# Testimony of
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**Before the**
**Subcommittee on Oversight and Investigations**
**Committee on Energy and Commerce**

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# The House Investigates the Oil Bubble

The Senate and the House of Representatives continue to hold hearings regarding the impact of speculation on the recent run-up in oil prices. Oil prices, which are near their record high reached a couple of weeks ago, are up more than 100% from a year-ago level, despite adequate supply, with no disruptions, and weaker demand outlook than the year ago projection, which should have helped keep oil prices at or below their year-ago level of $65 per barrel, but instead, oil prices more than doubled. Large investment banks keep fanning the fire by making exaggerated oil price predictions that they believe they can help achieve, given the government's inability or unwillingness to hold them accountable.

Below are the main reasons we believe the record oil prices are inflated by speculation and not justified by market fundamentals:

- There were no unexpected changes in industry fundamentals in the last 12 months, when crude oil prices were below $65 per barrel. I cannot think of any reason that explains the run-up in crude oil price, beside excessive speculation.
- World oil demand growth forecasts have been trimmed to reflect the current economic slowdown, which should have resulted in lower, not higher, oil prices.
- World oil production is economic at prices well below $65 per barrel. Marginal replacement cost, however, is distorted by high government take of royalties and taxes due to record oil prices.
- Windfall profits have boosted capital spending and inflated service cost. Bursting the oil bubble could help return the oil markets to more realistic levels.
- Record oil prices in a highly speculated oil market provide fewer incentives for oil exporting countries to increase production, since oversupply, combined with tighter regulations, could cause oil prices to crash.

Below are the answers to the questions by the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce before a hearing held on Monday, June 23, 2008, at 11:00 am in room 2123 Rayburn House Office Building.

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**Question # 1**
**The closing price of light sweet crude on the New York Mercantile Exchange was $116.32 per barrel on May 2, 2008. Do the fundamentals of supply and demand justify this price, and if not, what is the dollar amount of the speculative premium in the market at this time? What is your view based on?**

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I do not believe the current record crude oil price is justified by market fundamentals of supply and demand. I believe the surge in crude oil price, which more than doubled in the last 12 months, was mainly due to excessive speculation and not due to an unexpected shift in market fundamentals. After all, demand growth in China, India and other developing countries was not a surprise and was reflected in crude oil futures a year ago. In fact, the slowdown in global economic growth, caused by the sub-prime debacle and fears of a run on banks, trimmed world oil demand forecasts, which should have resulted in a lower, not higher, oil price. On the supply side, the impact of the unrest in Nigeria on oil exports, the decline in Mexico's crude production, and other less than newsworthy factors, were hardly new news, and were already discounted in crude oil futures.

I firmly believe that the current record oil price in excess of $135 per barrel is inflated. I believe, based on supply and demand fundamentals, crude oil prices should not be above $60 per barrel. My view is based on the following observations:

- There were no unexpected changes in industry fundamentals in the last 12 months, when crude oil prices were below $65 per barrel. I cannot think of any reason that explains the run-up in crude oil price, beside excessive speculation.

- World oil demand growth forecasts have been trimmed to reflect the current economic slowdown, which should have resulted in lower, not higher, oil prices.

- World oil production is economic at prices well below $65 per barrel. Marginal replacement cost, however, is distorted by high government take of royalties and taxes due to record oil prices.

- Windfall profits have boosted capital spending and inflated service cost. Bursting the oil bubble could help return the oil markets to more realistic levels.

- Record oil prices in a highly speculated oil market provide fewer incentives for oil exporting countries to increase production, since oversupply, combined with tighter regulations, could cause oil prices to crash.

- Sharing our conclusion that the surge in crude oil prices is driven mainly by excessive speculation are; Energy Secretary, Samuel Bodman, OPEC oil ministers, and the CEOs of major oil companies.

**Question # 2**
**Does the increasing demand for oil from China and India explain the increase in prices when you examine worldwide production versus consumption?**

Crude oil demand in China and India continues to grow, mainly because of strong economic growth, relatively low demand base, low energy efficiency, and government subsidies. The demand growth was the main reason that crude oil price more than doubled between 2003 and 2006, but I think it is very unrealistic to think that it was the reason for doubling the price in the last 12 months.

The sharp decline in the value of the US. dollar against major currencies, especially the euro, helped mitigate some of the impact from soaring crude oil prices on those countries with stronger currencies. There are clear signs that the sharp rise in crude oil prices is beginning to strain the Chinese and Indian economies, especially with soaring food prices, which are causing social unrest in the two countries. Although economic growth in both countries is expected to continue, the growth is likely to moderate significantly going forward.

**Question # 3**

**What roles have major investment banks, commodity index funds, and other speculators played in the increase in oil prices?**

I firmly believe that major investment banks, commodity index funds, and other financial speculators have played a key role in the current crude oil price bubble. Electronic trading volumes on the NYMEX, the Intercontinental Exchange (ICE), and other smaller exchanges have grown significantly in the last five years. The current trading volume in oil future is more than 12 times world crude oil consumption, and long positions are more than 40 days of world oil consumption.

Investment banks trade crude oil futures for commercial customers as well as financial players including; hedge funds, mutual funds and pension funds, as well as in their own account using their equity capital. Some large investment banks also own energy assets, including refineries, pipelines, and storage facilities, which qualify them as commercials. That is in part how Enron managed to manipulate the California energy market.

Large investment banks trade crude oil futures as agents for their clients and as principals in their own account. They are also clearing houses for other crude oil trading firms. They also trade securities, currencies, and interest rates, and all their derivatives. They also provide merger, acquisition, fairness opinions on deals. Combining all these financial services with crude oil trading raises serious conflict of interest issues, I believe, and a difficult challenge for regulators.

**Question # 4**

**How much of the price of oil currently is a risk premium attributable to political instability in places such as Iraq, Iran, Nigeria, and Venezuela versus price hikes driven by financial speculation?**

Political instability has been the norm, not the exception, for the oil industry for decades, but became more prominent since the invasion of Iraq. Even at the peak of the sectarian violence in Iraq, crude oil production was not disrupted and has averaged close to 2 million barrels/day in the last three years.

Security issues in Nigeria and occasional violence have been going on since the end of that country's civil war 40 years ago. Nigeria's shut-in crude oil production volume has averaged 400,000 barrel/day in the five years. Iran has been in the U.S. cross hairs since the hostage crisis in 1979 and more prominently in recent years over its nuclear program.

Financial speculators continue to spread fears of potential supply disruptions in the event of air strikes against Iran's nuclear facilities. However, since Iran needs crude oil export revenues more than the world needs its oil, it is highly unlikely than the Iranian government, even in the event of such military action, would stop crude oil export. I think it is also unlikely that any military action would target Iran oil facilities, but most likely be aimed at a regime change. Despite economic sanctions on one side and record oil export revenues on the other side, Iran oil production has not changed meaningfully in the last five years.

Venezuela, in my opinion, has been a case of poor diplomacy and gross misunderstanding between the U.S. and the Chavez government. It is the fourth largest oil exporter to the U.S. and has a large refining capacity in the U.S. Despite continued verbal attacks by President Chavez on the U.S., and the expropriation of oil assets owned by foreign companies, including those of ConocoPhillips and ExxonMobil, the U.S. likely will remain Venezuela's largest oil export market. Venezuela's crude oil production fell from over 3 million barrels per day before the general strike in September 2002, to less than 2.5 million barrels today, almost 500,000 barrels below its current OPEC quota. The situation in Venezuela has not changed in the last six years. Normalizing relations with Venezuela could increase access to its energy resources and boost its oil production and exports to the U.S.

It is my view that there was no material change in oil production in any of the four countries—Iraq, Iran, Nigeria, and Venezuela—that had any meaningful impact on oil prices in the last 12 months.

**Question # 5**
**Is the weak U.S. dollar a contributing factor to high prices of oil? If so, is the price of oil being exacerbated by speculation in derivatives which link the dollar to oil prices?**

There is an almost perfect inverse correlation between the weakness in the U.S. dollar, especially against the euro, and crude oil price. I think of the $65 per barrel surge in crude oil price in the last 12 months, $10-$15 may be attributed to the weak dollar. This inverse correlation has exacerbated speculation in derivatives that link the dollar to oil prices, and the large investment banks are also the largest traders in derivatives.

**Question # 6**
**While you recognize the importance of futures trading to hedge price risk in commercial transactions such as oil shipping, you have also called for greater transparency, curbing excess speculation, and preventing potential conflicts of interest and abuses by traders. What are the key policy changes you would recommend to Congress?**

The globalization of the financial markets has been a double-edged sword. It improved efficiency, opened new markets and introduced new financial products. It also increased trading volumes significantly and made it more difficult for government agencies to sufficiently monitor and effectively regulate global trades, which allowed more abuse by financial speculators. They have more sophisticated tools at their disposal than government regulators, and the gap is growing.

Because of the global nature of the financial markets, any efforts to regulate them must be coordinated between government agencies around the world. Regulators in the U.S., Europe, Japan, and even China, if possible, must co-operate in enforcing trading rules in order to put an end to excessive speculation, which has benefited a few at the expense of many.

- Seek international cooperation on regulating oil futures exchanges.
- Raise the margin requirement to 50%, similar to that required on stocks.
- Bar companies operating in the U.S. from trading oil futures on exchanges not in compliance with U.S. regulations.
- Set trading volume limits by commercials in relation to physical needs.
- Limit trading by financials to a percentage of the commercial volume.
- Bar investment banks and other financial traders from owning energy assets.
- Separate crude oil trading from other trading and investment services.
- Require full disclosure by investment banks of oil trading results.
- Impose stiff penalties, including prison terms, on violators.

**Question # 7**
**Last year you testified before a U.S. Senate Committee in support of raising the current margin for oil futures to 50 percent of the value of the trade. Would this action reduce oil prices? Would this curb speculation? Would this action drain liquidity from the futures market to the point that they would still be able to serve their purpose?**

I do believe that raising the margin requirement, on financials, not commercials, to 50% is a critical first step in the right direction to end excessive speculation, but it has to be universal and must be enforced by other governments.

I believe successful implementation of global crude oil trading regulation would significantly curb speculation and could burst the current oil price bubble. Once speculators see that the game is over, they are likely to dump their long positions, which would exacerbate the drop in crude oil prices. They could make a huge profit, but it would likely be their last.

I don't believe that oil future markets will be negatively impacted by more restrictive rules on trading by financial speculators. It would reduce volatility and provide commercial traders with more transparency and a true picture of supply and demand and help them better manage oil price risk. Oil exchanges, in my opinion, have become licensed global gambling halls.

I believe the role of financial intermediaries should be limited to facilitating oil trades, and not to participate in oil trades as principals, or link oil trades with financial derivatives, which could exacerbate price volatility and increase the risk to commercial traders. The oil markets behaved more rationally before the oil exchange was established 25 years ago, and there is no reason to think that tighter regulation would do any harm to anyone but the speculators.

**Question # 8**
**Would the benefits from raising the margin outweigh the costs to commercial hedging activity by buyers and sellers?**

The margin requirement should be raised only on financials, not commercials. Raising the margin requirement would disadvantage speculators, and benefit commercials whose primary objective is to manage risk, not necessarily make a profit. The primary objective of a financial speculator who trades oil futures is to generate superior returns relative to other investment options and the more volatility, the higher the risk and the returns.

**Question # 9**
**What are your views on the practice of the Commodity Futures Trading Commission (CFTC) to exempt from its regulation the trading of derivatives for U.S. benchmark crude oil on Foreign Boards of Trade, if the foreign regulator does not provide oversight at least as rigorous as the CFTC?**

The Commodity Futures Trading Commission (CFTC) has no jurisdiction over foreign trading of derivatives. The reinforcement efforts must be coordinated among governments in the U.S., Europe and Japan, and universally regulated. I don't believe that any unilateral action by the U.S. is likely to yield the desired results, unless companies operating in the U.S. are barred from trading oil futures on exchanges not sanctioned by U.S. regulators. Regulations must be airtight in order to be effective, and all loopholes must be closed in order for this goal to be achieved.

**Question # 10**
**Should there be greater transparency with respect to bi-lateral trades conducted off exchange for crude oil and other energy commodities?**

Investment banks and other financial firms must be required to disclose their oil futures trading results. Full disclosure should be an integral component of any future energy trading regulation. More disclosure and transparency are steps in the right direction. Companies that operate within the law and have nothing to hide should have no objection to more disclosure. Hiding behind proprietary trading programs is an excuse and a smokescreen not to disclose trading information. I believe bi-lateral trades conducted off the exchange for crude oil and other energy commodities should be subject to full disclosure and transparency.