to Enlarge

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This is a long and detailed report, with many graphs and data supportive of a)the tightness in global supply and demand for oil and b)the lack of correlation between speculative positioning and price increase. It is worth a complete read for those interested in this issue (which has seemed front and center in many CNBC debates on oil speculation). Below are some excerpts of the main findings of the report (italics/bold added).

From the Executive Summary:

> The Task Force's preliminary assessment is that current oil prices and the increase in oil prices between January 2003 and June 2008 are largely due to fundamental supply and demand factors. During this same period, activity on the crude oil futures market – as measured by the number of contracts outstanding, trading activity, and the number of traders – has increased significantly. While these increases broadly coincided with the run-up in crude oil prices, the Task Force's preliminary analysis to date does not support the proposition that speculative activity has systematically driven changes in oil prices.

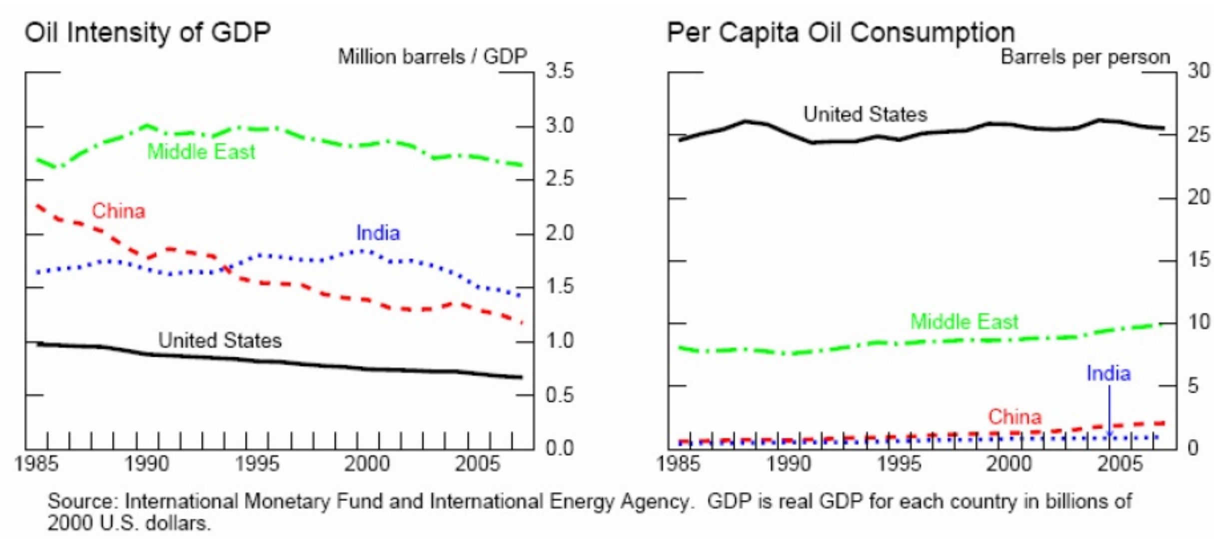

Figure 2 - Oil Intensity and Use by Country ***Click to Enlarge***

> The world economy has expanded at its fastest pace in decades, and that strong growth has translated into substantial increases in the demand for oil, particularly from emerging market countries. On the supply side, the production of oil has responded sluggishly, compounded by production shortfalls associated with geopolitical unrest in countries with large oil reserves. *As it is very difficult to rely on substitutes for oil in the short term, very large price increases have occurred as the market balances supply and demand.*
>
> If a group of market participants has systematically driven prices, detailed daily position data should show that that group's position changes preceded price changes. The Task Force's preliminary analysis, **based on the evidence available to date, suggests that changes in futures market participation by speculators have not systematically preceded price changes**. On the contrary, most speculative traders typically alter their positions following price changes, suggesting that they are responding to new information – just as one would expect in an efficiently operating market.

This conclusion was discussed here in a post on Peak Oil and Reflexivity following George Soros and Michael Masters testimonies before Congress. In effect, at the end of trending cycles the tail eventually wags the dog. This can be seen in real time in energy stocks (down already 30% from their highs in the last month with oil still 'only' at $126).

More from the CFTC report:

> On the demand side, world economic activity has expanded at close to 5 percent per year since 2004, marking the strongest performance in two decades. Between 2004 and 2007, global oil consumption grew by 3.9 percent, driven largely by rising demand in emerging markets that are both growing rapidly and shifting toward oil-intensive activities. Moreover, some of the fastest growing nations also rely on price subsidies that hold down the prices of oil and refined products such as gasoline, which further boosts oil consumption.

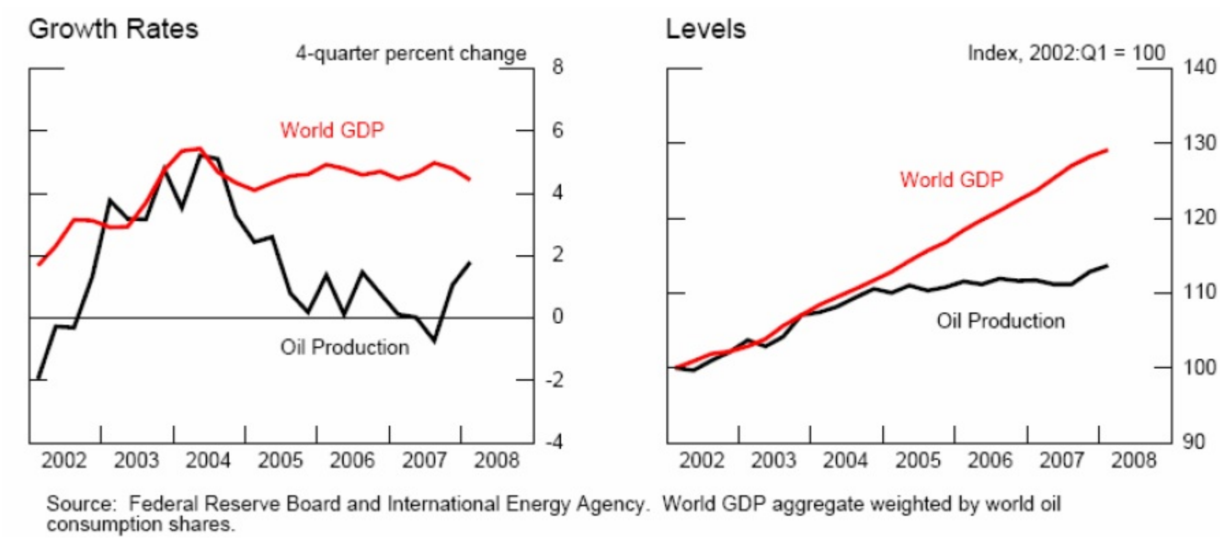

Figure 1 Click to Enlarge

> While global demand has proven strong, oil production growth has not kept pace. In the past three years, non-OPEC production growth has slowed to levels well below historical averages, and world surplus capacity has fallen below historical norms. Preliminary inventory data also shows that Organisation for Economic Co-operation and Development (OECD) stocks have fallen below 1996-2002 levels. Moreover, supply disruptions have adversely affected both world oil production and exports.

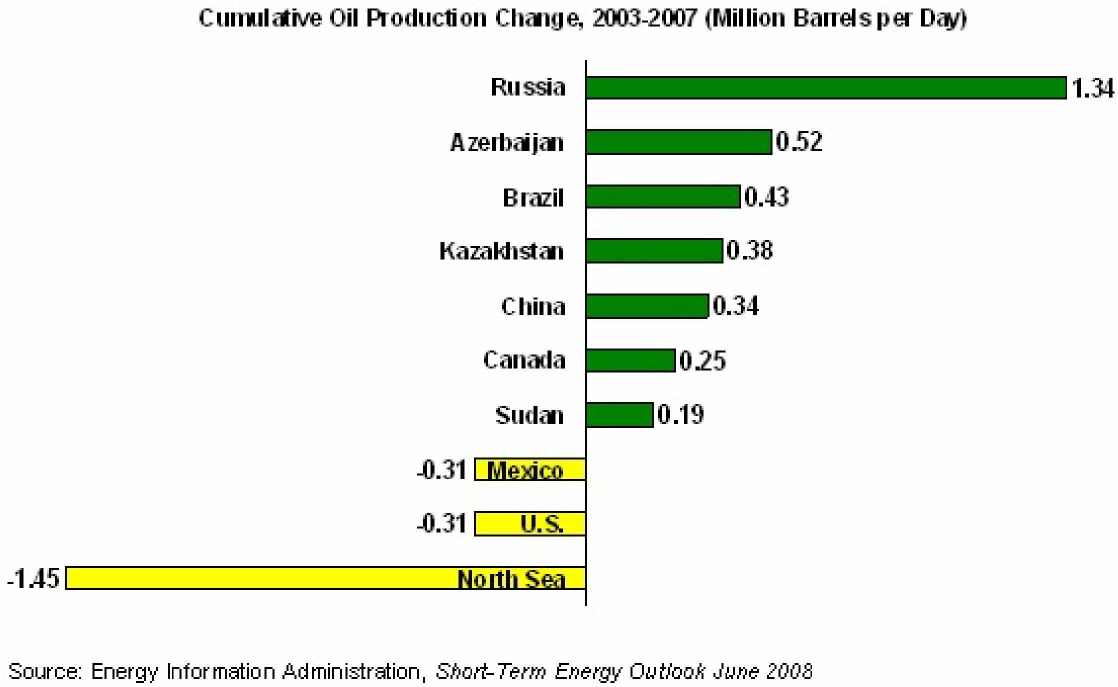

Figure 5 - Non-OPEC Oil Supply Growth

> The imbalance between scarce supply and growing demand, and expectations that this imbalance will persist in the future, have led to upward pressure on oil prices and greater market reactions to any actual or perceived disruptions in available supply. Under such tight market conditions, it is often the case that only large price increases can re-establish equilibrium between supply and demand. Consequently, large or rapid movements in oil prices are not inconsistent with the fundamentals of supply and demand; such price movements, by themselves, do not indicate that prices have become divorced from fundamentals. *Moreover, if speculative positions, rather than fundamentals, were pushing prices upward, then inventories would be expected to rise. To date, there is no evidence of such an accumulation; in fact, known inventory levels actually have declined.*

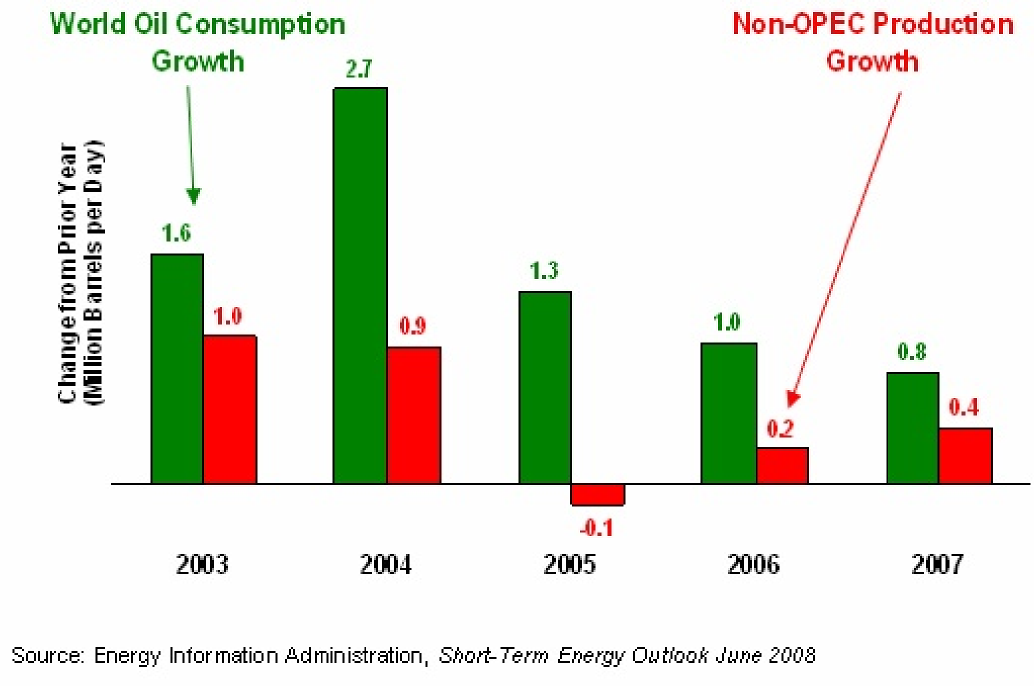

Figure 6 - Increasing Reliance on OPEC Production

Activity in crude oil futures and options contracts has been increasing since 2004. During that period, the number of contracts outstanding (known as "open interest") has more than tripled, and the number of traders has almost doubled. The fastest growth in open interest has been recorded among non-commercial traders – often called "speculators" – holding spread positions combining long positions in one month with short positions in another month. *Thus, while the long positions of non-commercial traders have increased, the short positions of non-commercial traders also have increased*. Additionally, although the net long positions of non-commercial traders have increased somewhat since 2004 – which some market observers have hypothesized has pushed prices up – the proportion of those positions has been relatively constant as a share of open interest over the last few years, undercutting that hypothesis.

Much of the attention related to participants in futures markets has focused on the role of commodity index investment funds and the commodity swap dealers that often act as their intermediaries. During the period studied, January 2003 through June 2008, pension funds and other investors have increasingly used index funds as vehicles to participate in commodity markets. Some observers have suggested that this rapid inflow of investments through index funds has been a cause of oil price increases. The CFTC has issued Special Calls for data about this activity, but only partial responses have been received as of the date of publication of this interim report. An analysis of the data from these Special Calls will be made available in September.

The data currently at hand – which incorporates non-public surveillance information – includes positions held by commodity swap dealers. Commodity swap dealers offer institutional investors contracts whose returns are linked to a variety of commodity indices. Broadly speaking, after netting their index fund clients' positions against the positions of their other clients, these dealers use futures contracts to hedge the risk remaining from this business. Thus, the activity of commodity index participants should

> become evident in the position changes of commodity swap dealers.
>
> Non-public CFTC trading data shows that commodity swap dealers have held roughly balanced long and short positions in the crude oil markets over the last year and actually held a net short position over the first five months of 2008 – that is, swap dealers' futures positions would have benefited more from price decreases than from price increases like the ones experienced in the last few months. *Moreover, any pressure exerted by the long positions of swap dealers' commodity index clients has largely been offset by the short positions of the dealers' other clients*.
>
> The Task Force's preliminary analysis also suggests that changes in the positions of swap dealers and non-commercial traders most often **followed** price changes. *This result does not support the hypothesis that the activity of these groups is driving prices higher*. The Task Force has found that the activity of market participants often described as "speculators" has not resulted in systematic changes in price over the last five and a half years. On the contrary, most speculative traders typically alter their positions following price changes, suggesting that they are responding to new information – just as one would expect in an efficiently operating market. In particular, the positions of hedge funds appear to have moved inversely with the preceding price changes, suggesting instead that their positions might have provided a buffer against volatility-inducing shocks.

From the reports concluding remarks:

> Observed increases in the speculative activity and the number of traders in the crude oil futures market do not appear to have systematically affected prices. Moreover, if speculative activity has pushed oil prices above the levels consistent with physical supply and demand, increases in inventories should emerge as higher prices reduce consumption and investment in productive capacity is encouraged. Although this process may take time to unfold, inventories of crude oil and petroleum products, according to available data, have declined significantly over the past year. The view that financial investors have pushed prices above fundamental values is also difficult to square with the fact that prices for other commodities that do not trade on established futures markets (such as coal, steel, and onions) have risen sharply as well.

OK, at least based on this preliminary report, speculators are not the primary culprit behind high oil prices. Clearly SOME % of oils rise is due to speculators, in the same vein that some rise in corn, live hogs and SP500 is due to speculation - in the intermediate term fundamentals will always win. The year of production peak is largely irrelevant - what matters is cheap and abundant liquid fuels to power the economic system the world has become dependent upon - for all practical purposes we are already past this point. We are likely going to continue to witness denial of this obvious but threatening theme from the Wall Street -government-OPEC trifecta. Investment analysts will claim demand destruction, governments will blame speculators and OPEC will posit that the markets remain well supplied. There will be no end to how long these parties continue to use these arguments. Every year there will be a normal 20+% correction in oil prices and confident authority figures will say that peak oil is a myth.

What is it going to take?