

Petroleum Derivatives Trading Sends Oil Price Skyrocketting

by Richard Freeman

The current explosion of petroleum prices has resulted not from underproduction, but from unchecked and unregulated speculation. At the world's two dominant energy-futures exchanges—the International Petroleum Exchange (IPE) in London and the New York Mercantile Exchange (NYMEX) in New York—tens of millions of speculative bets on oil futures contracts have, over the past two years, manipulated oil prices through the roof. The bets in this increasingly wild energy-price casino are placed by two of the principal instruments of the Anglo-American financier oligarchy: the world's biggest derivatives traders, and the leading forces of the raw materials cartel.

As a result, since January 1999, the price of oil has tripled, and hovers in the range of \$32 to \$35 per barrel, poised to resume its climb. The global hyperinflation in petroleum prices threatens, along with the accelerating financial disintegration, to detonate a chaotic breakdown in many, if not all economies of the world.

The combined speculation at the IPE and NYMEX exposes as a fairy-tale, the claim that OPEC is responsible for the price rise by holding oil off the market. Since the start of this year, OPEC has increased oil production by 800,000 barrels, and world oil production has been consistently greater than consumption.

Yet, if not OPEC, who? Let us look at the three real causes

of the petroleum price rise. First, there is the increased concentration of ownership of oil companies through mergers and acquisitions. This is led by the Aug. 1, 1998 merger of British Petroleum and Amoco, and the Dec. 1, 1998 merger of Exxon and Mobil. The considerable costs of these mergers have been passed on in higher prices.

Second, since the third quarter of 1998, Federal Reserve Board Chairman Alan Greenspan has pumped up U.S. monetary aggregates in order to prop up the financial aggregates, which has set the world on the path of a Weimar-style hyperinflation. This hyperinflationary spiral has also pushed up the price of petroleum and other commodities.

Third, as a strategic element within this setting, there has been the use of oil derivatives to bid up the price of petroleum, and to benefit from the rise in the markets for both derivatives and physical delivery of petroleum. The speculators trade oil futures contracts which represent "paper oil," which contracts are a paper claim against oil, far in excess of the volume of oil that is produced and actually delivered at oil terminals on behalf of those contracts. As will be documented, the reality that the ratio of paper oil is many times that of actual oil, is what forces up the price of oil.

For example, according to one Texas source, a single contract at the NYMEX is traded 15 times before it expires. That is, each barrel of oil represented by this contract is traded 15 times, before the oil is delivered. At the IPE, the total oil which is traded on the exchange is only a very small percentage of all oil produced in the world, but this small volume is traded many times.

Worldwide Leverage

The speculators employ tremendous amounts of leverage. At the exchanges, the crude oil futures contract entitles the speculator to put down, as the margin cost of his purchase, only 2.5 to 5% of the underlying dollar value of all the oil covered by the futures contract. Yet the Brent Crude Futures contract, which is traded at the IPE in London, determines the price of actual Brent crude oil; likewise, the West Texas Intermediate Crude futures contract, which is traded at the NYMEX in New York, determines the price of actual West Texas Intermediate crude oil.

Moreover, Brent crude oil and West Texas Intermediate crude oil, constitute the basis against which more than 90%

In This Section

What is causing the oil price explosion, and what should be done about it? We present here new documentation of how speculation—not OPEC!—is to blame. We also reprint Lyndon H. LaRouche's ten-point program for government-to-government negotiations on a fair oil price. Next, are reports on the terrible energy policies of Presidential candidates Al Gore and George W. Bush—the first representing Occidental Petroleum, and the second representing Enron—as well as the slightly more interesting views of Ralph Nader and Pat Buchanan.

TABLE 1

Brent Oil Futures Contracts, 1991-2000

	No. of Brent Crude Oil Futures Contracts (Millions)	No. of Barrels of Oil Covered by Brent Futures Contracts (Billions)	No. of Barrels of Brent Oil Produced per Year (Millions)	Ratio of Barrels Covered by Brent Futures Contracts to Barrels of Brent Oil Actually Produced
	5.23	5.23	66.80	78.30
1992	6.17	6.17	85.05	72.6
1993	8.85	8.85	84.68	104.5
1994	8.94	8.94	72.27	123.6
1995	9.77	9.77	69.72	140.2
1996	11.41	11.41	70.81	161.1
1997	10.30	10.30	48.55	212.2
1998	12.67	12.67	46.72	271.2
1999	15.98	15.98	69.72	229.3
2000	17.69*	17.69*	29.65*	596.6

* This covers the period January through August 2000, on an annualized basis.

Sources: International Petroleum Exchange; Petroleum Institute (London); Wood MacKenzie U.K. Upstream.

of the world's oil is priced. Thus, what importers, whether they be individual companies or nations, pay for their oil, is determined by the price of Brent crude and West Texas Intermediate crude.

Pinpointing this theme, in a Sept. 19 memorandum, Lyndon LaRouche cited "an intensity of speculative activity, especially in the form of financial derivatives, in this area, which threatens to bring the per-barrel price of petroleum to between \$40 and \$50 per barrel, soon, and not much later, much higher." LaRouche outlines emergency actions that nations must take (see p. 12).

A NYMEX document, "How the Exchange Works," boasts that it has nothing to do with oil production. "Yet the buying and selling on the Exchange occurs amid the winding streets of the oldest section of New York, with nary an oil well or copper mine in sight. In fact, many thousands of transactions conducted on the Exchange each day are accomplished without the participants ever seeing a gallon of heating oil. . . . If you visit the Exchange trading floor, you won't find samples of metal or barrels of oil scattered about, but you will see a lot of people standing in circles yelling at each other."

We will first see the volume of oil futures trading operations, and how the futures work; and then those agents, acting for the Anglo-American financier oligarchy, who run the markets, and for what purpose.

Speculative Frenzy at the IPE

The IPE's biggest contract is the Brent Crude Futures contract. The "paper barrels" are many times the physical barrels of oil. **Table 1** shows that the volume of trading in Brent crude oil futures contracts tripled from 5.23 million in 1991, to 17.69 million in 2000. (The figure for this year is annualized from the first eight months.) Moreover, the volume of Brent Crude Futures oil contract betting rose by 5

million contracts during the past two years, an instrumental force in driving up the price of oil threefold.

Each contract (or lot, as they are sometimes called) that is traded represents 1,000 barrels of oil. Thus, the 17.69 million contracts traded in 2000 represent 17.69 billion barrels of oil. The fourth column represents the total annualized production of Brent North Sea oil: In 2000, it is 29.65 million barrels. The fifth column is a ratio: the number of barrels of oil traded through Brent Futures contracts annually, compared to the number of barrels of oil annually that are brought out of the North Sea in production. In 2000, the ratio of paper oil to actual oil was 597. The trend is important, rising from 78 in 1991, to 212 in 1997, to 597 today.

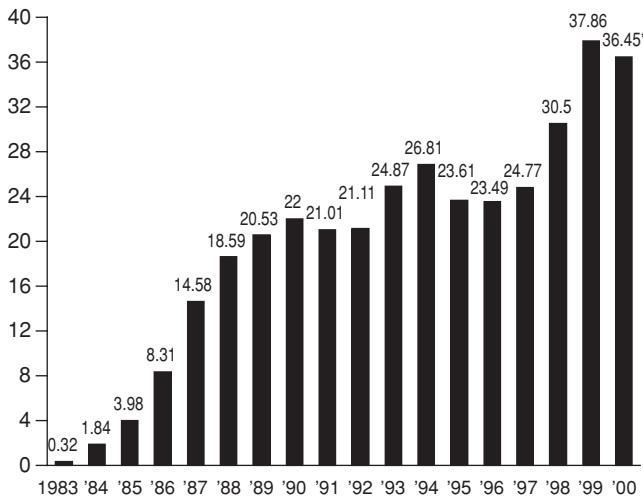
However, there is an important qualification. The Brent Crude Futures contract is a contract that has a price against Brent North Sea oil, which is produced in the North Sea and has a specific API gravity. However, other oils are deliverable against the IPE's Brent Crude Futures contract, such as Nigerian Bonny Light, or Norwegian Oseberg Blend, with a conversion factor that converts these other oils to a basis that is equivalent to Brent crude (these other oils either have a premium or discount in price comparable to Brent). Thus, other oils are deliverable against the Brent Crude Futures contract.

In reality, only a limited amount of the world's oil production, other than Brent oil, is traded at the IPE and delivered against the Brent Crude Futures contract. The IPE says that it cannot assist the researcher on this: It claims it does not know the volume of oil, other than Brent oil, that is traded and delivered against the Brent Crude Futures contract, which would make more possible a calculation of paper oil to actual oil. However, it is possible to see how limited the amount of other oil that is traded on the IPE is. For example, a source at the IPE reported on Sept. 26, "Some Arab [nations] do not have their oil traded through the IPE. Aramco [run by Saudi

FIGURE 1

West Texas Intermediate Crude Futures Contracts, 1983-2000

(Millions of Contracts)



*This covers the period January through August 2000, on an annualized basis.

Source: New York Mercantile Exchange.

Arabia] will not trade oil through IPE and have [IPE] futures contracts posted against their oil.” Saudi Arabia produces 8.02 million barrels per day (mbd). It is believed that Iran will not allow IPE futures to be traded against its oil (Iran produces 3.58 mbd), and that most Middle East OPEC members (which produce approximately 23 mbd) will not. It is also believed that China will not (3.27 mbd), nor will most of the nations of the former Soviet Union (which produced 7.68 mbd). Most of the oil of the Americas is not traded or delivered at the IPE against IPE Brent Crude Futures contracts, and if it is exchange-traded at all, it is traded through the NYMEX.

Thus, the amount of physical oil that the Brent Crude Futures contracts are traded against is unknown, but limited. If one takes the ratio of the number of barrels of oil which are traded through Brent Futures contracts annually, to the number of barrels of oil annually that are brought out of the North Sea, which is presented in column 5 in Table 1, even if that ratio of paper oil to actual oil is off by a factor of 10 to 100, the trend shown there is significant, and increasing. (This comprises a necessary approximation; in future issues, *EIR* will work to refine this further.)

The NYMEX Speculative Binge

Figure 1 shows that the volume of crude futures contracts traded on the NYMEX has also shot up.

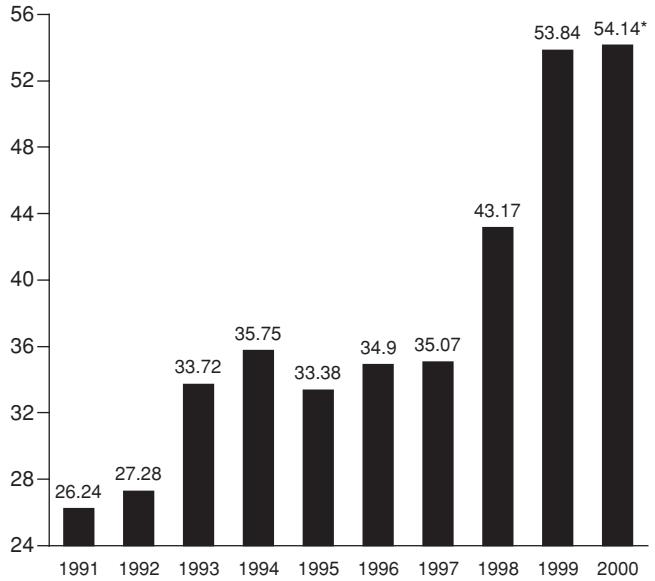
In just the last two years, the volume of speculative NYMEX WTI Crude contracts traded has increased by 6 million.

According to a source in Texas, “A single WTI crude

FIGURE 2

Crude Oil Futures Contracts Traded at the IPE and NYMEX, Combined

(Millions of Contracts)



*This covers the period January through August 2000, on an annualized basis.

Sources: International Petroleum Exchange; New York Mercantile Exchange.

contract at the NYMEX trades 15 times before the contract expires. Usually the contract is for 18 months, and the heaviest trading period, when the most trading of it takes place, is the last month and one-half before it expires.”

Figure 2 shows the number of crude oil futures contracts traded together on the IPE and NYMEX.

Between 1998 and 2000, the volume of crude oil futures, a form of derivatives, rose from 43.17 million contracts to 54.14 million contracts, an increase of 10.97 million contracts, which represent an underlying volume of oil of 10.97 billion barrels. But between 1998 and 2000, the volume of world oil production increased by only 183 million barrels. So, during 1998-2000, there were derivatives contracts representing 325 new paper barrels of oil for every new barrel of oil produced (10.97 billion versus 183 million). This is a huge concentration in speculation, which had an equivalent effect in pushing up the oil price.

Overall, in 2000, there will be 54.14 million futures-derivatives oil contracts deals, which cover and are a claim on 54.14 billion barrels of oil.

Leverage

The oil futures-derivatives build a tremendous amount of leverage into the oil market, so that a small amount of money is having a great effect.

A futures contract is an agreement to purchase or sell a commodity for delivery in the future, at a price which is determined at initiation of the contract. In the case of oil, one can buy one contract or lot of oil, at, say \$37 per barrel. Since each contract or lot is 1,000 barrels, one lot would cover \$37,000 worth of oil (1,000 barrels at \$37 per barrel). But here's the catch: At the London IPE, at the moment, the margin that a speculator must put down to buy a Brent Crude futures contract is \$1,400. Thus, one buys a futures contract, which has a claim on an underlying value of oil of \$37,000, for a margin of only \$1,400, or a margin of 3.8% of the underlying value of the oil. At the NYMEX, the margin is between 2.5 and 4% of the underlying value of the oil in the contract. This transmits to the speculator a tremendous amount of leverage. The leverage on the IPE is 26:1, i.e., \$37,000 divided by \$1,400.

As yet, if one buys a futures contract, one does not own the oil; one has the ability to buy it at the future specified date at \$37 per barrel. However, in the technical language of the exchanges, the futures contract is said to "control" the underlying commodity, indicating a high degree of influence.

Now consider the manner by which speculators drive up the price of oil through the use of oil futures trading. Assume that oil is trading at \$35 in October, and speculators wish to drive it up to \$40 in November. A core group of speculators would buy tens of thousands, or hundreds of thousands of Brent Crude or WTI Crude futures contracts for November delivery at \$40 per barrel. The object is to move the price of physical oil upward. Consider the case of an individual who needs an amount of oil in November. He sees that the "savvy investors" (in reality, speculators) are taking out oil contracts for November delivery for \$40 per barrel. He fears, based on his reading of the futures market, that when November comes around, he will have to pay \$40 per barrel. He cannot afford to wait for November. Since oil is \$35 per barrel now, he will be willing to pay in the range of \$36 to \$39 per barrel of oil, recognizing that he will no longer be able to get the oil at \$35 per barrel.

The individual needing oil in November will do one of two things. He will try to buy oil at \$36-39 per barrel on the futures market. That will most likely fail, so therefore he will try to buy oil on the Rotterdam spot market (i.e., physical delivery market), and take delivery of oil at \$36-39 per barrel. The price of oil has been bid up from \$35 per barrel to the range of \$36 to \$39 per barrel. This is one example: There are other ways that the futures market drives up the current price of oil. The futures market strangles the productive forces in the economy really needing oil. The speculators will repeat the process as many times as is necessary (and also make money through their control of the spot market).

Now, add into this situation, the fact that over the last two years, 10.97 million additional crude oil futures contracts, above the level of 43.17 million that existed at the end of 1998, were brought into play as speculative instruments. These contracts represent 10.97 billion barrels of oil (not all

the contracts were for oil's price to rise, but the overall process of the contracts was shaped to create a price increase). In the case above, the futures price of Brent Crude is determining the spot physical price of Brent crude. Likewise, the futures price of WTI is determining the spot physical price of WTI crude.

This has global repercussions. Critically, the IPE boasts, the Brent Crude complex "is used to price two-thirds of the world's oil supplies, and its influence is still spreading." That is, the price of two-thirds of the world's oil is pegged to the Brent Crude complex. Most of the rest of the world's oil is priced against WTI (a little bit of it is priced against Dubai oil).

But, further, the IPE also is rigging the price of oil products, in particular in Europe. It shamelessly brags that its "gas oil prices are used as a basis to price heating oil, diesel, and aviation jet fuel in Europe and beyond."

The Oligarchy Runs the Exchanges

It is the financier oligarchy's derivatives traders, and the House of Windsor-pivoted Anglo-American oil and raw materials cartels, that run the IPE and NYMEX.

Here is a list of the major IPE floor member companies: ABN Amro; ADM Investors Services International; AIC Limited; Amerex Futures; Arcadia Petroleum (a division of Mitsui); Banc of America Futures; Bank of Nova Scotia; Barclays Capital; Bear, Stearns International; BP Oil International; Cargill Investor Services; Crédit Lyonnais Rouse; Deutsche Futures London; Enron Europe Finance and Trading; Fimat International Banque; GNI; Goldman Sachs International; ING Barings Futures & Options; Ixomex; Lehman Brothers; Merrill Lynch; J.P. Morgan Securities; Morgan Stanley International; Paine Webber International; Paribas Futures; Phibro Futures (a division of Citicorp-Salomon); Prudential Bache International; PVM Oil Futures; REFCO Overseas; Salomon Brothers International; Shell International Trading; Skandinavisk Enskilda Banken; Swiss Finance Corp.; and Trafalgar Commodities.

From its inception in 1980, the IPE has been a not-for-profit society, owned by its member firms. In April, it voted to demutualize and become a private, for-profit company. A majority of the controlling shares in the new private company will be owned by the member firms.

As for the NYMEX, the list of its major floor members is almost identical to IPE's. The NYMEX is also a not-for-profit mutually owned society.

Thus, the same group of oligarchically controlled firms run both the IPE and NYMEX. This same group of firms, comprised of derivatives traders and members of the Anglo-American raw materials cartel, also set off the Russian GKO crisis in 1998, attacked the Asian currencies in 1997, and have destroyed various sections of the world economy.

Using 54.14 million oil futures contracts, all highly leveraged, they have been driving the oil price speculatively upward.