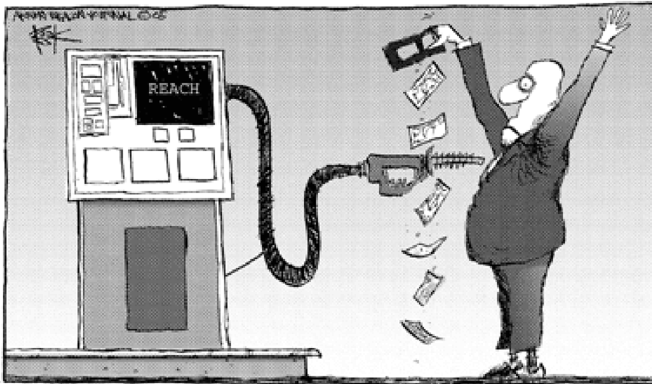
"$100 crude!"

"We are entering a 'super spike period' that could see prices as high as $105" according to a major investment bank, but it is also "...equally likely that oil will touch $105 or $15" according to a major US bank analyst and as a well respected oil market analyst put it "...I have no idea what they [the above] are talking about". As NYMEX futures were reaching new highs, comments such as the ones mentioned above were hitting the screens, adding to the market frenzy that prevailed during the last days of March and the beginning of April. Where does the truth lie remains to be seen, but it is clear that Q1 2005 has set the stage for very exciting days ahead of us.

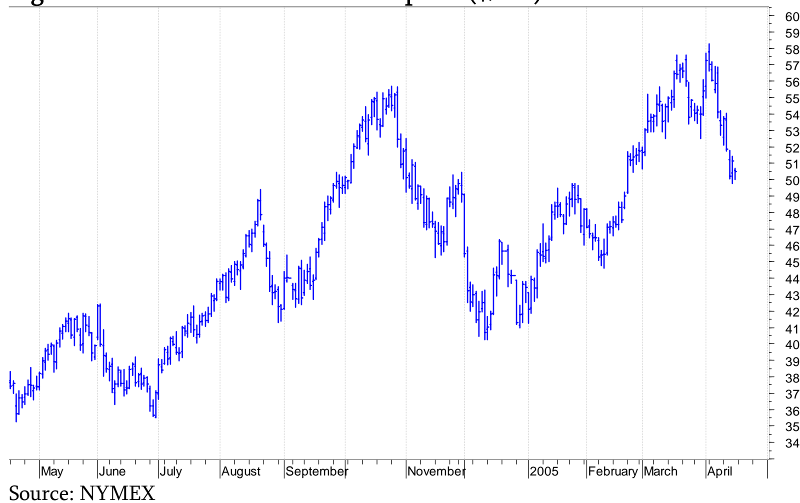


The sheer fact that we have hit record highs on the beginning of Q2 and that during the first three months we saw a remarkable 34% rise to $58.28 on April 4th and then a 14% fall $49.75 (in just 8 trading days) makes it clear that volatile days lie ahead of us. There were a number of reasons why prices moved the way they did since the beginning of the year.

Weather conditions in the US and Europe, which remained rather cold during the first quarter, supported heating oil and led to a rally in crude oil which saw prices reach $55.67 on February 22nd. The quick drop that followed was reversed once again after a blast at BP's Texas City refinery, the third largest in the US, which caused the death of 14 workers and highlighted once again the vulnerability of the US markets to the limited domestic refining capacity. Crude oil futures rallied further to hit record after a report by a major investment bank mentioned $105 as the possible target of a price spike. That did not last long either, as prices dropped sharply again to reach the $50 level as this report was being written.

Going into further detail, however, one can see that the abovementioned events do not fully justify the surge in prices. Heating degree days in the US indicate that the weather during the first quarter of 2005 was warmer than the past two previous ones, and at the same time there were no major supply disruptions during this period. Even the BP refinery blast, albeit tragic, did not cause major disruption in the US product supplies. It is clear in other words that the conditions encountered during Q1 can be described as relatively stable.

Figure 1. NYMEX crude oil futures price ($/bbl)



Source: NYMEX

The real driving force behind the price strength of Q1 was the same that supported petroleum early last year; continuously rising demand. The Energy Information Administration has revised its estimates for world petroleum demand by 300,000 barrels per day for 2005 and by 400,000 bpd for 2006, since the beginning of the year. World's appetite for oil is not waning despite the rising prices. This is exactly what proponents of significantly higher prices are using to argue that, unless we reach price levels which curb demand, the upward trend will remain intact.

We would note, however, that predicting prices $50 higher than where they now stand could be an exaggeration. Leading world economies will probably not wait for their collapse before they start addressing the challenge facing them. We have mentioned in previous reports that even though prices have risen, no "oil crisis" has occurred. World economies are not yet considering energy prices a serious obstacle and consumer behaviour remains unaffected. If, however, signs start appearing, we would expect more drastic reactions.

It should not be considered a coincidence that as capital markets and consumer sentiment in the US, Europe and Japan deteriorated during the past weeks and as the US trade deficit with China reached record levels, US officials called for the floating of the Chinese currency and threatened with tariffs if this is not accepted by Chinese authorities. China was the driving force behind last years surprising surge in demand and any serious dent to its growth prospects could have an immediate impact on energy demand. We may see such pressures mount during the coming months if economic conditions deteriorate further.

For a longer term easing in petroleum prices, however, we would have to observe either a significant drop in world economic growth or a clear shift in energy consumption patterns to alternative sources. The former is by no means desirable as it will lead hardships and ripple effects to many sectors of the world economy, while the latter can only be a result of increased investments in other energy sources combined with consumer desire to use them. If leading world economies can swiftly take decisions to invest in such technologies and provide incentives to consumers the transition will be swift, whereas the opposite will probably vindicate those who predict "super spikes" in prices.

What would, however, consist a "high" price, or are today's prices high or not?

Figure 2. Real World Oil Prices

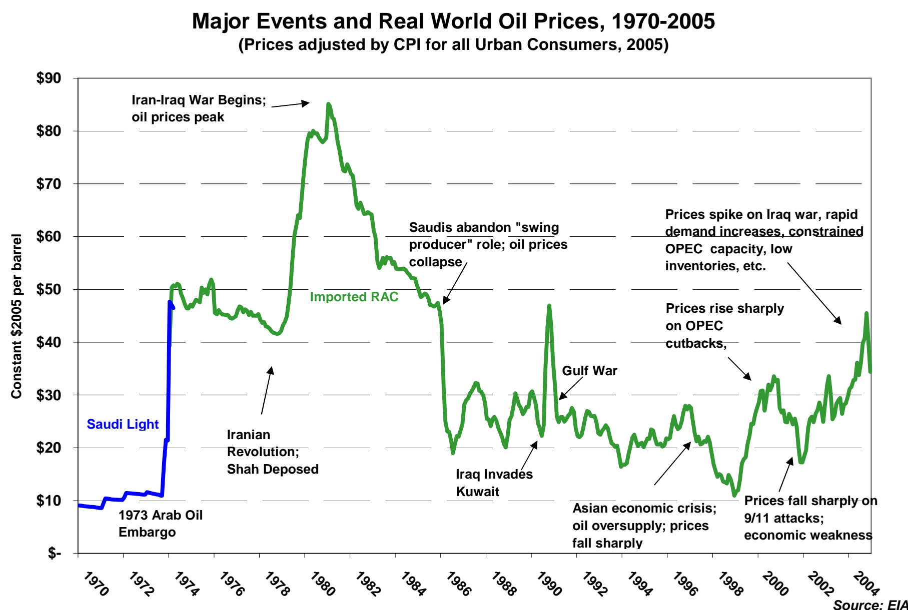
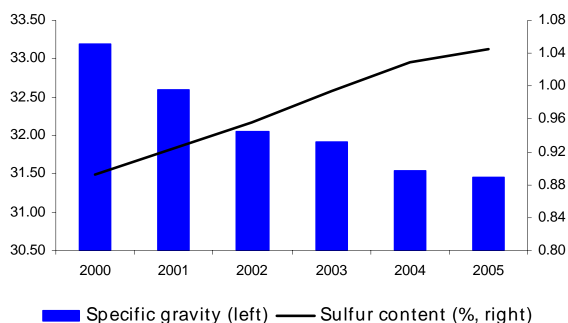


Figure 2 shows that in real terms world oil prices rose above $80 during the Iran-Iraq war in 1981 and that while prices are in a steady upward trend since 1998, we still are a long way away from the prices that caused the “oil crisis” of the 80’s. Again, however, we would note that more control mechanisms are in place today, than were in the early 80’s, leading world economies are a lot more diverse and political power balances are also very different. As a result, it is our belief that using price comparisons with 1981 to draw conclusions about current conditions is a simplistic way of approaching the issues.

Apart from rising demand, however, a few more other issues exist that are also underpinning petroleum prices. Namely, the lack of “light” (ie crude with containing high percentage of lower boiling materials, therefore easier to distil) and “sweet” (ie crude with low sulphur content) crude grades. Most of the production capacity added during the past year consists of heavy, sour crude grades, which many refineries cannot process, especially as the requirements for cleaner fuels (with lower sulphur content) are rising both in US and Europe. US will move to using gasoline with 30 ppm of sulphur by 2006, Europe to 50 ppm in 2005 and down to 10 ppm by the end of this decade. This diverging situation is causing serious refining bottlenecks, especially in the US, which will most likely deteriorate in the coming years.

In order to ease some of the concerns, Saudi Arabia announced last September that the bulk of an additional 1.5 million barrels per day they are bringing into supply from their Eastern province will be Arabian Light, but this cannot counter the fact that the average quality of oil from non-OPEC countries is also falling steadily since 2000 (Figure 3) and that demand for light grades is rising at an increased pace. Tackling the issue would require significant investment from the side of the refiners, and while current price differentials between heavy and light grades would justify such efforts, it is clear that refiners would need signs that current price conditions will last for several years before the aggressively pursue such a venture.

Figure 3. Non-OPEC crude quality



Source: Deutche Bank

The issue of reduced spare capacity from oil producers comes to add to the existing worries. While for the last decade it averaged more than 2 million bpd, reaching a peak of 5.6 million on 2002, it has sharply dropped to slightly above 1 million bpd in 2004 and is expected, according to EIA to drop below 1 million by 2006. Such a development makes the energy complex very vulnerable to any supply disruption and will continue to lead to very volatile market conditions and exaggerated price reactions to any major development. Given the last few years' geopolitical conditions it is easily conceivable how sensitive market participants will be.

We would conclude that price direction will mainly hinge on the tag of war between petroleum demand, supply stability, economic conditions and political decisions from the major parties involved. Whereas the outcome cannot be easily predicted now (i.e. it is not clear if $100 crude is nearing), it is clear that volatility will remain increased, as market participants will swiftly react to developments; much more swiftly than the major institutions and governments involved.

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