Consumer Federation of America

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SPECULATION: A KEY CAUSE OF RISING GAS PRICES

Once More Wall Street Wins While Main Street Pays More at the Pump

Washington, D.C. – The past decade has been a nerve wracking, budget busting, roller coaster ride for American gasoline consumers. Since January 2002, gasoline was below $2.00 per gallon for 170 weeks (54 below $1.50), it was above $3.00 per gallon for 140 weeks (77 above $3.50). Since driving and gasoline are basic needs of daily life in the United States, the gas pump roller coaster is wreaking havoc on household budgets.

The bad news: Last year household expenditures of gasoline set a record at about $2,900 for the average household. Americans today are on one of the highest points in the gas price roller coaster. With West Texas Intermediate (WTI) crude oil, the benchmark for U.S. oil, at $104 per barrel, it is $30 higher than it should be. This overpriced oil is due solely to excessive speculation in commodity markets – <u>the same problem that drove oil to $140 per barrel before the bubble burst in 2008</u>.

At the bottom of the oil market in December 2008, when the price of West Texas crude was just below $33 per barrel, the value of contracts for future delivery of oil on the NYMEX was about $40 billion. Last week, the value of open future contracts was a little less than $160 billion. Over that same period, the amount of oil held in open futures contract increased by 25%, while the amount of oil consumed in the United States decreased by 10%. The vast majority of these contracts are held by speculators who never actually take delivery of oil, they just trade it back and forth with each other. Too much money chasing too few goods is a recipe for price inflation and that is causing the oil price speculation which is driving up the price of oil and the price at the pump.

The good news: today's roller coaster prices could have been much higher. While West Texas crude is at $104 per barrel, Brent crude, the price benchmark for Europe and the rest of the world is $20 higher, at $124 per barrel. The reason that U.S. oil is $20 below the world level is that over the past five years, policies adopted by the Bush and Obama administrations have done a good job of improving the supply and demand situation in the United States market. The rising gasoline price, in the face of improving fundamentals is strong evidence that market fundamentals are not the cause of the recent run up in prices.

Since early 2008, all of the market fundamentals driving U.S. petroleum prices have leaned against price increases. Consumption is down by ten percent (2 million barrels per day). Due to the decision to raise fuel economy standards, new vehicles are getting 20 percent more miles per gallon, while consumption has dropped by 10 percent in the industrial sector. Domestic oil production is rising for the first time in over three decades, up over 10 percent in the past four years; and alternative fuel use has doubled and now equals 3 percent of total consumption. Net imports are down to mid-1990s levels, and spare refinery capacity is up has doubled.

"The bad news, good news: excessive speculation has raised gasoline prices by $0.75 per gallon, while sound policy on market fundamentals is saving $0.50 per gallon."

"Three clear policy paths must be taken given what we have learned from this difficult decade," said Mark Cooper, CFA's Director of Research. The three are:

First, we should stick to and reinforce the balanced approach to improving market fundamentals that is working well. That balanced approach had bipartisan support when the Energy Independence and Security Act was signed into law in 2007 by George Bush and it deserves bipartisan support today.

Second, we need to protect ourselves from the short term volatility that emanates from a market in which the OPEC cartel sets production quotas that restrict investment. Never before has coordination among the major consuming nations been so critically important. While the United States consumes a little over one-fifth of the world's oil, the other members of the Organization for Economic Cooperation and Development (OECD) consume one-third.

Third, we must launch vigorous efforts to rein in excessive speculation. The Commodity Futures Trading Commission has taken initial steps in the right direction, but the big banks, hedge funds and index traders are trying to water down or stop the rules. The CFTC should move forward with the rules on the books and strengthen them to accomplish several goals that we have called for in the past. More specifically, the efforts should include the following:

- **Chase out bad actors and bad products:** All traders must register and be certified (for honesty and competence, like bankers and brokers). All trading must be reported across all transactions and some products, like credit default swaps and index funds, should be banned.
- **Eliminate the funny money:** Raise margin requirements. Increase capital reserve requirements.
- **Reduce the ability to push prices up:** Lower position limits and tie limits and margin policies to needs of physical, traders. Lengthen settlement windows. Ban conflicts of interest (analysts' reports that enrich analysts' portfolios)
- **Restore the proper functioning of commodity markets and their regulators:** Enforce meaningful speculative limits, Do honest analysis (classify traders correctly). Close the loopholes (foreign boards of Trade exemptions, the Enron and swaps). Create minimum criminal penalties for violation of commodity laws
- **Redirect investment to productive long-term uses:** Put a tax on short-term capital gains. Move pension funds out of speculation, Ban institutional index funds.

Policies to rid commodity markets of excessive speculation deserve the same bipartisan support that the long-term fundamentals policy received.

The Consumer Federation of America is a non-profit association of some 280 national, state, and local pro-consumer organizations founded in 1968 to promote the consumer interest through research, education and advocacy.

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