

## **World Oil Prices, by Carla L. Romita**

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Oil prices have recently reached extraordinarily high levels and there is no indication that the market will soften in the foreseeable future.

Many factors influence the world oil markets. Oil prices are primarily driven by the laws of supply and demand—what the industry refers to as “fundamentals.” Since 2002, growth in worldwide oil demand has unexpectedly accelerated to nearly 85 million barrels a day. This demand volume is approximately 98% of total worldwide daily delivery capability. In short, there is such a narrow margin of excess production capacity that the market has become extremely vulnerable to any type of supply disruption caused by equipment breakdowns, political instability, or natural disasters. When a refinery is incapacitated or a pipeline is disrupted, the markets compete for the oil that remains available. Supply disruptions—even fears of supply disruptions—have the effect of increasing prices.

Why is excess capacity so tight? Despite increasing demand for petroleum products over the decades, no new refining capacity has been constructed in the United States since the 1970's. Although existing refineries have been updated and, in some cases expanded, the amount of construction needed to create reliable excess capacity has not kept pace with the growing demand for fuel.

Fundamentals alone are not driving the volatility in today's energy markets. Last winter, for example, was relatively warm. As a result, inventories of no. 2 heating oil are high and the market is well supplied for the upcoming season. Based on fundamentals, the price of no. 2 heating oil should have weakened by now, but it has not. Speculation has become a serious driver of today's global energy markets. Deep pocket speculators purchase and sell large numbers of heating oil contracts on the New York Mercantile Exchange (NYMEX). The positions they take create significant market fluctuation. It is important to understand that speculators make money off of market volatility. They care only that the market moves, not that it moves in a particular direction. That is why any news, however unrelated to actual supply disruptions, can drive prices higher.

Conversely, in periods when the geopolitical situation appears to be calm, prices tend to stabilize. Recently, the death of terrorist Zacharias Moussawi in Iraq temporarily drove oil prices down as the news media rejoiced. By the end of the same trading day, however, prices returned to their prior levels. The mere fact that there was news (not that there was relevant news) created price movement in the market that day. The current escalation in hostilities between Israel and Hezbollah in Lebanon is driving prices higher based on fear that \$100 per barrel crude may become a reality. Political instability and violence in Nigeria (a major U.S. supplier of crude oil), Iran's refusal to respond to United Nations' proposals to limit Iran's nuclear program, and ever more threatening behavior from North Korea all contribute to an environment of ever higher oil prices and serve to increase volatility in an already volatile market.

Some consumers imagine that their local fuel oil dealers are participating in windfall profits during these times of rising prices. Nothing could be further from the truth. Fuel oil dealers buy their product in the marketplace. They grapple on a daily basis with the market's volatility. When prices are high, fuel oil dealers must pay higher prices to buy the product which they resell to their customers. The dealers have to deal with higher working capital requirements and pay much more to borrow money to finance their product purchases. Fierce competition in the New York metropolitan area and customer resistance to movement past certain price points limit the dealers' ability to pass these increased costs on to their customers. Compounding the problem is that high prices make it more difficult for customers to pay their bills according to terms, which saddles the dealers with higher credit balances over a longer time. The lost time value of money chips away at the dealers' profits. You can well understand that no one hates high prices more than your fuel oil dealer.

Government, private industry, and consumers can all help to moderate energy prices. Government should continue to implement higher efficiency standards for automobiles and should streamline the permitting process for new energy development as well as open more areas for responsible, environmentally sensitive exploration and development. Businesses should improve fuel efficiencies at facilities. Consumers can take steps to conserve energy by taking steps such as combining errands into one car trip, using more public transportation, adjusting thermostats to cooler temperatures, installing programmable thermostats in single family homes, installing computerized heating plant management systems in multi-family buildings, and installing insulation and new thermal pane window and doors. Eventually all of these measures will reduce demand, increase supply, and dampen prices. The fundamentals will ultimately prevail and the markets will stabilize again, but nobody knows when.