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What Caused the Big Slide in Oil Prices

By Ari J. Officer | Friday, Nov. 14, 2008

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On July 11, when the price of crude oil peaked at $147.27 per bbl., SemGroup, a major oil distributor based in Tulsa, Okla., was only a week or so away from a potential $5 billion payoff. Instead, the company imploded. And soon afterward, so did the price of oil, dropping some 60% in the subsequent months, to a recent price below $60.

Tom Mihalek / AP

A sign advertises the price of a gallon of regular grade gasoline at $1.98 at a gas station in Collingswood, N.J.

Clearly, demand for oil didn't fall that much, but the price of oil isn't set by demand alone. It's the product of an extremely volatile mixture of speculation, oil production, weather, government policies, the global economy, the number of miles the average American is driving in any given week and so on. But the daily price is actually set — or discovered, in economic parlance — on the futures exchange. In late June and early July, speculators in oil futures battled one another, suspecting that a top was near. In the ensuing weeks, oil would come crashing down to earth as traders everywhere — including hedge funds, banks and pension funds — unwound their positions. And as SemGroup demonstrated, getting the timing wrong on this great unwind can have catastrophic results. (Read "Iraq's Pain at the Pump.")

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SemGroup was short oil. Massively. That is, it had bet that the price was going down by contracting to sell millions of barrels of oil it did not own at a future date, on the assumption that the price would fall and SemGroup could supply the barrels at a lower price and pocket the difference. Three days after oil peaked, as it still threatened new all-time highs, the New York Mercantile Exchange (NYMEX) called margin on SemGroup, forcing the firm to put up more cash collateral to back its losing positions. Unable to raise the capital, SemGroup sold its entire crude-oil futures position the very next day to Barclays investment bank. SemGroup posted a $2.4 billion loss in the process, forcing the company into bankruptcy.

Given that SemGroup lost that much money as oil prices soared, it must have amassed a short position of at least 100 million bbl. of crude — that's about five times what the U.S. has on hand at any given moment. Had SemGroup bought back the oil on the open market, oil prices would have continued to skyrocket, feeding off the frenzy. Fortunately for consumers, Barclays was ready to assume SemGroup's position.

But there's far more to oil's big price plunge. SemGroup, of course, was now out of business, and as similar behavior came to a halt at other firms, oil lost its upward momentum. Enter the financial crisis, which dealt the finishing blow. The dollar had weakened during the first revelations of the mortgage crisis, but as that situation spun out of control into an international credit crisis, the currency markets favored the U.S. dollar. Since oil is traded internationally, as the dollar gained value, the price of oil in dollars had to come down. A weakening dollar played a role on the way up; a strengthening dollar on the way down. But the euro has dropped only 20%, and oil, three times that. So currency is not the whole story but certainly is a major trigger. (Read "Four Steps to Ending the Foreclosure Crisis.")

Stock prices, too, began to tumble as talk of bailouts and rescue plans permeated the media. The price of oil began to fall, and speculators had to put up more money for margin, but their other investments were simultaneously declining. Thus, they were forced to close out their long positions and sell oil. As everything spun out of control, everyone wanted out: a full liquidation. Even diversified investors tend to hold long positions in commodities as inflation hedges. Losses in stocks forced these long speculators to liquidate their positions in all commodities.

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