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Fund buying adds $8 premium to oil price--experts

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By Richard Valdmanis

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NEW YORK, March 18 (Reuters) - Red hot crude oil prices have surged as much as $8 per barrel above their fair market value due to an influx of money from speculative hedge funds, energy experts said on Thursday.

"The fundamentals are bullish but it is hard to justify $38.00 (oil prices)," said Bill O'Grady, director of futures research at brokerage A.G. Edwards in St. Louis. "I see the fair value at $30 to $31."

The speculative surge has come in the midst of increasing pressure from U.S. lawmakers for the Bush Administration to help rein in high energy costs, which have been spreading pain to domestic consumers and industries such as transportation.

The fund money bet on a further rise, fueled partly by fears that fresh attacks by militants could disrupt already thin supplies. That has pushed oil within reach of $40 a barrel -- a level widely seen as damaging to the economies of

energy consumer nations.

And there's no sign that the bubble will soon burst.

"The question is not what is going to get (crude) to $40, it's what's going to stop it from getting to $40," said Ed Silliere, an analyst with Energy Merchant,

Speculative funds once operated on the edges of the commodities arena, but now make up about 20 percent of the crude and gasoline markets on the New York Mercantile Exchange, according to government data.

They recently bolstered their net long positions, essentially bets that prices will rise, to within a hair's breadth of all-time highs in the crude market and to new records in the gasoline market.

"Speculation encompasses several aspects including terrorism, currencies, faith in OPEC, and momentum," a Bear Stearns analyst wrote in a report. "We believe this explains $8 per barrel or more of the strength in oil prices."

Rising energy costs have led Congress to propose the White House slow its buying of crude oil for the Strategic Petroleum Reserve to leave more barrels for the open market, though the Department of Energy has since said it plans no such slowdown in buying for the stockpile.

Including the reserve, U.S. oil inventories are the highest they have been since 1995, when oil prices were $18 a barrel. Ignoring the reserve, however, oil supplies are eight percent below the five-year average for this time of year.

The low inventory, coupled with producer group OPEC's planned output cut from April that could slice supplies further as the U.S. enters its high-demand summer driving season, has steadily fed the "speculative premium" in futures prices.

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Oil dealers have also pointed to uncertainty over the impact of new cleaner burning gasoline regulations on imports as a reason for market gains.

The global energy watchdog, the International Energy Agency, sounded a warning in a report this month that keeping inventories tight with output restraints was encouraging investment funds to speculate on continued high prices.

"Actions that promote tight balances in the face of geopolitical uncertainty, limited spare production capacity and constrained refining capacity provide opportunities for speculators," the Paris-based IEA said.

While oil dealers are edgy that the speculative bubble will inevitably burst, fund buyers said the elements that would trigger a sell-off in oil prices to more moderate levels are not yet in place.

"In this market, there's no choice of going short," said one fund buyer who declined to be named. "For one thing, we could all wake up tomorrow and find another bomb has gone off in Europe, and that would tack 50 cents onto the price."

He added that fears of a supply crunch this summer when U.S. driving season hits and the new OPEC cut is in full swing has made it profitable to keep long positions.

"The name of the game is 'better safe than sorry'," he concluded.

(Additional reporting by Bernard Woodall)

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