

OIL SHTICK

MAY 2006

A long time ago, in a galaxy far, far away... Companies that sold pet food online, web portals geared toward left-handed vegetarian cross-dressers, and just about any company that held the criteria of having a dot com attached to it and was led by some "visionary" 22 year-old with a goat-tee and black turtleneck had a multi-billion dollar valuation.

Actually it wasn't that long ago, and it wasn't that far away, the 1990's the era of the dot com and a dream, where billions of dollars chased ridiculous startups to dizzying heights. A time where Wall Street systematically constructed and carried out the greatest transfer of wealth from their clients coffers to their own. Now fast forward to 2006. Dot com stock certificates are acting as wallpaper for many Americans' basement bathrooms and many investors are still dealing with their 1990's wounds. But now there is a new game in town which has once again brought Wall Street profits to heights not even seen during the tech wreck, the commodities market. With few players, easy manipulation and very little regulation the commodities market creates a perfect storm for consumers and a huge opportunity for Wall Street.

The dot com bubble and subsequent bust was made possible due to some very slick marketing and sales through CNBC and other dim-witted journalists, compromised stock analysts, and ethically bypassed brokerage firms. Another culprit, greed; Americans wanted to believe the "new economy" myth because it stoked their ego and their "champagne wishes and caviar dreams" scenarios. Despite Wall Street's well orchestrated smoke and mirrors show, nobody held a gun to anyone's head and told them to buy theglobe.com, or webvan, etc.

Oil is different. We all need to buy it. Whether it be to heat our homes, or fuel our vehicles there is no escape. Even if you decided to join a hippie commune in northern Vermont with Al Gore, Ralph Nader, and the surviving members of the Grateful Dead the price of oil would still be felt when buying life's necessities like patchouli oil, rolling papers and tofu.

The reason we are paying the prices we are currently paying comes down to many different factors, none of which are the conventional wisdom being offered up by the Chucky Schumer's and Barbara Boxer's of the world. The federal government and these blowhard politicians who love holding press conferences in front of gas stations have about as much power over oil prices as they do over the weather. **We** as a society have chosen to pay the prices **we** are paying. Through our democratic institutions and our votes, **we** have collectively priced oil where it is today. **We** have made our bed and **we** will have to lie in it.

THE GLOBAL MARKET

Oil companies **DO NOT** set oil prices! The global market does. The market decides what people are willing to pay at any moment in time. The wealth of the world is growing; countries like China and India are demanding more and more resources. We currently have supply disruptions that are affecting the price. Iraq was producing 2.5 million a day; currently Iraq is at 1.6 million. There are also supply problems in Nigeria, Venezuela, and the Gulf of Mexico due to Hurricane Katrina and Rita. The retail price of gasoline and crude oil has fluctuated in response to various uncertainties. In 1973/1974 and 1979/1980 geopolitical problems caused great volatility and severe price spikes. We are having similar problems today. However, the long term trends in regards to the energy markets have been stable and orderly. This trend has allowed America to prosper and enjoy gasoline prices that are among the lowest in the world. Try filling up in Italy on your next vacation. Drivers in eleven countries in the European Union are paying more than \$6 a gallon.

COST OF OIL

The biggest factor in the rising cost we are paying at the pump is the price of crude oil, followed by the costs of refining. According to the U.S. Department of Energy, if you are paying \$3.00 a gallon at the pump, the crude accounts for approximately \$1.70. Refining costs add another 64 cents a gallon. The balance of the price is taxes, approximately 55 cents, and distribution and marketing costs at 11 cents. Oil companies make their money by producing crude oil. Most companies invested in oil fields when the prices were much lower than today.

THE FUTURES MARKETS

Jeroen van der Veer the CEO of Royal Dutch Shell commutes between their London office and their headquarters in The Hague. He stated in a recent *Fortune Magazine* article that when he flies over the port of Rotterdam, Europe's energy hub, he notices the same thing. *"I see tanks full of product. The crude carriers aren't waiting to have to unload in the port. There are no lines at Dutch gas stations. Airplanes aren't waiting for fuel."* Jan Mouwad and Heather Timmon reported in the *New York Times* that hedge funds and other investors have propelled crude oil from \$50 to \$70 a barrel. *"Gold prices don't go up just because jewelers need more gold, they go up because gold is an investment,"* said Roger Diwan, a partner with PFC Energy. *"The same has happened to oil."*

Oil contracts traded on the NYMEX, which are mostly held by hedge funds and the wirehouse brokerage firms, rose to more than one billion barrels this month. That's twice the amount held five years ago. Trading has also increased outside the official exchanges, including swaps or over the counter trades conducted directly between entities such as banks and an airline company. This is in addition to the standard trading conducted by oil company's oil brokers, or funds held by Wall Street brokerage firms.

Oil traders are in great demand on Wall Street where average and salary and bonus packages are close to \$1 million a year with top traders earning as much as \$10 million. *The Wall Street Journal* recently reported that Lehman Brothers and Credit Suisse have added to their oil trading business to compete with the market leaders Goldman Sachs and Morgan Stanley. Leverage also plays a huge part in the volatility of oil prices. Oil contracts can be leveraged at a 10 to 1 ratio. This means that an oil speculator needs to put up only 10% to purchase the contract. The ratio for stocks is 2 to 1. This is a double edged sword that can cause the price to rise very quickly and can force prices down just as fast. Volatility is the norm, not the exception. Joe Stanislaw, an independent energy advisor to Deloitte & Touche, in a Nelson Schwartz, Jon Birger piece in *Fortune Magazine* calculates that the physical realities of supply and demand point to a price of \$50 a barrel for oil, while geopolitical uncertainties add another \$10. Anything above that, he states is due to oil's popularity as an investment. *"Certainly the fundamentals are strong,"* says Stanislaw. *"But the financial players exaggerate the upward movement by driving the trend."*

The rising price of oil feeds on itself, by encouraging many investors to bet that it will likely continue. This is essentially the herd mentality that was evident during the dot com craze. *"The oil market has been driven by speculators, by hedge funds, by pension funds and commodity indexes, but the fact of the matter is that it's mostly been driven by the fundamentals,"* said Craig Pennington, the director of the global energy group at Schroders in London. *"Prices are supported by the fact that there is no spare capacity."* Philip Verleger Jr. a consultant and a former senior adviser on energy policy at the Treasury Department stated, *"Everybody is jumping into commodities and there is a log of cash chasing oil. The question is when does the thing stop? Eventually they will get burned."*

TAXES

Supply and demand forces, brokerage firms and hedge funds bidding up the price, geopolitical strife all are contributing factors in what we pay at the pump. However, the 800 pound gorilla is taxes. The federal gas tax alone equals 18.4 cents for every gallon purchased. According to the

Energy Information Administration the average state gas tax is 20.8 cents per gallon. In addition to statewide taxes, consumers often pay local excise taxes on gasoline purchases. The combined burden of federal, state and local gas taxes costs consumers an average of 45.9 cents on every gallon purchased. By utilizing data on gasoline use from the U.S. Department of Transportation, the tax burden from gasoline roughly amounts to \$271 for every man, woman, and child in the United States. According to the Tax Foundation the U.S. government is the real price gouging profiteer by reaping \$54 billion. Since 1977, federal and state governments have collected more than \$1.34 trillion in gasoline tax revenues in inflation adjusted dollars. The Tax Foundation noted that it is *“more than twice the amount of domestic profits earned by major U.S. oil companies during the same period”*. To put this into greater perspective, ExxonMobil's first quarter profit was \$8.4 billion. Their profit margin is nine cents per gallon. The U.S. government makes roughly double that, \$16.8 billion. Whoops, I almost forgot they also tax Exxon Mobil's profits as well. Nice work. Just to think these collective Congressional jerks wanted to send you \$100 *“relief”* check. More like hush money to placate the masses.

ECONOMICS, IGNORANCE & SOLUTIONS

Economic ignorance is to politicians what idle hands are to the devil. Both provide the workshop for the creation of evil.

Dr. Walter E. Williams

One of the most **moronic/populist/communist** solutions offered up to solve the oil/gasoline price problem is the windfall profits tax. ***Is it so difficult to understand that oil companies will pass this tax back to consumers, thus resulting in higher gas prices?*** Another ridiculous idea was proposed by Sen. John Thune R-SD. He stated, *“As we see skyrocketing gas prices around the country, it is time for this Congress to act.”* Thune said the energy legislation would suspend until September 30 the 18.4 cents-per-gallon retail gasoline tax. The measure would be aimed at helping consumers during the summer months. To pay for the lost revenues, Thune said, the legislation *“would suspend a number of tax credits and royalty waivers received by oil corporations.”* Watch the economic ignorance at work...Suspend the taxes on purchasers of fuel and make up for it by raising the taxes on producers. ***Could be me...call me crazy...but wouldn't the producers then pass those tax costs on to the consumer?***

Time for a big math test! The big oil companies make approximately 8 cents per gallon of gasoline sold. For arguments sake, and to make it a little easier for the mathematically challenged like myself we will round big oil's profit up to 10 cents per gallon. The Watchdog on Wall Street's vehicle has a 15 gallon tank. Let's assume as well that gasoline prices are \$3 a gallon. Question: If the Neo-Communists like Charles Schumer, Nancy Pelosi have their way and the *“evil oil companies”* are no longer allowed to make money and just break even, how much would the Watchdog save at the pump?

If you said \$1.50, congratulations you have mastered basic algebra. My total gas bill would drop from \$45 to \$43.50. But would it really? This was a trick question. If the neo-communists eliminated the profit incentive for the oil companies the prices would not only be significantly higher than \$3, but I would be waiting for hours just to fill the tank up.

Another grand myth is the idea that we are paying record prices at the pump. Over the past two years the price of gasoline has increased sharply, however the costs of other goods and services have increased much more. To understand price, one must think in inflation adjusted terms. Was gasoline 30 cents a gallon in the 1960's? Yes, but in inflation adjusted terms that is the equivalent of \$1.75. In 1980 gas prices were at \$1.25 the equivalent today is \$3.07.

The study of Economics is a complete mystery to most Americans. This fact alone allows for the Donald Luskin coined phrase ***“the conspiracy to keep people poor and stupid”*** to be carried out. Economic ignorance and greed are the reasons why so many Americans do so poorly with their investments and financial plan.

Economics is the study of choice. For everything that **WE** want, **WE** have to give something up in return. Nick Murray in his piece *In the Wake of the Exxon Valdez* points out that **WE** as a society have **CHOSEN** not to drill for oil in the Artic National Wildlife Refuge. Mind you that the proposed drilling site in ANWR bears roughly the same size relationship as a period does with the size of this page. **WE THE PEOPLE** have made it our national policy to ban offshore drilling in huge deposits of natural gas. The eastern Gulf of Mexico has an estimated 58 trillion cubic feet of natural gas. The Rocky Mountain Front has another 86 trillion cubic feet. Liquefied natural gas which Alan Greenspan called on Congress to empower construction has been shelved. **WE** have not built a new oil refinery since 1976. **WE** have not built a nuclear power plant since 1979. Let us take politics out of the equation. **WE** as a society can have and do just about anything **WE** want as long as **WE** are willing to pay for it.

This is simple economics.

The idea that **WE** can have abundant supplies of cheap gasoline and other fuels without making some difficult tradeoffs is ridiculous. **WE** as a nation, whether you want to believe it or not, have collectively put ourselves in the situation **WE** are in. The debate, myth, controversy surrounding oil prices, complete with demagogue politicians and media hacks holding press conferences in front of gas stations or calls for the heads of the oil companies is reminiscent of medieval politics and was one of the underlying causes of the fall of Athens in the Peloponnesian War. The complete ignorance surrounding this fiasco is unfortunately at the same type of discourse we are having in regards to Social Security, tax cuts, and immigration.

All slogans no sanity. Populism rules, facts do not matter, and 2+2 is equal to six.