

**STATEMENT OF SENATOR CARL LEVIN (D-MICH), CHAIRMAN**  
**PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**  
**BEFORE A JOINT HEARING WITH THE SUBCOMMITTEE ON ENERGY**  
**ON**  
**SPECULATION IN THE CRUDE OIL MARKET**

**December 11, 2007**

Good morning. The Permanent Subcommittee on Investigations and the Subcommittee on Energy are conducting a joint hearing into why U.S. oil prices keep rising despite what appears to be an adequate U.S. supply of oil.

The price of crude oil recently rose above \$99 per barrel, a record high. Just before Thanksgiving, the national average price of gasoline went over \$3.10 per gallon for the second time this year. The price of diesel fuel is at a record high, as is the price of home heating oil. These record high prices severely hurt millions of Americans and American businesses. They raise the cost of virtually everything in our daily lives—the gasoline in our cars and trucks, the food we eat, air travel, heating our homes and offices, generating electricity, and manufacturing countless industrial and consumer products. It is our duty in the Congress to do everything we can to ensure that the price Americans pay for energy is a fair price.

Just about a year ago, on January 18, the price of crude oil on the New York Mercantile Exchange (NYMEX) was about \$50 per barrel. A few weeks ago, the NYMEX price reached an all-time high of just over \$99 per barrel. [Exhibit 1] Although the price of oil virtually doubled during this period—an unprecedented rise of nearly \$50 in just one year—the overall inventory of oil in the United States has been above the 5-year average for the entire year. [Exhibit 2] It seemingly defies the laws of supply and demand to have an astronomical increase in the price of oil at the same time the U.S. inventory of oil has stayed above average.

On any given day, we can read in the newspapers or hear on the television the familiar explanations for why the price of oil is so high. Instability in the Middle East, bad weather affecting oil production platforms, civil strife in oil producing countries, the declining value of the dollar. These are just a few of the “usual suspects” that are often cited as the reasons for high prices.

The problem with these explanations is not that they’re false. Most of them are true. But most of them been true for some time. Unfortunately, instability in the Middle

East is not new. There is always bad weather somewhere around the globe that affects oil production and transportation. There is, unfortunately, a lot of civil strife in a number of oil producing countries. The dollar rises, and the dollar falls. The world is a dangerous place. These factors alone cannot justify a doubling in the price of oil.

So, what else can help explain record prices? In this hearing we will examine some of the other factors that are contributing to the high price of oil, as well as what we can do about it.

One key factor that has contributed to the rise in oil prices over the past few years is the virtual explosion of trading of paper contracts for oil delivery in future months – trading which is speculative and not intended to result in the actual delivery of oil. Traders are trading paper oil contracts in record amounts. In the last four years we have seen a huge increase in the number of oil futures contracts traded on the New York Mercantile Exchange. And there also has been tremendous growth of trading of U.S. crude oil in London. As Secretary of Energy Bodman recently said, "The prices for crude oil are now set in New York and London and Tokyo, Singapore and other trading hubs around the world."

Data compiled by the Commodity Futures Trading Commission (CFTC) shows that, in the past few years, out of this overall increase in energy trading, the amount of trading due to speculation has nearly tripled. This next chart shows that in the last few years the percentage of oil futures contracts held by speculators has risen from around 15% to nearly 45%. [Exhibit 14] These are traders who are solely interested in trading for a profit, rather than hedging their positions to assure a stable supply at a price they can count on. These energy speculators not only comprise a larger percentage of U.S. oil trades, but are also responsible for the larger amount of dollars involved in U.S. energy commodity trades.

A fair price is a price that accurately reflects the forces of supply and demand for a commodity, not the trading strategies of speculators who only are in the market to make a profit for themselves by the buying and selling of paper contracts with no intent to actually purchase, deliver, or transfer the commodity. But as we have all too often seen in recent years, when speculation grows so large that it has a major impact on the market, prices get distorted and stop reflecting true supply and demand.

Last year, my Subcommittee released a bipartisan report, "*The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat.*" The report found that trading of futures contracts by speculators had increased the demand for oil futures, and this additional demand for contracts had contributed an additional \$20 to the price of oil. At the time the price of oil was around \$70 per barrel, so speculation was a major contributor to what was then thought to be sky-high crude oil prices. Our report recommended additional market transparency and stronger market oversight to reduce the effects of increased speculation.

Given the hefty increases in speculation in the U.S. oil market, we need to know what the effect of all this speculation has been on U.S. oil prices. To what extent, for example, has dramatically increased speculation contributed to the extraordinary jump in prices we have seen this year? Is speculation responsible for \$20 per barrel of oil? More? This is a vitally important question. If the extraordinary increase in oil prices is not based on actual supply and demand, then we need to figure out what role is being played by speculation, and what steps can be taken to restore the market's focus on supply and demand.

Speculation is not, of course, the only reason for sky-high oil prices in 2007. There's another key reason we want to examine, and that is the policy of the Administration relative to adding oil to the Strategic Petroleum Reserve or SPR. One of today's witnesses, Dr. Philip Verleger, will present his analysis of how the Administration's program to fill the SPR with high-quality crude oil, also known as sweet crude, has contributed to the recent price increases. He will tell us how the SPR fill program has helped deplete supplies of sweet crude normally used to fulfill crude oil futures contracts traded on the NYMEX, and how those reduced supplies have, in turn, pushed up crude oil prices.

There's a third problem as well that the SPR fill program has exacerbated – the fact that the standard NYMEX futures contract that sets the benchmark price for U.S. crude oil requires a particular type of high quality crude oil known as West Texas Intermediate (WTI) to be delivered at a particular location, Cushing, Oklahoma. Because the price of the standard contract depends upon the supply of WTI, which again is but one type of sweet crude oil, the supply and demand conditions in Oklahoma have a disproportionate influence on the price of NYMEX futures contracts.

Four years ago, I called for reform of this outdated feature of the standard NYMEX crude oil contract, but it has never been fixed and the problems caused by the standard contract have gotten worse. This next chart [Exhibit 4] shows that in 2007, the crude oil inventory in Cushing, Oklahoma, fell. When that inventory crashed, it caused a big supply drop in Oklahoma, even though overall U.S. crude oil inventories remained above average. But because the Oklahoma supply fell, the benchmark price on the NYMEX jumped, since, again, the NYMEX price depends on the supply and demand for oil at Cushing, Oklahoma.

According to Dr. Verleger, it is only sweet crude oil that now is in relatively short supply compared to demand, and that is part of the reason why oil traded on the NYMEX has become so expensive. Indeed, last month, the difference in price between sweet crude oil and some other types of crude oils reached \$20, \$30, even \$40 per barrel in U.S. trading. That's a striking price gap.

Why does it matter that the Administration is depositing sweet crude into the SPR? It matters because the price of one key type of sweet crude, WTI, determines the price of the standard NYMEX contract. The standard NYMEX contract price, in turn, has a major influence on the price of fuels refined from crude oil such as gasoline,

heating oil, and diesel. That means when the WTI price is no longer representative of the price of U.S. crude oil in general, the prices of all of these other commodities are also thrown out of whack.

And DOE has made the situation much worse by purchasing several million of barrels of sweet crude and depositing them into the SPR over the past few months. Those purchases remove sweet crude from the marketplace and reduce the supply of oil available for WTI contracts. As you can see from the chart, the drop of several million barrels in the inventory of crude oil at Cushing since August has been accompanied by a huge increase in the price of U.S. crude oil. [**Chart 4**]. It seems that the only place in the United States where price really reflects supply and demand is in Cushing, Oklahoma.

In the last four months, DOE has taken several million barrels of sweet crude off the market to fill the SPR, regardless of price. If DOE had simply postponed the SPR fill for one year, it would have not only alleviated the upward pressure on U.S. oil prices, but also saved U.S. taxpayers millions of dollars. Based on the market and futures prices at the time the DOE bought oil for the SPR, for example, DOE could have saved \$10 per barrel by simply locking in the futures price and deferring current deliveries for one year. That's because at the time the oil was acquired, the futures price for delivering the oil in one year was about \$10 per barrel cheaper than the current price. Since the Administration bought enough oil to deposit another 8.7 million barrels in the SPR, that \$10 price difference would have translated into a one-year taxpayer savings of nearly \$87 million. In light of Congress's direction in the Energy Policy Act of 2005 to fill the SPR in a manner that minimizes costs to taxpayers and minimizes impacts on oil prices, it is incomprehensible why DOE continues to fill the SPR without taking advantage of the lower futures prices.

This state of affairs raises two questions. First, why is DOE contributing to the shortage of sweet crude oil by placing it into the SPR, and thereby helping boost the standard NYMEX price? What's worse, it is our understanding that DOE intends to deposit another 7 million barrels of sweet crude oil into the SPR beginning next month. DOE will be taking this high-quality oil off the market just at the time when it will be in the highest demand to produce gasoline and diesel fuel for the spring and summer driving seasons.

Second, it appears that we have an oil futures market that reflects the supply and demand conditions in Oklahoma, but not necessarily the overall supply and demand situation in the United States as a whole. Our Subcommittee raised this very issue in 2003, and called on the CFTC and NYMEX to work together to revise the standard NYMEX crude oil futures contract to reduce its susceptibility to local imbalances in the market for WTI crude oil. The Subcommittee report suggested that allowing for delivery at other locations could reduce the volatility of the contract. It is truly disappointing that since our report was issued no progress has been made in allowing for delivery in other places than Cushing. Again, the price of oil to our consumers is higher because of that failure.

A final problem is that a large portion of trading of WTI crude oil now takes place in London, regulated by the British authorities under British law. How can we really know what is influencing our oil markets when we can't see all of the market data? Although the CFTC has a data-sharing agreement with the British authorities, none of this data is available to the public. Unlike the U.S. oil futures market, there is no public data on how much of the trading occurring in London is done by speculators. So a key issue is how can we improve the transparency of the crude oil market?

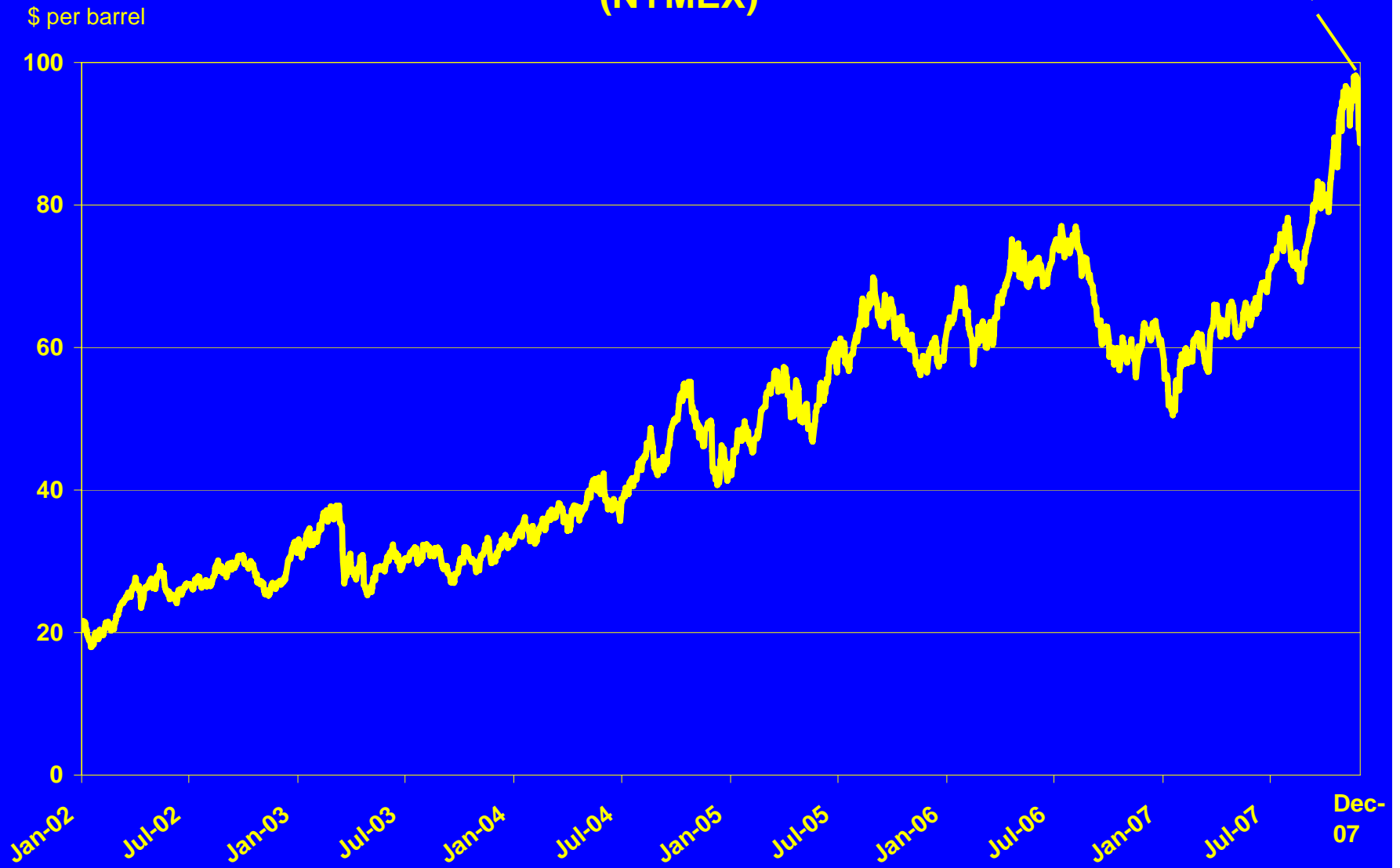
In addition to stopping the SPR fill, fixing the NYMEX contract, and getting information about WTI trades in London, a number of us have introduced the "Close the Enron Loophole Act" to improve the transparency of U.S. energy markets. Our bill would give the CFTC the authority to police what are now unregulated electronic trading markets for large energy traders. This vitally needed legislation is more important right now for natural gas prices, but there is nothing preventing crude oil contracts from being traded on unregulated electronic markets as well, and which took place until recently. Many of us are working together to pass this legislation as part of the Farm Bill.

All of our witnesses today are very knowledgeable about the oil markets. I thank all of them for their willingness to testify at this joint hearing. I look forward to their testimony.

I would also like to express my appreciation to the Ranking Member of the Permanent Subcommittee, Senator Coleman, and his staff, for their support in organizing this hearing, and to our colleagues on the Senate Energy Committee for working together with us to conduct this joint hearing. I want to particularly thank Senators Dorgan and Murkowski of the Subcommittee on Energy for their efforts. The price of oil is an important issue for all of us and our constituents, as it affects virtually every aspect of our economy. I am glad that we have been able to work together so we can focus our witnesses and our attention in a single forum where this issue can be examined.

# Crude Oil Prices (NYMEX)

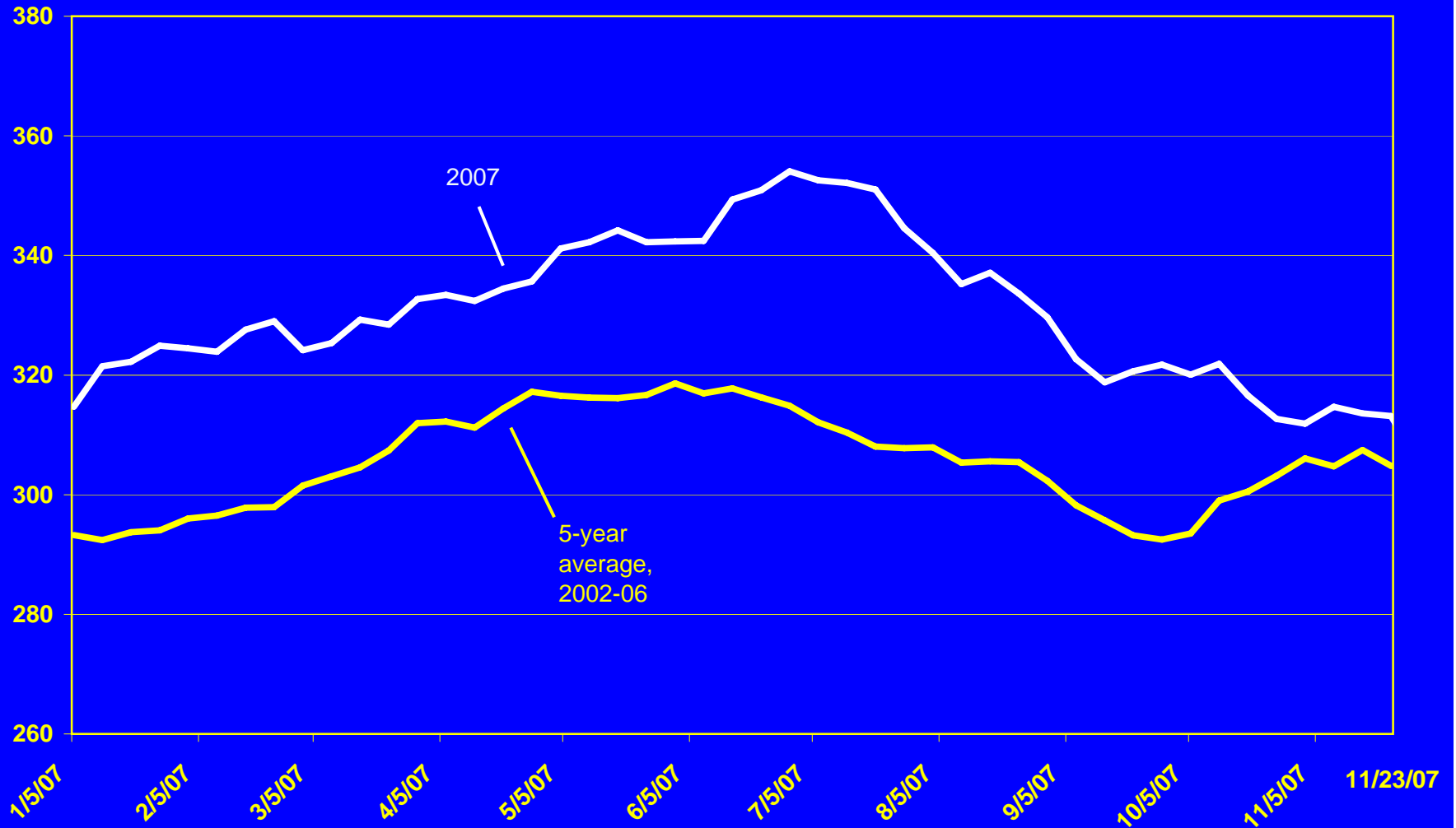
\$98.18  
Nov. 23, 2007



Data source: EIA, NYMEX  
Chart prepared by: Majority Staff,  
Senate Permanent Subcommittee on Investigations

## U.S. Crude Oil Inventories 2007 Compared to Previous 5-Year Average

millions of barrels

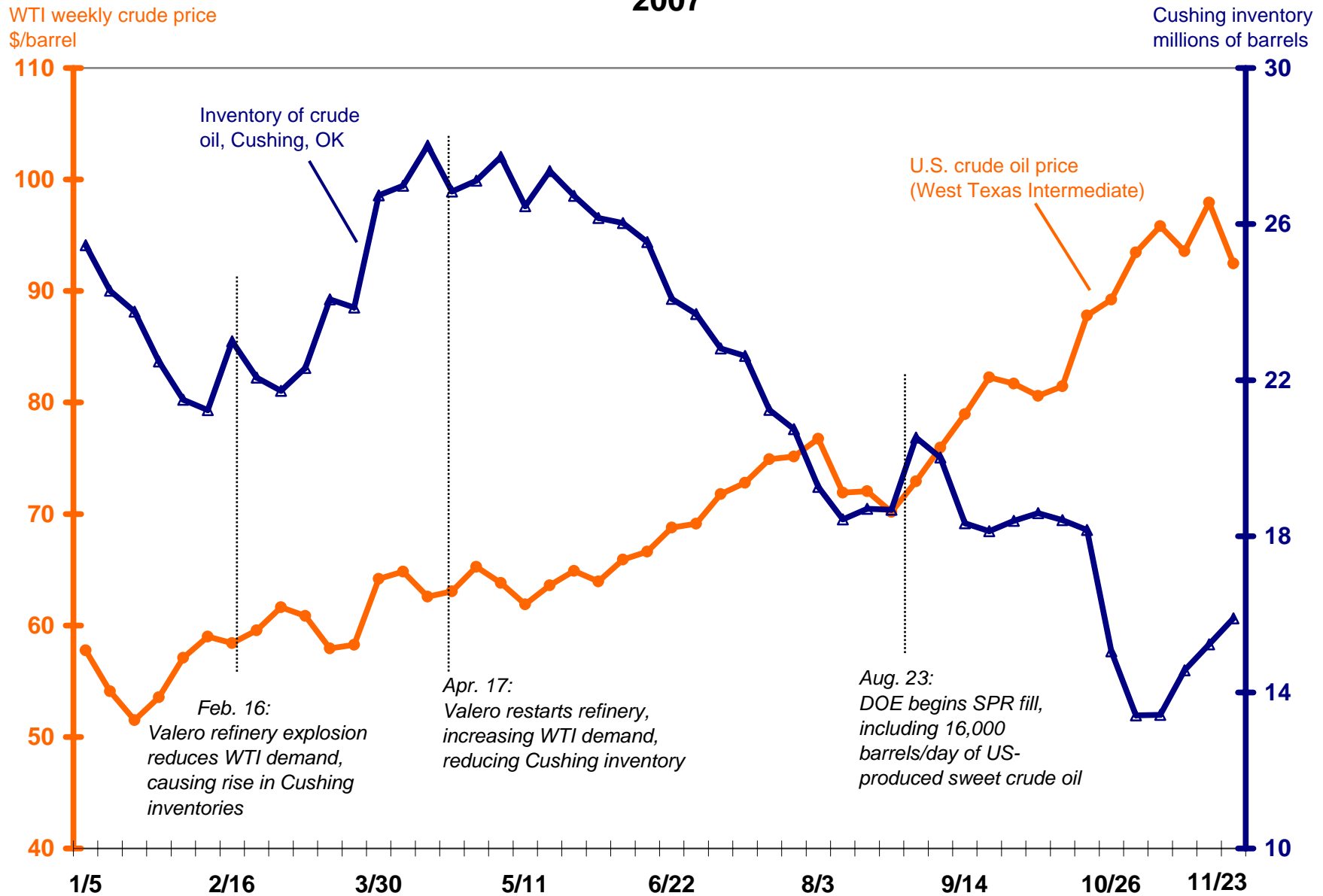


Data source: EIA

Chart prepared by: Majority Staff,

Senate Permanent Subcommittee on Investigations

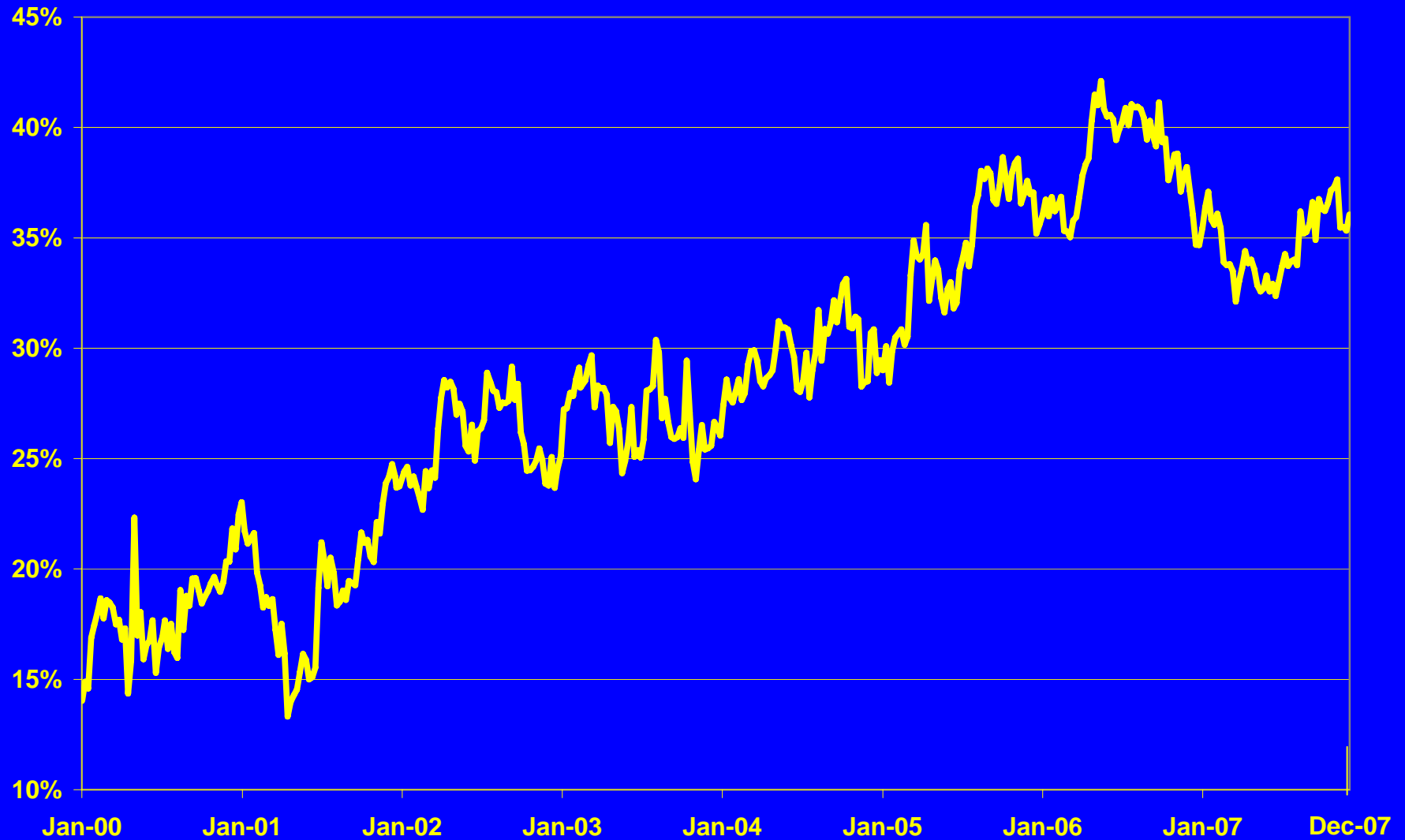
# U.S. Crude Oil: Prices and Inventories at Cushing, OK 2007



Data source: EIA  
 Chart prepared by: Majority Staff,  
 Senate Permanent Subcommittee on Investigations



## Speculative Interest in Crude Oil (Percent of Open Interest Held by Speculators)



Data source: CFTC

Chart prepared by: Majority staff,

Senate Permanent Subcommittee on Investigations